NATIONAL TAXPAYER ADVOCATE

FY 2001 ANNUAL REPORT TO CONGRESS

IRS

Department of the Treasury
Internal Revenue Service

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Publication **2104** (Rev. 12-2001)
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December 31, 2001

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TAXPAYER ADVOCATE SERVICE
INTERNAL REVENUE SERVICE

This Report is dedicated to

Patricia A. Berliner

and

David W. Bernard

in memory of their

public service

and

personal heroism.

It is my pleasure to submit to you for your review the National Taxpayer Advocate's 2001 Annual Report to Congress. This report reflects a year's effort on the part of many Taxpayer Advocate Service employees, to whom I am very grateful. We believe this report meets our Congressional mandate, set forth in Internal Revenue Code section 7803(c)(2)(B)(ii), to provide full and substantive analysis of our activities for the year, including a summary of significant taxpayer problems and our administrative and legislative recommendations to resolve those problems.

In his 2000 Annual Report to Congress, Acting National Taxpayer Advocate Henry O. Lamar, Jr., identified tax code complexity as the top problem for both individual and business taxpayers. This year's Report adopts that concept as a truism and incorporates it into every aspect of the report.

I have chosen to focus our attention on several key legislative proposals that create significant complexity for large numbers of taxpayers. Correction of these few provisions will have a great impact on the problems taxpayers face today. I use the term "correction" deliberately. In many instances the problems we identify grew up over time and bring about consequences that no one would deliberately design. These problems are "errors" in the Internal Revenue Code that beg to be corrected.

On the operational side, we report on the activities and initiatives of the Taxpayer Advocate Service. We identify key areas of TAS casework and describe, beyond the numbers, what initiatives we are undertaking with the Operating Divisions and Functional Divisions to reduce, if not eliminate, these cases. However, our case analysis demonstrates that in some areas – the Earned Income Tax Credit and other "family status" issues in particular – no amount of IRS process improvement will significantly reduce taxpayers problems. To achieve significant reduction in taxpayer and IRS burden, Congress must enact a uniform definition of a qualifying child that is applicable to all tax provisions that key off of family status.

I realize that many today in the United States believe that there is no constituency or political reward for achieving tax simplification, or, more importantly, tax rationalization. I maintain that this nation can ill afford to ignore the increasing burden (for taxpayers and tax administrators alike) and irrationality of our tax system.

Our tax system is a voluntary system, relying on taxpayers to inform the government of their taxable income and resulting tax. To the extent that we, as tax legislators or tax administrators, make this compliance too burdensome, or too confusing for taxpayers, or out of tune with taxpayers' sensible way of life, we create an environment in which even

the most compliant taxpayers wonder why they bother. In fact, some taxpayers will stop bothering to comply. It matters not that this complexity or irrationality is an unintended or inadvertent consequence.

The sheer numbers of taxpayers affected by the six key legislative proposals and the top taxpayer problems discussed in this report should lead any public servant to the conclusion that he or she must act to remedy this problem. We in the Taxpayer Advocate Service, through this Annual Report to Congress, have attempted to identify problems that can be solved rather than merely complained about. We have also attempted to propose solutions that are practical and achievable.

As National Taxpayer Advocate, I look forward to working with Congress and the Internal Revenue Service to help taxpayers resolve their tax problems. I humbly submit this Report, on behalf the Taxpayer Advocate Service, in the hope that you will find it of some use toward that goal.

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2001

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INTRODUCTION

For many U.S taxpayers, tax filing season brings stress, anxiety and frustration. These emotions are too often compounded after the tax returns are sent to the Internal Revenue Service and problems develop with taxpayers' accounts – problems that sometimes take months or years to settle. The Taxpayer Advocate Service (TAS) exists to help these taxpayers by working to clear up problems that have not been resolved through established IRS channels. We strive to help all taxpayers and the IRS by developing system-wide solutions to problem issues.

Only 14 percent of our inventory is composed of hardship cases. A small percentage of taxpayers contact us because they either don't like the way the tax law has been applied to their situation, or because they feel that their side of the issue did not get a fair hearing. Most taxpayers contact us because the IRS does not offer timely or appropriate taxpayer assistance.

Resolving customer service problems is fundamental to restoring public respect for the way in which the IRS administers the tax system. Failure to provide basic services and respond promptly to taxpayers who are making a good faith effort to meet their tax obligations imposes a burden on taxpayers and the IRS alike, and increases public disaffection. For many individual taxpayers, navigating the IRS bureaucratic structure is difficult. The frustration and confusion taxpayers experience in dealing with the IRS undermines confidence in the system.

At the same time, the IRS is comprised of dedicated employees working hard to administer a complex tax code. The IRS' leaders make tough decisions about service trade-offs, knowing that they cannot satisfy competing demands with their limited resources. The taxpayer population and volume of returns continue to grow, while the resources available to service them have not kept pace. The IRS is working to solve many of the problems reflected in this section of the Report. It is our hope that IRS will continue to make progress.

Congress continues to play a key role in two areas: reducing tax law complexity and providing necessary resources. Legislative changes are required to address a number of the most serious problems. Many other problems can only be resolved with continued, long-term commitment to modernizing the IRS information systems infrastructure. Finally, sustained budget support is required to get the job done.

METHODOLOGY

This year we are taking a new approach to identifying the most serious problems taxpayers face when dealing with the IRS. To make the report more useful, we have abandoned broad categories such as "tax law complexity" to focus on specific issues. We have used a more comprehensive base of information to develop the list. Above all, we are concentrating on issues that are large enough to matter, but small enough to tackle.

As promised in the National Taxpayer Advocate's Fiscal Year 2002 Objectives Report to Congress, we have prepared two lists of problems Americans face in meeting their tax obligations: the TAS Inventory List and the Most Serious Problems Encountered by Taxpayers List. While the Most Serious Problems List is the focus of this section of the Report, many of the same issues are included in both lists.

TAS INVENTORY LIST OF TAXPAYER PROBLEMS

We began analyzing taxpayer problems with a list based on our inventory data. Every case worked by the Taxpayer Advocate Service is tracked by our Taxpayer Advocate Management Information System (TAMIS) and is assigned a major issue code to track taxpayer problems. By analyzing our data, we developed a list identifying the 23 problems that generated the largest number of taxpayer contacts with TAS. We refer to this as the TAS Inventory List of Taxpayer Problems.

While our management information system provides the number of cases worked for each code, some tracking system codes can include a variety of issues and may not pinpoint underlying problems. We have included a short description of each issue. For those interested in greater detail, we provide the inventory-based list and a description of each issue in Appendix A.

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

This year's list of the Most Serious Problems Encountered by Taxpayers originates from the work experiences of Taxpayer Advocate Service employees who assist taxpayers every day. This list defines 23 specific issues such as "Access to Customer Service Toll-Free Telephone Service" and "Computing Income Tax Using Schedule D" and is intended to provide a clearer understanding of the barriers to resolving these problems.

We began developing the list by looking at the kinds and volumes of problems that taxpayers bring to us throughout the year. We asked our local taxpayer advocates to talk with front line employees to find out what they were hearing from taxpayers. We considered what the four Citizens Advocacy Panels reported about the feedback they received from the public. We listened to tax practitioners and observed focus groups of taxpayers discussing their experiences with preparing and filing last year's returns. We then reflected upon what we had learned and drew up our final list of most serious problems.

THE LISTS REFLECT IMPORTANT ISSUES

Although the TAS Inventory List and the listing of most serious problems are not identical, they both reflect difficult issues Americans face in filing returns and paying taxes. The number one problem on the list of most serious issues, "Access to Customer Service Toll-Free Telephone Service", does not appear in our management information system, nor does topic number four, "Answers to Questions on Customer Service Toll-Free Lines." However, TAS offices receive thousands of calls each month because taxpayers are unable to reach IRS' toll-free service, or because taxpayers feel unsure of the answers given by toll-free assistors. When taxpayers contact TAS, they tell us they were unable to get help from the toll-free system.

The Earned Income Tax Credit (EITC) appears as four separate issues to give a clear picture of specific problems with EITC. Why do EITC issues receive so much attention? Our Taxpayer Advocate Service experience tells us that on the inventory-based list, issue number one, "Revenue Protection Strategy" cases, are mostly EITC examinations. Problem number three, "Refund Inquiries" are often requests for EITC refunds, while inventory-based problem number eight, "Audit Reconsideration," includes many EITC cases. Problems with the EITC are more prevalent in our inventory than they first appear.

IRS OPERATIONS RESPONSE

We provided the IRS Operating Division Commissioners with a definition and analysis of each problem and gave them an opportunity to offer "IRS Comments" on each issue. They have reported actions taken or planned to resolve these problems under the heading "IRS Initiatives to Address the Problem." Along with the problems, we have listed the "IRS Responsible Official" provided to us by the Office of Tax Administration

Coordination, although we recognize that other officials or Commissioners of the Operating Divisions may also play a role in resolving issues.

IRS PROGRESS ON TAXPAYER PROBLEMS

We applaud the IRS for taking positive, helpful actions in some areas, such as redesigning Earned Income Tax Credit forms and Schedule D to reduce math errors, and improving the processing of Innocent Spouse Cases. We look forward to implementation of the Refund/Notice Integration Project. This will enable IRS and the Financial Management Service to combine refund checks and IRS error notices into one mailing, so that taxpayers will understand immediately why their refund has changed from the amount claimed on the return.

At the same time, concrete steps are needed to resolve other persistent problems, such as taxpayers' inability to reach a "live person" on the IRS' toll-free assistance lines and the IRS' inability to routinely acknowledge taxpayer payments and correspondence.

ADMINISTRATIVE CHANGE, LEGISLATIVE CHANGE AND IMPROVED TECHNOLOGY

While the Operating Divisions identified the role technology plays in resolving some of these problems, they restricted their comments to ways in which technology can be expected to impact taxpayer concerns over the next eighteen months. Many service problems, such as the ability to provide concise, clear notices pinpointed to the taxpayer's specific issue, can only be completely resolved by long term commitment to modernizing the IRS information systems infrastructure.

We believe legislative changes are required to address a number of the taxpayers' most serious problems. Throughout this section of the report, we put forth other suggestions and recommendations that could be accomplished administratively and we believe would ease the burdens facing taxpayers today. We hope that the IRS and the Congress will give these proposals serious consideration.

TAXPAYER ADVOCATE SERVICE

INVENTORY LIST OF TAXPAYER PROBLEMS*

RANKING ISSUE	
1	Revenue Protection Strategy (RPS) — Examination Projects to Protect Revenue
2	Processing of Claims or Amended Returns
3	Refund Inquiries
4	Processing Individual Income Tax Returns
5	Penalty Issues (Other Than Federal Tax Deposit)
6	Lost or Misapplied Payments
7	Open Examinations
8	Requests for Reconsideration of Examination Assessments
9	Requests for Employer Identification Number(EIN) or Requests for Entity Changes
10	Automated Underreporter (AUR) Program - Document Matching Program
11	Other Casework Issues
12	Lost or Stolen Refunds
13	Requests for the IRS Individual Taxpayer Identification Number (ITIN)
14	Requests for Forms, Copies of Returns, and Transcripts
15	Offer in Compromise Issues
16	Account or Notice Inquiries
17	Levy Issues
18	Problems with Federal Tax Deposits, Electronic Fund Transfer Program System, or Estimated Tax Payments/Credits
19	Federal Tax Deposit (FTD) Penalty Issues
20	IRS Criminal Investigation Freezes
21	Offsets
22	Earned Income Tax Credit (EITC) Issues
23	Substitute for Return Assessments

*SEE APPENDIX A FOR A DESCRIPTION OF EACH ISSUE.

MOST SERIOUS PROBLEMS

ENCOUNTERED BY TAXPAYERS

RANKING	ISSUE
1	Access to Customer Service Toll-Free Telephone Service
2	Multiple Definitions Of "Qualifying Child"
3	Determining Earned Income Tax Credit (EITC) Eligibility
4	Answers to Questions on Customer Service Toll-Free Lines
5	Documenting Earned Income Tax Credit (EITC) Eligibility
6	Refund Inquiries
7	Earned Income Tax Credit (EITC) Examinations
8	Understanding Estimated Tax Payments
9	Explanations on Math Error Notices
10	Processing Claims for Refund
11	Recertification for Earned Income Tax Credit (EITC)
12	Computing Income Tax Using Schedule D (Capital Gains and Losses)
13	Awareness and Understanding Federal Tax Deposits Requirements
14	Obtaining Employer Identification Numbers (EINs)
15	Misapplied Payments
16	Lack of Access to Free Tax Preparation for Low-Income Taxpayers
17	Processing Offer in Compromise Applications
18	Computing the Alternative Minimum Tax (AMT)
19	Determination and Notification of Revised Tax Liability
20	Cost of Electronic Filing for Low-Income Taxpayers
21	Automated Underreporter (AUR) Tax Assessments
22	Status of Innocent Spouse Claims
23	Delay in Receiving Requested Documents

PROBLEM

TOPIC #1 ACCESS TO CUSTOMER SERVICE TOLL-FREE TELEPHONE SERVICE

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Taxpayers are unable to reach the IRS through its toll-free lines, especially during tax season when the need for assistance is greatest.

ANALYSIS OF PROBLEM

Taxpayers call the toll-free numbers with questions about preparing returns, tax law, refunds, and IRS notices regarding errors in returns. Many people complain that they are unable to get through to employees, must navigate a complicated menu system and spend excessively long times on hold. These problems sometimes lead taxpayers to hang up in frustration and search for answers elsewhere. The level of service for the 2000 filing season measured 61 percent.[1]

IRS COMMENTS

IRS is continuing to make improvements to Toll-Free Service a top priority. This past filing season improvements were made in automated services offered and with our delivery of live assistance. Through June 30, 2001, over 94 percent of those taxpayers attempting to call IRS could reach our system without experiencing a busy signal. For those wishing to talk with an assistor, the wait time, after menu selection, was less than five minutes.

IRS INITIATIVES TO RESOLVE PROBLEM

To improve access to personal service, IRS is concentrating its assistor resources to be available year round on Monday through Friday for 15 hours per day. During the filing season, personal service will also be available on Saturdays from 9 a.m. to 5 p.m. The shift from the current 24 hour, 7 day a week service approach is based on an AT&T usage study that identified that 94 percent of the telephone traffic comes in Monday through Friday. The change will make more employees available during peak times to answer calls. IRS will continue to provide automated service 24 hours a day, seven days a week.

INFORMATION TECHNOLOGY IMPACT

IRS began implementation of a new telephone system that includes:

- Voice recognition in English and Spanish

[1] Level of service is calculated by dividing the number of calls answered by the total call attempts. Total call attempts is the sum of calls answered, calls abandoned by the caller, and calls that receive a busy signal.

- Ability to inquire about the status of a refund by speaking rather than using only the telephone touch pad keys
- More accurate pre-routing of calls. As an example, IRS could quickly establish a new routing pattern for callers to our September 11th Disaster Hotline and the specialists serving those with issues related to the terrorist events.

TAXPAYER ADVOCATE SERVICE COMMENTS

Access to toll-free service has appeared on the Taxpayer Advocate "Most Serious Problems List" every year since 1997, this year ranking as problem number one. Taxpayers, citizen advocacy groups and focus groups all cite the inability to access the toll-free system as a major problem. The IRS' statistic that 94 percent of taxpayers could reach the system without a busy signal fails to tell the full story. Many callers hang up in frustration after trying to maneuver through the toll-free menu or after encountering significant delays waiting for a telephone assistor. Some calls are disconnected by system failure or by an assistor. Callers are often unable to speak with a Customer Service Representative (CSR) and receive a recording telling them that only automated services are available. The message then tells the caller to hang up and call back later if they wish to speak to an assistor. The level of service better reflects these issues.

We support the IRS strategy to schedule Customer Service Representative service to concentrate IRS resources on the hours that the majority of telephone traffic is received, making more people available to answer calls during peak hours. We are encouraged that the new, enhanced telephone system should provide improved toll-free service. The IRS has emphasized the importance of providing "world-class" customer service to taxpayers, and the IRS' toll-free telephone system is a cornerstone of its customer service operations. However, Taxpayer Advocate offices receive thousands of calls each month because taxpayers are unable to contact a Customer Service Representative using a toll-free number. A recent IRS Commissioner memorandum to Treasury Secretary O'Neill states that reaching a "world class" 90 percent level of service would require additional funding of $35 million. The IRS goal for the level of service in fiscal year 2002, based on current funding levels, is 74 percent.

The IRS has provided alternatives to talking to a "live person." As part of the toll-free system, automated service on a variety of tax topics and the status of refunds is expected to be accessible 100 percent of the time. This may be a viable alternative for some taxpayers; however, there is a lack of data to substantiate that this fulfills taxpayer needs. Another lesser-known alternative, the Electronic Tax Law Assistance program, allows taxpayers to submit tax law and procedural questions on the IRS' Digital Daily Internet web site. Over 90 percent of the taxpayers who use the Electronic Tax Law Assistance program were satisfied with the timeliness of responses and would continue to use the program. The same report stated that the IRS should consider expanding the program by providing additional resources and increased marketing.

We concur that expanding the Electronic Tax Assistance program would offer taxpayers another alternative for contacting the IRS. Currently, IRS Compliance staffers are brought in to help with the large volume of questions during filing season. This is very costly when considering the loss of tax revenue that results from diverting these employees from Compliance work. A significant expansion of this program would come at a considerable resource cost.

PROBLEM
TOPIC #2 MULTIPLE DEFINITIONS OF "QUALIFYING CHILD"

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The Internal Revenue Code provides uses different tests and rules to determine if a child qualifies a taxpayer to claim Dependency Exemptions, the Earned Income Tax Credit (EITC), Child Tax Credit, Dependent Care Credit and Head of Household filing status. These differences confuse many taxpayers and lead to errors.

ANALYSIS OF PROBLEM

Of a total of 7,570,150 math error notices issued in 1999, 44 percent or 3,310,330 are attributable to five Internal Revenue Code provisions that provide basic benefits to taxpayers with children.[2] These provisions include Dependency Exemptions, Earned Income Tax Credit, Child Tax Credit, Dependent Care Credit, and Head of Household filing status. Three provisions – Dependency Exemptions, Child Tax Credit, and Earned Income Tax Credit – account for 40 percent of all 1999 math errors.

Taxpayers who attempt to make use of these provisions must apply different definitions to the same child to determine if that child qualifies the taxpayer for each benefit. For example, the "age test" for the Child Tax Credit means a child under 17 years old; the age limit for the Dependency Exemption and Earned Income Tax Credit is under 19, or under 24 if a full-time student; and the age limit for the Dependent Care Credit is under 13.

Besides the age rules, a relationship test, a residency test, a support test, and a gross income test may apply to determine if a child qualifies a taxpayer to claim a particular benefit. The tests and the rules for them differ, depending on the benefit claimed. These distinctions cause taxpayer errors.

IRS COMMENTS

The IRS agrees that the different tests and rules for determining if a child qualifies a taxpayer to claim Dependency Exemptions, Earned Income Tax Credit, Child Tax Credit, Dependent Care Credit and Head of Household filing status are confusing and can potentially cause errors for taxpayers claiming these tax benefits. These tests, however, reflect the complexity of the law and simplification of the tests and rules without legislative changes is problematic. Within the current legal parameters, the IRS is focusing on:

- training of employees
- measuring performance

[2] Tax year 1999 data, Compliance Research Information System (CRIS), Model IFM 2001.

- ensuring that our instructions to the public are clear.

IRS INITIATIVES TO RESOLVE THE PROBLEM

Training on this issue is increasing for employees at the Taxpayer Assistance Centers, for tax specialists and for volunteers helping with basic tax preparation. Employees at the Taxpayer Assistance Centers will receive an additional 12 hours of training on this issue and other tax law areas prior to January 2002. The issues are a critical part of the annual training of Tax Specialists and the training of volunteers on this subject is an essential part of the classroom and materials training that they receive.

In FY 2001, the IRS began measuring tax law accuracy within topic areas, including Earned Income Tax Credit, the Child Tax Credit, Dependency Exemptions, and filing status. IRS will analyze this data and then target the best method to allocate training resources in the future.

Forms, instructions, and publications are being revised to ensure that they are as clear as possible. There are ongoing surveys and focus groups used in this area to try to clarify these complex issues. Results are then used to improve the next version of the forms, instructions and educational materials.

Commercial-off-the-shelf (COTS) products that include instructions on "qualifying child" have greatly improved. These products, which explain the "qualifying child" to tax preparers and taxpayers, also gather data that analyze the returns for their acceptance level into the IRS system. The low error rate indicates that these products are of high quality and clearly explain potential credits and obligations. Nonetheless, improvements to these products are made each year to ensure that these products meet the legislative requirements enacted as well as to enhance a continued user-friendly software for the public.

TAXPAYER ADVOCATE SERVICE COMMENTS

When rules are so complex that they cause a high percentage of math errors for taxpayers trying to claim basic benefits, the need for change is clear. The Taxpayer Advocate Service's concern about the differing definitions of a qualifying child is a major theme of the FY2001 report.

The deduction for Exemptions, a benefit area affected by the Internal Revenue Code provisions for a qualifying child, ranks third on this year's list of "most litigated" issues elsewhere in this report. We agree with IRS Operations that legislative action is needed to simplify the tests and rules. The National Taxpayer Advocate proposes changes that would produce a more uniform definition of a qualifying child in the "Legislative Recommendations" section of the report.

We appreciate the IRS' efforts to ensure that publications, tax forms, and instructions, including those contained in commercial products, are clearly written. It is also clear from focus group interviews that many taxpayers find tax preparation software to be a great help in sorting through com-

plex issues. We are concerned that the low-income taxpayers who could benefit from commercial products may not be aware of them, may be unable to afford them, or may not be able to use them, particularly if a computer is needed.

We support the initiative to provide additional training for employees. We are uncertain if the amount of time planned for training is adequate for staff to learn the nuances of the qualifying child provisions. Congressional action to simplify the definition of a qualifying child would greatly simplify filing tax returns for millions of taxpayers.

PROBLEM

TOPIC #3 DETERMINING EARNED INCOME TAX CREDIT (EITC) ELIGIBILITY

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Taxpayers have a difficult time determining if they are eligible for the EITC.

ANALYSIS OF PROBLEM

EITC Publication 596, Earned Income Credit, contains 15 qualification rules and is more than 50 pages long. Chapter Two, which spells out the rules for a qualifying child, covers seven pages and is very complex for some taxpayers. The EITC instructions for Form 1040 are also seven pages long. The EITC section of Publication 17, Your Federal Income Tax for Individuals, takes up 14 pages.

Since EITC forms were redesigned for the 1999 tax year, math errors have dropped by 28 percent. Even with such a significant improvement, 1,471,611 taxpayers, or eight percent of all EITC claimants, either had their credit recomputed or were denied EITC for tax year 1999.[3]

IRS COMMENTS

EITC can be a complicated issue that leads to errors on returns. The goal of the IRS is to clarify EITC as much as possible for the taxpayer through a multi-pronged approach of:

- training of employees and volunteers
- outreach to and education of practitioners and EITC eligible taxpayers; and
- ongoing improvements to our printed materials on EITC.

There is another issue that is of concern for IRS. Practitioners repeatedly report that many taxpayers are aware of the tax law and many of the rules about EITC. With this information, they know how to answer the questions so as to qualify for the credit while working with the tax preparer even if they do not qualify. However, some of these claims are deleted during processing.

The complexities of the EITC may be reduced in 2002 due to several law changes that are designed to simplify the EITC. Those changes include:

- The definition of earned income for EITC will change and non-taxable earned income will no longer be part of the eligibility calculation for EITC. Examples of non-taxable earned income include military housing allowances and parsonage

[3] Tax year 1999 data, Compliance Research Information System (CRIS), Model IFM 2000.

allowances.

- EITC will not require the additional calculation of "modified" adjusted gross income (AGI).
- The tiebreaker rule will be changed to allow parents, living with relatives who have a higher AGI, to claim their children for EITC.
- To claim EITC, the residency requirements will be the same for all children, including foster children.

IRS INITIATIVES TO RESOLVE PROBLEM

Training of employees and volunteers

- EITC is included as part of approximately 12 hours of training that employees will receive prior to January 2002. Employees are being trained to assist taxpayers with EITC questions by using Publication 596, Earned Income Credit, and to show the taxpayer the exact location in the publication where the answer is found. By referencing the publication, both the employee and the taxpayer will have confidence that the answer provided is correct.
- IRS provides training for those participating in volunteer programs. In these programs, volunteers help prepare basic tax returns for taxpayers with special needs, including persons with disabilities, those with a low income, non-English speaking persons and elderly taxpayers since many of those assisted by these volunteers are eligible to claim the EITC. EITC rules are an important part of a volunteer's training.
- Training consists of classroom instruction, supplemented by reference materials that the employees will use at their desks. These materials are developed by the IRS and contain the latest income tax law. Each of the credits, including EITC, is taught in separate lessons. This gives proper attention to the complexities of the credits. Each lesson contains specific examples of EITC scenarios.

Outreach to and education of practitioners and EITC eligible taxpayers

- IRS identified a small percentage (.3 percent) of EITC paid preparers in Tax Year 2000 who were responsible for a disproportionate number of EITC returns containing errors. IRS strategy includes one-on-one visits to these preparers to share with them their individual count for each type of error. The main educational focus is to discuss the appropriate application of tax law and thus work towards reducing the number of errors.
- Information is provided to taxpayers about qualifying for the credit, common errors and where they may have their returns prepared for free and electronically filed. In 2001, over 194,000 taxpayers were assisted with EITC through outreach efforts.

- IRS field personnel attend conferences and trade shows around the country to promote awareness of the EITC to eligible taxpayers and answer questions.

Ongoing improvements to our printed materials on EITC

- IRS continues to monitor the error rates in EITC returns to determine if redesigned forms and instructions implemented in tax year 1999 continue to have a positive impact. Error rates continued to decline from tax year 1999 to tax year 2000. The percentage of EITC errors was 7.37 percent in tax year 1999 and 6.42 percent in tax year 2000.
- IRS provides tax practitioners with several printed products containing the eligibility rules, foster child definition and information on "non-work" SSNs. The IRS provides a toolkit to practitioners that contains information on eligibility rules, what is needed to complete an EITC return, information about identification numbers, due diligence and information products that can be ordered.

INFORMATION TECHNOLOGY IMPACT

Small Business/Self Employed Division has requested the inclusion of a report mechanism within the Dependent Database Application to record counts of probable error by preparer ID number. Access to this system during the filing season would provide the opportunity to meet more quickly, possibly during the filing season, with preparers and ask them to address the errors at issue. We are currently working to establish a time frame for testing this mechanism.

A request has also been made to match problem returns identified during the filing season against the list of preparers previously identified and give those returns priority in the service center exam selection process.

If the paid preparers continue to be responsible for significant numbers of problem returns after the visit, a focused program to deal with the potentially intentional non-compliance may result in taxpayers using more knowledgeable preparers.

Additionally, the Electronic Filing System (ELF) and the Participants Acceptance Test System (PATS) perform a significant amount of validation and consistency checks. These systems check the main 1040/1040A return, Schedule EIC, Form 2441, Form 8812 and other forms/schedules to determine if a taxpayer's "child" qualifies him for these different tax credits.

TAXPAYER ADVOCATE SERVICE COMMENTS

The significant decline in math errors since EITC forms were redesigned demonstrates the positive steps IRS has taken to help taxpayers determine if they qualify to claim the EITC. The law changes

taking effect in 2002 should further reduce errors in determining EITC eligibility. Training of employees and volunteers, outreach to practitioners and taxpayers eligible for EITC and improvements to printed materials on EITC should all bring continued progress.

Despite these improvements, we are concerned that it will still be very difficult for some taxpayers to determine their entitlement to the credit. The complexity of the tax code, lack of access to free tax assistance, accessibility and affordability of professional tax assistance, literacy limitations, language barriers, and even fear of contacting the IRS are some of the reasons some taxpayers still have problems determining their eligibility.

PROBLEM

TOPIC #4 ANSWERS TO QUESTIONS ON CUSTOMER SERVICE TOLL-FREE LINES

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

When a taxpayer succeeds in reaching the IRS through toll-free lines to ask a technical or procedural question, he or she may be given inaccurate information or receive differing answers to the same question.

ANALYSIS OF PROBLEM

Taxpayers who call the toll-free number with technical or procedural questions feel they do not always receive accurate answers. They may call back and repeat the same query several times to see if they get the same reply. Data from fiscal year 2001 indicates that IRS employees gave the correct answers about tax law 75 percent of the time. For questions about individual taxpayer accounts, the figure was lower, at 69 percent.[4]

IRS COMMENTS

Providing accurate responses to Toll-Free customer questions on tax law and account inquiries continues to be a high priority for the service. The IRS has very exacting criteria for both tax law and accounts related telephone calls. While the answer to the taxpayer may be correct, if an assistor fails to meet even one of the criterion, the call fails the quality test. IRS continues to be committed to providing the public with the best service possible and to achieve this goal, it will provide its employees with the tools and training so that they may meet all the quality criteria.

With nearly 108 million phone calls a year, IRS improved its quality indicators in the 2001 Filing Season with an increase from 72.6 percent to 75 percent in tax law quality and an increase from 60 percent to 69 percent in accounts quality.[5]

IRS INITIATIVES TO RESOLVE PROBLEM

IRS is continuing to refine employees' research tools to make them more accessible and easier to use. Improvements are being made to the IRS' electronic research capabilities. Currently, Customer Service Representatives (CSRs) have access to the Integrated Data Retrieval System to research taxpayer's accounts and a variety of electronic research tools with information on tax law, regulations, court cases, IRS locations, and procedures.

[4] Weighted Quality Reports, Quality Review Database (QRDb).

[5] Id.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud the IRS' success in increasing the accuracy rates for tax law questions and taxpayer account inquiries for the FY 2001 filing season. The continued effort to improve the Customer Service Representatives' ability to research accounts, procedures and tax law is also encouraging.

However, we recognize that the IRS faces a challenging task in providing accurate tax information, ranging from simple account inquiries to highly complex questions about tax law. Assistors must be trained in very broad areas of tax law in order to handle the full range of possible issues that they may encounter. Calls to the IRS average almost 11 minutes in length – more than three times that of private sector calls on financial matters.[6] *Even tax questions that seem simple on the surface can be much more complex. According to a recent General Accounting Office report*[7]*, the IRS has major difficulties in recruiting, training, retaining and scheduling Customer Service Representatives*[8] *at its Customer Call Sites. This report cites problems in hiring qualified employees, providing the proper and timely training on complex issues, extremely high attrition rates, and coordinating employee work hours with periods of peak demand.*

We would add that the IRS should continue to strive to find and retain the very best employees to be assistors by considering ways of making the position more desirable. A plan to recruit, hire and maintain a professional, year-round work force, with rewards for increasing levels of technical expertise, is critical to solving this problem.

We also believe that this problem cannot be completely solved without addressing the complexity of the tax law that assistors must explain and translate to the public. For example, inconsistent definitions of a qualifying child greatly increase the complexity of determining dependent status for the purpose of claiming the child care credit, earned income tax credit, child tax credit, and the proper filing status. See the Key Legislative Recommendations section of this report for a discussion of this issue.

6 Memorandum dated June 26, 2001 from Charles O. Rossotti to Secretary 0'Neill regarding "Response to your memo "A World Class Treasury Department"

7 GAO Report: January 2001, IRS Telephone Assistance, Opportunities to Improve Capital Management

8 The CSR position requires a high school diploma and a year of customer service type work experience (or a college degree); pay at the full working level is about $32,000.

PROBLEM

TOPIC #5 DOCUMENTING EARNED INCOME TAX CREDIT (EITC) ELIGIBILITY

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The IRS standards and processing of documentation to prove Earned Income Tax Credit eligibility create a heavy burden for the taxpayers who are least equipped to comply with these requirements.

ANALYSIS OF PROBLEM

The standards for documentation to prove eligibility for the EITC do not reflect the reality of what this population of mostly low-income taxpayers can readily provide. EITC notices are intimidating and not easily understood. Taxpayers are asked for statements, lists, copies of multiple documents such as social security cards, birth certificates, school/medical records, and divorce decrees. This is a tremendous burden for the taxpayer.

Examiners disallow EITC based on school records that reflect the addresses of a taxpayer's relatives and friends. Custodial parents may provide these addresses in order for their child to attend a particular school for purposes of busing and facilitating before-school or after-school care. The credit may be disallowed if school records do not verify six months residency, even when other documents substantiate proof of residency. Court documents may be rejected because of their age. Taxpayers may mail or fax documentation more than once because the IRS cannot locate their responses.

In addition, examiners sometimes disagree about what constitutes acceptable and unacceptable documentation, resulting in additional requests for documentation or disallowance of the EITC. Examiners often refuse to accept third-party affidavits to verify a taxpayer's residence, insisting they need cancelled checks, leases, or rent receipts to prove the taxpayer lived with a claimed dependent child. This can cause problems in urban environments, where rent-controlled apartments are frequently occupied by several families or are sublet, and cash payments are common.

IRS COMMENTS

The basic information requested to prove eligibility for the Earned Income Tax Credit (EITC) has remained fairly constant for the last few years. It is essentially the same as the documentation required to verify dependency exemptions. However, in spite of continuous IRS efforts to educate the public, the documentation to prove EITC eligibility is sometimes overwhelming to the taxpayer.

IRS is striving to ensure that EITC is limited to the qualifying taxpayer. This is difficult to do unless verification of the qualifying child is proven. Unless the taxpayer can verify that he/she is eligible using sufficient documentation, the credit must be disallowed. Treasury Inspector General for Tax Administration (TIGTA) shares this concern and recently reported that duplicate dependent and qualifying child overclaims resulted in substantial losses of tax revenue each year. They estimate unintentional and fraudulent EITC non-compliance has increased to an estimated $9.3 billion a year.

Current eligibility requirements are based in large part on the living arrangements and familial relationships of taxpayers. School records are not the only documents that IRS accepts to verify the residency. IRS will accept medical records and insurance records that include the child's name and address.

As a result of complex situations like this and others, IRS auditors need to inquire about a taxpayer's personal life in order to determine if the taxpayer meets the EITC eligibility requirements.

IRS INITIATIVES TO RESOLVE PROBLEM

Despite these complexities, IRS is taking steps to reduce taxpayer burden by:

- Continuing to educate the public and practitioners on EITC requirements.
- Revising notices and correspondence.
- Making better use of quality review procedures to capture errors and then use them to train and correct practices.
- Clarifying its manuals and procedures so that taxpayers are treated equally and asked for the same information.
- Establishing toll-free lines and fax machines for taxpayers to address and forward the required documentation.
- Ensuring that examiner names and phone numbers are included in correspondence so that taxpayers have direct contact with the examiner whom is reviewing their documentation.

INFORMATION TECHNOLOGY IMPACT

IRS has developed a Dependents Database using internal and external information. This Database is designed to identify ineligible and questionable EITC claims during processing.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS' planned initiative to revise EITC notices and correspondence should alleviate some of the difficulties taxpayers experience in trying to comply with information requests. However, Form 886-H, Explanation of Items, used to request documentation for EITC, dependent exemptions and head of household filing status, revised in June 2001, is still a confusing and intimidating form. It is part of a package that is several pages long and is sent to the taxpayer, whereas the taxpayer may only need to send one or two items to the IRS to substantiate an EITC claim. This is not easily understood because the taxpayer may become overwhelmed by the amount of material that he or she must read to determine what to provide.

The process is often further complicated because the same form is used to substantiate dependency exemptions and the head of household filing status. IRS states the "basic information requested to prove eligibility for the EITC…is essentially the same as the documentation required to verify dependency exemptions." The Taxpayer Advocate Service asserts that the Form 886-H is difficult to understand for the task of substantiating either dependency exemptions or the Earned Income Tax Credit.

Low-income taxpayers usually cannot afford to take time off from work to gather the documentation required. They often do not maintain financial records. Many have moved several times, making it even more difficult to provide what is asked of them. Obtaining such documentation may therefore involve long-distance telephone calls, which are beyond the financial means of many of these taxpayers. The IRS is very interested in the address information on most of the acceptable forms of documentation as a means of detecting fraudulent EITC claims. The fact that these taxpayers frequently change their addresses makes it difficult for them to prove that the address is valid and that they qualify for the EITC.

The IRS must improve its standards of acceptable documentation required for taxpayers to substantiate EITC claims. Instructions, forms, letters and notices must be written in plain language and available in several languages. Taxpayers should not face the burden of providing data that is readily available to IRS employees, including information pertaining to birth records, social security numbers, and parental names. Research techniques to obtain this information from internal sources prior to taxpayer contact should be considered to reduce taxpayer burden.

PROBLEM

TOPIC #6 REFUND INQUIRIES

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Taxpayers do not understand why their refunds are changed, delayed or not received.

ANALYSIS OF PROBLEM

The main reasons taxpayers contact the IRS about the status of their refunds include:

- A pre-refund examination of the Earned Income Tax Credit may cause the entire refund to be held or "frozen."
- When a refund is changed, taxpayers frequently receive the adjusted refund before receiving the notice explaining the change. Providing the explanation separately from the refund causes confusion and generates inquiries.
- Taxpayers do not understand why it takes so long to trace a lost, stolen or destroyed refund and to issue a replacement.
- When taxpayers file Forms 8379, Injured Spouse Claim and Allocation Forms, they do not understand why their portion of a joint overpayment is offset to a past-due amount owed by their spouse. Offsets of payments to tax and non-tax debts occur before the Form 8379 is processed. Examples of non-tax debts include past due child support and unpaid student loans.

IRS COMMENTS

The following are some examples of what happens if a refund is changed, delayed or not received:

- When the IRS adjusts a taxpayer's account, a notice is mailed to the taxpayer from the IRS explaining why the adjustment occurred.
- When a taxpayer receives a refund from the IRS, the Financial Management Service (FMS), a bureau of the Treasury Department, makes an electronic deposit to his or her account, or mails a paper refund check to his or her home.
- When the IRS adjusts a taxpayer's refund the modified refund and notice explaining the adjustment are mailed separately to the taxpayer.

Frequently, the taxpayers receive the adjusted refund prior to receipt of the notice. This lapse in timing causes confusion and generates telephone inquires from taxpayers.

This issue has consistently appeared in the National Taxpayer Advocate's Annual Report to Congress as one of the most serious problems faced by taxpayers and IRS has taken steps to remedy this situation.

The Philadelphia Service Center and the local Financial Management Service Regional Financial Center worked jointly on a process to develop programming to combine the refund check and the IRS notice into one mailing. This process became known as the Refund/Notice Integration Project. The project involves printing two-dimensional barcodes on each page of the notice that are later used to accurately match up with the corresponding refund checks. Once printed, the notices are then hand carried to the Financial Management Service where they are collated with the refund check and inserted into one envelope. In January 2001, the project was temporarily delayed due to limited Information Technology resources and is now scheduled for full implementation by February 2002. Timing is especially critical; beginning in February 2002 IRS will begin to issue Filing Season 2002 refunds.

Refund traces involve the Financial Management Service, the agency that actually issues the check. IRS initiates the trace and the remaining process continues at Financial Management Service. The process takes approximately four to six weeks. IRS follows up with Financial Management Service to ensure completion and issuance of another check.

The issue of offsets for Injured Spouse claims is being studied. There are instances where the offset is made before the Form 8379, Injured Spouse Claim and Allocation, is processed. This is especially true when there is an electronic direct deposit and the form is not filed with the return. Deposits usually post to taxpayers' financial accounts by mid-night on Thursday and the taxpayers generally receive Financial Management Service notices of non-federal tax offsets on the following Saturday or Monday.

IRS INITIATIVES TO RESOLVE PROBLEM

- Beginning in the Spring of 2002, IRS will offer a self-service application to allow individual taxpayers to check on the status of their income tax return posting (fact-of-filing) and their refund via the Internet, 24 hours a day, 7 days a week. The application has been designed to maintain a secure environment needed to protect taxpayer Privacy Act data and tax account data.
- IRS is developing a system for daily processing to FMS instead of the current weekly process. This will reduce refund delivery by approximately 10 days.
- Form 8379 can now be filed electronically, which will expedite the process for those who e-file.

- IRS will continue to study two issues:
  - How to handle offsets for injured spouses.
  - Partial refund freezes rather than a full freeze when EITC is involved.

INFORMATION TECHNOLOGY IMPACT

The project to allow for daily issuance of refund checks is part of the IRS Modernization Efforts.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud the various IRS initiatives to expedite refund processing, such as the modernization project, which would allow refund checks to be issued daily. Full implementation of the Notice/Refund Integration Project, providing for a notice explaining changes to a refund to be received with the check, should lessen taxpayers' confusion and inquiries about their refunds. As we go to press, there has been no final decision about whether it is feasible for the IRS to issue partial refunds to taxpayers engaged in pre-refund audits.

Although it may be beneficial for taxpayers to file Form 8379 (Injured Spouse Allocation) electronically, we are not convinced that this will reduce offsets. Currently, Forms 8379 need to be reviewed and verified manually before processing.

We continue to be concerned about low-income taxpayers whose refunds are delayed until Earned Income Tax Credit Eligibility can be determined. The IRS has the difficult job of balancing the competing interests of revenue protection and prompt service to this taxpayer population. We are continuing to work with the Wage and Investment Operating Division to find ways to reduce undue burdens and delays for taxpayers who are eligible for the credit, and to achieve this without compromising the integrity of the Earned Income Tax Credit Program.

PROBLEM

TOPIC #7 EARNED INCOME TAX CREDIT EXAMINATIONS

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Lengthy Earned Income Tax Credit (EITC) examinations cause unreasonable delays of refunds to low-income taxpayers.

ANALYSIS OF PROBLEM

The Examination division may take a year or longer to process an EITC case when resources to work these cases are inadequate and sufficient documentation is not provided.

As of September 2000, Service Center Exam had opened 229,331 cases for tax year 1999 Pre-Refund EITC examination. On March 31, 2001, over 72,000 cases were still open in Exam for these project codes.

IRS COMMENTS

IRS is making improvements in all steps of the examination process to make it more efficient. Those improvements begin with enhancements to our pre-examination or selection stage and continue through a redesign of the process itself and provide additional communication avenues to the taxpayer. On a parallel track, IRS is simplifying its forms and letters to the taxpayers, improving the distribution of the workload across the IRS and is placing increased emphasis on training.

The length of an examination depends on a number of factors:

- the taxpayer's participation in the examination process
- the systems used to produce the examination reports
- the condensed timeframe in which the taxpayers file for their Earned Income Tax Credit refunds. Most taxpayers who file a return claiming the Earned Income Tax Credit file within a twelve-week time period (January through April).

The time to examine any tax return varies from situation to situation. There are however, some mandatory steps for both the IRS and the taxpayer. Before an examination can be closed, the taxpayer must sign the examination closing report and agree to the adjustments or send in the correct documentation to verify that the deduction or credit is allowable. If the taxpayer does neither of the two, IRS must issue a Statutory Notice of Deficiency, giving the taxpayer 90 days to petition Tax Court. The taxpayer also has the

option of disagreeing with the examination report or the Statutory Notice and appealing the matter. These steps are explained through various publications sent with the notices.

The audit process can range from 30 to 210 days depending on the type of the audit and receipt of information the taxpayer supplies. If the taxpayer does not reply to IRS notices, the case cannot be closed or the assessment made until the taxpayer has received the Statutory Notice of Deficiency and 90 days has expired.

Statistics show that approximately 80 percent of the tax returns selected for correspondence examination with EITC being claimed have been disallowed.

Correspondence Examination did experience problems with the computer system used to issue examination reports during the fiscal year 2000 filing season, causing delays in generating examination reports. Those systemic problems have now been corrected.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS is working to resolve this problem both internally and externally. IRS:

- Is enhancing its selection process, using external and internal data. The improved data will allow us to better determine which taxpayers are entitled to the Earned Income Tax Credit without an audit, thereby reducing audits of EITC entitled taxpayers and focusing on the non-entitled taxpayer.
- Is simplifying Examination forms and letters used to request documentation. This should make it easier for taxpayers to understand what is needed of them.
- Has established toll-free access to answer questions and the ability to fax information in an effort to expedite these cases.
- Is working with the paid preparers to ensure their understanding of this complex issue. IRS has identified a number of EITC paid preparers who prepared Schedule C/EITC Tax Year 2000 returns. This represents .3 percent (three tenths of one percent) of paid preparers who are involved with EITC returns and who have a disproportionate number of errors. IRS will meet with these preparers to discuss the errors and ways to avoid them in the future.
- Continues to educate and train personnel handling audits to ensure consistent treatment.

INFORMATION TECHNOLOGY IMPACT

IRS has developed a Dependents Database using internal and external information that will be used on TY2001 returns. This Database is designed to identify ineligible and questionable EITC claims during processing.

TAXPAYER ADVOCATE SERVICE COMMENTS

Simplification of EITC forms and letters, better distribution of workload, and increased emphasis on training are all positive steps the IRS has taken to reduce the time needed to complete an EITC examination.

The IRS states that the length of an examination depends in part on the "condensed" timeframe for filing for EITC refunds; however, the twelve-week period (January 1 through April 15) during which most taxpayers file a federal return claiming EITC is the required, standard filing period for each calendar year. The Taxpayer Advocate Service understands that the IRS has little control over the volume and timing of when audits of EITC are begun, because this process starts as the returns are filed. Although we can appreciate the difficulty IRS faces in reviewing a tremendous number of EITC returns, we are concerned about the impact on compliant taxpayers who are entitled to the credit. These taxpayers should not be burdened by unreasonable delays in receiving their refunds, including the Earned Income Tax Credit (EITC), because IRS resources are not allocated to review returns timely.

The IRS states that the taxpayer's participation in the examination process is a factor in the time needed to conclude the examination. It is true that taxpayer failure or delay in responding to Examination's requests for information will increase the amount of time required to finish the audit. In past filing seasons, IRS has been backlogged in reviewing taxpayer responses that were received on time. This year, the Operating Divisions made significant improvement in reducing the volume of uncontrolled correspondence. However, during the press of filing season, EITC cases receive less priority. For example, as of February 23, 2001, Service Center Examination had over 23,000 pieces of mail that were over 30 days old and potentially contained information from taxpayers to resolve their issues. Often the mail that Examination has not had an opportunity to review is much more than 30 days old.

We have no way of knowing how many taxpayers do not respond to the EITC examination notices because they are afraid, overwhelmed by trying to understand or meet the documentation requirements, or unable to afford representation. However, experience working with these taxpayers tells us that this is the case for some. Thirty percent of requests for reconsideration of an examination assessment received by TAS for the six-month period from October 2000 to February 2001 involved the EITC. We suggest the IRS put up posters and leave brochures at IRS walk-in sites and tax assistance centers to inform taxpayers of services available at low-income tax clinics.

We are concerned that the statistic "80 percent…of correspondence examinations with EITC being claimed have been disallowed" can be misleading to those unfamiliar with the way it is computed. The IRS' inventory system reflects a "change" rate. This 80 percent figure includes all adjustments to EITC during pre-refund audit/initial processing, whether the EITC amount is increased, decreased or fully disallowed. Furthermore, this percentage is not adjusted for audit reconsideration cases, where EITC is

later allowed (after an initial Examination disallowance). For the 1997 tax year, 18,400 taxpayers requested audit reconsideration on tax returns where EITC was disallowed. The average refund was $2121; the IRS refunded a total of $39 million to these taxpayers.[9]

We fully understand the challenge of reviewing the growing volume of EITC returns and applaud the improvements the IRS has made. At the same time, we believe further action is needed to ease the burden on low-income taxpayers who are entitled to receive the credit, may need the funds to pay basic living expenses, and are unable to cope with a complex, sometimes intimidating process.

9 Tax year 1997 data, Compliance Research Information System (CRIS), Model IFM 2001.

PROBLEM

TOPIC #8 UNDERSTANDING ESTIMATED TAX PAYMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Taxpayers do not know about the requirements for or understand how to compute estimated tax payments.

ANALYSIS OF PROBLEM

Estimated taxes are difficult to compute because taxpayers may not know in advance the amount of their final tax liability. Despite their best efforts to comply with the law, they may incur estimated tax penalties.

Taxpayers must make estimated payments based on their projected annual income. However, estimating income can be difficult for the self-employed, who are subject to seasonal and economic fluctuations. Although the threshold for estimated tax penalty has increased from $500 to $1,000, it is still very low.

Individuals may become liable for estimated payments for many reasons, such as a change in the amount of withholding credits, a new business, a change in the number of eligible dependents or a substantial increase in wages. Should these factors come into play in the middle of a tax year, taxpayers may not realize the impact on their taxes until they or their tax professionals are preparing returns. If a taxpayer is unaware of the estimated tax payment requirement, it is too late to comply once the return is filed. The current exceptions to the requirement do not cover these circumstances.

Taxpayers have the option of computing their own estimated tax penalty or having the IRS compute it for them. If the IRS computes the penalty, it is not assessed if the amount falls below a certain tolerance level. If a taxpayer computes the estimated tax penalty on his or her own return by attaching Form 2210, Underpayment of Estimated Tax by Individuals, Estates and Trusts, the IRS assesses the penalty even if it is less than the tolerance level.

IRS COMMENTS

Two issues have been raised. The first involves the difficulty in computing estimated tax payments. Most taxpayers are wage earners and have income taxes and social security taxes withheld from their paychecks on a regular basis and do not face the issue of estimated tax payments. The Estimated Tax (ES) system supports the “pay-as-you-go”

concept by requiring quarterly deposits from taxpayers who are self-employed and/or have earnings from such sources as interest, dividends, rent, alimony, and unemployment. The IRS only imposes an Estimated Tax penalty on taxpayers who do not have enough withholding or pay enough estimated taxes throughout the year or did not make the payments on time. IRS has published guidance and instructional material dealing with the rules for estimated tax payments for quite some time. Generally, taxpayers are not liable for Estimated Tax penalties if either: (1) their current year's tax liability minus their withholding is less than $1,000, or (2) their withholding covered at least 90 percent of their current year's tax liability or 100 percent of the prior year's tax liability. The exceptions for not asserting the penalty are set out in the Code and cannot be changed without legislation.

The second issue concerns different treatment when the taxpayer computes a penalty and when IRS computes the penalty. Taxpayers have the option of letting the IRS compute their ES penalty or computing their own penalty, and Form 2210 provides such instructions. When IRS computes the penalty, it uses a tolerance level before asserting the penalty. This issue has been raised earlier and the IRS is developing a legislative remedy for this issue.

IRS INITIATIVES TO RESOLVE PROBLEM

- IRS has recommended to the Treasury Department that the threshold for asserting the penalty for estimated tax payments be raised from $1,000 to $2,000.
- In FY 2002, IRS will redesign the Form 2210 to reduce the computation complexities and to improve clarity. Although paid preparers complete 92 percent of the Forms 2210 filed, IRS will explore ways to simplify the process.
- Estimated Tax payments guidance has been included in the many workshops held with the small business community.

TAXPAYER ADVOCATE SERVICE COMMENTS

The burden of estimated tax payment (ES) and penalty calculations continues to be a tremendous problem for taxpayers. Although IRS states that "most taxpayers are wage earners…and do not face the issue of estimated tax payments," in 1998 approximately 1.84 million taxpayers filed a Form 1040 with a completed Form 2210.[10] *While this may be a small percentage of the total number of tax returns filed, the issue affects almost two million people.*

We are extremely pleased to see IRS' planned initiative to reduce the computation complexities and improve clarity of this form. We have concerns about raising the threshold to $2000 because such a threshold may encourage a year-end tax liability that some taxpayers cannot pay in a lump sum. Thus, they may end up in debt to the IRS and incur additional penalties and interest.

10 Treasury Inspector General For Tax Administration, September 2001. This estimate does not include the number of Forms 2210 completed for taxpayers by the IRS

We believe that a better approach would be to index the estimated tax penalty to inflation and to adjust the threshold amounts in easily remembered $100 increments.

PROBLEM

TOPIC #9 EXPLANATIONS ON MATH ERROR NOTICES

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Math error notices do not contain the clear explanations that would enable taxpayers to understand changes in the returns they filed.

ANALYSIS OF PROBLEM

Math error notices are vague and do not clearly explain changes in returns. Taxpayers who call the IRS to ask for a better explanation may receive incomplete or incorrect answers from the toll-free sites. Filing season 2001 data indicates that IRS employees gave correct information about account-related issues 69 percent of the time.[11]

IRS COMMENTS

IRS processes approximately 124 million Form 1040 series tax returns each year. An average of 25 percent of these tax returns contains errors that are corrected by the IRS. Errors are assigned an "error condition" code to alert tax examiners of an issue to be resolved. There are approximately 225 categories of error conditions. After being corrected, the tax return is given a Taxpayer Notice Code (TPNC) describing the error. This becomes part of the computer-generated notice that is sent to the taxpayer to explain the error condition and changes made as a result of the error. The IRS uses approximately 300 pre-worded taxpayer notices that are designed to communicate information concerning the error as accurately as possible.

IRS has shown significant improvement in quality of its accounts-related telephone calls going from 60 percent in the 2000 Filing Season to 69 percent in the 2001 Filing Season.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS recognizes that clarity of notices is an integral part of providing quality service to its customers. During the 2002 Filing Season, the IRS is planning significant improvements to the review of outgoing individual and business math error notices. The selection process for reviewing notices will target those notices that have the greatest impact to taxpayers. Work has been initiated this year to review all the taxpayer notice codes for language content and clarity so that a "plain language" approach to developing notices can be implemented. This approach teaches writers how to script notices in a way that is

11 Weighted Quality Reports, Quality Review Database (QRDb).

less technical. Through continued taxpayer testing, focus groups, and ongoing revisions, the IRS will work to improve the clarity of all IRS notices.

Additionally, other review programs at the service centers will be enhanced so that a more comprehensive review of Business Master File (BMF) math error conditions can be obtained prior to the issuance of the notice. To date, the IRS has successfully redesigned over thirty (30) notices, most of which are specifically math error notices.

The IRS will continue to promote Electronic Federal Tax Payment System (EFTPS) to business taxpayers and reinforce the message that using EFTPS results in dramatic decreases in the number of math errors that generate issuance of many math error notices.

Finally, the IRS has commissioned a multi-functional Notice Modernization Team under the direction of an executive to formulate an overall notice design and development strategy that correlates the taxpayer needs and the needs of the new IRS customer focused business divisions. Their recommendations regarding future strategy and structure essentially form the master plan relating to our entire notice process, not only the math error notices.

INFORMATION TECHNOLOGY IMPACT

Any change to the notice process will rely heavily on the ability of Information Technology Services to make timely programming changes and to deliver new systems.

TAXPAYER ADVOCATE SERVICE COMMENTS

We appreciate the IRS' initiative to review all taxpayer notice codes for language content and clarity to implement a "plain language" approach to developing notices. We also commend IRS on its initiatives to improve the review of outgoing individual and business math error notices, and on its enhancements to other review programs at the service centers. Information gathered from these reviews can provide meaningful information for improving math error explanations.

However, we remain concerned that the IRS has not yet placed enough emphasis on the process and has made little progress on improving the system. Too many taxpayers still have to call or send written requests because they cannot use the IRS' math error explanations to identify mistakes on their returns. The IRS recently won an award for the clarity of some of its redesigned notices. We encourage the IRS to apply this kind of effort to the problem of math error notices, which lead a considerable number of taxpayers to contact the IRS for assistance.

PROBLEM

TOPIC #10 PROCESSING CLAIMS FOR REFUNDS

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The IRS timeframe for processing claims for refunds and amended returns is too long.

ANALYSIS OF PROBLEM

The IRS normally needs eight to 12 weeks to process claims for refunds and/or amended returns but in some instances processing takes even longer. Both the standard and actual processing times are unreasonable, especially for taxpayers who are experiencing financial hardship and need their refunds immediately.

IRS COMMENTS

IRS has changed its criteria for processing claims and amended returns as of June 2001. The change will allow an additional 23 percent (700,000) of the claims filed to be fully processed and a refund issued after standard rather than comprehensive review. Processing of claims and amended returns will continue to vary based on the complexity of the issues and returns. They are received in Submission Processing Centers and are sorted by technical complexity. Those that are more complex will require some contact with the taxpayer and will take longer to process.

TAXPAYER ADVOCATE SERVICE COMMENTS

Currently, there is no mechanism for tracking the time it takes to process amended returns for either individual or business taxpayers. The processing time varies based upon the complexity of the returns and the time of the year they are filed.

This causes hardship to many taxpayers who have an immediate need for their refunds. Based on Taxpayer Advocate Management Information System (TAMIS) data (Appendix A), delays in processing claims for refund ranked second highest among the issues that generated taxpayer contacts to TAS during FY 2000 and FY 2001

IRS comments indicate that the criterion for processing claims and amended returns has changed as of June 2001. Sorting claims by technical complexity should improve the processing time. It is too early to notice any significant progress in this area.

PROBLEM

TOPIC #11 RECERTIFICATION FOR EARNED INCOME TAX CREDIT (EITC)

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Recertification requirements for claiming the EITC in year(s) subsequent to denial of the credit are unclear and burdensome to taxpayers.

ANALYSIS OF PROBLEM

When the IRS makes changes to an EITC claim, the IRS sends a letter explaining those changes. Taxpayers do not receive Form 8862, Information to Claim Earned Income Credit After Disallowance, from the IRS with that letter. The letter states only that taxpayers "can get Form 8862 at most locations where tax forms are available."

Because of the time lapse between having the EITC disallowed in one year and filing the subsequent year's return claiming it again, taxpayers forget the requirement to recertify. Some do not attach Form 8862 because they are not claiming the same child disallowed previously or because EITC was previously disallowed for a dependent and the taxpayer is now claiming income-only EITC (no children).

The requirement that taxpayers be asked to submit documentation in addition to completing Form 8862 is not clear. A taxpayer may believe that filing Form 8862 means he or she will receive the EITC. In actuality, when the return is processed it is systemically forwarded to Exam and the refund is frozen.

The year requiring recertification is also easily misunderstood. If the EITC issue is still open in Exam, Form 8862 is not required the following year. For example, a taxpayer's 1999 return is selected for EITC examination. On April 15, 2001, the taxpayer files a tax year 2000 return and includes Form 8862. However, the statutory period for assessment is still open on the 1999 return, so the Form 8862 is not required with the 2000 return.

When the recertification indicator is not removed from a taxpayer's account, subsequent refunds may be held in error.

Returns filed without the required Form 8862 have similar error rates whether filed electronically or on paper.

- Data for tax year 1999[12] indicates returns missing form 8862, accounted for 74,543 or one percent of e-file errors.
- Paper returns where Form 8862 is not attached as required are classified "unpostable" and the taxpayer subsequently receives a math error notice. A 1999 Math Error Analysis indicates approximately 61,000 paper returns or approximately one percent were missing Form 8862.[13]

IRS COMMENTS

IRS continues to work to improve this complex process. IRS is reviewing recent suggestions by the National Taxpayer Advocate regarding recertification to identify adjustments that can be made in this process. Some of the suggestions that require extensive programming changes will be implemented in the 2003 Filing Season.

IRS has considered the issue of including Form 8862, with its closing letter and has decided not to include it, since the taxpayer would need to keep the form until the subsequent year's return is filed. Our experience has been that taxpayers are likely to be confused as to whether to attach the Form 8862 for the year already disallowed (in essence filing a claim) or with the next year's return. In one site, tax examiners were including Form 8862 with the closing letter. As a result, taxpayers were completing and returning the loose form prior to the subsequent tax years filing causing confusion for both the IRS and the taxpayer.

The closing letter does inform the taxpayer that they can get the form from the IRS Website or if they file electronically, they will be able to send Form 8862 electronically.

Taxpayers are not required to recertify until after EITC has been disallowed. If an examination is not completed prior to the time of the subsequent year's filing, there is no basis on which to place a recertification indicator on a taxpayer's account. Therefore, the subsequent year's module is flagged for review by examination. If the taxpayer continues to claim EITC on a subsequent year return, an examination will be started on the newly filed return. If the prior year's audit is completed before the subsequent year's filing, the flag is removed from the subsequent year's module to allow the recertification indicator to direct the subsequent year's case.

12 ELF1545 report dated 4/18/2000.

13 Tax year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has made adjustments to this process:

Education and Outreach

- IRS has instituted Tax Clinics for taxpayers and preparers, targeting the population likely to claim EITC. In these Tax Clinics, instruction is provided on the qualifications for EITC and the requirements for recertification.
- IRS identified a small percentage (.3 percent) of EITC paid preparers in Tax Year 2000 who were responsible for a disproportionate number of EITC returns containing errors. While no information on the Recertification problem was used in identifying these paid preparers, it will be one of the issues for the EITC Preparer Visitation Program. The IRS strategy is one of education and includes one-on-one visits to these preparers to share with them their individual count for each type of error. The main education focus is to discuss the appropriate application of tax law and thus work towards reducing the number of errors. Specifically, IRS will discuss:
- Reminding tax practitioners to determine the need for Form 8862 when preparing returns.
- Failure to carefully determine a taxpayer's eligibility for EITC, and its subsequent disallowance, results in burden and possible disallowance of EITC when the taxpayer is eligible.
- Failure to advise or support taxpayers who are entitled to EITC during the audit process results in significant burden on the taxpayers and potential future disallowance of EITC.

TAXPAYER ADVOCATE SERVICE COMMENTS

The fact that over 137,000 taxpayers neglected to send the required EITC recertification form with their 1999 return is noteworthy. Since taxpayers forget about the requirement, developing a notice to remind them to send Form 8862 may help taxpayers file the form at the proper time. If the taxpayer completes and returns the recertification form before it is required, the IRS could send a notice stating it is premature and reminding the taxpayer to file with the next return.

We applaud IRS' inclusion of requirements for EITC recertification in the EITC educational tax clinics. The one-on-one visits to selected preparers should also improve their understanding of recertification. We look forward to receiving information on which of our suggestions regarding recertification will be implemented in the 2003 filing season, so that we may monitor IRS Information Technology Services' progress on the implementation.

PROBLEM

TOPIC #12 COMPUTING INCOME TAX USING SCHEDULE D (CAPITAL GAINS AND LOSSES)

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Taxpayers have difficulty computing the tax on capital gains using the Schedule D form.

ANALYSIS OF PROBLEM

Taxpayers need to determine if they are required to file Schedule D by reviewing the instructions for Line 13 of Form 1040, as some capital gain distributions do not have to be reported on Schedule D. If the entire capital gain consists of capital gain distributions, the taxpayer completes a 15-line capital gain worksheet. Taxpayers with net capital gains must review the seven pages of Schedule D instructions to compute their tax liability on a 36-line form. This involves a complicated series of math calculations. Two of the ten most common errors on Forms 1040 filed for 1999 are related to the capital gain tax computation.

IRS COMMENTS

The IRS understands that this is an extremely complex and difficult computation. Several tests are performed to test Schedule D each year to ensure all current legislation has been incorporated into the product. However, until the underlying complex tax law is revised, taxpayers will continue to have problems computing capital gains. IRS is simplifying the Schedule D to the maximum extent possible.

IRS INITIATIVES TO RESOLVE PROBLEM

A new shortened Schedule D will be in effect for tax year 2001. IRS enlisted an independent contractor to conduct a series of focus groups and cognitive interviews with taxpayers. The sessions were to gather reactions to a 40-line version of the Schedule D, solicit taxpayer preferences for the 40-line form versus the current 56-line form, and test a worksheet developed to accompany the revised 40-line schedule. As a result of these studies, it was determined that the 40-line form was suitable for the majority of taxpayers completing Schedule D. In tax year 2001, IRS will monitor error rates to assess the impact of the revised Schedule D and worksheet.

To improve this ability to accurately answer commonly asked but complex tax law questions, IRS Field Assistance employees received specialized training in 2001. The training was targeted to issues most commonly encountered in Taxpayer Assistance Centers such

as capital gains computations. The IRS will continue to refer questions regarding Schedule D and Capital Gains and Losses to employees who have been trained in these specialized subject areas.

IRS continues to work with vendors to develop high quality commercial-of-the-shelf (COTS) products that automatically generate the Schedule D capital gains computation. All commercial off-the-shelf products are tested to ensure all legislative requirements have been updated.

TAXPAYER ADVOCATE SERVICE COMMENTS

Schedule D (Capital Gains and Losses) impacts many middle-income to high-income taxpayers as well as elderly and retired taxpayers who have capital gains or losses. Tax year 1999 filing data indicates that taxpayers filed approximately 27.3 million Schedule D returns. Some taxpayers may have only a relatively small investment income, but are still required to work through the complicated form. Many taxpayers cite the current method of computing capital gains and losses as a major source of complexity in their returns.

IRS has recognized that the Schedule D form is unduly complex and is pursuing ways of resolving the problem. We also agree that the law is complicated and will be difficult to simplify without legislative changes. We support the IRS' use of focus groups and taxpayer interviews to test the revisions aimed at simplifying Schedule D. Results from the IRS study capturing error rates will help determine if further revisions to the form are needed.

PROBLEM

TOPIC #13 AWARENESS AND UNDERSTANDING OF FEDERAL TAX DEPOSIT REQUIREMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Taxpayers do not know about or understand the requirements for making federal tax deposits.

ANALYSIS OF PROBLEM

Taxpayers required to make federal tax deposits must meet all related requirements under IRC § 6656. In other words, deposits must be made on time, in full and in the correct manner to avoid a penalty for failure to deposit. A taxpayer may deposit the right amount of tax on time and still be subject to the penalty for not paying through the correct depository.

In addition, the required date or method of deposit changes as a taxpayer's business grows and the payroll rises. Even though the taxpayer deposits his or her tax the same way as before, a penalty is assessed.

IRS COMMENTS

IRS has been aggressive in educating taxpayers and has devoted significant resources in developing educational tools and providing direct assistance to taxpayers concerning tax deposit requirements.

IRS has also extended the penalty relief granted by RRA '98 Section 3304 (b), by providing a waiver of the Federal Tax Deposit penalty for the entire tax quarter following a change in deposit frequency (issuance of the CP-136 or CP137 notices). Rather than assessing the Federal Tax Deposit penalty, the IRS now issues an information notice (CP-235) telling the taxpayer that they are not following the deposit requirements for the current year, but that the penalty was excused for that tax period.

IRS INITIATIVES

Over the last two years IRS has:

- Distributed copies of the Small Business Resource Guide CD-ROM that contains the entire life-cycle reference guide for small businesses, including federal tax deposits to practitioners and taxpayers.

- Distributed additional copies through the Small Business Administration's Small Business Development Centers, Business Information Centers and Service Corps of Retired Executive (SCORE) locations.
- Produced and distributed the "ABC's of FTDs" video explaining the federal tax deposit rules.
- Sent revised notices to all taxpayers informing them of their federal tax deposit requirement for the 2001 tax year, even if there is no change in their deposit requirement. Previously, IRS only notified taxpayers if their requirements changed. The new notices (CP-136 & CP137-137A-137B) sent to taxpayers informing them that their deposit requirements for the upcoming tax year now include an explanation (a condensed version of the information in Publications 15 & 51) of the requirement rules.
- Implemented the change in the de minimis tax amount due with employment tax returns. For tax periods beginning on or after January 1, 2001, if the total tax due for a tax period is less than $2,500, a taxpayer is allowed to pay that amount by the return due date, without being penalized.
- Delivered educational products through a variety of outreach channels such as workshops, seminars, conferences, trade shows, and through the IRS Small Business Self Employed Community Web Site.
- Concluded its Mentor and Monitoring Pilot and has awarded a contract to survey the 13,200 participants to see if the effort was beneficial to the small business taxpayers. The pilot focused on assisting new businesses with FTD rules and procedures. Based on the survey results, IRS will determine if it should expand the program.

TAXPAYER ADVOCATE SERVICE COMMENTS

In spite of the IRS' extensive outreach, business taxpayers struggle to comply with Federal Tax Deposit requirements. The resulting Failure to Deposit penalties create a significant burden on self-employed and small business taxpayers. A primary source of confusion for the business owner is the fact that as the business grows, the deposit requirements change. A change in the business' employment tax liability may require a new deposit date as well as a change in the method of deposit. The inconsistent procedures, required deposit dates and required deposit methods promote unintended non-compliance and result in large penalties for business owners.

We support the Electronic Federal Tax Payment System (EFTPS) enhancements under consideration, which would provide on-line notification when deposit requirements change. We are eager to see the survey results on the "Mentor and Monitoring" pilot conducted by IRS to assist new businesses with Federal Tax Deposit requirements and procedures. However, until the requirements are simplified and rules do not change as often as they do now, Federal Tax Deposits will continue to be a problem.

PROBLEM

TOPIC #14 OBTAINING EMPLOYER IDENTIFICATION NUMBERS (EINS)

IRS RESPONSIBLE OFFICIAL

Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Taxpayers are unable to obtain EINs within the specified timeframes, hindering their ability to file federal and state returns, set up bank accounts or conduct other business.

ANALYSIS OF PROBLEM

Every year more than three million taxpayers need Employer Identification Numbers. Though taxpayers are promised same-day service if they call in for an EIN, telephone coverage at IRS facilities is inconsistent. Some sites answer their phones three days a week. Others limit coverage to four hours a day. Faxed requests for EINs are to be processed within four days, but some taxpayers have waited several weeks to receive numbers.

IRS COMMENTS

Securing an Employer Identification Number has been a continuing problem for the taxpayer. IRS telephone systems were not sufficient to manage the customer demand. IRS assistors must spend an extensive length of time on calls helping customers understand the requirements for obtaining an EIN and discussing information needed to receive the number. Even with additional staffing, taxpayers have experienced long delays or a busy signal.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS established an Employment Improvement Team in January 2001. The team has planned improvements for January 2002, which should significantly ease the problem. These include:

- Employer Identification Number operations will be consolidated into three Small Business/Self-Employed Accounts Management Sites. All service will be provided through the Brookhaven, Cincinnati and Philadelphia IRS Centers. This will result in more focused attention on these new business customers and improved IRS skills, resulting in better quality, because optimum staffing will be devoted to the EIN operation.

- A new toll free number will be established allowing for calls to be directed to the next available assistor in any of the three locations.
- Hours of operation will be 7:30 a.m. to 5:30 p.m. in the customer's local time zone.
- The December 2001 revision of the Form SS-4, Application for Employer Identification Number, will include an embedded authorization. This change eliminates the need for the customer to file a Form 2848, Power of Attorney, or Form 8821, Tax Information Authorization along with the Form SS-4. This will help on future discussions with taxpayers and practitioners.

The following changes have already been put into place:

- Customers who call the EIN telephone line but do not have a completed Form SS-4 in hand were previously asked to obtain a form and call back. As of April 1, 2001, procedures require assistors to walk these taxpayers through the line items on the form in order to provide the number. This change is anticipated to allow service to an additional 60,000 customers annually.
- Information has been published on the IRS Small Business Web Site. This web site, www.biztax.gov, provides information on "Do I Need an Employer Identification Number?" and other pertinent facts for new business customers.

All the changes have been shared with representatives from the Citizen Advocacy Panels (CAP) and with representatives from the American Institute of Certified Public Accountants (AICPA).

IRS is also working toward a future goal of making it possible for taxpayers to obtain EINs on-line, thereby eliminating any delay in the process.

INFORMATION TECHNOLOGY IMPACT

Significant Information Technology improvements are currently in process:

- We have established a toll free (1-800) number for use beginning in January 2002. This has required significant change to our national telephone system.
- IRS is acquiring a Fax File Server System to be installed in the Brookhaven Center TeleTIN operation. This will allow the IRS to receive maximum volumes of faxes. Currently, customers receive busy signals while attempting to fax in requests.
- IRS will acquire additional Fax File Server Systems as the need arises. It is anticipated that the other improvements scheduled for January will negate the need for any additional systems.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Taxpayer Advocate Service has received numerous complaints of delays and inconsistencies in the Employer Identification Number assignment process. Congressional representatives, Citizen Advocacy Panel members, tax preparers and taxpayers have all raised concerns.

We were pleased when IRS apprised us of its intent to form an Employment Improvement Team to address inconsistencies and delays. TAS supports this initiative and designated an analyst to serve as a team member. We are encouraged by the processing changes the team has already put in place. The IRS has taken a step to lessen the burden on taxpayers by preparing the necessary forms for those who request EINs by phone.

TAS will continue to work with IRS on this issue. We will monitor changes and assess progress as EIN operations are consolidated into three sites and a new toll-free number is established for taxpayers to use when requesting these numbers.

PROBLEM

TOPIC #15 MISAPPLIED PAYMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Unidentified taxpayer payments are misapplied or are not credited to the correct accounts.

ANALYSIS OF PROBLEM

In FY 2000 the IRS received 38,000 payments, including cash, money orders and checks, without sufficient information to determine the taxpayer's identity or the tax period to which the funds were meant to apply.

Taxpayers sometimes send payments with no Social Security Numbers, Employer Identification Numbers, and/or tax period data, making it difficult for IRS employees to credit the payments to the right taxpayer accounts. Another complication is the need to quickly process and deposit these payments in the bank, usually by the next business day, to minimize loss of interest to the government. The IRS cannot always determine where to correctly apply the credit during this short time. Payments are moved to Excess Collections Accounts when they cannot be associated with a specific taxpayer's account.

IRS COMMENTS

Payments received that do not have sufficient information to apply to a particular account have decreased in recent years and represent a very small percentage of the 226 million payments the IRS receives a year but still present a challenge for the IRS to resolve. Despite IRS messages to taxpayers, some taxpayers do not provide the IRS with enough information to associate payments with a particular account. If a payment cannot be associated, the funds are credited to an "Excess Collections" account until they can be associated properly.

New computer applications implemented this fiscal year and some specific projects have resolved some of these discrepancies. The IRS has also implemented revised procedures that will protect the taxpayer payments or credits for a period of time.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has made a number of procedural changes:

- Procedures have been implemented to keep unidentified credits on Masterfile for accounts that require a return to be filed. The account will remain open during the statutory period for making a refund claim so the IRS may eventually resolve placement of the unidentified payment.
- Notices are now being generated and mailed to taxpayers every six months as a reminder that IRS has credit(s) available and that a return must be filed to receive the credit. One final notice generates to the taxpayer prior to the expiration of the statute of limitations period for a refund claim to alert them that the statute expiration date is imminent and action is needed.
- Programming changes were made that identify balance due notices that have credits for the same tax periods in Excess Collections. This allows credits to be reapplied to the taxpayers accounts and the notices to be destroyed or reissued with correct balances.

In addition, two aggressive "clean-ups" were performed on the credits in Excess Collections which resulted in a total of $58.2 million dollars being reapplied to taxpayers' accounts. The remaining credits in Excess Collections are being periodically reviewed for possible application.

A multi-faceted strategy is being developed to encourage the use of the Electronic Federal Tax Payment System (EFTPS) On-Line. Use of this method of payment would resolve many of the problems listed for taxpayers with a bank account. Encompassed within the strategy are a number of initiatives designed to provide information to tax professionals and taxpayers who have payment responsibilities beyond those of payment at the time of filing a return.

INFORMATION TECHNOLOGY IMPACT

Currently, the Masterfile and the Excess Collections Accounts File are two separate systems with no linkage between the two. This prevents the automatic matching of credits in Excess Collections to a taxpayer's accounts. It also does not provide for automatic moving of credits in or out of Excess Collection. Information on the linking limitations has been provided to the Customer Account Data Engine (CADE) team so that the issue may be addressed.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud steps taken by the IRS to apply credits to taxpayer accounts from Excess Collections. Two new notices, one to remind taxpayers of amounts not credited to them and the second to help avoid loss of potential refunds when the statutory period is about to expire, are also positive achievements.

We also believe that it should become a standard IRS business practice in the near future to send a notice to the taxpayer showing each payment the IRS receives. While current computer systems do not allow IRS to routinely acknowledge receipt of taxpayer correspondence or payments, this business requirement is included in the IRS modernization blueprint. This will allow taxpayers to become aware of discrepancies in their payment records sooner, so that timely corrections can be made to their accounts, thereby helping to avoid their payments being transferred to the Excess Collection Account file.

Continued support of the IRS' information systems modernization efforts is essential to resolve this problem. Information technology system upgrades that will further reduce payment problems include linking the Masterfile and Excess Collection Account file to automate the application of credits to taxpayer accounts.

PROBLEM

TOPIC #16 LACK OF ACCESS TO FREE TAX PREPARATION FOR LOW-INCOME TAXPAYERS

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Rather than seek free assistance from the IRS, the majority of low-income taxpayers pay preparers to complete and file their returns.

ANALYSIS OF PROBLEM

Very few low-income taxpayers owe federal income tax but must still file returns to receive their excess withholding and refundable Earned Income Tax Credit. While IRS walk-in offices provide help in preparing returns, and low-income taxpayers usually meet the criteria for this service, the offices are not always conveniently located for these customers. IRS hours of operation may also limit access to assistance.

The IRS sponsors the Volunteer Income Tax Assistance program, which offers free tax preparation; again, however, volunteer sites are not necessarily located in areas where low-income taxpayers live or work.

IRS COMMENTS

The needs of low-income taxpayers pose a special challenge to the IRS. Very few owe tax and need to file only the simplest of tax forms to claim a refund. However, the Earned Income Tax Credit adds a factor that many may consider too complex to calculate themselves. Heavy advertising by the preparer community encourages this and the promise of a quick "refund" that is really a refund anticipation loan. The IRS is focusing on helping this taxpayer group primarily through our Volunteer Income Tax Assistance (VITA) Program and the establishment of additional IRS tax assistance centers around the country that can offer need based tax preparation services.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS plans to open 118 new tax assistance centers within the next seven to eight years (absent budget constraints). The majority of these sites will offer return preparation services. Where possible, traditional "brick-and-mortar" sites will be located on public transportation routes. Approximately 18 sites will be non-traditional mobile vans that will provide assistance at various locations throughout the filing season. The overall goal of this effort is to have 85 percent of all taxpayers within a 45-minute commute of an IRS Taxpayer Assistance Center.

To ensure that IRS can focus its tax preparation services on low-income taxpayers, IRS has made a number of changes for the 2002 Filing Season:

- It will take appointments for tax preparation up to three days in advance.
- It has changed the threshold for need-based return preparation from $41,000 to $33,000. This will reduce the overall number of taxpayers who qualify for free return preparation but will reduce wait times and focus assistance on the lower income taxpayer. The amount of $33,000 is tied to the income phase-out of EITC.

A number of tax practitioners also offer free tax return preparation and electronic filing when income criterion is met. Continuous coordination among all IRS functions aids in referral of taxpayers to volunteer sites where free return preparation services, including free electronic filing, are offered.

For fiscal year 2002, the goal is to also increase Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites to more than 18,000 nationwide. IRS has also focused on delivering expanded return preparation services (including e-file) through key community based, corporate, and service organization partnerships. A few successful examples include our ongoing cooperative efforts with American Association of Retired Persons (AARP), Kroger Stores, the National League of Cities, National Educational Association, the Cherokee Nation, the Anne E. Casey Foundation, and the Welfare to Work Partnership. Where such partnerships and volunteer efforts are unavailable, such as in remote areas, IRS will continue to use its own resources to educate taxpayers and provide return preparation services.

The IRS also administers the Low-Income Taxpayer Clinic program by annually awarding grants up to $100,000 per clinic. These awards, made since passage of enabling legislation in 1998, provide matching funds for qualified organizations that provide legal assistance to low-income taxpayers in controversies with the IRS and/or inform individuals of their tax rights and responsibilities. The program includes assisting targeted taxpayers in the preparation of their tax returns or other tax forms. The IRS annually awards grants aggregating approximately $10,000,000, with $6,000,000 going to low-income tax clinics and the balance to the Tax Counseling for the Elderly (TCE) program.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS effort to increase access to free tax preparation for low-income taxpayers is important, as these taxpayers are least able to effectively handle the complexities of income taxes due to the burdens of poverty, language and illiteracy.

We are pleased that the IRS recognizes that low-income taxpayers present a special challenge to the organization. Poverty, language and literacy barriers, as well as the constant changes in tax law pro-

visions such as those covering the Earned Income Tax Credit, contribute to the ever-increasing challenge of preparing what is considered by most tax experts to be a "simple return." The very real possibility of an IRS compliance audit (due to the IRS initiatives to reduce Earned Income Tax Credit fraud) places even heavier burdens on these taxpayers.

We support the IRS initiative to focus on helping this taxpayer group. The Volunteer Income Tax Assistance Program, corporate and service organization partnerships, and additional IRS tax assistance centers around the country can offer need-based tax preparation services.

Despite the IRS-sponsored tax preparation programs and service at its walk-in offices, data indicates that only a small fraction of low-income taxpayers use these services. For example, according to 1998 filing year data, 17 million return filers had incomes below the poverty threshold, yet volunteers prepared only 113,000 returns.[14]

As noted above, the IRS goal for fiscal year 2002 is to raise the number of Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites to more than 18,000 nationwide. The IRS' long-range plan to open 118 new tax assistance centers is also commendable. However, we are concerned because this initiative may take as long as seven to eight years and could be hampered by budget constraints.

We suggest the IRS consider establishing National Filing Days, similar to National Problem Solving Days, early in the filing season. The National Filing Days could be held at public schools or houses of worship in low-income communities, be staffed by volunteers, and offer on-site electronic return submission and direct deposit accounts. Regardless of the approach, it is important to make free tax return preparation available to low-income taxpayers where they live and work.

14 Tax year 1998, Compliance Research Information Systems (CRIS), IFM 2000.

PROBLEM

TOPIC #17 PROCESSING OFFER IN COMPROMISE (OIC) APPLICATIONS

IRS RESPONSIBLE OFFICIAL

Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Taxpayers experience delays in receiving determinations on their Offer in Compromise (OIC) applications.

ANALYSIS OF PROBLEM

Over the past several years, the number of Offer in Compromise applications has risen tremendously, due to the following factors:

- The IRS made a strong effort to improve service by changing the criteria for a processable offer. Instead of rejecting as "unprocessable" any imperfectly completed application, the IRS began contacting taxpayers to advise them how to make corrections and submit a processable offer. The IRS automatically rejects initial offer applications when the taxpayer is not in compliance (e.g., has not filed tax returns) or has filed for bankruptcy. The IRS expanded the criteria for rejecting offers on August 29, 2001, to include offers that were filed solely to delay collection[15], failure to make required estimated tax payments or failure to provide requested financial information.
- An installment agreement cannot be entered into unless the agreement provides for full payment of the liability (over the life of the statute of limitations for collection, with one five-year extension). As a result, the IRS must ask taxpayers who are unable to pay the tax in full – but may be able to pay part of the amount due – to submit deferred payment offers. Many taxpayers object to following the more cumbersome deferred payment offer process when they are willing to pay the maximum that they can afford.
- There is an absence of agreement or understanding of the purpose of the program.

To reduce the backlog, the IRS has significantly increased the resources committed to the Offer in Compromise program. A recent General Accounting Office (GAO) study found the total direct time charged to the program rose 77 percent, from 350 full-time equivalents (FTE) in fiscal 1997 to 619 FTE in fiscal 2000. Between fiscal years 2000 and 2001, the resource commitment rose a dramatic 94 percent to 1200 FTEs. While the IRS has put more effort into the OIC program, the number of offers received has skyrocketed.

[15] Solely to delay collection includes re-submission after prior reject or return, resubmission after prior default or prior collection determination and offer submitted to avoid a specific enforcement action. In all situations stated above the taxpayer's financial situation has not materially changed and the new offer is substantially the same as the prior one. Further, no special circumstance exists.

Although the IRS suspends collection action against taxpayers while their offers are evaluated, the taxpayers are naturally anxious and want prompt answers.

The inventory backlogs create additional work. By the time an OIC specialist receives an offer, the information may be outdated, requiring extra work for both the IRS and the taxpayer. Other delays take place because the Service requires the taxpayer to submit information that could be secured by using internal information or credit bureau reports, which would make the process less burdensome for the taxpayer and more uniform for the IRS.

IRS COMMENTS

The growth in Offers in Compromise has caused processing delays. Receipts have grown dramatically compared to FY 97 levels. After the passage of the Internal Revenue Restructuring and Reform Act of 1998, there was an increased popularity of Offer in Compromise as a viable method for resolving tax debts. Many practitioners have increased advertising of Offers in Compromise to attract potential business as a method to resolve tax debts.

Some concerns about the Offer in Compromise program do currently exist:

- IRS human resources could not keep pace with the growth in customer demand for Offer in Compromise. Approximately 1,000 Offer in Compromise Specialists and 200 Tax Examiners were devoted to the program in FY 2001. Because program emphasis changed to encourage perfection of offers that were technically incomplete rather than returning them to the taxpayer, ending inventories rose dramatically.
- While practitioners respect the IRS' commitment to resolve pending offers within six months, there are some concerns that deadlines given to taxpayers for submitting supporting financial information may be too short. Taxpayers may simply be unable to provide requested financial information timely. Practitioners feel, however, that with continued training and experience, the IRS will develop more realistic timeframes for requesting information and how to improvise when requested information is not available.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has spent the better part of FY 2001 exploring ways to reduce the Offer in Compromise backlog. It has adopted an inventory reduction strategy that involves centralizing the process in the Service Centers and training groups of employees whose primary responsibilities are to respond to the requests.

Process Improvements

- Service Centers have been receiving all new offer submissions from taxpayers for initial processing since August 2001. In many cases, these offers will be worked to conclusion in these locations. The work done in the campuses will significantly reduce the time frame to respond to the taxpayer's request and make a determination regarding the Offer in Compromise. The consolidation into the campuses brought additional staff to bear on new work while existing field staff will continue to focus on the back logs in the field locations.
- Counsel review requirements were reduced.

Policy and Procedural Changes

- Expanded Offer in Compromise return procedures will reduce the number of "frivolous" offers submitted.
- IRS will return those offers:
  - that are submitted solely to delay collection,
  - where estimated income tax payments are due and not paid, and
  - re-submitted after rejection or default that are not materially different from the prior offer.
- Approvals for certain OIC actions have been delegated to lower levels in the organization to help speed processing without sacrificing quality.

Legislative & Regulatory

- Legislation is being considered to amend IRC §6159 to allow for installment agreements that may not fully pay the liability. This may reduce the number of Offers in Compromise.

TAXPAYER ADVOCATE SERVICE COMMENTS

The attention the IRS has given to improving the processing of offers is to be commended. The dramatic increase in the number of offers submitted after Congress expanded the program in the Restructuring and Reform Act of 1998 caused a sudden backlog. The IRS is making some meaningful changes that should reduce the Offer in Compromise inventory.

The backlog should be lessened by the strategy of separating offers by complexity to better utilize the skills of offer specialists and allow relatively simple offers to be handled by a trained group of employees at two centralized sites. Policy and procedural changes to reduce the number of frivolous offers should also decrease the inventory. As IRS becomes more current with OIC inventory, the need for taxpayers to resubmit outdated financial information should also diminish.

One of the National Taxpayer Advocate's legislative recommendations involves amending Internal Revenue Code section 6159 to allow long-term installment agreements instead of deferred offers. This change, if adopted, would give taxpayers another way to address their tax debts, thereby helping to reduce the number of offers filed.

PROBLEM

TOPIC #18 COMPUTING THE ALTERNATIVE MINIMUM TAX (AMT)

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The Alternative Minimum Tax is difficult for taxpayers to compute.

ANALYSIS OF PROBLEM

Some taxpayers must compute their income taxes twice: first to determine their basic tax liability and then to compute alternative minimum tax (AMT) liability. The process of figuring the AMT includes reading ten pages of instructions, and preparing and performing calculations on several worksheets and forms. Taxpayers complete a 13-line worksheet to determine if they must file the 50-line form (Form 6251, Alternative Minimum Tax-Individuals) for computing the alternative minimum tax. They may in fact owe little or no AMT, but will not know this until after they complete the complex Form 6251. Taxpayers filed 124 million individual tax returns in 1998. Of that total, 6.4 million returns required computation of Form 6251; however 4.4 million actually filed the form. More than 3.4 million of these taxpayers included Form 6251 just to demonstrate that they did not owe AMT.[16]

IRS COMMENTS

IRS agrees that this is an extremely complex and difficult computation. However, until the underlying complex tax law is revised, taxpayers will continue to have problems computing Alternative Minimum Tax.

To limit the number of taxpayers subject to the complex computations of the AMT, practitioners have recommended that Congress continue to permit taxpayers to count nonrefundable tax credits against alternative minimum tax. The Economic Growth and Tax Relief Reconciliation Act of 2001 has already permanently extended the child tax credit and adoption tax credit against AMT liability. Some practitioners believe similar treatment needs to be permanently allowed for the remaining nonrefundable credits, which include credits for education and dependent care costs. The American Institute of Certified Public Accountants (AICPA) noted that it takes only one credit to force someone from the regular tax into the AMT and that the popular education credits could be the triggering issue. Without an extension of the credits against AMT, some middle-class taxpayers would suddenly find themselves subject to the Alternative Minimum Tax. The

[16] Tax Year 1998 Compliance Research Information System (CRIS), Model IMF 2001.

AICPA also noted that many middle-class taxpayers find themselves subject to AMT because legislation has never indexed rate brackets and personal exemptions for inflation under AMT as it has done for regular income taxes.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has worked to reduce the complexity of Form 6251 and its instructions. This form is available to assist taxpayers with the Alternative Minimum Tax computation. For tax year 2001, the Form 1040 line 41 will be in bold print to direct tax filers to appropriate instructions.

There are also high quality commercial-off-the-shelf (COTS) products that automatically generate the AMT computation. IRS has coordinated with these product developers and has tested their products to ensure each all the legislative requirements have been updated. These products contain necessary worksheets for filers to determine if AMT computations are applicable.

TAXPAYER ADVOCATE SERVICE COMMENTS

The number of taxpayers affected by Alternative Minimum Tax is rising, partly because the tax structure is not indexed to account for inflation. Congress enacted the first minimum tax in 1969 after it was revealed that 155 Americans with adjusted gross incomes of over $200,000 paid no federal income tax at all. Today, the AMT has a much greater impact. A recent study published by the Joint Committee on Taxation projects that the number of taxpayers affected by AMT is expected to increase significantly over the next 10 years, from approximately 1.4 million to approximately 35.5 million.[17]

Due to the complexity of Alternative Minimum Tax provisions, many taxpayers are unaware that they need to complete the calculation. Those who do realize they must go through this process are frequently forced to seek professional help because the calculations are so complex. According to IRS records, during the1999 filing year paid preparers completed 93 percent of all returns with AMT.

We recognize that IRS faces challenges in administering these provisions. Some taxpayers' calculations of the tax can be verified by IRS computers, while more complicated computations must be verified by office or field audits. The IRS examiners themselves consistently rank AMT as one of the most complex provisions they encounter.

We agree that excellent commercial tax preparation software is available to ease the burden of computing the AMT. However, not all taxpayers are able to use this method. Further, all software requires the taxpayer to complete additional worksheets.

[17] U.S. Congress, Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1836}, (JCX-51-01) p. 8, May 2001.

We understand that IRS has made minor changes to the Alternative Minimum Tax forms and instructions for the upcoming filing season. We concur with IRS that tax law must also change to reduce the complexity of the calculations, which in turn may enable IRS to further improve the forms and instructions. The National Taxpayer Advocate has included a proposal on this issue in the Legislative Recommendations section of this report.

PROBLEM

TOPIC #19 DETERMINATION AND NOTIFICATION OF REVISED TAX LIABILITY

IRS RESPONSIBLE OFFICIALS

John Dalrymple - Commissioner, Wage & Investment Division
Joseph Kehoe – Commissioner, Small Business/ Self Employed Division

DEFINITION OF PROBLEM

Delays in assessing additional tax increase the amount of penalties and interest charged to taxpayers.

ANALYSIS OF PROBLEM

Under the IRS Restructuring & Reform Act of 1998, interest and penalty on a deficiency are suspended unless the IRS notifies taxpayers of the proposed amount of increase to their tax liability and the basis for the increase within 18 months (12 months as of 2003) of the due date, or the date the return is filed. Interest and penalty resume 21 days after the IRS provides notice to the taxpayer. However, due to staffing and other workload priorities, it takes much longer to complete an examination after the initial IRS contact. Interest continues to accrue during these delays, causing increased costs to taxpayers.

Because of these long delays, taxpayers (especially self-employed ones) have trouble substantiating the items questioned because documentation may have been misplaced. It is difficult and can be expensive to retrieve copies of bank records that are sent to microfilm after one year; businesses may have closed or the records may no longer be available.

IRS COMMENTS

Two most significant program areas impacted by these new requirements are the general examination program and the Document Matching Program or Automated Underreporter (AUR). While Automated Underreporter (AUR) meets the 18-month contact timeframe on 98 percent of cases, the general examination program requires additional focus and staffing to accomplish the goal. We acknowledge that delays create additional interest and penalty assessments and can contribute to difficulties in obtaining records. For the Automated Underreporter Program, FY 2001 statistics through June 30 show that 48.4 percent of cases are closed in less than six months and an additional 50.4 percent are closed in less than 12 months with only 1.2 percent open beyond 12 months.

IRS INITIATIVES TO RESOLVE PROBLEM

To further ensure that the timeframes will be met in the Automated Underreporter matching program, IRS has scheduled the program to begin four weeks earlier in FY 2003. This effort will reduce the time between taxpayer filing and Automated Underreporter contact. Analysis of historical data and filing requirements has led to plans to explore earlier income matching and case selection/contact for those information return types (Forms W-2, 1099s, etc) with January 31 reporting deadlines. This initiative will help maintain a standardized weekly notice volume (rather than starting with small notice volumes and building to large ones) and level response receipts.

The timeliness of the general examination program is being addressed through the hiring and training of new field and office examiners and a comprehensive re-engineering process. Most of the additional staff has been hired and are currently in training. The re-engineering process is a three-phase effort and is in its second phase. IRS expects a report on the re-engineering process in late spring 2002 with implementation of its recommendations to follow.

TAXPAYER ADVOCATE SERVICE COMMENTS

The time between initiation and completion of an examination of a tax return has been too long for many taxpayers. Although most of the Automated Underreporter cases are closed within a reasonable time frame, this is not the case for the field examination program. The delay in resolving an examination causes unnecessary frustration and anxiety to the affected taxpayers.

We are pleased that the IRS is hiring and training new field and office examiners to improve the timeliness of the general examination program. We support the IRS re-engineering project to design a more efficient and fair audit process and enhance compliance. We also recognize IRS' need for continued financial support for these additional examination resources. We look forward to reading the IRS report and the accompanying recommendations.

PROBLEM

TOPIC #20 COST OF ELECTRONIC FILING FOR LOW-INCOME TAXPAYERS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Fees for return preparation can be excessive when electronic filing and refund anticipation loans are included.

ANALYSIS OF PROBLEM

The majority of low-income taxpayers file returns to obtain their excess withholding or Earned Income Tax Credit (EITC). Most of these people have pressing financial hardships and need their available funds as soon as possible.

While all low-income taxpayers have the option of filing paper returns, these take longer to process (usually four to six weeks). The expected refund processing time for electronically filed returns is substantially shorter: a taxpayer choosing direct deposit can receive a refund in as little as ten days.

However, many low-income taxpayers have no bank accounts and must pay third parties to obtain a direct deposit. These taxpayers may not be computer literate, may have no access to personal computers or may be unable to file electronically from their homes. Some IRS offices provide electronic filing but the service is not always available in areas that are convenient for low-income taxpayers. IRS hours of operation sometimes limit access to this service as well. IRS-sponsored Volunteer Income Tax Assistance sites may not have the proper computers for electronic filing.

IRS COMMENTS

IRS does not play a role in setting fees for preparation of electronic tax returns or refund anticipation loans but encourages practitioners to assist low-income taxpayers by providing free or reduced tax preparation fees. IRS has established regulations stating that preparers are not allowed to set their fees based on the amount of refund or income. In tax year 2000, many preparers had programs for low-income taxpayers. These included many H&R Block locations and Intuit among others. Many tax preparers offer free electronic filing along with return preparation.

IRS estimates that up to 20 percent of taxpayers do not have bank accounts. Most preparers offer a viable solution to the taxpayers who need money quickly but it is not free. Part of the fee paid by taxpayers for tax return preparation may include a fee for establishing a bank account to receive the anticipated refund.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS is focusing on three solutions.

First, the establishment of more volunteer preparation sites as discussed in Problem # 16. This will give taxpayers an alternative to using a paid preparer. For fiscal year 2002 the goal is to increase Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites to over 18,000 nationwide. Last year, some offices experienced a shortage of computers and the "Tax Wise" software needed to assist taxpayers with filing tax returns electronically. Hardware and software has been purchased so that the field assistance function will be fully operational for 2002.

Another solution is the use of the Advanced Earned Income Tax Credit. Taxpayers who qualify to receive EITC may choose to get part of the EITC through their paycheck and would not have to rely on a refund anticipation loan or quick refund for the money. Using Form W-5 they can get these monies as part of the Advance EITC (AEITC) program. Subsequently, adjustments are made to an employee's withholding to allow the employee to receive the refund over a series of paychecks. Because many taxpayers treat EITC as a savings mechanism, rather than receive the benefit throughout the year, the vast majority does not choose Advance Earned Income Tax Credit. IRS has been proactive working with employers and preparers to promote Advanced Earned Income Tax Credit to qualified EITC recipients. This has been done through the Small Business Tax Workshops, Corporate Partnership, and e-file/EITC seminars. Advanced Earned Income Tax Credit is also promoted through the Welfare-to-Work Program.

The third solution is for IRS to reach more taxpayers directly. IRS has made a number of changes for the 2002 Filing Season:

- It will take appointments for tax preparation up to three days in advance
- It has changed the threshold for need-based return preparation from $41,000 to $33,000. This will reduce the overall number of taxpayers who qualify for free return preparation but will reduce wait times and focus assistance on low-income taxpayer. The amount of $33,000 is tied to the income phase out of EITC.
- A number of tax practitioners also offer free tax return preparation and electronic filing when income criterion is met. Continuous coordination among all IRS functions aids in referral of taxpayers to volunteer sites where free return preparation services, including courtesy electronic filing, are offered. Congress has increased IRS' appropriation to assist the elderly in filing returns electronically.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Earned Income Tax Credit was intended to provide a benefit to working low-income taxpayers. Many of these taxpayers incur a substantial cost in order to receive the government benefit.

A large number of low-income taxpayers need assistance in preparing their return because of the complexities of determining filing status, and entitlement to dependency exemptions and EITC. Because of the lack of access to free tax preparation, many low-income taxpayers turn to paid preparers for assistance.[18]

Many taxpayers claiming EITC incur a substantial cost to file electronically because they need their refunds as soon as possible, often for basic living expenses. In 1999, for those taxpayers who claimed EITC, 10.2 million, or 53 percent, filed electronically.[19] *These taxpayers may be charged one fee for return preparation, another for electronic return submission and a third fee for a refund anticipation loan (RAL) if they need their money immediately.*

The refund anticipation loan fee is often for establishment of a bank account for deposit of the refund. The average tax preparation fee is about $85; the electronic filing fee averages $40; and the fee for the refund anticipation loan ranges from $60 to $85; therefore the total cost to file an EITC return electronically can exceed $150. Even the most basic return preparation fee is rarely less than $50.[20] *The EITC filers most harmed by the amount of money they pay to file a simple return are those filing only to receive their EITC entitlement. 2.8 million taxpayers with average adjusted gross incomes of less than $7,000, and who used paid preparers, received an average EITC refund of $1,129 in 1999.*[21]

The Department of the Treasury has designed a special low-cost direct deposit account, the Electronic Transfer Account. An Electronic Transfer Account is available to all federal benefit recipients, even those who have had problems obtaining credit or qualifying for a checking or savings account.[22] *These deposit accounts can receive direct deposits of tax refunds. We recommend that IRS publicize the availability of an Electronic Transfer Account as an option for taxpayers paying a preparer to establish a direct deposit account for them.*

18 See Most Serious Problem Number 16, "Lack of Access to Free Tax Preparation for Low-Income Taxpayers" for further discussion of this issue.

19 Tax Year 1999 data, Compliance Research Information System (CRIS), Model IFM 2001

20 2001 Tax Notes Today 5-106

21 Tax Year 1999 data, Compliance Research Information System, (CRIS) Model IFM 2001

22 Direct Deposit News Alert, update Oct. 25, 2001

The IRS is developing and testing improvements which should enable taxpayers to receive a deposit of their refunds within two to three days of final return processing. We are hopeful that these initiatives will remove most of the demand for refund anticipation loans. However, we are concerned that commercial return preparers may increase return preparation and electronic filing fees, to recover lost revenue as the demand for RALs diminishes.

We are pleased by the planned IRS initiatives to provide additional sites for free tax preparation services for taxpayers. We understand that lowering the threshold for need-based assistance may reduce wait times and focus assistance on low-income taxpayers. This does raise a concern that other taxpayers in need of assistance may not receive the customer service that IRS has been fostering. We hope that the added sites will allow IRS to accommodate all taxpayer groups successfully.

We have doubt about the effectiveness of using the Advanced Earned Income Tax Credit (AEITC) to help solve the problem of cost of electronic filing for low-income taxpayers. In tax year 1999, of over 19 million EITC claimants, only 126,860 taxpayers, or less than one percent, received AEITC.[23] *The program is not popular with taxpayers or employers.*

The Taxpayer Advocate Service recognizes the importance of electronic tax administration. We realize the many benefits to the IRS and to taxpayers when returns are filed electronically. We want low-income taxpayers to be able to realize these benefits without incurring disproportionate electronic filing fees. We are mindful of Congress' direction that IRS not interfere with the free operation of the market for income tax preparation. Although we do not believe the IRS should enter the tax return preparation business, we do feel oversight is needed to ensure affordable electronic filing for low-income taxpayers.

23 Tax year 1999 data, Compliance Research Information System (CRIS), Model IFM 2001

PROBLEM

TOPIC #21 AUTOMATED UNDERREPORTER (AUR) TAX ASSESSMENTS

IRS RESPONSIBLE OFFICIAL

John Dalrymple - Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The high volume of AUR tax assessments that are later abated places an unnecessary burden on taxpayers.

ANALYSIS OF PROBLEM

The IRS's AUR program creates assessments that are later abated for some taxpayers. Once the assessment is made, the taxpayer's only recourse is to contest it and go through a complicated, time-consuming reconsideration process for abatement of additional liability.

A Treasury Inspector General for Tax Administration (TIGTA) study found a significant portion of audit reconsideration abatements in FY 1999 were related to prior AUR assessments. According to TIGTA sources, 35,000 or approximately 33 percent of a total of 106,000 reconsideration abatement cases were AUR cases.[24]

IRS COMMENTS

There are two primary reasons that give rise to tax assessments that might be eventually abated. The first is when the taxpayer has ignored IRS correspondence and then raises concerns when the collection process begins. The second is when the IRS has sent correspondence and notices to an old address and the correspondence does not reach the taxpayer. A new program has been implemented that enables the IRS to access the U.S. Postal Service's National Change of Address (NCOA) database. This allows IRS to get the latest available address for a taxpayer who has moved and notified the Postal Service. This will reduce the number of notices not reaching the taxpayer. However, it is outside of IRS' control on how taxpayers choose to interact with IRS.

The issue raised in the Treasury Inspector General for Tax Administration Report should be put into perspective of the entire Automated Underreporter Program. The 35,000 abatements may represent 33 percent of the audit reconsideration inventory reviewed but only 2.7 percent of the 1.3 million assessments made annually through the AUR program. With the advent of the National Change of Address program, IRS hopes to reduce these numbers further.

24 TIGTA Report, No. 2001-40-053, March 2001

TAXPAYER ADVOCATE SERVICE COMMENTS

Automated Underreporter program assessments are responsible for a large volume of time-consuming administrative work, as well as legal proceedings. The issue of "Unreported or Underreported Income" ranks first among the ten most litigated tax issues of fiscal year 2001, which are detailed on page 239 of this report. In these litigated cases, individual taxpayers generally challenged interest, dividends, and non-employee compensation reported under their taxpayer identification numbers by third parties. The document matching or Automated Underreporter (AUR) program normally handles these items.

Joseph Kehoe, Commissioner, Small Business/Self Employed, responded to the above mentioned Treasury Inspector General for Tax Administration report [25] by stating that IRS did not capture all reconsideration cases in its management information reports, therefore, "the true volume of reconsideration cases was not readily apparent to IRS." IRS worked with the Office of Revenue Analysis to develop a report that will include all reconsideration cases, regardless of which IRS function processes them. TIGTA recommended that this report also identify whether a case is closed with or without an abatement of tax. Such a report will aid in determining what actions are needed to reduce the volume of future AUR reconsideration cases.

Although the percentage of Automated Underreporter abatements compared to assessments may not be an important factor for IRS, this issue continues to be a major source of taxpayer contacts with TAS. The IRS' lack of contact with the affected taxpayers and taxpayers' failure to respond to the AUR program seem to be the main reasons for inappropriate assessments. The Taxpayer Advocate Service inventory of these cases grows in relation to the number of AUR cases the IRS closes. In fiscal year 2002, IRS plans to close over 3.3 million income reporting discrepancy cases, which would represent a 16 percent increase over fiscal year 2001. We expect a corresponding increase in the volume of taxpayers contacting TAS for assistance with AUR cases.

[25] TIGTA Report, 2001-40-053, March 2001

PROBLEM

TOPIC #22 STATUS OF INNOCENT SPOUSE CLAIMS

IRS RESPONSIBLE OFFICIALS

John Dalrymple - Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Taxpayers seeking relief from tax liability under the Innocent Spouse provisions are unable to determine the status of their requests.

ANALYSIS OF PROBLEM

Due to the large influx of cases and changes in the program brought about by RRA 98, the Restructuring and Reform Act of 1998, processing timeframes are not always met. According to IRM 104.5. Exam Relief From Joint and Several Liability, Chapter 7, Customer Service Guidelines, a taxpayer should be contacted within 30 days of receipt of the innocent spouse request. If a determination cannot be reached in this time, a letter (2645C) should be sent advising the taxpayer that he or she will be contacted within the next 90 days.

Taxpayers expect innocent spouse claims to be handled expeditiously, when in fact the steps required by law add 165 days to the process even in optimal situations. Taxpayers need to be educated about the steps and timeframes required to process their Forms 8857, Request for Innocent Spouse Relief. Taxpayers should also be kept informed of the progress of their claims.

IRS COMMENTS

Innocent Spouse Claim processing is complicated, requiring letters to be sent to the requesting spouse and the non-requesting spouse. IRS has procedures in place to send these letters within the first thirty days and has revised the letters to reflect the time period that may be involved in processing the claim through closure. IRS has also implemented procedures that call for additional letters, advising the taxpayer of the status of the case, to be sent to the taxpayers every 90 days until the request is closed.

IRS INITIATIVES TO RESOLVE THE PROBLEM

In addition to revising its correspondence, IRS has taken a number of other steps to publicize Innocent Spouse Relief and improve the overall processing of claims.

To better educate taxpayers and practitioners about the program's criteria, IRS has focused on:

- Pre-filing of innocent spouse claims
  IRS encourages taxpayers to use the Innocent Spouse Tax Relief Eligibility Explorer, which is an interactive computer-based program. This application will enable a taxpayer to determine if they meet the basic requirements necessary to qualify for relief. It also directs them to the injured spouse publication if that provision is applicable.
- Revision of applicable forms and publications
  All the major publications now include information on Innocent Spouse Relief. Many of the publications and forms are available in Spanish. An interactive questionnaire is being developed that will have questions designed to help taxpayers file valid and complete claims. The questionnaire will be posted on the IRS Website.
- Customer outreach
  IRS continues to make presentations at practitioner and public forums such as those held by the American University, American Bar Association, the Community Tax Law Project, and Tax Talk Today. IRS has also published articles for the Family Law Forum and the Quarterly Newsletter of Minnesota Bar Association Family Law Section.

IRS has taken the following steps to expedite processing of the claims:

- IRS has established a Centralized Unit in one location to process claims.
- Staffing increases, a revised management and staffing structure and additional training and workshops for examiners at the Centralized Unit. In FY 2001, the staffing at the Centralized Unit in FY 2001 increased by 45 percent from the prior fiscal year, from 107 to 155 employees.
- The first phase of a computer-based case processing innocent spouse application was provided to examiners at the Centralized Unit. This application embeds the algorithm for working an innocent spouse case that leads the examiner through the complex decision-making process and provides expert knowledge to enhance that process.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS on the numerous positive steps it has taken to improve innocent spouse claim processing. Particularly noteworthy are the IRS' accomplishments in strengthening communication with taxpayers. The IRS has expanded its outreach activities, enhanced training, and increased the number of employees reviewing and providing responses on innocent spouse claims.

We are beginning to see decreased innocent spouse case receipts in the Taxpayer Advocate Service (TAS), based in part on IRS' recently revised procedures for keeping taxpayers apprised of the status of their claims.

The Taxpayer Advocate Service continues to work with the Innocent Spouse project office to improve the innocent spouse claim process. This year we identified and developed legislative proposals to further assist taxpayers seeking innocent spouse relief. The National Taxpayer Advocate is proposing a legislative recommendation to clarify criteria for Innocent Spouse relief, which appears in the Key Recommendations section of this report.

PROBLEM

TOPIC #23 DELAY IN RECEIVING REQUESTED DOCUMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple - Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Requests for copies of tax returns or assessment documents are not processed within the 60-day timeframe.

ANALYSIS OF PROBLEM

Taxpayers do not always receive timely, complete responses to requests for copies of returns or other materials. These requests require the IRS to locate the files among millions of paper documents. The IRS must coordinate with Federal Record Centers and National Archives and Retrieval Administration (NARA) to find returns filed more than three years prior to the request. Misfiled documents can be impossible to retrieve and quality checks to prevent misfiling are limited. The IRS refunded the following copying fees to taxpayers after failing to secure copies of returns: $2,642,996 for FY 1999 and $2,564,888 for FY2000.

The timeframe for securing copies of prior year tax returns is lengthy. Taxpayers often have to wait much longer than 60 days to receive the documents requested. This delay can cause significant hardship for taxpayers who need copies of returns for a court proceeding or loan approval.

Administrative files or assessment documents are also required for audit reconsideration and offer in compromise (doubt as to liability) cases. Delay in finding these documents slows the resolution of these cases.

IRS COMMENTS

This issue must be put into perspective. IRS processes and files more than 218 million multiple page tax returns a year. IRS retrieves and refiles tax returns to accomplish a number of responsibilities in such programs as its document matching or Underreporter program, examinations, Earned Income Tax Credit, math errors or perfecting claims for refund. Returns move in and out of IRS Service Centers and Federal Records Centers. IRS does find that there are times when it can not locate a return promptly.

The traditional process for a request is that a taxpayer will ask for a copy of his or her return or return information via telephone or a written request. If the taxpayer's request is

over the telephone, the Customer Service Representative will offer other options such as a copy of the taxpayer's account information that IRS will provide to the taxpayer at no cost. Account transcripts are normally acceptable in lieu of a copy of the tax return to meet the requirements for mortgages, student loans, and other bank loans. If the taxpayer's request is in writing (Form 4506, Request for Copy or Transcript of Tax Form), IRS will first search local files. If it is not in the Center, the request is forwarded to National Archives and Records Administration (NARA). NARA has five days to find the return. If NARA's staff cannot locate the return, we would offer the taxpayer his or her account information and refund the taxpayer's copy fee.

Given the variety of ways that a request may be received, the alternatives in filling the requests and the fact that the underlying need is usually met, IRS has not kept detailed records as to why it refunds monies to taxpayers asking for copies of their returns.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS will assemble a study group comprised of IRS personnel, representatives from the National Taxpayer Advocate Service and National Archives and Records Administration to explore ways to improve the tracking and availability of returns as they are retrieved and refiled.

TAXPAYER ADVOCATE SERVICE COMMENTS

Although IRS handles more than 218 million multi-page returns a year and provides retrieval and re-filing support to several IRS programs, taxpayers still require help from the Taxpayer Advocate Service to obtain copies of returns or other information.

TAS welcomes the opportunity to participate in a study group to improve the tracking, retrieving and re-filing of tax returns. One option we would like to evaluate is using the National Archives and Retrieval Administration's (NARA) Centers Information Processing Systems (CIPS) to request returns.

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INTRODUCTION

Section 7803(c)(B)(VIII) of the Internal Revenue Code requires the National Taxpayer Advocate to include in her Annual Report to Congress legislative recommendations that might mitigate taxpayer problems. This year, we are presenting three categories of legislative recommendations – key, additional, and potential. I submit these proposals because we in the Taxpayer Advocate Service believe that they will reduce or eliminate some of the difficulties, complexities, and unintended consequences a taxpayer encounters when attempting to comply with the federal tax laws.

In developing the recommendations, we requested and received information and data from both internal and external sources. Internal sources include the Taxpayer Advocate Service, IRS Operating Divisions and Functional Units, and the Office of Chief Counsel. Among the external sources are various national tax professional associations, the Citizen Advocacy Panels, low-income taxpayer clinics and other members of the tax practitioner community.

The first category of legislative recommendations is titled Key Recommendations, and it outlines proposals to change six areas of tax law. For each key recommendation, we present a summary page, in which we identify a specific problem and include at least one example to illustrate the operation of that problem. A more detailed discussion follows, in which we describe the present law and our reasons for proposing the change, including where available an analysis of the proposal's impact on taxpayer and IRS administrative burden.

Following the Key Recommendations are eight Additional Issues. This section presents proposals that we feel are significant but merit additional consideration and development. Each Additional Issues proposal includes a problem statement, an example of the problem, and a recommendation. We expect that in the coming year we will further develop these proposals; some of them may become key recommendations in next year's Annual Report.

The third and final category contains legislative issues that are under consideration for further research and inquiry. We identified many of these issues as a result of conversations with sources both internal and external to the IRS. We hope that their inclusion in the Annual Report, on an "issue identification" basis, will direct attention to these issues and prompt our internal and external partners to provide examples and suggestions to resolve these problems. The issues are titled Potential Legislative Issues and are included in Appendix B of this report.

Taken as a whole, these legislative recommendations represent proposals that we believe will either reduce the complexity of the Code, reduce taxpayer burden in complying with tax requirements, or reduce the Service's burden in administering the tax system and/or monitoring compliance. Many of them relate directly to the top problems experienced by taxpayers and the most litigated issues described in other sections of this Report.

Several of the Key Recommendations – those proposing a uniform definition of a qualifying child and the alternative minimum tax reforms – beg to be enacted immediately. Many aspects of these two proposals are not new. Others have proposed them before us. But I believe that by including them so prominently in this Report, we can highlight the absolutely critical and essential need for reform.

Too many taxpayers are impacted by the problems underlying the following recommendations, and the IRS expends too much in the way of resources to ensure compliance, for Congress not to act. We submit these proposals with the hope that Congress will find them helpful as it continues to address the complexity of the Internal Revenue Code and our system of tax administration.

1 FAMILY STATUS ISSUES

INTRODUCTION

One of the very first questions each individual taxpayer must answer before beginning to compute taxable income is the nature and size of his or her "taxable unit." Every individual taxpayer must determine his or her filing status – single, head of household, married filing jointly, or married filing separately – as well as the number of personal and dependency exemptions he or she can claim. From these basic determinations flow numerous tax consequences, including the determination of the appropriate tax rate schedule, eligibility for the child, earned income, and dependent care credits, the taxation of social security benefits, and the imposition of joint and several liability for tax debts attributable to one's spouse.

These basic questions arise in that gray area where a taxpayer's definition of a family intersects with the tax code and where state domestic relations jurisdiction collides with federal taxing authority. For a vast majority of individual taxpayers, particularly ones with children, this area of tax law is simply too complicated for them to navigate without making inadvertent errors. The experience of confusion and consequent error for taxpayers at their entry point into the tax system undermines their whole confidence in the system.

The key legislative changes that I am recommending in the following pages will:

- Create a Uniform Definition of a Qualifying Child
- Remove Means-Tested Public Assistance and Other Government Benefits in the Computation of Support
- Require a "Voluntary" Release of Exemptions by Custodial Parents
- Eliminate the Age Restrictions for Taxpayers Claiming Earned Income Tax Credit With No Qualifying Child
- Expand the Definition of Head of Household Filing Status

I believe that these proposals are fundamental to achieving the goal of a fairly administered tax system. Perpetuation of the current provisions imposes a burden on taxpayers and the IRS alike and increases the likelihood of taxpayer disaffection. It is possible to achieve "family status issues" simplification so that the tax code comports with the common sense expectations of United States taxpayers without sacrificing the integrity of the tax system.

DID YOU KNOW?

- Out of the 7.6 million error notices sent to taxpayers in 1999, 1.35 million (17 percent) concern the basic issues of Filing Status and Dependency Exemptions.
- Another 2.1 million (28 percent) math error notices were sent concerning issues which key from Filing Status and Dependency Exemptions. They are Earned Income Tax Credit (EITC), Child Tax Credit and Child and Dependent Care Credit.
- Publications, forms, instructions and schedules that apply to child-related provisions number about 202 pages for the preparation of a 2000 tax return.
- 416,000 taxpayer refunds were held in tax year 2000 due to EITC issues and 389,000 were issued deficiency notices.
- Filing Status, EITC and Dependency Exemptions Laws were the 4th most litigated of all issues in 2000.
- In 1997, Congress authorized the IRS to spend $716 million over a 5-year period for the improved administration of the EITC. In the final year, 2002, $146 million has been allotted.
- The IRS EITC Program Office uses 8 Full-Time Equivalents (FTEs) annually to administer and monitor the EITC appropriation.
- During FY 2001, the IRS allotted 1,212 FTEs to Service Centers to examine EITC tax returns selected from the Dependent Database. These FTEs do not include those needed for Information Systems programming and support.

FAMILY STATUS ISSUES

UNIFORM DEFINITION OF A QUALIFYING CHILD

SUMMARY

PROBLEM

Under present law, approximately 44 million taxpayers will claim a dependency exemption for a child in tax year 2001. From these dependency exemptions flow additional tax consequences: 19 million returns will claim the earned income credit, six million returns will claim the child and dependent care credit, 26 million returns will claim the child tax credit, and 18 million returns will claim head of household filing status.[1]

There are three Internal Revenue Code provisions that are central to the determination of a taxpayer's family status for tax purposes – the personal and dependency exemptions, head of household status, and the definition of "not married" under IRC § 7703(b). Three other provisions bestow significant tax benefits on taxpayers with children – the earned income tax credit, the child tax credit, and the child and dependent care credit.

Each of the six provisions requires a taxpayer to satisfy different eligibility criteria. A child who qualifies the taxpayer for one provision does not automatically qualify the taxpayer for the others. Taxpayers find this confusing and frustrating. Publications, forms, instructions and schedules that are applicable to child-related provisions number about 202 pages[2], for the preparation of an individual income tax return. Because these provisions address the most basic and personal human relationships – the family unit – the issue touches the lives of millions of Americans each year.

Adopting one uniform definition of a qualifying child would reduce complexity and burden in an important and fundamental way for a large segment of taxpayers.

EXAMPLE

Mary and her 10-year-old son Sam lived together for the entire year. In order to claim a dependency exemption for Sam on her 2000 income tax return, Mary must prove she paid over one half of his support. To claim Head of Household filing status, Mary must show that she paid more than half the cost of maintaining their home. The support and maintenance of household tests are similar, but not identical. For earned income tax credit purposes, Mary needs to show that Sam resided with her in the United States for more than half the year.

[1] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01) April 2001, at Vol. I, page 11.

[2] Tax preparation reading materials for child-related provisions include: Form 1040 Instructions, Publications: 17, 501, 503, 504, 552, 596. Forms: 2120, 2441 with Instructions, 8332, 8812,and Schedule EIC with Instructions. Additional related pages from 1040/1040A Instruction Booklet are not included in this count.

In order to prove support to claim the dependency exemption, Mary must show proof of payment of over one half of receipts that include over one half of the expenses pertaining to Sam including:

- rent
- utilities
- food
- medical expenses
- dental expenses
- education
- clothing

If Mary meets the support test for Sam, she will also be eligible for the child tax credit, the child and dependent care credit, and various education credits,[3] if she meets additional eligibility requirements.

To meet the maintenance of household test for Head of Household filing status, Mary must provide proof of payment of over one half of the expenses pertaining to the "household" including:

- rent
- utilities
- food
- mortgage interest expenses
- property upkeep and repairs
- property taxes
- property insurance

Mary may have to furnish an entirely different set of records to prove residency to claim Sam as a qualifying child for EITC. Proof of residency could include some of the items listed above such as medical or dental receipts showing Sam's name and her home address. However, lacking these records, Mary may provide school records or other official documents showing Sam's name and her address.

Under the recommendation, Mary would be able to claim the dependency exemption, the Head of Household filing status, the earned income tax credit, the child tax credit,

[3] IRC § 25A

and the child and dependent care credit without having to satisfy three different tests and without maintaining three different sets of records. Mary would still have to meet the other statutory tests for each of these tax provisions.

RECOMMENDATION

Modify the following provisions by adopting a uniform concept of a "qualifying child" applicable to biological, step, and adoptive children or descendants for purposes of:

- The Dependency Exemption (IRC § 151 (a) and (c); IRC § 152)
- Head of Household Filing Status (IRC § 2(b))
- The Definition of "Not Married" (IRC § 7703(b))
- The Earned Income Tax Credit (EITC) (IRC § 32)
- The Child Tax Credit (IRC § 24)
- The Child and Dependent Care Credit (IRC § 21)

This would require a qualifying child to meet identical Relationship, Age and Principal Place of Abode tests. Under this uniform definition, a child would be a qualifying child of the taxpayer if the child has lived with the taxpayer for more than one half of the tax year. The term "qualifying child" will be clearly defined as a person with a specific relationship to the taxpayer and less than a specific age.

Modifications include:

- Eliminate the Dependency Exemption support test with regard to a qualifying child.[4]
- Eliminate the age restriction for disabled children.
- Eliminate the "cost of maintaining a household" test for Head of Household status, including IRC § 7703(b) provision, with regard to a qualifying child.
- Extend the revised EITC tie-breaker rules for qualifying children to all provisions using the "qualifying child" test. [5]

4 Any modification to Dependency Exemptions (IRC § 151 & IRC § 152) will also affect Child Tax Credit (§ 24), Child and Dependent Care Credit (IRC § 21) and Hope and Lifetime Learning Credits (IRC § 25A) referenced as "Education Credits".

5 Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 § 303(f) amended to read: (c) two or more claiming qualifying child – (i) In general. – Except as provided in clause (ii), if (but for this paragraph) an individual may be claimed, and is claimed, as a qualifying child by 2 or more taxpayers for a taxable year beginning in the same calendar year, such an individual shall be treated as the qualifying child of the taxpayer who is (I) a parent of the individual or (II) if (I) does not apply, the taxpayer with the highest adjusted gross income for such a taxable year. (ii) More than one claiming credit. – If the parents claiming the credit with respect to the qualifying child do not file a joint return together, such a child shall be treated as the qualifying child of – (I) the parent with whom the child resided for the longest period of time during the taxable year, or (II) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.

- Expand and conform the definition of "foster child" for all provisions utilizing the "qualifying child" test.
- Accept a governmental agency's award of benefits as evidence of a "foster child" relationship between a caretaker and child who has not been formally placed with the caretaker by a qualified placement agency.

FAMILY STATUS ISSUES

UNIFORM DEFINITION OF A QUALIFYING CHILD

DETAILED EXPLANATION

PRESENT LAW

Three Internal Revenue Code provisions are central to determining a taxpayer's family status for tax purposes – the personal and dependency exemptions,[6] head of household status,[7] and the definition of "not married" under IRC § 7703(b).[8] Three other provisions bestow significant tax benefits on taxpayers with children – the earned income tax credit,[9] the child tax credit,[10] and the child and dependent care credit.[11] "Under present law, it is estimated that for tax year 2001, 44 million returns will claim a dependency exemption for a child, 19 million returns will claim the Earned Income Tax Credit, 6 million returns will claim the child and dependent care credit, 26 million returns will claim the child tax credit, and 18 million returns will claim head of household filing status."[12]

Each of the six provisions requires a taxpayer to satisfy different eligibility criteria. A child who qualifies the taxpayer for one provision does not automatically qualify the taxpayer for the other provisions. Since these provisions address the most basic aspects of a taxpayer's situation – i.e., family status – millions of taxpayers encounter significant complexity at the very beginning of the tax filing process.

Following are brief summaries of the six primary "family status" provisions:[13]

- Dependency Exemptions
- Head of Household Filing Status
- Definition of "Not Married" Under IRC § 7703(b)
- Earned Income Tax Credit
- Child Tax Credit
- Child and Dependent Care Credit.

6 IRC § 151

7 IRC § 2(b)

8 IRC § 7703(b)

9 IRC § 32

10 IRC § 24

11 IRC § 21

12 Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01)*, April 2001, Vol. I, at page 10.

13 Additional family status provisions include IRC § 25A(b) and (c), the Hope and Lifetime Learning Credits.

Dependency exemptions reduce taxable income. For tax year 2001, the dependency exemption amount is $2,900 for each dependent. In 1999, over 45 million returns claimed dependency exemptions (see chart below).

TABLE 2.1.1

	1– SINGLE	3 – MFS WITHOUT SPOUSE EXEMPTION	4 – HEAD OF HOUSEHOLD	5 – WIDOW(ER) W/ DEPENDENT CHILD	6 – MFS W/SPOUSE EXEMPTION	TOTAL
Exemptions, Children Away From Home	379,110	28,978	77,849			843,706
Exemptions, Children at Home	1,248,168	556,103	14,247,963	82,757	12,827	42,361,488
Exemptions, Other Dependents	277,449	18,015	1,801,040	2,075		2,603,472
Total for all filing statuses claiming dependent exemptions						**45,808,666**

Five tests determine eligibility for claiming a dependency exemption: relationship or member of household; citizen, national, or resident; joint return; gross income; and support:

- The individual must have a specific familial relationship with the taxpayer or, for the entire tax year, the individual must have been a member of the taxpayer's household and must have lived in the taxpayer's home as his or her principal place of abode[14].
- The individual must be either a U.S. citizen, national, or resident of the U.S., Canada, or Mexico[15].
- The individual generally cannot have filed a joint tax return for the tax year in question even if the other dependency tests are met.[16]
- The individual must have gross income of less than the exemption amount[17] ($2900 for 2001) unless he or she is a child of the taxpayer who is under the age of 19 (24 if a full-time student[18]).

14 IRC § 152(a)

15 IRC § 152(b)

16 IRC § 151(c) Exception: if a joint return is filed by the dependent and his or her spouse merely as a claim for refund and no tax liability would exist for either spouse on separate returns.

17 IRC § 151(c)(1)(A).

18 IRC § 151(c)(1)(B), A student must be a either a full-time student at a school that has a regular teaching staff, course of study and regular student body, or a student taking a full-time on-farm training course by a state, county, or local government, during some part of each of any 5 calendar months (not necessarily consecutive) of the calendar year.

- The taxpayer must have generally provided over half of the individual's total support.[19]

Internal Revenue Code section 152(e) addresses the case of a child of divorced or legally separated parents or the case of a child whose parents live apart at all times during the last six months of the calendar year. In these situations, the parent having custody of the child for the greater portion of the year receives the exemption if the child receives over half his support for the calendar year from his parents and is in the custody of one or both for over half the year.[20] The parent who is entitled to the dependency exemption under IRC §152(e) may release the exemption to the noncustodial parent according to procedures established by the Secretary of the Treasury[21]. An additional National Taxpayer Advocate family status recommendation addresses issues related to the voluntary release of the dependency exemption under IRC § 152(e).

Additional rules apply when no taxpayer provides more than half of a person's support.[22] If two or more taxpayers, each of whom meet all the exemption tests except for the support test, together provide over half the person's support, only one eligible taxpayer can claim the exemption, and he/she must contribute over 10 percent of the person's support. All others contributing more than 10 percent of the person's support must sign a written statement agreeing not to claim the exemption for that year. Form 2120, Multiple Support Declaration, is used for this purpose.

Head of Household filing status is generally for unmarried individuals who pay over half the cost of keeping up a home for a qualifying person. Certain married individuals who lived apart from their spouse for the last six months of the tax year may also be able to use this status.[23] About 16 million returns selected the Head of Household (HOH) filing status for 1999 (HOH status claiming children away from home 77,849; HOH status claiming children at home 14,247,963; and HOH status claiming other dependents 1,801,040).[24]

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19 IRC § 152(a) - The amount the taxpayer contributed to the person's support must be compared with the entire amount of support the person received from all sources, including support the person provided from his or her own funds. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. Generally, the amount of an item of support is the amount of the expense incurred in providing that item. Expenses not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. Benefits provided by the state to a needy person generally are considered to be used for support.

20 IRC § 152(e)(1)

21 IRC § 152 (e)(2)

22 IRC § 152(c)

23 IRC § 7703(b)

24 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

Filing status is used to determine filing requirements, standard deduction and correct tax. It is also used to determine eligibility for certain other deductions and credits. Head of household filing status usually results in a lower rate of tax than for the single status or married filing separately, and provides a larger standard deduction than either single or married filing separately status (see chart below for a comparison).

TABLE 2.1.2

TAX YEAR 2001 RATES BY FILING STATUS AND INCOME BRACKET

	SINGLE	MARRIED FILING SEPARATELY	HEAD OF HOUSEHOLD
Tax Rate	**Of Taxable Income Up To**	**Of Taxable Income Up To**	**Of Taxable Income Up To**
15%	27,050	22,600	36,250
27.5%	65,550	54,625	93,650
30.5%	136,750	83,250	151,650
35.5%	297,350	148,675	297,350
39.1%	Of Taxable Income Over 297,350	Of Taxable Income Over 148,675	Of Taxable Income Over 297,350

To qualify for Head of Household filing status, the taxpayer must be unmarried (or considered unmarried on the last day of the tax year as defined in IRC § 7703), not a surviving spouse,[25] and meet three tests - maintenance of household, principal place of abode, and relationship. These tests are satisfied if:

- The taxpayer maintains a household in which he or she resides (except for temporary absences), by paying more than half the cost of keeping up the home for the tax year.
- The home is the principal place of abode for a qualifying individual.
- The qualifying individual is the taxpayer's child, stepchild or grandchild who lives with him or her for more than one-half the tax year (except for temporary absences, such as school). However, if his or her child, stepchild or grandchild is married at the end of the tax year, the taxpayer must be entitled to a dependency

[25] IRC § 2(b)(1)

exemption deduction under IRC § 151 or would be entitled to one except for the fact that the exemption is released to the noncustodial parent, or the noncustodial parent is entitled to the exemption under a pre-1985 divorce or separate maintenance decree[26], *or*

The home is the principal place of abode for any other person who is a dependent of the taxpayer, if the taxpayer is entitled to a deduction for the tax year for this person, under IRC § 151.[27]

In addition, the taxpayer is eligible to claim head of household filing status if he or pays more than one half the cost of maintaining a household for the tax year that is the principal place of abode of the father or mother of the taxpayer, as long as the taxpayer is entitled to the dependency exemption deduction for the father or mother under IRC §151.[28] The mother and/or father do not have to reside with the taxpayer.

The definition of "not married" under Internal Revenue Code section 7703(b) significantly impacts the determination of head of household filing status for some taxpayers. Certain married taxpayers living apart from their spouse may be considered unmarried on the last day of the tax year and thus eligible to use the more favorable head of household filing status. To do so, *all* the following tests must be met:

- The taxpayer files a separate return.
- The taxpayer maintains a household in which he or she resides, paying more than half the cost of keeping up the home for the tax year.[29]
- The home is the principal place of abode for his or her child, stepchild or adopted child for more than one-half the tax year (except for temporary absences, such as school), *or*
- The home is the principal place of abode for his other foster child for the entire year.[30]
- The taxpayer may claim a dependency exemption for his or her child under IRC § 151 or would be entitled to one except for the fact that the exemption is released to the noncustodial parent, or the noncustodial parent is entitled to the exemption under a pre-1985 divorce or separate maintenance decree.[31]
- The taxpayer's spouse did not live in this home during the last six months of the tax year.[32]

26 IRC § 2(b)(1)(A)(i).
27 IRC § 2(b)(1)(A)(ii).
28 IRC § 2(b)(1)(B).
29 IRC § 7703(b)
30 IRC § 7703(b)(1).
31 IRC § 7703(b)(1).
32 IRC § 7703(b)(3).

The **Earned Income Tax Credit**[33] is a refundable tax credit enacted in 1975[34] with the goal of providing relief to the working poor from social security taxes[35] and to create a greater work incentive for low-income families.[36]

In 1997, the Earned Income Tax Credit (EITC) reduced the number of children living in poverty by 2.2 million.[37] Since 1975, the laws and administration of this credit have grown increasingly complex (from a single line on the tax return for the EITC to a publication and schedule devoted solely to EITC instructions and computations). The dollars involved have also increased significantly (amount of this credit has expanded from a maximum amount of $400 in 1975 to $3,888 in 2000).

Taxpayers can qualify for the credit in two ways, "child-related" or "income-only." About 19.4 million taxpayers claimed $30.6 billion in EITC on 1998 tax returns (approximately 16.1 million claimed "child-related" EITC and 3.3 million claimed "income-only" EITC).[38] Under the qualifying child(ren)[39] rules, the qualifying child MUST have a valid social security number (SSN) and meet three tests for determining eligibility for the Earned Income Tax Credit: relationship, age, and principal place of abode:

- The qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or eligible foster child. (The child does not have to be the taxpayer's dependent unless he or she is married.)
  - An *eligible foster child* for purposes of EITC is a child the taxpayer cared for as his or her own child; who lived with the taxpayer for the entire tax year[40] (except for temporary absences); *and* is the taxpayer's brother/stepbrother, sister/stepsister, stepchild, niece or nephew, or was placed by an authorized placement agency.

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33 IRC § 32

34 Tax Reduction Act of 1975; Public Law 94-12; (H.R. 2166); Title II Sec 204, Reductions in Individual Income Taxes, March 29, 1975. During this period in history, the United States Economy experienced its sharpest decline since the 1930's. As the economy situation deteriorated, unemployment rates rose – from 5.2 percent in January 1974 to 8.2 percent in February 1975, which was the highest since 1941. Senate Report No. 94-36; 1st Session; H.R. 2166; March 17, 1975; II – Reasons for the Bill; Tax Reduction Act of 1975.

35 The Earned Income Tax Credit was to provide relief to workers with dependent children who pay little or no income taxes but were subject to the social security payroll tax on their earnings. Because it would increase their after-tax earnings, the credit, in effect, was anticipated to provide an added bonus or incentive for low income people to work, and therefore, of importance in inducing individuals with families receiving Federal assistance to support themselves. It was also expected to be effective in stimulating the economy because the low-income people were expected to spend a large fraction of their increased disposable incomes. Senate Report No. 94-36; 1st Session; H.R. 2166, March 17, 1975; II – Reasons for the Bill – Earned Income Tax Credit; Tax Reduction Act of 1975.

36 "The Tax Reduction Act of 1975 takes prompt and effective action to check the drastic downward slide in our economy and to restore economic growth and move us closer to full employment." House of Representatives Report No. 94-19; 94th Congress, 1st Session; H.R. 2166; February 25, 1975; II – Reasons for the Bill; Tax Reduction Act of 1975.

37 Good News for Low Income Families: Expansions in the Earned Income Tax Credit and the Minimum Wage, The Council of Economic Advisers, December 1998.

38 Improvements Are Needed in the Earned Income Tax Credit Recertification Program, TIGTA Report Reference Number: 2001-40-030; December 2000; Background page 6

39 IRC § 32(c)(3).

40 Requirement will change to more than one-half year effective after December 31, 2001; Public Law 107-16, § 303(e)(1).

- The qualifying child must be under the age of 19 at the end of the tax year, or a full-time student under the age of 24 at the end of the tax year, or permanently and totally disabled at any time during the tax year, regardless of age.
- The child must have lived with the taxpayer in the United States for more than half of the tax year (all of the tax year if an eligible foster child[41])
- A home can be any location where a taxpayer regularly lives within one of the 50 states or the District of Columbia.
- Military personnel (for purposes of EITC) who are stationed outside the United States on extended active duty are considered to live in the United States during that duty period.

The **child tax credit** reduces the tax liability of families with children, over and above the deduction for the dependency exemption. In 1999, nearly 24.6 million taxpayers claimed $18.4 billion attributable to the basic child tax credit.[42] When first enacted, this credit was refundable only for families with three or more qualifying children, but the Economic Growth and Tax Relief Reconciliation Act of 2001 makes this credit refundable for all families.[43] To claim the credit, taxpayers must meet relationship, age, dependency exemption, and citizen, national or U.S. resident tests.[44]

- The qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild or eligible foster child.
  - An eligible foster child is: a child the taxpayer cared for as his or her own child; who lived with the taxpayer for the whole year[45] (except for temporary absences); *and* is the taxpayer's brother/stepbrother, sister/stepsister, a descendent of the individual's brother/stepbrother or sister/stepsister, or a child placed by an authorized placement agency.
  - The child must be under the age of 17 at the end of the calendar year in which the taxable year of the taxpayer begins.
- The taxpayer must be allowed a dependency exemption for the child (under IRC § 151).
- The child must be a citizen or resident of the United States.

41 Requirement changes to more than "one-half of such taxable year" effective after December 31, 2001, P.L. 107-16, Sec 303.

42 Tax Year 1999, Individual Returns Transaction File.

43 Economic Growth and Tax Relief Reconciliation Act of 2001; Public Law 107-16, Title II, Sec 201 – Tax Benefits Relating to Children – Modifications to Child Tax Credit (effective for taxable years beginning after December 31, 2000).

44 IRC § 24(c)

45 Requirement will change to more than one-half year effective after December 31, 2001; Public Law 107-16, § 303(e)(1).

The **child and dependent care credit**[46] can offset both regular tax and alternative minimum tax.[47] This credit is based on a percent of work related expenses paid to someone (who is not claimed as a dependent by the taxpayer) to care for a dependent. In 1999, 5.8 million taxpayers claimed this credit.[48] Tests for this credit *with regard to a child* include: qualifying individual, age limit, and dependency exemption.

- **A qualifying individual is either:**
  - any disabled person not able to care for him or herself whom the taxpayer can claim as a dependent (or could claim as a dependent except that person had gross income of $2,800 or more),
  - a dependent child who is under the age of 13 at any time during the tax year,
  - a dependent child regardless of age who is totally and permanently disabled.
- An exception to the dependency rule[49] exists for children of divorced or legally separated parents (or if the taxpayer and spouse lived apart during the last six months of the tax year). Where the custodial parent releases the dependency exemption to the non-custodial parent, the child can still be treated as the qualifying individual of the custodial parent. To meet this exception, the child may be a qualifying individual for the custodial parent only if all five of the following conditions apply:
  - The child resided with the taxpayer for a longer period of time during the tax year, *and*,
  - One or both parents provided over half of the child's support for the tax year, *and*,
  - One or both of the parents had custody of the child for more than half of the tax year, *and*,
  - The child was under age 13 or disabled and unable to care for himself or herself, *and*,
  - The noncustodial parent claims the child as a dependent under IRC § 152(e)(2) (custodial parent releases claim to exemption for the tax year,) or IRC § 152(e)(4) (exception for certain pre-1985 instruments).

46 IRC § 21

47 A "special rule for 2000 and 2001" prevented this credit from being limited by AMT. This provision (Ticket to Work and Work Incentives Improvement Act of 1999, Public Law 106-170, H. R. 1180, signed 12/17/1999) expires Dec. 31, 2001. H. R. 3090 has been introduced Oct. 11, 2001 to allow an extension of this nonrefundable credit against regular and minimum tax liability. As of Nov. 14, 2001, it is still under consideration.

48 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

49 IRC § 21(e)(5).

FAMILY STATUS ISSUES

REASONS FOR CHANGE

The definition of the taxable unit is fundamental to the United States tax system. The family status provisions discussed here either define the taxable unit or provide benefits based on a definition of the taxable unit. Thus, family status issues must be resolved before a taxpayer can determine his or her correct amount of tax for any given tax year. These basic provisions – several of which constitute the taxpayer's earliest entries on the tax form[50] – involve different tests and measure different variables, all to determine who should claim tax benefits relating to the family. This complexity is reflected in the high examination and error rates for returns on which the Earned Income Tax Credit is claimed, and for the large number of returns involving duplicate dependency exemptions and Head of Household status claims.[51]

The IRS held 415,793 refunds for EITC[52] issues in tax year 2000. The IRS also sent 389,541 deficiency notices that were either agreed upon or later assessed,[53] and issued approximately 17,300 EITC deficiency notices involving accuracy-related penalties.[54] IRS adjusted three million accounts due to family status issues (dependency exemption, filing status, EITC, Child Tax Credit and Child and Dependent Care Credit) under math error notice authority[55] in fiscal year 2000.

The consequences of "getting it wrong" with respect to these basic provisions are compounded by the fact that so many other tax provisions key off the determination of dependent and filing status.[56] Personal and dependency exemptions rank third on the Taxpayer Advocate Service list of the ten issues most litigated by taxpayers, discussed in Appendix C of this report. No fewer than four separate EITC issues appear on our list of the most serious problems facing taxpayers (page 7).

50 Form 1040 and 1040A, page 1 lines 1 – 5 are Filing Status and line 6 is Exemptions.

51 Taxpayer returns claiming EITC with a dependent go through computer validity checks during initial processing. These checks verify against information contained on a database reported from the Office of Child Support Enforcement, the states and the Social Security Administration.

52 Information from Report 1 – Exam Section Service Center Inventory – dated 05-25-01 Total number projected 470,160. May report was last date W&I and SBSE combined data available.

53 Information provided by the EITC Program Office.

54 Information provided by the EITC Program Office. (Numbers include taxpayers who were assessed fraud/accuracy related penalties under IRC §§ 6662 and 6663, imposed as a result of their disqualification for the EITC during the 2 or 10-year ban period as provided for under IRC § 32(k)(1)(b). The number of fraud/accuracy related penalties specifically charged for the 2 or 10-year ban are not available.

55 IRC § 6213 grants math error authority. (Fiscal year 2001data not currently available.)

56 A taxpayer disqualified as "not married" under IRC § 7703(b) not only loses a larger standard deduction, but also eligibility for the earned income tax credit. (IRC § 35(5)(d) Married individuals)

There have been many attempts to simplify the rules and definitions related to family status issues. Most recently, the Economic Growth and Tax Relief Reconciliation Act of 2001[57] adopted helpful changes. However, much more can be done to simplify this area of the tax law. Both the Joint Committee on Taxation and the leading tax professional associations have recommended adopting a uniform definition of "qualifying child" for various family status provisions.[58]

The use of different tests in determining eligibility for the various provisions with regard to the same child causes confusion to the taxpayer, unintentional but critical errors on tax returns and, ultimately either high noncompliance or the failure to make legitimate credit claims. Current application of the age test for various benefits for the same child illustrates the potential for confusion; the child tax credit age limit test is under seventeen years of age; the dependency exemption and earned income tax credit age limit is under the age of nineteen or under age twenty-four if a full-time student; and the age limit test for the child and dependent care credit is under the age of thirteen.

Complex considerations and calculations are required for the taxpayer to determine eligibility under the various provisions. These complexities contribute to a high error rate. For example, the current dependency exemption "support" test requires the completion of a 22-line worksheet, and the reading of five pages of instructions.[59] The worksheet directs the taxpayer to compute:

- Total income of the person being supported (including taxable and nontaxable income received, amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year);
  - Total household expenses (including rent, food, utilities, repairs);
  - Total such income and expenses for the dependent claimed (each person's part of the household expenses, clothing, education, medical and dental expenses);
  - Amount the person provided for own support;
  - Amount others provided for the person's support, and amount taxpayer provided for the person's support; and
  - Amount the taxpayer provided for the person's support (must be more than 50 percent of the total in order to meet the test).

57 Economic Growth and Tax Relief Reconciliation Act of 2001; Public Law 107-16 § 303 (b) EITC to include only amounts includible in gross income, (d) replace MAGI with AGI, (e) outlines the relationship test, and (f) explains 2 or more claiming the qualifying child.

58 Joint Committee on Taxation, Study of Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01), April 2001; American Bar Association, American Institute of Certified Public Accountants Tax Division and the Tax Executives Institute; American Bar Association Section of Taxation, Government Submissions, ONLINE. Available: http://www.abanet.org/tax/pubpolicy/2001/01simple/home.html. [12 Dec. 2001]; American Bar Association Section of Taxation, Government Submissions. Statement of Richard M. Lipton on the Subject of Tax Simplification. ONLINE. April 26, 2001. Available at http://www.abanet.org/tax/pubpolicy/2001/tes010126simpl/intro.html. [12 Dec. 2001].

59 IRS Publication 17, Your Federal Income Tax, For use in preparing 2000 Returns.

FAMILY STATUS ISSUES

Taxpayers are required to keep records, such as the information used to prepare this worksheet, in case there is a question about an item on the tax return. If the return is examined, taxpayers will be asked to explain the items reported.[60]

To determine if a child qualifies the taxpayer for each benefit, the taxpayer must apply up to five different tests in addition to the other rules required for that specific provision. In order to claim the child tax credit and the dependency exemption for Child A, the taxpayer must provide over one half of the child's support. There is no support test for determining eligibility for the earned income tax credit with regard to Child A. In order to claim the child and dependent care credit for Child A, the taxpayer must provide over half the cost of maintaining the household during the time the expenses are incurred. To claim head of household filing status with Child A as a qualifying child, the taxpayer must pay over half of the cost of maintaining the household for more than half the tax year.

Of the 7.6 million math error notices issued for tax year 1999, approximately 44 percent (or 3 million) contained these five family issues: EITC, Child Tax Credit, Child and Dependent Care Credit, Dependent Exemptions and Head of Household Filing Status.[61] The largest source of taxpayer errors is principally those related to eligibility of qualifying children. These errors are difficult and time-consuming for the IRS to verify.[62] The overwhelming volume and complexity of worksheets, instructions and forms discourage complete and accurate claims by taxpayers. For example, for the 2000 tax return, there are 12 publications, forms, instructions and schedules numbering over 200 pages[63] that apply to child-related provisions, not including Forms 1040/104A instructions.

60 IRC § 6001, Notice or Regulations Requiring Records, Statements, and Special Returns. Recordkeeping requirements are explained in Publication 552, Recordkeeping for Individuals.

61 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

62 The following statistics were included in the Annual report from the Commissioner of the Internal Revenue Service on Tax Law Complexity – June 5, 2000. The Ten Most Frequently Made Math Error Report (1998) listed EITC Figured or Entered Incorrectly as number 1 (9.3 percent) of total errors made, Taxpayer Identification Number or Name for Dependent Exemption Does Not Match as number 2 (8.6 percent), Identifying Number for Dependent Exemption Not Included as number 4 (5.0 percent), EITC Figured Incorrectly due to Excluded Nontaxable Earned Income number 6 (4.2 percent) and Incorrect Filing Status number 9 (2.8 percent). The Ten Most Frequent Adjustments to Taxpayer Accounts report (1995) listed EITC as number 1 or 11.9 percent.

63 Tax preparation reading materials for child-related provisions include Form 1040 Instructions, Publications 17, 501, 503, 504, 552, 596, 929, Forms 2120, 2441, 8332, 8812 and Schedule EITC.

EXPLANATION OF RECOMMENDATION

In order to reduce complexity and burden on both the taxpayer and the IRS, the National Taxpayer Advocate proposes the following revisions to create a uniform definition of "qualifying child" applicable to tax provisions relating to children and family status.

Definitions

A *qualifying child* is generally one who meets the relationship, age, and "principal place of abode" tests described below.

An *eligible individual* is a person with respect to whom a child is a qualifying child (i.e. the child meets the relationship, age, and "principal place of abode" tests). Internal Revenue Code section 32, Earned Income Credit, makes use of the term "eligible individual" to describe the filer of the tax return. However, other Internal Revenue Code sections pertaining to the family status provisions utilize the terms "individual" and "taxpayer" interchangeably. Congress may want to consider conforming these terms in future tax law.

Relationship Test

For purposes of all six family status provisions, define the term "child" as an individual who bears one of the following relationships to the taxpayer:

- a son/daughter or descendent (e.g., grandchild or great-grandchild);
- a stepson/stepdaughter or descendent (e.g., step-grandchild or step great-grandchild);
- an adopted child; or
- an eligible foster child.

Retain the definition of eligible foster child as provided for in current law.[64] An eligible foster child should be further defined as a child:

- who is placed in the home by an authorized placement agency or under a state court decree (including an order of temporary custody); or
- whose caretaker is recognized as the custodian (in a generic sense) of the child by agencies providing benefits such as food stamps or supplemental social security on behalf of that child, eligibility for such benefits having been investigated by a governmental agency (federal, state or local).

64 IRC § 152(b)(2) generally provides that in determining whether any of the relationships (for dependent) exists, a foster child of an individual (if such child satisfies the requirements of subsection § 152(a)(9) with respect to such individual) shall be treated as a child of such individual by blood. IRC § 152(a)(9) states "An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 7703, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household." Exception: The proposal changes the requirement for the qualifying child to reside with the taxpayer for the entire year to one half year.

Each year, foster children are claimed as dependents on a significant number of returns (1,710,828 million in 1999).[65] This proposal will expand the definition of "eligible foster child" as described in IRC § 32 for EITC.[66] The proposal recognizes that many taxpayers care for children in their homes without the formal intervention of a placement agency but with some involvement by state or local agencies that administer benefits for those children. In many instances, the state or local agency has conducted an extensive investigation before awarding benefits. The IRS should be able to rely on the results of such investigations in much the same way it can rely on placement of a child by an "authorized placement agency" under present law.

Age Limit

A qualifying child of the taxpayer should be under age 19 (24 if a full time student), except for purposes of the child and dependent care credit, which limit should remain at age 13. The age restrictions for permanently and totally disabled children of the taxpayer as defined in Internal Revenue Code section 22(e) should be eliminated for purposes of claiming the dependency exemption and the child tax credit, to bring them into conformity with the other family status provisions.

This recommendation increases the age limit for purposes of the child tax credit from age 17 to age 19 (or age 24 for full-time students). The proposal *eliminates* the age restrictions for claiming the child tax credit based on a permanently and totally disabled qualifying child. We estimate that the number of returns claiming the child tax credit may increase by about 351,000 per year.[67] The estimated cost of this increase in the child tax credit age requirement is $433 million annually in credit allowable.[68] Statistics are not available to show how many additional permanently and totally disabled qualifying persons could be claimed as a result of this proposal.

The recommendation does not impact the number of claimants for the dependency exemption and for head of household filing status (including those claiming permanently and totally disabled qualifying persons) because the recommendation merely groups otherwise qualifying persons into "children" and "other than children." As in the recommendation, there is currently no age limit for claiming EITC based on a permanently and totally disabled qualifying child.[69]

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65 Tax Year 1999 Information Returns Transaction File.

66 Effective for tax years beginning after 1999, IRC § 32(c)(3)(B)(iii) defines an eligible foster child as an individual who is the taxpayer's brother, sister, stepbrother, stepsister or a descendant of any such relative; or who is placed with the taxpayer by an authorized placement agency; and the taxpayer cares for as his or her own child; and who lives with the taxpayer for the entire taxable year. Prior tax law did not require the eligible foster child to be related to the taxpayer, however, as with current law, the child must have lived with the taxpayer the entire year. Effective for tax years beginning 1/1/2002, Public Law 107-16, § 303 amends IRC § 32 to require the eligible foster child to reside with the taxpayer for more than one half of the tax year.

67 IRS, W & I, Office of Research Group 3. Data extracted August 2001.

68 Id.

"Principal Place of Abode" Test

For all six family status provisions, a qualifying child should be required to reside with the taxpayer for more than one half of the year in a home within the United States that is the taxpayer's principal place of abode. As currently provided for in the EITC statutes, a member of the Armed Forces shall be treated as having a principal place of abode in the United States for any period of time he/she is stationed outside the United States on extended active duty (Under this section, "extended active duty" means any period in excess of 90 days or for an indefinite period.).[70] Current provisions regarding the child's temporary absences from the home under Treas. Reg. § 1.152-1(b) would also apply.[71] However, the law should make clear that institutionalized care for permanently and totally disabled children will be treated as a temporary absence for purposes of the residency requirement. The National Taxpayer Advocate does not support disqualifying permanently and totally disabled children solely on the basis of their gross income, since their families incur additional costs in obtaining in-home or institutionalized care, and since, if these children's gross income is too high, they lose substantial disability, Medicaid, and vocational and rehabilitation benefits.[72]

Under the proposal, a foster child would also be subject to the six-month residence requirement. This proposal would amend the current law's requirement that the foster child reside with the taxpayer for the entire year.[73] Currently, Public Law 107-16 allows the six-month rule for EITC claimants only, effective for tax years beginning January 1, 2002.

69 IRS, W & I, Office of Research Group 3. Data extracted August 2001.

70 IRC § 32(c)(3)(C) (iii) provides that an individual meets the age requirements of this subparagraph if the individual is permanently and totally disabled

71 IRC § 32(c)(3)(E)

72 Treas. Reg. § 26 Section 1.152-1(b)

73 The Social Security Administration uses a threshold amount to measure whether a disabled person's annual earnings are high enough to replace his/her Supplemental Social Security (SSI) and Medicaid benefits. This threshold differs on a state-by-state basis, but ranges from as little as $14,690 for the State of Arizona to $36,750 for the State of New Hampshire. Social Security Administration, Office of Support Programs, Continued Medicaid Eligibility (Section 1619 (B)). ONLINE. Available: http://www.ssa.gov/work/Resources Toolkit/Health/1619b.html.

This proposal expands the EITC, Head of Household, and IRC § 7703(b) "principal place of abode" tests and applies the expanded test to the dependency exemption, child tax credit, and child and dependent care credits. The proposal retains the current rules permitting a dependency exemption for children residing in Canada, Mexico or contiguous countries.[74] The National Taxpayer Advocate believes that extension of the "contiguous country" rule to the Head of Household or EITC provisions is a tax policy rather than a tax administration decision best left to Congress. However, the National Taxpayer Advocate notes that retaining these rules creates confusion and complexity for taxpayers who can claim a child as a dependent but not for Head of Household or EITC purposes, and she encourages Congress to review this issue.

Tie-Breaker Rule

The proposal retains the revised Earned Income Tax Credit tie-breaker rules and extends their application to each of the other family status provisions for determining eligibility with respect to a "qualifying child."[75] Thus, a parent who is an "eligible individual" with respect to his or her qualifying child "trumps" any other taxpayer who is also an "eligible individual" with respect to that child. For example, where a child, parent, and grandparent share the same principal place of abode, and the child meets the "age" test, the parent will be considered the "eligible individual" for purposes of the family status provisions.

The National Taxpayer Advocate recognizes that the extension of the tie-breaker rule may have adverse consequences for some taxpayers. For example, the grandparent in a multi-generational household may be providing more than half of the support for the grandchild and of the cost of maintaining a home. The tie-breaker rule, on its face, would prevent that grandparent from claiming the tax benefits of the dependency exemption, the head of household status, and the earned income tax credit. The National Taxpayer Advocate recommends that the legislative history to these provisions acknowledge the trade-offs between simplicity and specificity.

74 Treas. Reg. § 1.152-2 provides that to qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico or, for taxable years beginning after December 31, 1971, a national of the United States. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956 when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if he/she otherwise qualifies.

75 Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 [H.R. 1836]; Title III, § 303(f), (effective for taxable years beginning after Dec. 31, 2001) applies the new tie-breaker rule to EITC only. It provides that when two or more taxpayers are otherwise eligible to claim the same qualifying child, the hierarchy of eligible individual is (1) parent of the child, (II) parent with whom the child resided for the longest period of time during the taxable year if a joint return is not filed, (III) parent with the highest adjusted gross income if the child resided with both parents for the same amount of time during the taxable year; (IV) taxpayer with the highest adjusted gross income.

The tie-breaker rule achieves significant simplification, the need for which is evidenced by the substantial resources currently expended in IRS audits and court cases involving this issue. An IRS EITC Compliance study shows that taxpayer returns with qualifying child errors accounted for 65 percent of the $4.4 billion in over-claims. Of this amount, 18 percent or $780 million is associated with errors in applying the "adjusted gross income (AGI) tie-breaker" rule.[76]

Under the proposal, a parent who is an eligible individual and lives in a multigenerational household does not have to claim his or her qualifying child. Instead, a grandparent could claim the child as "other than a qualifying child" (rather than as her grandchild) and would have to meet all the current tests for the dependency exemption and head of household status, respectively. If a parent/eligible individual "opts out" of eligible individual status, the "opt out" is applicable for all six family status tax benefits. This requirement will reduce "gaming" the system and "allocation" of benefits among taxpayers.

In the case of divorced or otherwise separated parents, the parent who has physical custody of the child for the longest period of time during the tax year would receive the tax benefit if otherwise allowable. (See the discussion in the following section about the custodial parent's ability to release the dependency exemption to the noncustodial parent.) When both parents have equal custody of the child and are otherwise eligible individuals, for example, unmarried parents living in the same household, the Taxpayer Advocate believes that the extension of the tie-breaker rule should apply. That is, the tax benefit would go to the parent with the higher adjusted gross income (AGI).[77]

The recommendation does not change the current law requirement that the qualifying child, for purposes of the child and dependent care credit, live with the taxpayer during the time the expenses were incurred. The individual paying the child's expenses would receive the benefit as long as the other tests for the credit are met, including the requirement that the taxpayer be an "eligible individual" with respect to the qualifying child.

76 "Earned Income Tax Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance," General Accounting Office, GAO/GGD-98-150, July 1998.

77 Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 [H.R. 1836]; Title III, § 303(f)

Support and "Cost of Maintaining a Household" Tests

The proposal eliminates the support test required for claiming a "qualifying child" for purposes of the dependency exemption, child tax credit and child and dependent care credit. The recommendation further eliminates the "cost of maintaining a household" test for purposes of claiming the child and dependent care credit, head of household filing status and unmarried status under Internal Revenue Code section 7703(b). Thus, for all six family status provisions, the "principal place of abode" test would replace both the support and "cost of maintaining a household" tests. The "tie-breaker" rule (see above) would apply to this provision.

This provision would simplify procedures for millions of filers. In 1999, 43 million taxpayers claimed dependent children, constituting 94% of all filers who claimed dependents.[78] The 2.6 million filers who claim dependents "other than children" would still be held to the support test. The proposal would greatly reduce the tax preparation burden related to children by eliminating the need for 43 million taxpayers to complete the Worksheet for Determining Support, the worksheet for Cost of Keeping Up a Home, as well as Form 2120, Multiple Support Declaration.

Not everyone would benefit from this effort to simplify the tax law. Taxpayers who pay a substantial amount to support children who do not live with them would still not be able to automatically claim the various family status benefits. For the 1999 tax year, only 843,707 returns claimed "children who did not live with you" as dependents (versus over 42 million returns that claimed "children who lived with you").[79] While the recommendation retains the "custodial" parent's right to release the exemption to the non-custodial parent with a written waiver, the National Taxpayer Advocate is proposing a significant change to that provision under a separate legislative proposal later in this section.[80]

78 A total of 45,808,668 taxpayers claimed dependents including those dependents "other than children" on their 1999 return. Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

79 IRS, W & I, Office of Research Group 3, Data from Compliance Research Information System (CRIS).

80 See Legislative Proposal, Family Status Issue – "Voluntary" Release of Exemption by Custodial Parent in this report.

Where parents separate for less than the last six months of the tax year, the non-custodial parent would lose the option to claim the dependency exemption for the child available under present law if he/she paid more than half of the child's support. For example, a non-custodial father who paid all of the support of the son who continued to live with the mother after their separation in October (three months) of the taxable year (no divorce or legal/written separation agreement) is eligible to claim a dependency exemption for the son under current law for the following reasons:

- Internal Revenue Code section 7703(b) defines "not married" individuals, in addition to other provisions, as those married individuals who during the last six months of the taxable year, "such individual's spouse is not a member of such household."[81] Consequently, if the individuals are separated for *less than* the last six months of the taxable year, they are considered as married.
- The provisions of Internal Revenue Code section 152(e) do not apply to married taxpayers who have not lived apart at all times during the last six months of the year.[82] (This section of the code deems the custodial parent – the mother in the example – to have supplied over half of the support required to claim the dependency exemption for the child.)

Thus, under the provisions of Internal Revenue Code section 152(a) the noncustodial father is eligible to claim the dependency exemption for the child because he paid over half of the child's support.

The recommendation would award the dependency exemption to the parent who had physical custody of the child for the longest period of time during the tax year – in this example, the mother (see Tie-Breaker Rule above). In this instance as well, the custodial parent retains the right to voluntarily release the exemption to the non-custodial parent by executing a written release.

This recommendation would affect a relatively small number of taxpayers. For tax year 1999, approximately 43 million returns were filed claiming dependent children. Of this amount, approximately 29,000 (or .07 percent) returns were filed by taxpayers using the "married filing separate" status and claiming a dependency exemption(s) for children who did not live with them.[83]

81 IRC § 7703(b)(3)

82 IRC § 152(e) provides that in the case of parents who are divorced, legally separated under a decree of divorce or separate maintenance, separated under a written separation agreement or who live apart at all times during the last 6 months of the calendar year, the parent having custody of the child for the greatest portion of the taxable year is deemed to have furnished over half of the child's support during the calendar year, thus meeting the support test to claim the dependency exemption.

83 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

To partially address the negative impact inherent in this recommendation, we are also submitting a separate recommendation that will allow the head of household filing status to noncustodial parents who pay substantially all required child support during the calendar year (see Legislative Recommendations, Family Status Issue - Head of Household).

Gross Income Test

The legislative recommendation proposes a modest change to the current gross income test applicable to the dependency exemption.[84] That is, a child under the age of 19 (24 for full-time students) could be considered a qualifying child regardless of income. This test should be eliminated for permanently and totally disabled children, regardless of their age. Since the recommendation expands the definition of "child," the gross income test would no longer apply to some of the relationships subject to the test under current law, e.g. grandchildren. Under current law, only the son, stepson, daughter, or stepdaughter of the taxpayer is considered as a "child" for the gross income test purposes.

Conclusion

The National Taxpayer Advocate has long supported efforts to consolidate and simplify the rules contained in the tax provisions relating to children and family status. Although there may be a small number of taxpayers who lose benefits as a result of some of the proposed changes, it is the opinion of the National Taxpayer Advocate that the benefits of conforming these rules far outweigh any benefits lost as a result of the modifications. While the National Taxpayer Advocate proposals retain the current (complex) statutory tests for family arrangements not involving children, the National Taxpayer Advocate believes that the proposals achieve simplicity and clarity for the vast majority of taxpayers claiming benefits under these provisions.

Not only will taxpayer burden be significantly reduced if these proposals are adopted, but disputes between taxpayers and with the IRS (including litigation) will drastically decline by clear and consistent rules regarding family status. If these recommendations are enacted along with the other "family status" proposals set forth in this report, a substantial number of taxpayers will no longer face uncertainty and confusion about what are their tax obligations. Further, the provisions are intuitively sound and recognize the diversity of familial arrangements present in the United States today.

84 IRC § 151(c)(1) allows a taxpayer to claim an exemption for a dependent as described in IRC § 152 if the dependents gross income does not exceed the exemption amount. This gross income test does not apply to a "child" of the taxpayer who is under the age of 19 at the close of the calendar year, or a student under the age of 24 at the close of the calendar year.

MEANS-TESTED PUBLIC ASSISTANCE AND OTHER GOVERNMENT BENEFITS

SUMMARY

PROBLEM

Under current law, certain taxpayers cannot claim dependents or use the Head- of-Household filing status because they receive means-tested public assistance such as food stamps and Medicaid, and are required to include the value of these benefits when figuring total support. If the value of these benefits and other third party payments exceeds the amount the taxpayer is providing for support of a dependent or maintenance of the household, the taxpayer cannot claim a dependency exemption or Head of Household filing status, respectively.

EXAMPLE

A taxpayer has two children and earns minimum wage. She works 40 hours each week and earns $10,712 annually. The taxpayer's income is 77 percent of the federal poverty level for a family of three ($13,874).[85] The taxpayer applies her entire paycheck toward her family's basic living expenses, but still requires some public assistance – food stamps, subsidized housing, daycare, and children's health insurance payments – to get by. Because the total value of these means-tested government benefits is greater than the amount the taxpayer pays for support and household maintenance, she is unable to claim her children as dependents or the head of household filing status.

RECOMMENDATION

Amend Internal Revenue Code sections 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.

85 U.S. Census Bureau - Minimum wage rate September 1, 1997 $5.15 per hour yields $10,712 yearly income before taxes. Poverty 2000 - Poverty Thresholds in 2000 by size of family and number of related children under 18 years. The poverty level for a three-person family with two children is $13,874.

MEANS-TESTED PUBLIC ASSISTANCE AND OTHER GOVERNMENT BENEFITS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code sections 151 and 152 provide that a taxpayer is eligible to claim an individual as a dependent if, among other tests, he or she pays over half of that person's total support during the calendar year (support test). Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation and similar necessities.[86]

Internal Revenue Code section 2(b) allows a taxpayer who is unmarried[87] at the close of his or her taxable year to claim Head of Household filing status if during the taxable year the taxpayer, among other tests, paid more than half the cost of keeping up a home in which resides a person with the requisite relationship to the taxpayer (maintenance of household test)[88]. Where the requisite relationship is not present, the taxpayer must also be eligible to claim the individual as a dependent, subject to the support test, in order to claim head-of-household filing status. The cost of maintaining a home includes such expenses as rent, mortgage interest, property taxes, insurance on the home, repairs, utilities, and food.[89]

In determining if the taxpayer provides over half the dependent's support, his or her contributions toward the support of the dependent must be compared to the entire amount of support the dependent receives from all sources. Similarly, the total amount the taxpayer pays toward maintaining a home for the dependent must be more than the amount others pay for the year. Means-tested benefits such as welfare payments, food stamps and subsidized housing, which are used toward the dependent's support or home maintenance costs, are considered to be provided by the government.

REASON FOR CHANGE

Certain low-income taxpayers are not eligible to claim a dependency exemption or head of household filing status. This situation arises when a taxpayer does not provide more than half the support of the dependent nor pay more than half the cost of maintaining a home that was the main home of the dependent because means-tested benefits are included in the total support or maintenance of household determination as required by current law.

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86 Treas.Reg. § 1.152-1 General Definition of Dependent.

87 IRC § 7703 Determination of Marital Status. An "individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married." In addition, certain individuals living apart are considered not married if – 1.) an "individual who is married and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child (within the meaning of § 151(c)(3)) with respect to whom such an individual is entitled to a deduction for the taxable year under § 151 (or would be so entitled but for paragraph (2) or (4) of § 152(e)), Such individual furnishes over one half the cost of maintaining such household during the taxable year, and 3.) during the last 6 months of the taxable year, such individual's spouse is not a member of such household, such individual shall not be considered as married."

88 IRC § 2(b)(1)(a).

89 Treas.Reg. § 1.2-2 Definition and Special Rules.

For example, a custodial mother working for minimum wage must file as married filing separate because her incarcerated husband refuses to cooperate in obtaining a divorce. The taxpayer receives public assistance, including subsidized housing and Temporary Assistance for Needy Families (TANF) under the "workfare" program. Her government-provided assistance equals more than half the cost of keeping up a home for her dependent child, even though the taxpayer's entire paycheck goes toward the family's living expenses. The taxpayer is unable to meet the maintenance of household test, due to the inclusion of the assistance. Thus, the taxpayer is ineligible for head of household filing status, even if she meets all other tests under that provision. Because she does not provide more than half the cost of maintaining her home, she will not be considered "unmarried" under IRC § 7703(b) and must file as married filing separate. Thus, she will also lose the benefit of the earned income tax credit because of her ineligible filing status (married filing separate).

It is not possible to state with finite accuracy the number of persons not claimed as dependents because of receipt of public assistance, nor is it possible to state the number who were incorrectly claimed who received public assistance. However, we used census data to estimate the number of people (adults and children) who could not be claimed as dependents due to public assistance, and the number of individuals who could not claim Head of Household status because they, themselves, received public assistance.[90]

We estimate that approximately 1.4 million adults and children (518,000 children and 882,000 adults, 18 and over) could not be claimed as dependents for calendar year 1999 because of receiving public benefits.[91] Allowing these additional dependent exemption claims would result in a projected cost of about $196 million.[92]

The data also shows that during 1999, there were 282,000 taxpayers that were ineligible to claim the head of household filing status because they received public assistance. The estimated cost of allowing head of household filing status to this group of individuals is negligible.[93]

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90 IRS W & I Office of Research: The poverty level determined by the Bureau of Census for year 2000 was $9,000 for a single person.

91 Id. The estimate of 1.4 million adults and children is derived from the group of 31 million persons who are defined as in poverty, of which 4.4% are below the 50% poverty benchmark (receive less than $4,500 in total income during the tax year) and are far more likely to be in public assistance programs.

92 Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001. Cost estimates for these additional dependents were calculated based on the effective tax rate (tax paid divided by total income) of the filing population split by deciles. The filers of returns projected to be eligible for means tested assistance were prorated among the tax rates for the deciles of Adjusted Gross Income. The cost was then determined by multiplying the reduction in taxable income amount of each eligible return for an additional exemption by the effective tax rate for each adjusted gross income decile. The cost for the projected number of 518,000 children which could be claimed as dependents, in terms of reduced tax, is computed to be zero because the assumption was made that the parents would have to have limited income for their children to receive means tested assistance. In terms of EITC, the additional cost is also computed to be zero because there is no support test for EITC so this group of individuals should already be receiving it.

93 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001. The projected number of filers of returns eligible to claim means tested assistance was computed by determining the number in the lowest 50 percent of poverty level filers, in accordance with family size. The projected cost is negligible because the average tax rate for single, married filing separate, and head of household filers in this category is $0.

FAMILY STATUS ISSUES

EXPLANATION OF RECOMMENDATION

In this report, the National Taxpayer Advocate proposes a legislative recommendation to eliminate the support test requirement for determining if the taxpayer's child will qualify as a dependent, and the household maintenance test when a child qualifies a taxpayer for head of household status.[94] If enacted, the need for this current recommendation for those taxpayers who claim their *children* as dependents will be negated. However, to enable taxpayers who claim "other than children" (in addition to those claiming children under current law) to receive the tax benefits of a dependency exemption deduction or head of household filing status, means-tested public assistance and other government benefits should be excluded from the computation of support and the cost of maintaining the home.

In 1996, Congress enacted the Personal Responsibility and Work Opportunity Relief Act (Public Law 104-193) which replaced the Aid to Families with Dependent Children (AFDC) program with Temporary Assistance for Needy Families (TANF). The underlying goal of this new program is to require individuals receiving welfare to participate in the workforce, to become self-sufficient and independent, and to increase the stability of families.[95] The National Taxpayer Advocate proposal to amend Internal Revenue Code sections 152, 2(b), and 7703(b) to exclude means-tested benefits from their various eligibility tests would bring tax laws pertaining to the determination of family status into conformity with the United States welfare policy.

The National Taxpayer Advocate recommends that Internal Revenue Code sections 152, 2(b), and 7703(b) be amended 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
- Provide that means-tested public benefits are excluded from the cost of maintenance test for the purpose of head-of-household filing status or "not married" status.

94 See Legislative Recommendations, Family Status Issue – Uniform Definition of a Qualifying Child.

95 U.S. Department of Health and Human Services, Office of Child Support Enforcement – The Personal Responsibility and Work Opportunity Reconciliation Act of 1996. (HHS Fact Sheet)

VOLUNTARY RELEASE OF DEPENDENCY EXEMPTION BY CUSTODIAL PARENT

SUMMARY

PROBLEM

Internal Revenue Code section 152(e) establishes specific rules for who, between divorced or otherwise separated parents, may claim a child as a dependent for federal income tax purposes. Generally, if all other conditions of IRC § 152(e)(1) and (2) are met, the taxpayer who has custody of the child for the greater portion of the year is entitled to the dependency exemption. In these situations, the "noncustodial" parent can only claim the dependency exemption if the "custodial" parent signs a written release covering the tax year in question, and the noncustodial parent attaches that release to his or her tax return.

The courts in 35 states have held that they have authority to allocate the dependency exemption between spouses who are before them in a divorce or custody case. Taxpayers who are otherwise entitled to the dependency exemption must chose between claiming their tax benefits under federal tax law and violating a state domestic relations court order.

EXAMPLE

A state court granted a mother custody of her child. At the time of the suit, the mother earned less than the noncustodial father. She satisfied all of the other requirements for claiming the dependency exemption under IRC § 152(e). Against the mother's wishes and over her objections, the judge ordered the dependency exemption to be given to the noncustodial father. The mother cannot claim the dependency exemption without being considered in contempt of the state court order, although she meets all the federal requirements for claiming the exemption on her federal income tax return.

RECOMMENDATION

Amend Internal Revenue Code section 152(e)(2) to clarify that a custodial parent who is eligible to claim the dependency exemption under that section must *voluntarily* sign a written release of the dependency exemption to the noncustodial parent. Further, explicitly state that the dependency exemption cannot be allocated by state domestic relations courts, nor can taxpayers be ordered by such courts to relinquish the dependency exemption absent a voluntary agreement by the custodial parent.

VOLUNTARY RELEASE OF DEPENDENCY EXEMPTION BY CUSTODIAL PARENTS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code section 152(e) contains provisions for claiming a child as a dependent for federal tax purposes in the case of divorced or separated parents. Congress amended IRC § 152(e) in the Deficit Reduction Act of 1984[96] to simplify the rules under which parents determine who is entitled to properly claim the dependency exemption.

Prior to 1984, a noncustodial parent could claim the dependency exemption if a state court order or written agreement between the parties awarded the dependency exemption to the noncustodial parent and the noncustodial parent provided at least $600 in support for the child during the year in question. Alternatively, the noncustodial parent could claim the dependency exemption if he or she provided $1,200 or more in support of each child and the custodial parent did not clearly demonstrate that he or she provided more support for the child or children.[97]

For tax years beginning after December 31, 1984, IRC § 152(e) provides a special rule for parents who are divorced or legally separated, or have lived apart at all times during the last six months of a calendar year. In these situations, the parent having custody of the child for the greater period of time during that year (the "custodial parent") is entitled to the exemption for his or her child if the child is in the custody of one or both parents for more than one-half of the calendar year, and the child receives over half of his or her support during the calendar year from the parents. However, the noncustodial parent[98] can claim the exemption for the child if the custodial parent signs a written declaration that he or she will not claim the child as a dependent for that calendar year.

To claim the dependency exemption, a noncustodial parent must attach to his or her income tax return "a written declaration from the custodial parent stating that he or she will not claim the child as a dependent for the taxable year beginning in such taxable year."[99] The custodial parent may make such a declaration on Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or on a substitute statement that provides substantially the same information as Form 8332. The release may specify that it covers the current tax year, specific years, or all future years.

The provision also permits a non-custodial parent to continue to claim a tax exemption for a dependent child in cases of certain pre-1985 instruments.[100]

96 Public Law 98-369, sec. 423(a), 98 Stat. 799

97 IRC § 152(e)(2), prior to amendment by the Deficit Reduction Act of 1984.

98 The noncustodial parent is the parent who has custody of the child for the shorter part of the year (or not at all). IRC § 152(e)(2).

99 Treas. Reg. § 1.152-4T(a), Q&A 3.

100 IRC § 152(e)(4).

REASONS FOR CHANGE

In enacting the 1984 changes to the dependency exemption rules applicable to divorced or separated parents, Congress noted that the prior rules were often subjective and dragged the IRS into disputes between parents, each of whom claimed he or she provided the requisite amount of support. "The Congress wished to provide *more certainty by allowing the custodial spouse the exemption unless that spouse waives his or her right to claim the exemption*. Thus, dependency disputes between the parents will be resolved without the involvement of the Internal Revenue Service."[101] (Italics added.)

Since 1984, courts in 41 states have published opinions on the question of whether a state court has the authority to allocate the federal dependency exemption between the parents in a domestic relations proceeding. Eight states hold that they do not have authority to award the dependency exemption according to their own determinations, regardless of the fact that one parent qualifies for the exemption under the provisions set forth in IRC § 152(e)(2) and has not agreed to release the exemption to the noncustodial parent.

Over the years, state courts have determined that the dependency exemption can be awarded to the noncustodial spouse as incentive for that spouse to pay current child support[102] or because the exemption will bring about a greater tax benefit for the noncustodial spouse[103] or will maximize the financial resources available to the entire family unit.[104] Other courts have conditioned the allocation to the noncustodial parent on that parent's continuing payment of all court-ordered child support.[105]

In *Cross v. Cross*, the Supreme Court of Appeals of West Virginia found the 1984 amendment to IRC § 152(e) "entirely silent concerning whether a domestic court can *require* a custodial parent to execute a waiver, and this silence demonstrates Congress's surpassing indifference to how the exemption is allocated as long as the IRS doesn't have to do the allocating."[106] The court further noted that it found nothing in the legislative history of the 1984 amendment that precludes a state trial court from exercising its equitable power and ordering the custodial parent to execute the required waiver as an "integral part of setting child support."[107]

101 H. R. 98-432 (Part 2), at 1498 (1984).

102 Serrano v. Serrano, 213 Conn. 1 (1989)

103 Rolek v. Rolek, Iowa 555 NW 2d 675 (1996)

104 Motes v. Motes, Utah 786 P2d 232 (1990)

105 Peacock v. Peacock, Wash 54 Wash App 12 (1989)

106 Cross v. Cross, 178 W.VA 563, 571 (1987)

107 Id. at 572.

The Supreme Court of Georgia, on the other hand, held in *Blanchard v. Blanchard* that where a state forcibly takes the tax exemption from a custodial parent who has earned income, "that parent's income becomes subject to unauthorized tax liability. The state would be exerting the power of taxation, and that power '"is not subject to state control."'[108] The Georgia court noted that the statute's purposes of achieving "certainty" and easing the IRS's administrative burden would be defeated if state courts were able to make federal decisions.

> There can be no "certainty" or uniformity in taxation in our mobile society, when some state courts force custodial parents to "waive" their federal benefits. The will of Congress, not a state court, determines who is to be taxed. The difference in application among the states will prevent a uniform "nationwide scheme of taxation."[109]

The *Blanchard* court also discussed the requirements for a valid waiver such as the one provided for in IRC § 152(e)(2). "A waiver is a voluntary relinquishment of some known right, benefit, or advantage, which but for the waiver, the party otherwise would have enjoyed." The court noted that there cannot be a waiver of valuable rights where the circumstances show that the waiver was made involuntarily.[110]

The United States Tax Court recently held that a state court order awarding the dependency exemption to the noncustodial spouse did not constitute a signed, written declaration by the custodial spouse. Thus, even though the noncustodial spouse attached a copy of the court order to his federal income tax return, the decree was not effective in assigning the dependency exemption to the noncustodial spouse.[111] The Tax Court noted that a state court cannot determine issues of Federal tax law.[112]

In *Miller vs. Commissioner*, the signature of the custodial spouse's attorney on the court order was not the equivalent of a "signed, written declaration" as required by IRC § 152(e). The Tax Court noted that the signature of the custodial parent is critical to successful implementation of Congress' plan to eliminate support-based disputes regarding dependency exemptions and to simplify the rules regarding when a noncustodial parent may claim the dependency exemptions for his or her children."[113] The court further stated that the custodial parent's signature must confirm that the custodial parent intended to release the dependency exemption to the noncustodial spouse and that he or she did not intend to claim such exemption for himself or herself.

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108 Blanchard v. Blanchard, 401 S.E. 2d 714, 716 (Ga. 1991)

109 Id.

110 Id.

111 Miller v. Commissioner, 114 T.C. 184 (2000).

112 Id. at 196

113 Id. at 190.

Table 2.1.3, State Court Determinations on Allocation of Dependency Exemptions, illustrates the conflict between state courts on this issue. Taxpayers are placed in the untenable position of having to fight in state courts for the right to claim a federal tax dependency exemption. In the majority of states, a state court can award the dependency exemption to the noncustodial parent on the grounds that the exemption is of more value to that taxpayer and ultimately will provide greater resources for the child. The custodial parent must then petition the state court in the event her circumstances change and the exemption is more valuable to her than to the noncustodial parent.

The uncertainty taxpayers face in state court proceedings that affect federal dependency exemptions undermines the simplification reforms Congress enacted in 1984. Federal taxpayers should not have to turn to state courts for a determination about their rights or benefits under federal tax law.[114]

EXPLANATION OF RECOMMENDATION

In 1984, Congress overhauled the rules pertaining to allocation of the dependency exemption between parents who are divorced, separated, or otherwise living apart. At that time, Congress attempted to create simple, consistent rules that would generally award the dependency exemption to the custodial spouse unless that spouse voluntarily released the exemption to the noncustodial spouse.

Today, taxpayers once again face uncertainty in applying the dependency exemption rules. A custodial parent's federal entitlement to the dependency exemption hinges less on a federal court's interpretation of federal tax law than on a state court's interpretation of the scope of its equitable powers and domestic relations jurisdiction. Where the custodial parent is involuntarily ordered by a state court to waive the dependency exemption, that parent may face a state court contempt citation if he or she claims the federal tax benefit to which he or she is entitled under federal law.

Although federal law may be clear on the point that state courts cannot determine issues of federal law, taxpayers still face disparate results in state courts on this particular matter of federal law. The *Miller* case demonstrates that the IRS is still being drawn into disputes between parents over the dependency exemption. Therefore, the National Taxpayer Advocate recommends that Congress amend Internal Revenue Code section 152(e)(2) to make explicit that dependency exemptions may only be released *voluntarily* by the custodial parent, and that the statute's rules for assignment of the dependency exemption cannot be overridden by state courts or other government agencies.

[114] In 1999, 843,707 tax returns claimed exemptions for children who did not live with the taxpayer. (Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001). It cannot be determined how many of these taxpayers would be impacted by this recommendation.

TABLE 2.1.3

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
Alabama	Gamble, 562 So 2d 1345 (1990)	Civil Appeals	Yes	Trial court has discretion to allocate exemption and require custodial parent to execute waiver - not inconsistent with Congressional purpose
Alaska	No cases			
Arizona	Lincoln, 155 Ariz. 272 (1987)	Ct Appeals	Yes	Allocation does not interfere with Congressional intent. Financial impact of the allocation of the exemption is a proper consideration for the court.
Arkansas	Jones, 43 Ark. App. 7 (1993)	Ct. Appeals	Yes	Great deference is to be accorded to state courts in the area of domestic relations. Congress would have explicitly prohibited states from allocating the exemption, if it had intended to do so.
California	Cornejo, 53 Cal 3d 1271 (1991)	Supreme Court	Yes	Nothing in the 1984 amendment precludes state courts from exercising equitable power to allocate exemption to non-custodial parent by ordering custodial parent to execute waiver.
Colorado	Beyer, 789 P.2d 468 (1989)	Ct Appeals	Yes	Amendment creates a presumption that the custodial parent is entitled to the dependency exemption, but does not deprive state court of jurisdiction to award to the non-custodial parent. Court also has discretionary authority to order custodial parent to execute waiver.
Connecticut	Serrano, 213 Conn. 1 (1989)	Sup. Ct. Conn.	Yes	Congress has not explicitly prohibited states from allocating the exemption and state court order does not frustrate Congress' intent to eliminate IRS involvement in disputes concerning allocation.
Delaware	Hancock, 1989 Del. Fam. Ct. LEXIS 7 (1989)	Family Ct.	Undetermined	Not necessarily of the opinion that states completely divested of the right to compel a party to give up dependency exemption, but nothing in state law would allow such a result.
D.C.	No cases			
Florida	Ford, 592 So 2d 698 (1991)	Ct Appeals	Yes	No indication that Congress sought to foreclose state court action. Allowing trial court to reallocate dependency exemption maximizes available income for child support, by reducing taxes. Reallocation may be ordered as long as non-custodial parent current in child support payments.

TABLE 2.1.3

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
Georgia	Blanchard, 261 Ga. 11 (1991)	Supreme Court	No	Determination with regard to federal taxation province of Congress, not the states. Congress has determined that dependency exemption belongs to the custodial parent and state will not frustrate Congressional intent.
Hawaii	No cases			
Idaho	Rohr, 118 Idaho 689 (1990)	Supreme Court	Yes	Nothing in legislative history expressly prohibits state court from directing the allocation of dependency exemption to the non-custodial parent. State has the authority to require the custodial parent to execute the waiver.
Illinois	Einhorn, 178 Ill. App 3d 212 (1988)	Ct Appeals	Yes	Congress did not intend to divest state courts of authority to allocate exemptions, but only to eliminate IRS' role in fact finding determinations. Statute does not require the waiver of the custodial parent to be voluntary.
Indiana	Ritchey, 556 NE 2d 1376 (1990)	Ct Appeals	No	Amendment precludes court from allocating exemption, but does not prelude order requiring the custodial parent to waive the exemption. Support order may be adjusted to afford the non-custodial parent tax relief, if custodial parent refuses to sign waiver.
Iowa	Rolek, 555 NW 2d 675 (1996)	Supreme Court	Yes	Allocation within the authority of state court to achieve equitable resolution of economic issues. Allocation depends on state family law principles.
Kansas	No cases			
Kentucky	Hart, 774 SW2d 455 (1989)	Ct Appeals	Yes	Congress did not explicitly or by implication prohibit state courts from allocating and did not intend to extend reach to areas traditionally left to state courts.
Louisiana	Boudreau, 563 So2d 1244 (1990)	Ct Appeals	Yes	Allocation does not interfere with Congressional intent to remove IRS administrative burden.

CONTINUED ...

TABLE 2.1.3

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS (CONTINUED)

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
Maine	No cases			
Maryland	Wassif, 77 Md. App 750 (1989)	Ct Spec. Appeals	Yes	Within the discretion of trial court to order custodial parent to execute waiver in favor of non-custodial parent paying child support, as state court allocation does not interfere with Congressional itent.
Massachusetts	Bailey, 27 Mass App 502 (1989)	Ct Appeals	Yes	Amendment does not prevent state courts from allocating dependency exemptions.
Michigan	Stickradt, 156 Mich App 141 (1986	Ct Appeals	No	Amendment divested state court of jurisdiction to determine which parent is entitled to exemption.
Minnesota	Rogers, 622 NW.2d 813 (2001)	Supreme Court	Yes	Statute does not preclude state courts from allocating exemptions to non-custodial parent incident to determinations of child support and physical custody.
Mississippi	Nichols, 547 So 2d 766 (1989)	Supreme Court	Yes	Does not interfere with Congressional intent - trial ct. can allocate exemption to non-custodial parent as long as custodial parent is receiving child support payments.
Missouri	Echele, 782 SW. 2d 430 (1989)	Ct. Appeals	No	Statute does not provide state court with authority to allocate exemption, but allows court to use exemption as consideration in determining amount of child support to be awarded to custodial parent..
Montana	Milesnick, 235 Mont 88 (1988) `	Supreme Court	Yes	Statute was not enacted to strip state courts of power to allocate between parties, but to reduce administrative burden of IRS. State court allocation does not interfere with that goal.
Nebraska	Kalkowski, 258 Neb 1035 (2000)	Supreme Court	Yes	Adopts majority rule allowing allocation as part of a dissolution decree. Dependency exemption is an economic benefit. Court also has power to order execution of a waiver, if the situation requires.
Nevada	Septic, 111 Nev. 1192 (1995)	Supreme Court	Yes	State courts allocation of dependency exemption does not interfere with intent of Congress. District court has broad discretion in determining whether to order custodial parent to waive exemption.

TABLE 2.1.3

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
New Hampshire	No cases			
New Jersey	Gwodz, 234 NJ Super. 56 (1989)	Supreme Court	Yes	Within courts equity jurisdiction to allocate dependency exemption, as exemption has beneficial impact in the adjustment of the support obligation of the parties.
New Mexico	Macias, 126 NM 303 (1998)	Ct Appeals	Yes	Law on its face does not preclude state from acting and will not assume that Congress intended to tie the hands of the state judiciary.
New York	Bennett, 140 A.D.2d 400 (1988)	Supreme Court	No	Statute controls. Non-custodial parent may only claim exemption, if waived by custodial parent.
	Zogby, 158 A.D.2d 974 (1990)		Yes	Nothing in the language of the federal tax law limit's state court's discretion in allocating dependency exemptions.
North Carolina	Brooks, 522 SE 2d 590 (1999)	Ct Appeals	Yes	Court has authority to order custodial parent to waive exemption, especially since custodial parent derives no monetary benefit from exemption.
North Dakota	Fleck, 427 NW 2d 355 (1988)	Ct Appeals	Yes	State court allocation permissible, as it does not interfere with Congressional intent. Court has authority to order custodial parent to execute waiver.
Ohio	Singer, 63 Ohio St.3d 408 (1992)	Supreme Court	Yes	Statute enacted for the purpose of IRS administrative convenience, does not limit state courts authority to allocate exemption or to order custodial parent to sign waiver.
Oklahoma	Wilson, 831 P.2d 1 (1991)	Ct Appeals	Yes	IRC does not specifically divest state courts of the consistently recognized state authority to allocate exemptions and allocation by state does not conflict with objective of statutory amendment. Court has power to allocate and/or order execution of waiver.

CONTINUED ...

TABLE 2.13

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS (CONTINUED)

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
Oregon	Vinson, 732 P2d79 (1987)	Ct Appeals	No	Entitlement to Oregon dependency exemption depends on who is entitled to exemption under federal law.
	Richmond, 103 Ore. App. 55 (1990)		Yes	Nonetheless, the court may determine which party may claim the child as a dependent and may consider the tax impact on the parties as a result of that determination. Vinson should not be read to the contrary.
Pennsylvania	Miller, 1999 Pa Super 347 (1999)	Superior	Yes	Legislative history of amendment does not preclude courts exercise of its equitable power to allocate dependency exemption to non-custodial parent. Where court allocates must also order custodial parent to waive exemption. Exemption increases amount available for child support.
Puerto Rico	No cases			
Rhode Island	No cases			
South Carolina	Hudson, 340 S.C. 198 (2000)	Ct Appeals	Yes	Amendment only intended to get IRS out of administration, did not explicitly remove right of state court to allocate exemption or to order execution of waiver by custodial parent.
South Dakota	Brandriet, 442 NW 2d 455 (1989)	Supreme Court	No	Custodial parent entitled to exemption unless he or she voluntarily releases claim to exemption per federal tax law. Benefit of exemption can be taken into account in determining the amount of child support.
Tennessee	Shadoin, 1986 Tenn App Lexis 3242 (1986)	Ct Appeals	Yes	No support provided.
Texas	Davis, 707 SW2d 711 (1986)	Ct. Appeals	No	Equitable considerations do not control what deductions are permissible, must look to the Internal Revenue Code. State courts have no power to allocate.
Utah	Motes, 786 P2d 232 (1990)	Ct. Appeals	Yes	State courts have power to allocate exemption, as Congress did not expressly divest. Nothing in amendment that requires waiver of exemption to be voluntary. Courts sole objective is maximizing the financial resources available to the family unit.

TABLE 2.1.3

STATE COURT DETERMINATIONS ON ALLOCATION OF DEPENDENCY EXEMPTIONS

STATE	NAME, CITATION (YEAR)	COURT	ALLOCATE	BASIS
Vermont	Gazo, 166 Vt. 434 (1997)	Supreme Court	Yes	Federal statute silent as to whether state courts can allocate dependency exemption to non-custodial parent. Will follow majority rule that states retain right to allocate.
Virgin Island	No cases			
Virginia	Floyd, 17 Va. App 222 (1993)	Ct Appeals	No	State law does not authorize the court to award an exemption to non-custodial parent even though the non-custodial parent was paying over 87% of the child support. Tax consequences, however are factors that can be considered in determining support.
Washington	Peacock, 54 Wn. App 12 (1989)	Ct Appeals	Yes	Congressional interest in administrative efficiency is in no way affected by state court allocation. To conclude otherwise would be to allow federal tax policy to determine domestic relations issues in which the states have particular interest.
West Virginia	Cross, 178 W.Va. 563 (1987)	CT Appeals	Yes	If Congress had intended to forbid state courts from allocating the exemption, Congress would have said so.
Wisconsin	Pergolski, 143 Wis. 2d 166 (1988)	Ct Appeals	Yes	Trial courts authority to allocate the exemption does not interfere with Congressional intent. State court involvement has no impact on IRS.
Wyoming	No cases			

FAMILY STATUS ISSUES

TABLE 2.1.4

	COUNT OF EXEMPTION ALLOCATION CASES			
STATE	YES	NO	NO CASES	UNDETERMINED
New York	X	X		
Oregon	X	X		
Alabama	X			
Arizona	X			
Arkansas	X			
California	X			
Colorado	X			
Connecticut	X			
Florida	X			
Idaho	X			
Illinois	X			
Iowa	X			
Kentucky	X			
Louisiana	X			
Maryland	X			
Massachusetts	X			
Minnesota	X			
Mississippi	X			
Montana	X			
Nebraska	X			
Nevada	X			
New Jersey	X			
New Mexico	X			
North Carolina	X			
North Dakota	X			
Ohio	X			

COUNT OF EXEMPTION ALLOCATION CASES (CONTINUED)

STATE	YES	NO	NO CASES	UNDETERMINED
Oklahoma	X			
Pennsylvania	X			
South Carolina	X			
Tennessee	X			
Utah	X			
Vermont	X			
Washington	X			
West Virginia	X			
Wisconsin	X			
Georgia		X		
Indiana		X		
Michigan		X		
Missouri	`	X		
South Dakota		X		
Virginia		X		
Alaska			X	
District of Columbia			X	
Hawaii			X	
Kansas			X	
Maine			X	
New Hampshire			X	
Puerto Rico			X	
Rhode Islands			X	
Texas			X	
Virgin Islands			X	
Wyoming			X	
Delaware				X
TOTAL	**35**	**8**	**11**	**1**

FAMILY STATUS ISSUES

ELIMINATE THE AGE RESTRICTIONS FOR TAXPAYERS CLAIMING EARNED INCOME TAX CREDIT WITHOUT A QUALIFYING CHILD

SUMMARY

PROBLEM

The Omnibus Budget Reconciliation Act of 1993[115] allowed taxpayers without a qualifying child to claim the earned income tax credit (EITC). The individual claiming the credit must be at least 25 but less than 65 years of age at the end of the taxable year. If a joint return is filed, at least one of the spouses must meet the age requirement. Because of these age restrictions, independent taxpayers under the age of 25 and taxpayers over age 65 are not eligible to claim the EITC.

EXAMPLE

A 65-year-old single, employed taxpayer who is working to supplement his Social Security income in order to meet basic living expenses does not qualify for the EITC because of her age. A 19-year-old working parent paying child support for a child who does not live with him cannot claim the credit because of his age.

RECOMMENDATION

Amend Internal Revenue Code section 32(c) to eliminate the age restrictions for those taxpayers who do not have a qualifying child and who otherwise qualify for the EITC.

[115] Omnibus Budget Reconcillation Act of 1993, Public Law 103-66 [H.R. 2264], Title XII, Chapter 1, Part III, § 13131 (Aug. 10, 1993).

ELIMINATE THE AGE RESTRICTIONS FOR TAXPAYERS CLAIMING EARNED INCOME TAX CREDIT WITHOUT A QUALIFYING CHILD

DETAILED EXPLANATION

PRESENT LAW

The Omnibus Budget Reconciliation Act of 1993[116] expanded the population of taxpayers eligible to claim the earned income tax credit (EITC), to allow the credit to persons without a qualifying child. The individual claiming the credit must have lived in the United States for more than one-half of the tax year and cannot be eligible to be claimed as a dependent of another person for that year.[117] For tax year 2001, the total earned income or modified adjusted gross income of the taxpayer cannot exceed $10,710.00. All rules related to claiming the EITC *with* a qualifying child also apply to this category of taxpayer, e.g. investment income cannot be more than the threshold amount for the year in question.

Additionally, the person claiming the EITC without a qualifying child must be at least 25 but less than 65 years of age at the end of the tax year. If married and filing a joint return, either the taxpayer or the spouse must meet the age criteria. It does not matter which spouse meets the age test as long as one of them does.

REASONS FOR CHANGE

The current age restrictions for taxpayers claiming the earned income credit without a qualifying child result in inequitable treatment. An independent, employed, 19-year-old non-custodial parent who pays child support would not be eligible for the EITC allowable to a 25-year-old taxpayer whose circumstances are identical except for his age. The under-25 taxpayer population is a varied lot, including students supported by parents, non-custodial parents who have child support obligations, and emancipated students struggling to meet ever increasing college tuition expenses. The population includes young independents who do not live at home with their parents and are not claimed as exemptions on their parents' returns. We estimate that an additional 1.5 million individuals under the age of 25 would be eligible to claim EITC under an expanded age requirement.[118]

Under current law, a 65-year-old single taxpayer with "earned income" would be denied EITC solely because of age. The number of older Americans who work and earn at or near minimum wage continues to increase because of economic necessity.[119] The senior population within the 65 to 84 age-bracket represents approximately 10.9 percent of the total population (30,752,166 million individuals).[120] The costs of medical and dental services, an extremely critical expense for this group of taxpayers, continue to escalate.

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116 Id.

117 IRC § 32(c)(1)(A).

118 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

119 Capitol Connection – Seniors Suffer from Social Security Strain; Midwest Region Consumer Price Index (CPI) – July 2001.

120 U.S. Census Bureau, Census 2000, News Release: Nation's Median Age Highest Ever, But 65-and-Over Population's Growth Lags, Census 2000 Shows, (Table DP-1. Profile of General Demographic Characteristics for the United States: 2000).

Social Security payments do little to lessen the burden. "From 1991 to 1998 the average social security benefit for elderly couples increased by 22.9 percent and during the same period, the average retail prescription drug increased 57.9 percent. For elderly widows, their social security benefits increased 28.3 percent in face of this same 57.9 percent increase in drug costs."[121]

Though the maximum credit allowable per return is relatively small ($364.00 in tax year 2001), this amount might enable a taxpayer to purchase needed medication. "Older Americans spent 12 percent of their total expenditures on health, three times the proportion spent by younger consumers."[122] We estimate that an additional 335,000 individuals over the age of 64 would be eligible to claim EITC under an expanded age requirement.[123]

The population of taxpayers under the age of 25 and over 64 years of age may owe past due financial obligations to government agencies such as Office of Child Support Enforcement. Internal Revenue Code section 6402(c) and (d) authorize Treasury to collect past due debts owed to certain government agencies.

The proposal would raise the number of taxpayers qualifying for EITC by an estimated 1.9 million filers, which represents a 10 percent increase over the number who received EITC during tax year 1999. Of this newly eligible taxpayer population, 26,709 had overpayments from their 1999 tax returns offset by the IRS to debts owed to other government agencies. An average EITC refund of $192 for this category of taxpayer would return $5.1 million to government agencies.[124] The additional credit allowed would serve to reduce such debts, including child support.

EXPLANATION OF RECOMMENDATION

Eliminating the age restrictions described in Internal Revenue Code section 32(c)(1)(A)(ii)(II) would allow taxpayers under age 25 and over 64 to claim the EITC without a qualifying child if they are otherwise eligible for the credit. This proposal provides financial assistance to low-income senior citizens for expenses such as transportation, lodging, medical bills, and other necessities and to independent young adults who are working. This proposal would also simplify computation of the EITC for childless taxpayers and decrease errors.[125]

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121 Fiscal Policy Institute for US Action; Impossible Choices: Food and Housing or Prescription Drugs? September 10, 2001.

122 A Profile of Older Americans: 2000, prepared by the Administration on Aging (AoA), U.S. Department of Health and Human Services, Health and Health Care, http://www.aoa.dhhs.gov/aoa/STATS/profile/default.htm (12/6/01).

123 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

124 IRS Office of Research, Tax Year 1999 Compliance Research Information System. Report prepared for Operating Division Taxpayer Advocate EITC Team: *Additional Eligibility for EIC Due to Age.* August 1, 2001.

125 Approximately 129,000 taxpayers, either under the age of 25 or over 64, attempted to claim "income-only" EITC (without a qualifying child) on their 1999 returns. These claims were denied on the basis of age through the math error process (Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001).

EXPANSION OF HEAD OF HOUSEHOLD FILING STATUS

SUMMARY

PROBLEM

Current law does not provide for the fact that children may live in primary and secondary households during the same tax year. Noncustodial parents who are paying child support may have less ability to pay income tax. These taxpayers cannot deduct child support payments from income, nor can they file as Heads of Household.[126] In order to qualify for Head of Household status an individual must maintain a household, which is the principal place of abode of his or her child or certain other persons, for more than one-half of the taxable year.[127] Some taxpayers believe they should be entitled to Head of Household status since they incur household costs for their children. In some cases, they file using the Head of Household filing status, even though they are not entitled to do so by law.

EXAMPLE

A noncustodial parent lives in Chicago, Illinois, and earns $40,000 in tax year 2001. She pays $10,000 per year in child support to the custodial parent in accordance with Illinois child support guidelines. The taxpayer has liberal visitation with her children throughout the year and for an extended period during the summer. The taxpayer also incurs additional expenses when the children visit, including the cost of maintaining a two-bedroom apartment so the children have a place to stay on weekends and in the summer. The taxpayer's child support payments do not reduce taxable income even though they reduce her ability to pay tax by $10,000. The taxpayer cannot claim Head of Household status because her children do not live in her household with her as the principal place of abode for more than half of the year.

Assuming the taxpayer in this example does not itemize deductions and files her tax return using the single filing status, she would pay $1,103 more in income taxes than a person who files as Head of Household. If she uses the status of married filing separate, she will pay $1,175 more than individuals using the Head of Household filing status.

126 Treas. Reg. 1.2-2(b)(2)

127 IRC § 2(b)(1)(A)

FAMILY STATUS ISSUES

RECOMMENDATION

Amend Internal Revenue Code section 2(b) to allow single or separated noncustodial parents who are paying substantially all required child support to claim the Head of Household filing status as directed by a formal court ordered child support agreement. If a formal child support agreement does not exist, the noncustodial parent must be able to document that an informal agreement for child support was agreed upon by both parents and that the child support payments are equal to or greater than what the payments would be if computed by the child support guidelines of the state the child or children reside. The single or separated noncustodial parent with an informal child support agreement must also pay substantially all required support under the informal agreement. For both the formal and informal child support agreements the taxpayer will meet the requirement of paying substantially all required child support if 80 percent of the required child support payments are paid to the custodial parent during the taxable year.

EXPANSION OF HEAD OF HOUSEHOLD FILING STATUS

DETAILED EXPLANATION

PRESENT LAW

To qualify for the Head of Household filing status, a taxpayer must maintain as his or her home a household which constitutes for more than one-half of the taxable year the principal place of abode of his or her unmarried son, stepson, daughter, stepdaughter, or descendant of a son or daughter, or certain other individuals.[128]

A taxpayer can also qualify for the Head of Household status if he or she maintains a household that constitutes the principal place of abode of his or her parents for the entire taxable year by furnishing over half of the cost of maintaining the household of the parents during the tax year.[129] A taxpayer filing as a Head of Household is able to claim a larger standard deduction than a single or Married Filing Separately taxpayer.[130] Further, that taxpayer will enjoy more favorable rate brackets.

REASONS FOR CHANGE

There is an increasing number of nontraditional families and living arrangements in the United States, due to divorce and the fact that many taxpayers with children have never been married. In 1997, approximately 28 million divorced parents lived in the United States, 14 million of whom were noncustodial parents. Custodial parents cared for 22.9 million children and 7.9 million custodial parents were then entitled to receive child support. Of the 7.9 million custodial parents entitled to receive child support, 2.9 million received the full amount to which they were entitled. Another 7.3 million individuals were married with no spouse present in the household.[131]

Under current law, the Head of Household filing status is not available to noncustodial parents. However, many noncustodial single or separated parents provide some measure of assistance to their children. Noncustodial parents who are single or separated and who pay child support have a reduced ability to pay income taxes as compared to parents who do not make child support payments or to single taxpayers without such an obligation.

Internal Revenue Code section 152(e)(2) provides for a noncustodial parent to receive the benefit of a personal exemption deduction for their child or children if the custodial parent releases a claim for the exemption. However, the unmarried or separated custodial parent will still qualify for Head of Household filing status, even in situations where they may not have provided the majority of support for the child or children. The law only

[128] IRC § 2(b)(1)(A)(i). Head of Household status may also be claimed for the taxpayer's married son, stepson, daughter, stepdaughter, or descendent of a son or daughter if the taxpayer can claim a dependency deduction for that person or would be entitled under IRC § 152(e)(2) or (e)(4), or any other person for whom the taxpayer can claim a dependency exemption.

[129] IRC § 2(b)(1)(B).

[130] IRC § 63(c)(2).

[131] Child Support for Custodial Mothers and Fathers – 1997, U.S. Census Bureau.

requires an unmarried or separated custodial parent to furnish over half the cost of maintaining a household in which their unmarried child lives for more than one-half the taxable year. In a situation such as this, it is possible that the unmarried or separated noncustodial parent may pay the majority of the support expenses without the benefit of Head of Household filing status.

Noncustodial parents who are single and pay child support can only file as single, even if they are paying a substantial amount in child support. A noncustodial parent who is not yet divorced and is meeting his or her child support obligation can only file as Married Filing Separately. The proposed amendment to IRC § 2(b) would permit single or separated noncustodial parents who are paying substantially all required child support to claim the Head of Household filing status. These taxpayers would thereby realize an increased ability to pay income tax and would be less likely to feel compelled by their financial situation to incorrectly claim their children as dependents. The proposal would also provide an additional incentive to noncustodial parents to make full payment of child support as well.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate proposes that Internal Revenue Code section 2(b) be amended to permit single or separated noncustodial parents who pay substantially all required child support as prescribed by a court ordered child support agreement to claim head of household filing status. If a formal child support agreement does not exist, the noncustodial parent must be able to document that an informal agreement for child support was agreed upon by both parents and that the child support payments are equal to or greater than what the payments would be if computed by the child support guidelines of the state in which the child or children reside. The single or separated noncustodial parent with an informal child support agreement must also pay substantially all required support under the informal agreement.

This proposal could impact up to 4.1 million taxpayers.[132] Since child support is not reported as an item on the individual income tax return, the number of income tax filers who are paying child support cannot be determined.

[132] Tax Year 1998 Compliance Research Information System, IFM 2000 and the U.S. Census Bureau, 1997. The computation of the impact on the taxpayer population is based on a projection of the average impact for the current single and married filing separate filers applied to the projected affected population. Information from external sources indicates no child support agreements exist in over 40 percent of the possible instances where an agreement might exist. (Child Support for Custodial Mothers and Fathers – 1997, U.S. Census Bureau) The projected number of filers in this category was not included in arriving at the 4.1 million taxpayers noted above, but these filers could begin to pay child support in the future.

The term "substantially all required child support" should be defined as the payment of 80 percent or more of the child support a taxpayer is required to pay during the tax year by the child support agreement. The child support agreement would be defined as the agreement determined and defined by the guideline of the state or by the court with jurisdiction over the child. A clear definition of the term "substantially all required child support" is necessary in order for taxpayers to have a clear understanding of the tax law and for the fair administration of the law by IRS. By adopting this definition of "substantially all required child support," tax law would not be in conflict with state guidelines on what is considered fair and equitable payment for support of a child.

The Family Security Act of 1988 requires states to establish guidelines for determining child support.[133] These guidelines were required because the federal government determined that the amounts ordered for child support to be low and that there was too much variation in the amounts of support for children in similar circumstances both within and between states.[134]

Child support guidelines are formulas that consider the income of the custodial and non-custodial parents and the number of their shared children and do not take into consideration the children that one or both of the parents had with a prior spouse or partner. The formulas are based on studies of how much a family ordinarily expends on raising a child or children. The guidelines apply equally to children born to married parents and to children born out of wedlock.

When applying the child support guidelines, most states look at either the parents' gross income or net income.[135] Gross income is defined as the parents' income from all sources, including wages and investments with no consideration for taxes or expenses. Net income is defined as gross income less federal and state taxes, as well as health insurance. Some states allow other deductions in determining net income: union dues, mandatory retirement contributions, obligations of support to other families and payment on debts incurred during the marriage that were incurred for the benefit of the marriage. For self-employed parents, the determination of net income becomes more complex. Courts will allow deductions from gross income for reasonable business expenses, but the courts look closely at the expenses to ensure they are not unusually high or of a non-cash nature, such as depreciation and amortization.

133 Family Security Act of 1988, Pub.L.No. 100-485, § 103 (1988)

134 American Bar Association Educational Research, available at http://www.abanet.org/publiced/practical/books/family/chapter_11.pdf

135 American Bar Association Educational Research, available at http://www.abanet.org/publiced/practical/childsupport_guidelines.htm

FAMILY STATUS ISSUES

Child support guidelines vary from state to state, as does the flexibility of the judge in each divorce case. There are generally two types of child support guidelines. One type is based on the income of the person who is required to pay the support and on the number of children involved.[136] The second type of guideline is based on the income of both parents and the number of children involved.[137] The courts rarely depart from the guidelines except in unusual situations. A court may depart from the general guidelines in determining child support for a variety of reasons, including unusually high child care expenses; medical and dental expenses not covered by insurance, special education needs for the child or children, or the income of the noncustodial parent's new spouse.

Today 15 states base child support guidelines on a percentage of income, while the remaining 35 states base their guidelines on the income of both parents. Twenty-three states make allowances in computing child support where shared parenting or joint custody exists.[138]

A noncustodial single or separated parent's entitlement to the Head of Household filing status should hinge on a requirement that a substantial amount of all required child support is paid during the year. This requirement can be met if the single or separated noncustodial parent has paid 80 percent of the child support ordered by the court or under the state guidelines. Various sources of substantiation can be used to ensure against fraudulent or erroneous claims of the head of household filing status. Substantiation can include, but is not limited to, cancelled checks, divorce or custody decrees, and child support agreements.

In cases in which taxpayers do not have formal child support agreements, such as when divorcing taxpayers come to agreement outside the court structure, or parents never married and have not made formal arrangements through the courts, the noncustodial parent would be entitled to claim Head of Household status if he or she paid child support in an amount greater than or equal to 80 percent of state guidelines. These payments could be made directly to the custodial parent or could go toward expenses for the benefit of the children, such as college tuition or medical costs for a disabled child.

136 Examples of state child support guidelines: Arkansas (A.C.A. §9-14-106), Georgia (O.C.G.A. § 19-6-15), Illinois (750 ILCS 5/505)

137 Examples of state child support guidelines: Ohio (ORC Ann. 3119), California (Cal Fam Code § 4055), Oklahoma (43 Okl. St. § 118)

138 Laura W. Morgan, Child Support Guidelines: Interpretation and Application (American Bar Association Family L.Q. Review, 33 FAM L.Q. 908, Winter 2000).

Although the taxpayer can easily prove his or her entitlement to Head of Household status under this proposal, the IRS can administer and enforce the expanded definition through its access to federal databases. By partnering with the Federal Office of Child Support Enforcement (FOCSE), returns filed by single or separated noncustodial parents claiming head of household filing status could be cross-referenced with the FOCSE database of individuals who are in arrears on child support. This could be done upon filing of the tax return, avoiding audits of filing status and ultimately reducing taxpayer burden while encouraging payment of child support.

The National Taxpayer Advocate's proposal to expand the definition of the head of household filing status will have a more far-reaching impact than just payment and collection of income taxes. With the number of divorced and separated parents increasing each year, the number of child support agreements will increase as well. An amendment to IRC § 2(b) will assist in providing tax relief to single or separated noncustodial parents who are paying substantially all required child support under a court ordered agreement. The relief they realize will not only assist them in meeting their tax obligations, but it will also aid them in the financial support of their children. The National Taxpayer Advocate is hopeful that a "by-product" to the income tax consequences of this amendment would be a decrease in the number of child support agreements that are in arrears.

2 JOINT AND SEVERAL LIABILITY

FACTS ABOUT JOINT AND SEVERAL LIABILITY AND INNOCENT SPOUSES

- The IRS has received over 154,900 innocent spouse cases since 7/22/98.
- The volume of innocent spouse cases rose by 22% – from 46,619 to 54,402 – from FY 1999 to FY 2000.
- The IRS rejects 49% of innocent spouse claims as not qualifying or meeting basic requirements for consideration. The remaining 51% are reviewed and decided on merit.
- Of the cases the IRS accepts, the claimant obtains either full or partial relief slightly less than half the time (47.7% of cases).
- Claims may be denied because there is no reasonable belief the tax would be paid, because the income giving rise to the deficiency is attributable to the requesting spouse or because that spouse had knowledge of the item giving rise to the deficiency.
- The Taxpayer Advocate Service received 3,348 innocent spouse cases in FY 1999, with an ending inventory of 1,501. In FY 2000 TAS received 3,328 cases with an ending inventory (9/30/00) of 1,692.
- Though the exact number of injured spouse cases for FY 2000 cannot be determined, the figure does not exceed 44,939.
- The IRS used 887 FTEs – the equivalent of almost 1% of all IRS employees – to process innocent spouse claims in FY 2000.
- More than 51-million filers (as of tax year 1998) could be affected by eliminating the joint liability provision.
- Number of individuals claiming the married filing separate filing status: 2.47 million. Number of individuals claiming the married filing joint filing status: 48.95 million (tax year 1998).
- When married individuals file a joint return, the primary spouse usually earns significantly more than does the secondary spouse. This is true for all income ranges.
- Nearly 90% of the claims filed for relief from Joint and Several Liability are filed by women with earned income that is approximately 25% of the total income on a joint return.
- The currently divorced population is the fastest growing marital status category. The number of divorced people has more than quadrupled since 1970, rising from 4.3 million then to 19.4 million in 1998.
- As of 1998, there were 19.4 million divorced people in the United States or 9.3% of the population age 15 and over. Another 7.3 million (3.5%) people are listed as married, spouse not present.

SEPARATE LIABILITY ELECTION

SUMMARY

PROBLEM

When a married couple files a joint income tax return, both spouses are liable for the income taxes with respect to that return.[1] The only way for them to avoid joint and several liability is to file married filing separate.[2] However, the law does not allow married individuals filing a separate return to use many of the benefits they would be entitled to if they filed a joint return.

If taxes shown or assessed on a joint return are not paid, both will be liable for the taxes, regardless of who earned the income or claimed the deductions that caused the tax liability. Claims for relief from joint and several liability for Injured Spouse cases and Innocent Spouse cases stem directly from the issue of joint and several liability.

EXAMPLE

A wife works part time to supplement her husband's self-employment income from his construction business. The husband is abusive and a heavy drinker. The wife receives only enough money from her part time job and cash from her husband to meet the family's bare necessities. The wife does not question the husband about his business because it has resulted in outbursts of violent anger. She signs the joint return that he prepared. She is concerned about his business recordkeeping but is afraid to challenge him. If she were to insist on filing separately, she would not receive the earned income tax credit, which is critical to her children's well being.

RECOMMENDATION

Amend Internal Revenue Code section 6013(d) to allow married individuals to elect to sever their liability by declaring their separate items of income on their original married filing joint income tax return.

[1] IRC § 6013(d)

[2] IRC § 6013(a) (election to file a joint return).

JOINT AND SEVERAL LIABILITY

SEPARATE LIABILITY ELECTION

DETAILED EXPLANATION

PRESENT LAW

Taxpayers who are married at the end of the tax year have two choices in filing status: married filing joint or married filing separate.[3] Under Internal Revenue Code section 6013(d), taxpayers who choose to file a joint tax return will each be jointly and severally liable for the payment of taxes on that return without regard to individually earned income. A taxpayer who chooses to file as married filing separate will be liable only for the tax that arises from his or her own income, unless one or both of the spouses live in a community property state. However, the married filing separate status limits certain items. For example, both spouses must use either the standard deduction or itemize deductions. The following list details other tax attributes that are lost when married taxpayers file separately:

- Child and dependent care credit[4]
- Credit for the elderly or disabled[5]
- HOPE and Lifetime Learning credits for higher education expenses[6]
- Earned income tax credit[7]
- Adoption expense credit[8] and Adoption assistance exclusion[9]
- Social Security (and Railroad retirement) Act benefits exclusion[10]
- Interest exclusion from savings bonds for higher education[11]
- Qualified education loan interest deduction[12]
- IRA contribution deduction, and rollover (conversion) of regular IRA to Roth IRA[13]

3 IRC § 1(d) & 6013(a)

4 IRC § 21(e)(2): To receive this credit, married individuals must file a joint return or live apart the last six months of the year.

5 IRC § 22(e)(1): To receive this credit, married individuals must file a joint return except if they live apart for the entire year.

6 IRC § 25A(g)(6): No credit allowed for married individuals filing separate returns.

7 IRC § 32(d): This section shall apply only if a married individual files joint return.

8 IRC § 23(f)(1)

9 IRC 137 (e)

10 IRC § 86(c)(1)(C)(i): The base amount of Modified Adjusted Gross Income for computing exclusion is zero for married filing separate returns, while it is 32,000 for married filing joint and 25,000 for the other filing status.

11 IRC § 135(d)(3): This credit is not available unless a married individual files a joint return.

12 IRC § 221 (f)(2): Married individuals must file a joint return to take the deduction for qualified education loan interest.

13 IRC § Sections 408 & 408A (c)(3)(B)(ii) & (iii): Married individuals filing separate returns cannot roll over IRA to Roth IRA.

To qualify for relief from joint and several liability, an individual who filed a joint return must prove that he or she is an "Innocent Spouse" in accordance with the provisions contained in either IRC § 66 or § 6015. Section 66 provides exceptions to the operation of community property laws for taxpayers who file separate returns in community property states. In 1998, innocent spouse relief was expanded under the IRS Restructuring and Reform Act.[14] The provisions of IRC § 6015 (b), (c), and (f) offer joint filers relief from joint and several liability in limited circumstances.[15] Taxpayers who file joint returns must request Innocent Spouse relief from the IRS within two years of the first collection action.[16] In addition to this time constraint, many other qualifications must be met to obtain relief from spousal liability. The current factors used to determine the qualifications for relief from joint and several liability are provided in Exhibit A.

Sections 6402(c), (d) and (e) provide for the collection of child or spousal support or certain federal debts, such as student loans, before making a credit or refund to the taxpayer. All or part of the tax overpayment shown on the joint return may be used to pay these debts before a refund is issued. The debt may be a past-due obligation of only one of the spouses. Sections 6402(c), (d) and (e) provide relief for the non-obligated spouse and requires the separation of income and deductions between the married couple.

REASONS FOR CHANGE

Most married couples elect to file a joint return because the tax benefits of that filing status surpass those of the married filing separate status. In 1998, the number of individuals claiming the married filing joint status was 48.95 million.[17] The number of individuals claiming the married filing separate status was 2.47 million.[18]

Spouses who wish to separate their income and liability but who also desire the tax benefits of joint filing status are faced with a difficult choice. In many cases, they will receive the benefits of income splitting and numerous tax provisions while risking the possibility of being held liable for a tax arising from items over which they have no control. This dilemma encourages them to file a joint return but offers no protection from joint and several liability and increases the potential for innocent spouse claims.

14 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. Law 105-206.

15 Prop. Treas. Reg. § 6015-1 66 FR 3888 vol. 66, no. 11, dated 1/17/01. Rev. Proc. 2000-15, CB. 447, 2000.

16 IRC §§ 6015(b)(1)(E) and 6015(c)(3)(B)

17 Tax Year 1998 Compliance Research Information System

18 Tax Year 1998 Compliance Research Information System

JOINT AND SEVERAL LIABILITY

Under present law, spouses do not differentiate on their original return which spouse's income, credits or deductions generated the tax liability. Thus, the Internal Revenue Service is permitted to pursue either spouse to satisfy the liability arising from a joint return. As a result, the Internal Revenue Service will collect from the individual most easily located or whose assets are most easily reached. This practice sometimes places an unfair burden on the spouse whose wages or property is readily identifiable. This individual is usually the one who did not earn the income or claim the deduction causing the unpaid tax.[19] Most of the innocent spouse claims are filed by the secondary spouse, who is usually the woman.

The history of the election to file married filing jointly provides some insight into the continued complications that arise out of the application of joint and several liability. Joint tax returns were first authorized by the Revenue Act of 1918 and further clarified by the Revenue Act of 1921.[20] Before this Act, only taxpayers living in community property states had the ability to split their income.

The Revenue Act of 1918 extended the benefit of splitting income to all married individuals by establishing a separate tax schedule for joint returns. A joint return allows a husband and wife to include "the income of each…in a single joint return, in which case the tax shall be computed on the aggregate income."[21] This filing option often resulted in lower income taxes depending on the distribution of income between the couple. Married couples claimed that liability for deficient tax payments and penalties should be allocated according to individual income, while the IRS contended that spouses were jointly and severally liable.[22] In rejecting joint and several liability, the Ninth Circuit Court of Appeals noted "the fundamental principle that tax should be assessed in accordance with the ability to pay and that imposing joint and several liability would strip each taxpayer of the right to be taxed only in proportion to each spouse's income."[23]

19 Richard C.E. Beck, The Innocent Spouse Problem: Joint and Several Liability for Income Taxes Should be Repealed, 43 Vand. L. Rev. 317, 372 (1990).

20 Ch. 18, 223, 40 Stat. 1057 (1919) and Ch. 136, 223(b)(2), 42 Stat. 227 (clarifying the 1918 Act).

21 Id. 223(b)(2), 42 Stat. At 250.

22 Crowe v. Commissioner, 86 F 2d 796, 797 (7th Cir 1936); Cole v. Commissioner, 81 F 2d 485, 486 (9th Cir 1935)

23 Cole, Supra at 487; Sachs v. Comm, 111 F 2d 684 (6th Cir 1940); Comm v Rabenold, 108 F 2d 639, 640 (2nd Cir 1940); Crowe, 89 F 2d at 798.

In 1938 Congress expressly established that married couples filing joint returns are held jointly and severally liable.[24] Congress enacted IRC § 6013 allowing married individuals to file a joint income tax return and IRC § 6013(d) providing for the liability to be joint and several on the jointly filed returns.[25] "If a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several. The explanation for this provision was administrative necessity."[26]

Although the law provided for joint and several liability, the courts grappled with the inequities of this provision and were appalled at its harshness.[27] In *Huelsman v. Commissioner*, the trial court stated, "I apologize or I express my sympathies to Mrs. Huelsman. I wish I could do otherwise but I cannot, and I might say that if you can get me reversed on appeal, God bless you. I'd love to be reversed."[28]

In 1971, Congress created the innocent spouse doctrine, which was codified as IRC § 6013(e). Under this provision, the taxpayer had to prove that all requirements of the section were satisfied by a preponderance of the evidence to qualify for relief from the taxes due under this provision.[29] In 1930 the Supreme Court held in *Poe v. Seaborn*,[30] that each spouse in a community property state is liable for the tax on one half of the other spouse's earned income even when they file separately. Section 66 was enacted in 1980 to specifically address community property state laws because of concern for the spouse being held liable for the income tax in those states.[31]

The current innocent spouse statute, IRC § 6015, was designed to provide broader relief from joint and several liability, but these new provisions are quite complex and the administrative and judicial processes the taxpayer must invoke to obtain relief can be quite lengthy.[32] Failure to meet any of the conditions of IRC § 6015(b) or (c) will prevent relief under those provisions. A taxpayer requesting equitable relief under IRC § 6015(f) must establish that, after taking into account all of the circumstances, it would be inequitable to hold her or him liable for the tax. The new provisions, while broader in application, continue to be problematic in their implementation. The recommendations included in this section of the report address some of these issues.

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24 Revenue Act of 1938

25 26 USC 6013(d)(3)

26 HR Rep No 75-1860, at 30 (1938)

27 Scudder v. Comm, 28 TCM (CCH) 751, 753 (1969); Huelsman v. Comm, 416 F2d 477, 480 (6th Cir 1969)

28 Huelsman v. Comm, T.C. Memo 1968-95; 416.F. 2d.477 (6th Circ, 1969)

29 Friedman v Comm, 53 F 3d 523, 528 (2d Cir 1995); Shea, 780 F 2d 561, 565 (1986).

30 282 U.S. 101 (1930)

31 Sections 6013(e) and 66, as originally enacted, only provided relief from joint and several liability in income omission cases. Section 6013(e) was amended in 1984 to provide relief in cases involving overstated deductions or credits. To this day, section 66 relief only applies to income omission cases. See H.R. Rep. No. 432,pt. 2, 98th Cong, 2d Sess. 1502 (1984).

32 Community Renewal Tax Relief Act of 2000, Public Law 106-554; sec. 313(a)(3)(o)(i). The processing time for an administrative claim for relief under § 6015 currently averages more than 700 days.

JOINT AND SEVERAL LIABILITY

CURRENT PROCESSING DEMANDS

In order to process injured spouse claims, income, credits, deductions, exemptions, and payments must be allocated between the taxpayers on the joint return. Currently Form 8379, Injured Spouse Claim and Allocation, must be filed as a schedule with Form 1040. Although an exact number of injured spouse cases for FY 2000 cannot be determined, the number of cases does not exceed 45,000.[33]

While the Internal Revenue Service has made substantial progress in reducing the processing time and the cost of processing claims filed under innocent and injured spouse relief, the cost of processing innocent spouse claims is enormous when compared to the number of taxpayers affected. Given the many steps and legal requirements in the process, even the best case scenario requires 304 days to process a claim for relief under IRC § 6015.[34]

The Internal Revenue Service dedicated 887 employee staff years to processing 55,698 innocent spouse claims in fiscal year 2000. The Internal Revenue Service has about 100,000 employees. Thus, the innocent spouse staff time equals approximately 1 percent of the IRS work force. The Taxpayer Advocate Service received 3,348 innocent spouse cases in fiscal year 1999, with an ending inventory of 1,501 as of September 30, 1999. In fiscal year 2000, 3,328 cases were received by the Taxpayer Advocate, with an ending inventory of 1,692 as of September 30, 2000.[35] These figures do not include the cost of litigation on these issues.

Of the 51.4 million married individuals filing income tax returns in 1998, 49 million filed joint income tax returns.[36] If these married individuals were to file their returns separately, the cost to process the additional returns each year is estimated to be over 1.18 billion dollars.[37] While this additional cost is substantial, the Internal Revenue Service may be faced with processing more innocent or injured spouse claims if current demographic trends hold true. The number of divorced individuals in the United States has more than quadrupled in the sixteen year period for 1970 to 1998, rising from 4.3 million in 1970 to 19.4 million in 1996.[38] With the increase in divorces, the probability of an individual having to pay the lax liabilities of an ex-spouse also increases. The number of divorced individuals (age 15 and older) for 1998 was 19.4 million (9.3 percent of the United States Population, age 15 and older).[39]

33 Source: Submission Processing WP&C Report, Tax Year 2000

34 Current Population Survey dated March 1998; Innocent Spouse Tracking System, 7/29/01; Compliance Research Information System, 1998 Tax Year Data

35 Source: Taxpayer Advocate Management Information System – FY98, FY99 and FY00 (10/12/00).

36 Tax Year 1998, Compliance Research Information System (CRIS).

37 Cost to process a thousand average 1040 return is $1,493.89 plus non-pipeline costs of $916.38 composite 1040 series returns average cost is $ 2,410.25, Document 6746, IRM 3.30.10.10, FY 2000, Cost Estimate Reference Guide, Exhibit 3.30.10-44, page 224 (7-1-2001)

38 U.S. Census Bureau, Economics and Statistics Administration. Terry Lugaila, United States Dept. of Commerce News, April 13, 1998, January 7, 1999.

39 Tax Year 1998, Compliance Research Information System (CRIS)

MARRIAGE PENALTY AND TAX RATE STRUCTURE

The progressive rate structure of the Internal Revenue Code provides incentive for married couples to continue filing joint returns. That is, by filing jointly, many married couples will incur less tax than if they each filed separately. This is particularly true where one spouse earns significantly more than the other spouse.[40] Under current law, the trade-off for these favorable tax rates is joint and several liability.

There are instances, however, where marriage can cause a tax penalty rather than a tax bonus. Consider two taxpayers who each have an adjusted gross income of $32,200 for the 2000 calendar year. As domestic partners who file singly, each is entitled to a personal exemption of $2,800 and a standard deduction of $4,400, so each has a taxable income of $25,000. This falls just within the 15-percent bracket ($26,250 in 2000), so each pays income tax of $3,754. If the tax laws were marriage-neutral, their tax, if they were married, would be twice that amount, or $7,508.

Filing jointly in 2000, these taxpayers reported an adjusted gross income of $64,400. They claim two personal exemptions, which total $5,600. But instead of a standard deduction of $8,800 (twice $4,400) they are allowed only $7,350 on their joint return. This gives them taxable income of $51,450. The 15-percent tax bracket for joint filers ends at $43,850 of taxable income for 2000 returns, so the top $7,600 of their joint income is taxed at 28 percent, leading to a total tax bill of $8,713 – a "marriage penalty" of $1,205.

In these examples, it is clear that the distribution of income – 50/50 between the two spouses – produces the penalty. In the above example, if the wife were a single professional with an adjusted gross income of $64,400 and her domestic partner did not work outside the home, she would owe $12,611 in tax. Thus, by marrying she could reduce her income tax by $3,898.[41]

In the Restoring Earnings to Lift Individuals & Empower Families Act of 2001, Congress attempted to eliminate the marriage penalty by increasing rates and the standard deduction amount for married individuals.[42] These provisions are scheduled to be phased in from 2006 to 2010. Although, these changes will equalize rates and the deductions for married taxpayers vis a vis single taxpayers, married taxpayers filing jointly will still incur joint and several liability for any tax arising from the joint return.

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40 Joint Committee on Taxation Study of the Overall State of the Federal Tax System. Vol 1, April 2001(JCS-3-01)

41 News Release Whole Ball of Tax 2001 - Release 13 2001, CCH Inc. Married, Living together, Divorcing? They're all Taxing Situations…But Not Equally So, Riverwoods, IL

42 Economic Growth and Tax Relief Reconcilation Act of 2001, Public Law 107-16, HR 1836

JOINT AND SEVERAL LIABILITY

EXPLANATION OF RECOMMENDATIONS

Amend Internal Revenue Code section to permit married individuals to elect to sever their liability by declaring their separate items of income on their original married filing joint income tax return.

The National Taxpayer Advocate (NTA) recommends that Congress seriously consider the advantages and disadvantages of providing an election for each spouse to allocate his or her items of income, deductions, and credits at the time of filing the joint return. Married taxpayers would still be able to claim all the benefits of the married filing jointly status (including a larger standard deduction and favorable tax brackets and rates), since the tax would be computed on the combined taxable income. However, each spouse would only be liable for his or her share of the tax on the original return and for additions to tax attributable to his or her allocated income, deductions, or credits.[43]

This proposal would, of course, increase the burden on all taxpayers who file jointly to allocate their taxable items at the time of filing the return. The NTA believes that this burden may be offset by the benefits arising from a greater up-front awareness of the tax consequences of each spouse's financial arrangements, and by the virtual elimination of "innocent spouse" and "injured spouse" claims. Requiring each spouse to declare income ownership at the time of filing would reduce the subsequent burden on taxpayers who subsequently must file not only "innocent spouse" claims but also "injured spouse" claims. Further, the married couple will retain the benefits of married filing jointly status without incurring joint and several liability.

Several states offer married taxpayers the option of calculating tax based on either combining or separating the couples' income. The tax liability then becomes the lesser of the two calculations on the joint return. Kentucky, Indiana, and Missouri are among the states offering this option. None of these states allows taxpayers to sever their joint income tax liabilities. The calculation is limited to the option to use the lower of the two calculated liabilities on a married filing joint return. Each of these states has systems in place to capture this information from the combined state tax form. These tax forms could be used to provide a template for a federal tax form to separate the couples income tax liability by offering the option of filing a joint return while severing the tax liability.

43 We note that in February 1998, the Department of Treasury issued a report on Joint and Several Liability. Treasury reviewed several proposals to eliminate or modify joint and several liability and also raised several issues concerning the federal taxation of spouses living in community property states. The proposal we advance here is a variation on the "front end proportionate liability" approach outlined in the Treasury report. Dept. of Treasury, Report to the Congress on Joint Liability and Innocent Spouse Issues 30 (February 1998).

A prototype form will be used to cost this option. See Exhibit B for a possible template for this new form. Schedule C, Profit or Loss from Business; Schedule F, Profit or Loss from Farming; and Schedule SE, Self-Employment Tax are already separate. A dual-column Schedule A, Itemized Deductions, and Schedule B, Interest and Dividend Income would be needed (taxpayers could easily file separate Schedules D, Capital Gains and Losses, and E, Supplemental Income and Loss). Form 1040, Individual Income Tax Return, would be replaced with a two column version, one column for the primary and one for the secondary spouse.

Current IRC § 6015 is the result of a merger between two bills – one passed by the House and the other passed by the Senate – during the legislative process leading to the passage of the IRS Restructuring and Reform Act of 1998.[44] In the Senate version, the bill modified the innocent spouse provisions of § 6013(d) so that, to "permit a spouse to elect to limit his or her liability for unpaid taxes on a joint return, a spouse would be liable only to the extent items giving rise to the deficiency are allocable to the spouse."[45]

The House version expanded former IRC § 6013(e) to make it easier to afford traditional innocent spouse relief. The House was primarily concerned with the language in the statute that limited relief to situations where there was an "egregious understatement of income" and ensured that all taxpayers would have "access to the Tax Court in resolving disputes concerning their status as an innocent spouse."[46]

The act that emerged from conference is a combination of these two bills and became the three avenues for relief under IRC § 6015. Subsection (b) is closely linked to the original bill proposed by the House; subsection (c) more closely holds to the philosophy of the Senate version. Subsection (f) was designed to provide for equitable relief when neither (b) nor (c) provided for the relief and it would be inequitable under the circumstances to hold the taxpayer liable for the joint liability.

Even after these substantial changes, the relief provisions for IRC §§ 66 and 6015 continue to be complicated and are one of the most litigated areas of the tax law.[47] This proposed amendment to IRC § 6013(d) would allow an alternative method for spouses to gain the benefits of filing a joint return while reporting their own separate items of income, loss, deductions, and credit. This alternative election method for married couples would eliminate the joint and several liability requirement for those items adequately disclosed on the return and for later adjustments. The election to utilize this alternative reporting method would be made by completing or attaching allocation schedules on the face of or to the original return.

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44 H.R. Rep. No. 105-364, pt.1 (1997); S. Rep. No. 105-174 (1998)

45 S.Rep. No. 105-174 at 2.

46 H.R. Rep. No. 105-364, pt.1 at 2

47 Most Litigated Issues Section, Appendix C, herein.

Either the Form 1040 return series would provide a separate column for each spouse's individually stated items or schedules of the spouses' separate items would be attached to the return for information purposes only. In either case, certain key line items would be entered during processing, to allow the Internal Revenue Service to track adjustments. Jointly held investments which affect the return would be disclosed with a proposed allocation. As with any other item claimed on one's tax return, the allocation between the spouses would be subject to scrutiny by the Internal Revenue Service. Taxpayers filing such returns would be subject to the civil and criminal tax laws applicable to any other U.S. taxpayer.

As noted earlier, many of the current schedules are already or easily could be filed separately. The main difference for processing purposes will be two columns for the Form 1040, and two columns for the Schedules A and B. The additional front line processing would to some extent be offset by the reduction in processing for injured spouse claims and innocent spouse claims. If the return is filed electronically, individuals would transmit the schedule as part of their electronic file.

The proposed new Form 1040 would contain information that would eliminate the need for filing the Form 8379, Injured Spouse Claim and Allocation, for asserting an injured spouse claim, thus realizing some cost savings. In calculating the refund in an injured spouse claim, allocations are made for each of these items 1) Income, 2) Dependents, 3) Deductions, 4) Deferred Compensation, 5) Credits, 6) Other taxes, and 7) payments.

The main incentive for taxpayers to elect to allocate their income on a separate schedule would be the elimination of joint and several liability while keeping the tax benefits of their joint filing status. Adoption of this recommendation would eliminate the need for married couples to file separate tax returns to avoid joint and several liability. The Internal Revenue Service might realize some savings if taxpayers who are currently filing as married filing separate would file as married filing jointly under the proposed filing regime.

The Government Accounting Office (GAO) has noted in a report to Congress that many spouses are not aware that they are jointly and severally liable until after the return has been filed. The GAO recommended that the IRS improve the manner in which taxpayers are informed of this possibility.[48] Providing an election to separate liability on the original joint tax return would cause both parties to take an interest in the allocation and recognize their individual exposure prior to completing a joint tax return. It is recommended that a disclosure statement be added to the front of the return informing the taxpayers of their joint and several liability for tax unless the election is made. This recommendation would encourage married individuals to look at their respective liabilities before signing and filing their income tax return.

[48] GAO – Suggest Improvements to IRS' Innocent Spouse Procedures, 97 Tax Notes Today 49-20 (1997).

The National Taxpayer Advocate has not yet determined if this recommendation would entirely eliminate entirely the need for the relief provisions of IRC §§ 66 and 6015. We believe that some relief will continue to be required for taxpayers who do not make the election in circumstances involving duress. But it is clear that this proposal would substantially reduce, if not entirely eliminate, innocent spouse claims and litigation. The proposal enables spouses, while married, to elect to separate their income, deductions, credits, and tax liability before any events that might generate an innocent spouse claim occur. Further, in many instances this filing method will enable the Internal Revenue Service to propose additions to tax against the appropriate spouse based on information reported on the original return and its supporting schedules.

TAX COLLECTION CONSIDERATIONS

When married individuals file a joint return, the primary spouse usually earns significantly more than does the secondary spouse. The following table demonstrates that this is true for all income ranges. For joint returns with income under $30,000, 91 percent of gross income is attributable to the primary spouse. For joint returns showing income between $50,001 and $100,000, the primary spouse's income is 68 percent of the couple's total income. The table below provides income amounts for the primary and secondary spouses, including gross wages, net Schedule C, D, E, and F income, gross interest and dividends, and other separately stated income items. [49]

TABLE 2.2.1

INCOME PERCENTAGES FOR PRIMARY AND SECONDARY SPOUSES[50]

INCOME RANGE	PRIMARY SPOUSE INCOME PERCENT	SECONDARY SPOUSE INCOME PERCENT
Zero to 30,000	91%	9%
30,001 to 50,000	75%	25%
50,001 to 100,000	68%	32%
Over 100,000	79%	21%

One of the factors used to determine if IRC § 6015 relief will be granted to the requesting spouse under law is a determination of the ownership of income. Consequently, in many innocent spouse cases, the burden of compliance has been placed on the party who did not earn the income attributable to the balance due. Because these individuals generally earn significantly less then the culpable spouse, they usually have less ability to pay.

49 Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001 – Statistical sampling of tax returns, gross income includes gross wages, schedules C, D, E, & F net income, gross dividends & interest income

50 Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

JOINT AND SEVERAL LIABILITY

Allowing a joint filing couple to sever their tax liability raises concerns about the Internal Revenue Service's ability to collect the tax. Almost 82 percent of all returns filed did not require any additional tax payment (i.e., they were refund returns or their tax liability equaled the payments).[51] Thus, taxes are usually paid on most jointly filed returns before the Internal Revenue Service takes any collection action. Of the $49.7 billion of unpaid taxes at the end of the 1999 processing year, about $6 billion was attributable to married individuals filing joint returns.[52] The Internal Revenue Service collects about $123 billion in revenue each year. Married filing joint taxpayers did not pay approximately $2.4 billion in the 1998 tax year and $1.4 billion in the 1999 tax year.[53]

TABLE 2.2.2

BALANCE DUE INCOME TAX FOR MARRIED JOINT FILERS[54]

	PERCENT OF MARRIED FILING JOINT RETURNS	AMOUNT OF BALANCE DUE AFTER REMITTANCE FOR MARRIED FILING JOINT RETURNS	NUMBER OF BALANCE DUE RETURNS AFTER 4TH NOTICE	AMOUNT OF BALANCE DUE AFTER 4TH NOTICE FOR MARRIED FILING JOINT RETURNS
1998	40.0%	$6.9 billion	507 thousand	$2.4 billion
1999	39.7%	$7.0 billion	349 thousand	$1.4 billion

Married filing joint taxpayers report significantly higher wages, withholding, and total income than other filers. Single taxpayers are typically younger and they report lower wages than the rest of the Wage and Investment population. Head of Household filers report the lowest average total tax liability.[55] For tax year 1999 married filing joint equaled 31 percent of the individual income tax returns filed and married filing separate equaled 2 percent.[56]

Balance due filers vary by filing status. As presented in the following table, single filers accounted for the largest percentage of balance due returns in each of the three tax years. Married filing joint filers ranked second in all three years.[57]

51 Id.

52 Id.

53 Publication 55B, (8-2000) page 7, Total Individual Income tax 123 billion for 1998; Compliance Research Information System: 1998 Tax Year data

54 Tax year 1999 and 1998, Compliance Research Information System (CRIS), Model IFM 2001

55 Id.

56 Id.

57 Tax year 1999 and 1998, Compliance Reserch Information System (CRIS) Model IFM 2001

TABLE 2.2.3

BALANCE DUE INCOME TAX FOR MARRIED JOINT FILERS[58]				
	SINGLE	MARRIED FILING JOINT	MARRIED FILING SEPARATE	HEAD OF HOUSEHOLD
TY96	43.5%	39.2%	7.4%	9.9%
TY97	43.5%	37.5%	8.7%	9.9%
TY98	47.7%	35.7%	8.8%	7.8%

Of the 3.6 million taxpayers who filed balance due returns for tax year 1996, 918,000 (25.5%) also owed tax the previous year. For tax year 1997, out of the 3.4 million returns with a balance due, 991,000 returns (29.1%) showed tax owed the previous year. In tax year 1998, 881,000 of the 2.8 million returns or 29% from the prior year had a balance due.[59]

The sweeping reforms mandated by RRA 98 established many provisions to ensure taxpayer rights in the collection process, including the protection of the family residence.[60] Laws addressing taxpayer fraud, asset transfers, and other abusive situations would continue to apply to taxpayers regardless of whether their income tax liability was joint and several.

The National Taxpayer Advocate recognizes that this proposal might raise concerns about the Internal Revenue Services' ability to collect tax against property that is jointly owned by the spouse as tenants by the entirety. Section 6321 provides for a federal tax lien to attach to "all property and rights to property" of a taxpayer who has received notice and demand of a federal tax liability.[61] The Internal Revenue Service must look to state law in determining the taxpayer's "property and rights to property".[62]

The United States Supreme Court is currently considering a case involving the Service's right to collect against property held by a husband and wife as tenants by the entirety where only one spouse is liable for the tax.[63] The question is whether the property rights of the other spouse preclude collection by the IRS. The outcome of this case holds significant collection implications for the Internal Revenue Service. One of the main concerns is the ability to shelter assets from the collection process using state property laws.

58 Id.

59 Id.

60 The personal family residence of the individual is intended to be the last asset the Internal Revenue Service should seize – P.L. 105-206 H.R. 2676

61 IRC § 6321

62 Aquilino v. United States, 363 U.S. 509 (1960); United States v. Bess, 357 U.S. 51 (1958).

63 *Craft v. United States*, 65 F.Supp. 2d 651 (W.D. Mich. 1999), 233 F.3d 358 (6th Cir. 2000), cert. granted, No. 00-1831 (9-25-2001).

The proposed amendment to IRC § 6013(d) might necessitate a change to IRC § 6321 to clarify that the IRC § 6321 tax lien would attach to the spouse's interest in tenancy by the entirety property to satisfy that spouse's separate liability. Seventeen American jurisdictions (the "bar states" or "full bar states") provide that the liens of separate creditors cannot attach to entireties property or interest. Another ten jurisdictions (the "modified bar states") provide that the liens of separate creditors can attach subject to the rights of the nondebtor spouse, i.e., that the underlying property held by the entireties estate cannot be levied on until the nondebtor spouse's rights cease to be absolute, such as upon the termination of the entireties estate by death or divorce. The following table sets forth the states recognizing tenancy by the entirety property ownership.

TABLE 2.2.4

TENANCIES BY THE ENTIRETIES STATES WITH BARRIERS TO TAX COLLECTION[64]

TOTAL BAR JURISDICTIONS:	MODIFIED BAR JURISDICTIONS:
1. Delaware	1. Alaska
2. District of Columbia	2. Arkansas
3. Florida	3. Kentucky
4. Hawaii	4. Massachusetts
5. Illinois	5. Montana
6. Indiana	6. New Jersey
7. Maryland	7. New York
8. Michigan	8. Oregon
9. Mississippi	9. Rhode Island
10. Missouri	10. Tennessee
11. North Carolina	
12. Ohio (1973 to 1985 deeds only)	
13. Pennsylvania	
14. The Virgin islands	
14. Virginia	
16. Vermont	
17. Wyoming	

The proposed IRC § 6013(d) election will allow a married individual to be separately liable for the income tax attributable to his or her income while retaining the beneficial tax rates and other tax attributes available to a joint return. The proposed amendment to IRC § 6321 would protect the Service's ability to collect the tax from the appropriate debtor spouse. Congress may wish to direct the Secretary to develop guidelines describing the order in which the Service should proceed to collect against separate property, joint tenancy property, and tenancy by the entirety property.

64 Steve R. Johnson, Fog, Fairness and the Federal Fisc: Tenancy-by-the-Entireties Interests and the Federal Tax Lien, 60 Mo. L. Rev 844 (1995).

Another consideration is the impact of the proposed IRC § 6013(d) election on community property states and IRC § 66. Currently there are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Although there are variations from state to state, generally under community property laws, the property of one spouse is considered to be owned by both spouses equally. Married filing joint returns in the community property states constituted 40 percent of all returns for those states for 1998, similar to the overall percentage of Married filing joint returns for all filers. The claims for relief under IRC § 66 are significantly less than claims for relief under IRC § 6015.

TABLE 2.2.5

MERIT DETERMINATIONS MADE UNDER IRC §66(c)-3/6/99 THROUGH 11/23/01[65]

IRC SECTIONS	CLAIM YEARS	APPROVED	PARTIAL	DENIED
66(c) (second sentence)	162	68	12	82
66(c) (first sentence)	67	19	7	41
Total	229	87	19	123
Percent of Total Claims	100%	38%	8%	54%

Section 66(c) provides for the treatment of community income where married individuals who do not file a joint return or do not live together at all times during the calendar year. In general, the provision provides for relief of liability where the taxpayer establishes that he or she did not know of, and had no reason to know of, such item of community income, and in taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income.

The National Taxpayer Advocate has identified an IRC § 66 and community property law issue in the Additional Issues section of this Report. We intend to develop proposals regarding IRC § 66 and community property in the 2002 Annual Report to Congress. We believe that the federal tax system must address the legacy of *Poe v. Seaborn* and bring about greater uniformity of tax administration between common law and community property states.

65 Source: Innocent Spouse Tracking System, November 2001.

JOINT AND SEVERAL LIABILITY

Form **1040M** Department of the Treasury--Internal Revenue Service
U.S. Individual Income Tax Return **2001**
IRS Use Only--Do not write or staple in this space.

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type

LABEL HERE

For the year Jan. 1--Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 — OMB No. 1545--0074

Your first name and initial | Last name | Your social security number

If a joint return, spouse's first name and initial | Last name | Spouse's social security number

Home | Apt. no.

City, town

You **must** enter your SSN(s) above.

Presidential Election Campaign (See page 19.)

Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? . . . **You** ☐ Yes ☐ No **Spouse** ☐ Yes ☐ No

Exemptions

1a ☐ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6 a . . . . . **No. of boxes**

b ☐ **Spouse** . . . . . .

c **Dependents:**

If more than six dependents,

(1) Name	Last Name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) If qualifying child for child tax credit (see page 20)
				☐
				☐
				☐
				☐

No. of your children

No. of your children

Dependents on 1c

Add number entered on lines above

d Total number of exemptions claimed . . . . . .

e Check if: [ ] **You** were 65 or older, [ ] Blind; **Spouse** [illegible] older, [ ] Blind.
Add the number of boxes checked above and enter the total here . . . **e**

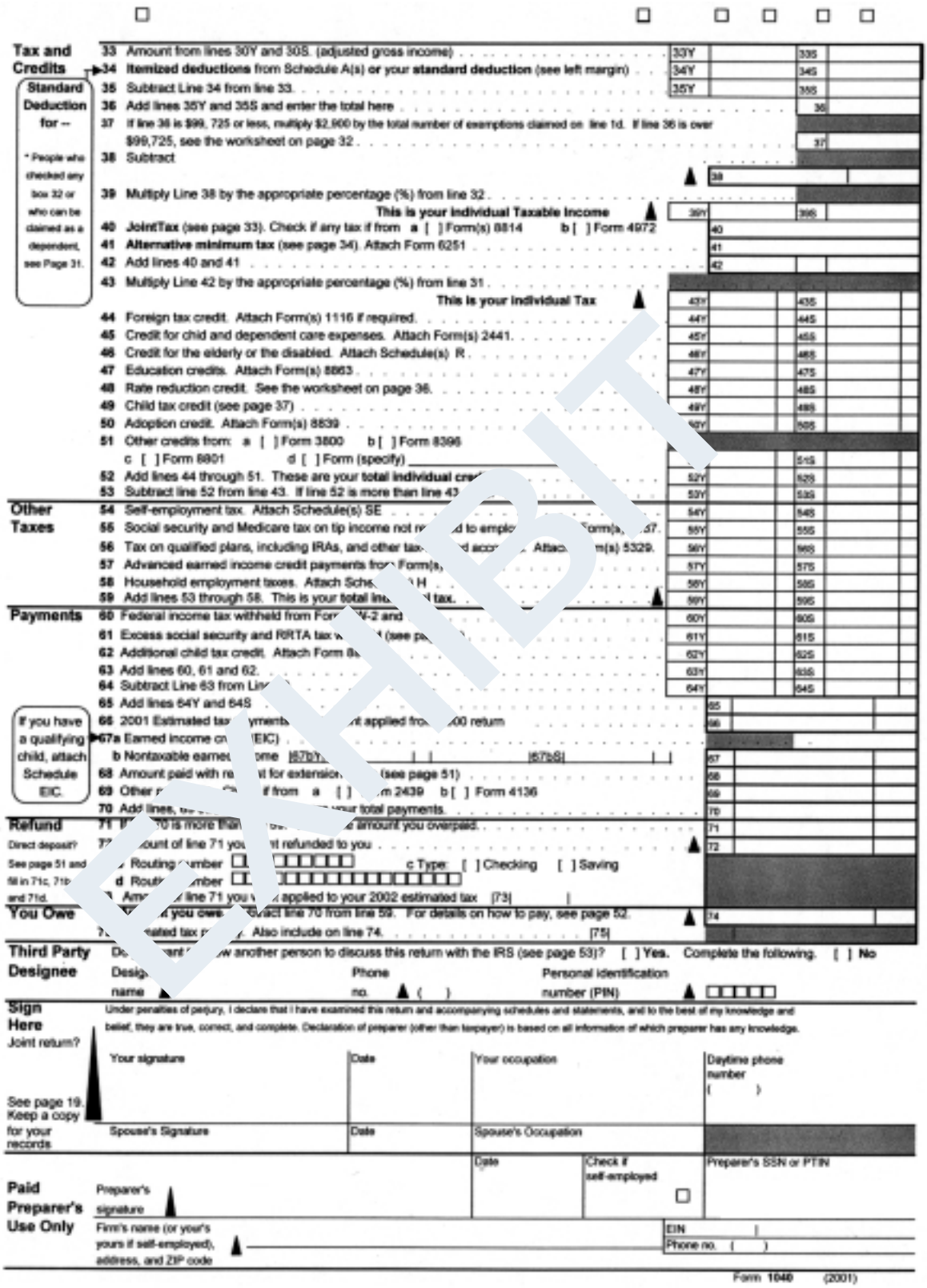
f Non-Obligated Spouse [ ] Yourself [ ] Spouse

See Instructions

			Yourself		Spouse	
Income	2	Wages, salaries, tips. Etc. Attach Form(s) W-2	2Y		2S	
	3a	**Taxable** interest. Attach Schedule if required	3Y		3S	
	3b	**Tax-exempt** interest. Do not include on line 3a	3bY|		3bS|	
	4	Ordinary dividends. Attach Schedule(s) if required	4Y		4S	
	5	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	5Y		5S	
	6	Alimony received	6Y		6S	
	7	Business income or (loss). Attach Schedule(s) C or C-EZ	7Y		7S	
	8	Capital gain or (loss). Attach Schedule D if required. If not required, check here [ ]	8Y		8S	
	9	Other gains or (losses). Attach Form(s) 4797	9Y		9S	
	10a	Total IRA distributions 10aY| 10aS| b Taxable amount (see page 23)	10bY		10bS	
	11a	Total pensions and annuities 11aY| 11aS| b Taxable amount (see page 23)	11bY		11bS	
	12	Total rental real estate,royalties,partnerships,S corporations,trust,etc. Attach Schedule(s) E	12Y		12S	
	13	Farm income or (loss). Attach Schedule(s) F	13Y		13S	
	14	Unemployment compensation	14Y		14S	
	15a	Social Security Benefits 15aY| 15aS| b Taxable amount (see page 23)	15Y		15S	
	16	Other income. Type and amount (see page 27) _____	16Y		16S	
	17	Add lines 2 through 16. . . . . **This is your individual Federal Income**	17Y		17S	
	18	Add lines 17Y and 17S. . . . . **This is your total Federal Income**	18			
Adjusted Gross Income	19	IRA deduction (see page 27)	19Y		19S	
	20	Student loan interest deduction (see page 28).	20Y		20S	
	21	Archer MSA deduction. Attach Form 8853(s)	21Y		21S	
	22	Moving expenses. Attach Form 3903(s)	22Y		22S	
	23	Alimony received	23Y		23S	
	24	One-half of self-employment tax. Attach Schedule(s) SE.	24Y		24S	
	25	Self-employed health insurance deduction (see page 30)	25Y		25S	
	26	Self-employed SEP, SIMPLE, and qualified plans.	26Y		26S	
	27	Penalty on early withdrawal of savings.	27Y		27S	
	28	a. Alimony paid b. Recipient's SSN _____	28Y		28S	
	29	Add lines 19 through 28	29Y		29S	
	30	Subtract line 29 from line 18. **This is your individual adjusted gross income**	30Y		30S	
	31	Add Lines 30Y and 30S and enter the total here. **This is your total adjusted gross income**	31			
	32	**Income percentages.** Divide Line 30Y by Line 31 and place in Line 32 Y. Divide Line 30S by the total on Line 31 and enter on Line 32S. (Total of columns 32Y and 32S must equal 100%)	32Y	%	32S	%

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2001)

EXHIBIT



Tax and Credits

Standard Deduction for --

* People who checked any box 32 or who can be claimed as a dependent, see Page 31.

33 Amount from lines 30Y and 30S. (adjusted gross income)
34 **Itemized deductions** from Schedule A(s) **or your standard deduction** (see left margin)
35 Subtract Line 34 from line 33.
36 Add lines 35Y and 35S and enter the total here
37 If line 36 is $99, 725 or less, multiply $2,900 by the total number of exemptions claimed on line 1d. If line 36 is over $99,725, see the worksheet on page 32
38 Subtract
39 Multiply Line 38 by the appropriate percentage (%) from line 32
This is your individual Taxable Income
40 **JointTax** (see page 33). Check if any tax if from a [ ] Form(s) 8814 b [ ] Form 4972
41 **Alternative minimum tax** (see page 34). Attach Form 6251
42 Add lines 40 and 41
43 Multiply Line 42 by the appropriate percentage (%) from line 31
This is your individual Tax
44 Foreign tax credit. Attach Form(s) 1116 if required.
45 Credit for chid and dependent care expenses. Attach Form(s) 2441.
46 Credit for the elderly or the disabled. Attach Schedule(s) R
47 Education credits. Attach Form(s) 8863
48 Rate reduction credit. See the worksheet on page 36.
49 Child tax credit (see page 37)
50 Adoption credit. Attach Form(s) 8839
51 Other credits from: a [ ] Form 3800 b [ ] Form 8396
c [ ] Form 8801 d [ ] Form (specify)
52 Add lines 44 through 51. These are your **total individual cre**
53 Subtract line 52 from line 43. If line 52 is more than line 43

Other Taxes

54 Self-employment tax. Attach Schedule(s) SE
55 Social security and Medicare tax on tip income not re d to emplo Form(s) 37.
56 Tax on qualified plans, including IRAs, and other tax d acco Attac m(s) 5329.
57 Advanced earned income credit payments fro Form(s,
58 Household employment taxes. Attach Schs H
59 Add lines 53 through 58. This is your **total in d tax.**

Payments

60 Federal income tax withheld from For W-2 and
61 Excess social security and RRTA tax d (see pa
62 Additional child tax credit. Attach Form 8
63 Add lines 60, 61 and 62.
64 Subtract Line 63 from Lin
65 Add lines 64Y and 64S
66 2001 Estimated tax yments t applied fro 00 return

If you have a qualifying child, attach Schedule EIC.

67a Earned income cr (EIC)
b Nontaxable earned come [67bY] [67bS]
68 Amount paid with re t for extension (see page 51)
69 Other p if from a [ ] m 2439 b [ ] Form 4136
70 Add lines, ur total payments.

Refund

Direct deposit? See page 51 and fill in 71c, 71b and 71d.

71 If 70 is more than amount you overpaid.
72 Amount of line 71 you t refunded to you
c Routing number c Type: [ ] Checking [ ] Saving
d Routing number
73 Amount of line 71 you applied to your 2002 estimated tax [73]

You Owe

74 **Amount you owe** Subtract line 70 from line 59. For details on how to pay, see page 52.
75 Estimated tax penalty. Also include on line 74. [75]

Third Party Designee

Do you want another person to discuss this return with the IRS (see page 53)? [ ] **Yes.** Complete the following. [ ] **No**

Designee name Phone no. ( ) Personal identification number (PIN)

Sign Here

Joint return? See page 19. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date | Your occupation | Daytime phone number ( )

Spouse's Signature | Date | Spouse's Occupation

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed | Preparer's SSN or PTIN

Firm's name (or your's if self-employed), address, and ZIP code | EIN | Phone no. ( )

Form **1040** (2001)

EXHIBIT

JOINT AND SEVERAL LIABILITY

EQUITABLE RELIEF FACTORS

SUMMARY

PROBLEM

Internal Revenue Code section 6015(f) provides an avenue for relief from joint and several liability in situations where the facts and circumstances indicate it is inequitable to hold the taxpayer liable. For example, under current guidance, the knowledge factor is weighted more heavily than any other factor in making a determination under IRC § 6015(f). The Service's narrow interpretation of this provision reduces the ability to provide relief.

EXAMPLE

A taxpayer's husband receives a total distribution of his retirement account. He advises his wife that, upon the advice of their CPA, they can "roll over" the proceeds into a new home and thereby defer taxation on the distribution. The couple uses part of the proceeds toward the purchase of a modest home. Several months later, the husband asks the taxpayer to sign their joint income tax return, which reports the gross distribution from the retirement account but includes in taxable income only the portion of the proceeds that was not "rolled over" into the new home. The husband assures the taxpayer that although he prepared the return himself using purchased software, he had spoken with the CPA again about the roll over of the retirement proceeds. With these assurances, the taxpayer signs the return.

The taxpayer later discovers that her husband lied about consulting the CPA, lied about the tax treatment of retirement account distributions, and deceived her about many other things pertaining to their financial and personal lives. As a result of these lies, she divorces him and finds herself in dire financial straits. Prior to her divorce, the wife was a homemaker for 25 years and had no formal education in business.

The IRS proposes a deficiency in tax arising from the "roll over" proceeds.

RECOMMENDATION

Modify Internal Revenue Code section 6015(f) to provide additional guidance to the Secretary about the factors to be considered in determining whether it would be inequitable to hold the taxpayer jointly and severally liable for a jointly filed return.

EQUITABLE RELIEF FACTORS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code section 6015(f) authorizes the Secretary to grant relief from joint and several liability if, taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for any unpaid tax or deficiency or portion thereof. To obtain equitable relief, the taxpayer must not be eligible for relief under IRC § 6015(b) or (c).

REASONS FOR CHANGE

Under pre-1998 law, IRC § 6013(e) provided for relief where it would be inequitable to hold the other spouse liable for a deficiency; however, eligibility was dependent upon a "no actual or constructive knowledge" requirement. To alleviate the perceived inequity of this standard in certain cases, Congress included a new equitable relief provision in IRC § 6015(f) without establishing firm qualifying criteria. Without clarification, the Internal Revenue Service continues to consider equitable relief claims under the new law while using a level of knowledge standard as a critical factor found to be unsatisfactory in certain cases under prior law.

Revenue Procedure 2000-15 sets forth the Service's procedures for determining whether a spouse is entitled to relief from joint and several liability under § 6015(f).[66] This guidance outlines a non-exclusive list of factors the Service can consider to determine whether it would be inequitable, considering all of the facts and circumstances, to hold the taxpayer liable for a joint tax debt. The revenue procedure states that "no one factor is determinative" in reaching a decision, and "… all factors will be considered and weighed appropriately." Exhibit A summarizes those factors.

Eligibility for equitable relief, however, can depend heavily upon the actual or constructive knowledge standard. Among factors considered in determining eligibility, Revenue Procedure 2000-15 provides that if "a requesting spouse knew or had reason to know of the item giving rise to the deficiency or that the reported liability would be unpaid at the time the return was signed," such knowledge would be an "extremely strong factor weighing against relief."

We believe that no one factor should categorically outweigh other factors. For example, under IRC § 6015(f), the taxpayer's actual knowledge of an item on the joint return should not categorically outweigh factors that mitigate that knowledge, including the complexity of the tax consequences flowing from the return item, the taxpayer's education level or business expertise, or the existence of abuse in the marriage. *Because actual and constructive knowledge bars relief under IRC § 6015(b) and actual knowledge bars relief under IRC § 6015(c), neither actual nor constructive knowledge should automatically bar relief under the "facts and circumstances" analysis of IRC § 6015(f). Nor should actual or constructive knowledge automatically weigh more than other factors in making a "facts and circumstances" determination under IRC § 6015(f).*

[66] Rev. Proc. 2000-15, 2000-1 C.B. 447.

Congress designed this provision to provide relief to certain joint filers who do not qualify for the revised traditional relief under IRC § 6015(b) or the separate liability election of IRC § 6015(c). Given Congressional intent in enacting equitable relief, it would appear that giving more weight to the extent of knowledge over other factors will result in denial of a claim where all other factors support a grant of equitable relief. Weighting the extent of knowledge equally with other factors such as economic hardship, lack of significant benefit and marital status would extend the benefit to those in most need while removing those claimants clearly ineligible from consideration.

Although the current procedures also state that a taxpayer's noncompliance is a factor weighing against providing relief, the procedures do not list the taxpayer's history of compliance with the tax laws as a positive factor. It is true that all taxpayers are required to comply with their tax obligations. Sometimes a taxpayer has a tax liability arising from unfortunate circumstances surrounding a marriage. Since that time, the taxpayer may have taken affirmative and consistent steps to be in compliance with all tax obligations and to make sure that those circumstances do not repeat themselves. While it should not be the sole factor upon which relief is based, the taxpayer's history of compliance or even cooperation with the IRS should be taken into consideration as a positive factor.

EXPLANATION OF RECOMMENDATION

Modify Internal Revenue Code section 6015(f) to describe the factors to be used in making the determination to grant equitable relief. The section should state that no one factor alone would be sufficient to warrant IRC § 6015(f) relief and that knowledge, actual or constructive, should not automatically be given more weight than other factors.

The following factors should be among those considered in making a determination of IRC § 6015(f) relief.

- Whether the tax was attributable to the income of the individual requesting relief;
- Whether the electing spouse derived significant and continued benefit from the income to which the tax is attributable;
- Whether the taxpayer was the victim of abuse, fraud, or deceit by the non-electing spouse;
- Whether the taxpayer's mental or physical health was seriously impaired at the time of signing the joint return;
- Whether the taxpayer demonstrates a history of compliance with the tax law, including affirmative acts to achieve compliance or cooperation with the IRS;
- Whether the taxpayer was ordered to file the joint return in question by a court of law, over the taxpayer's objection;

- The existence of a divorce or property settlement agreement addressing the spouses' obligation, as between themselves, to pay the tax liability;
- The taxpayer's level of education;
- The taxpayer's degree of involvement in the activity generating the tax liability;
- The taxpayer's involvement in the financial matters of the couple or business;
- The taxpayer's business or financial expertise;
- The taxpayer's constructive or actual knowledge of the item giving rise to the tax liability;
- The complexity of the tax treatment of the item giving rise to the tax liability; and
- Whether the taxpayer will experience significant hardship if the Service does not provide equitable relief.

In providing guidance under this section, there should be an explanation provided for each of the factors that should be used in making a determination under IRC § 6015(f).

Congress should clarify how IRC § 6015(f) differs from IRC §§ 6015(b) and (c), namely, that without IRC § 6015(f), the application of joint and several liability would result in some harm that offends the conscience of law-abiding taxpayers and their sense that the tax laws are administered fairly and sensibly. The inclusion of an expanded discussion of the nature of these factors in accompanying legislative history, will provide taxpayers, the Service, and the courts with clear guidance about the circumstances in which Congress intends the Service to grant "equitable" relief. The guidance should make clear that the taxpayer is required to make a showing of more than one compelling circumstance before joint and several liability will be disregarded.

The proper evaluation and weighing of equitable relief factors by the IRS is fundamental for a taxpayer to obtain equitable relief. In a judicial proceeding reviewing the Service's decision, the taxpayer must show that the Service abused its discretion in denying equitable relief. While the National Taxpayer Advocate agrees that this standard is appropriate for reviews of IRC § 6015(f) determinations, because the judicial standard of review is so high, it is imperative that the Service adequately consider all the facts and circumstances in the administrative proceedings. If the IRS merely "gets it wrong" but does not abuse its discretion, the taxpayer has no real judicial recourse. Thus, it is extremely important for the IRS to "get it right" the first time in IRC § 6015(f) cases. The National Taxpayer Advocate believes that additional Congressional guidance will assist the Service in making IRC § 6015(f) determinations consistent with Congressional intent.

EXHIBIT A

EQUITABLE RELIEF FACTORS

(Rev. Proc. 2000-15)

FACTORS WEIGHING IN FAVOR OF RELIEF

- Marital Status.
- Economic Hardship.
- Abuse.
- No Knowledge or Reason to Know.
- Nonrequesting Spouse's Legal Obligation.
- Attributable to the Nonrequesting Spouse.

FACTORS WEIGHING AGAINST RELIEF

- Attributable to the Requesting Spouse.
- Knowledge, or Reason to Know.
- Significant Benefit.
- Lack of Economic Hardship.
- Noncompliance with Federal Income Tax Laws.
- Requesting Spouse's Legal Obligation.

EXHIBIT B– FILING STATUS ISSUES – JOINT AND SEVERAL LIABILITY

THIS TABLE SUMMARIZES THE PROVISIONS OF IRC § 66 AND § 6015 INCLUDING REGULATIONS AS OF 9-6-2001[1]

FACTORS	INNOCENT SPOUSE RELIEF § 6015(b)	ALLOCATION OF LIABILITY § 6015(c)	EQUITABLE RELIEF § 6015(f)	EQUITABLE RELIEF COMMUNITY PROPERTY STATES[2] § 66(c) FIRST SENTENCE	EQUITABLE RELIEF COMMUNITY PROPERTY STATES § 66(c) SECOND SENTENCE
Type of Return	Joint	Joint	Joint	Mailing filing separate	Mailing filing separate
Type of Liability	Deficiency	Deficiency	Deficiency or underpayment	Deficiency	Deficiency or underpayment
Special Requirements			Relief under § 6015(b) and § 6015(c) not available Liability remains unpaid except for amounts meeting requirements for refunds listed here	Note: This section applies only to tax arising from omitted income items, not from disallowed deductions.	Relief under § 66(c), first sentence not available. Only applies to income items, not to disallowed deductions. Liability remains unpaid except for amounts meeting requirements for refunds listed here
Refunds (Normal refund statute (RSED) controls)	Refunds Available	No refunds	Refunds available for amounts paid between 7/22/98 and 4/15/99, & for amounts paid under an installment agreement (if not defaulted) after the later of 7/22/98 or date Form 8857 filed	Refunds available.	Refunds available for amounts paid between 7/22/98 and 4/15/99, & for amounts paid under an installment agreement (if not defaulted) after the later of 7/22/98 or date Form 8857 filed
Marital Status	Marital Status considered as an equitable factor	Must be divorced, legally separated; or not living together for at least 12 months prior to the election	Marital status considered as an equitable factor	Marital status considered as an equitable factor	Marital status considered as an equitable factor

CONTINUED ...

1 Relief only for amounts unpaid as of 7/22/98 and amounts arising after 7/22/98. For amounts paid prior to July 22, 1998, IRC § 6013 (e) applies.

2 AZ, CA, ID, LA, NV, NM, TX, WA, WI

EXHIBIT B– FILING STATUS ISSUES – JOINT AND SEVERAL LIABILITY

THIS TABLE SUMMARIZES THE PROVISIONS OF IRC § 66 AND § 6015 INCLUDING REGULATIONS AS OF 9-6-2001 (CONTINUED)

FACTORS	INNOCENT SPOUSE RELIEF § 6015(b)	ALLOCATION OF LIABILITY § 6015(c)	EQUITABLE RELIEF § 6015(f)	EQUITABLE RELIEF COMMUNITY PROPERTY STATES[2] § 66(c) FIRST SENTENCE	EQUITABLE RELIEF COMMUNITY PROPERTY STATES § 66(c) SECOND SENTENCE
Knowledge	TP must establish had no knowledge OR reason to know	IRS must establish TP had *actual* knowledge of deficiency items	Knowledge considered as an equitable factor	Taxpayer must establish had no knowledge or reason to know	Knowledge considered as an equitable factor
Equity	Inequitable to hold TP liable: consider all facts & circumstances		Inequitable to hold TP liable: consider all facts & circumstances	Inequitable to hold TP liable: consider all facts & circumstances	Inequitable to hold TP liable: consider all facts & circumstances
Required Factors Tier I			Tier I Cases (Relief ordinarily granted if all 4 factors met) 1) Underpayment 2) No longer married, legally separated, OR not living together for 12 months prior to request 3) No knowledge or reason to know when return signed 4) TP will suffer economic hardship if relief not granted		Tier I Cases (Relief ordinarily granted if all 4 factors met) 1) Underpayment 2) No longer married, legally separated, OR not living together for 12 months prior to request 3) No knowledge or reason to know when return signed 4) TP will suffer economic hardship if relief not granted

EXHIBIT B– FILING STATUS ISSUES – JOINT AND SEVERAL LIABILITY
THIS TABLE SUMMARIZES THE PROVISIONS OF IRC § 66 AND § 6015 INCLUDING REGULATIONS AS OF 9-6-2001

FACTORS	INNOCENT SPOUSE RELIEF § 6015(b)	ALLOCATION OF LIABILITY § 6015(c)	EQUITABLE RELIEF § 6015(f)	EQUITABLE RELIEF COMMUNITY PROPERTY STATES[2] § 66(c) FIRST SENTENCE	EQUITABLE RELIEF COMMUNITY PROPERTY STATES § 66(c) SECOND SENTENCE
List of Partial Factors - Tier II			Tier II Cases – Underpayment and Deficiency Factors Weighing in Favor of Relief: 1) Marital status (same as 6015(c)) 2) Economic Hardship (defined in Regs. § 301.6343-1(b)(4)) 3) Abuse (but not duress) 4) No knowledge or reason to know (that liability would not be paid (for underpayment) or of item (for deficiency) 5) Non-requesting spouse's legal obligation (not positive factor if knowledge NRS would not pay at time decree/agreement signed) 6) Liability solely attributable to non-requesting spouse		Tier II Cases – Underpayment and Deficiency Factors Weighing in Favor of Relief: 1) Marital status (same as 6015(c)) 2) Economic Hardship (defined in Regs. § 301.6343-1(b)(4)) 3) Abuse (but not duress) 4) No knowledge or reason to know (that liability would not be paid (for underpayment) or of item (for deficiency) 5) Non-requesting spouse's legal obligation (not positive factor if knowledge NRS would not pay at time decree/agreement signed) 6) Liability solely attributable to non-requesting spouse
			Factors Weighing Against Relief 1) Attributable to requesting spouse 2) Knowledge or reason to know (extremely strong factor) 3) Significant benefit 4) Lack of economic hardship 5) Noncompliance with federal income tax laws 6) Requesting spouse's legal obligation		Factors Weighing Against Relief 1) Attributable to requesting spouse 2) Knowledge or reason to know (extremely strong factor) 3) Significant benefit 4) Lack of economic hardship 5) Noncompliance with federal income tax laws 6) Requesting spouse's legal obligation

CONTINUED ...

EXHIBIT B– FILING STATUS ISSUES – JOINT AND SEVERAL LIABILITY
THIS TABLE SUMMARIZES THE PROVISIONS OF IRC § 66 AND § 6015 INCLUDING REGULATIONS AS OF 9-6-2001 (CONTINUED)

FACTORS	INNOCENT SPOUSE RELIEF § 6015(b)	ALLOCATION OF LIABILITY § 6015(c)	EQUITABLE RELIEF § 6015(f)	EQUITABLE RELIEF COMMUNITY PROPERTY STATES[2] § 66(c) FIRST SENTENCE	EQUITABLE RELIEF COMMUNITY PROPERTY STATES § 66(c) SECOND SENTENCE
Fraud	Fraud is a consideration in equity determination Deficiency	Election invalid if IRS shows TP transferred assets as part of a fraudulent scheme	Relief not available if 1) Fraudulent return, or 2) Assets transferred as part of fraudulent scheme	Fraud is a consideration in equity determination	Relief not available if 1) Fraudulent return, or 2) Assets transferred as part of fraudulent scheme
Disqualified Assets Transferred for Avoidance of Tax or Payment of Tax	Transfer of disqualified assets is a consideration in equity determination	Amount of allocation is increased by value of disqualified assets	Relief not available to extent of value of any disqualified assets	Transfer of disqualified assets is a consideration in equity determination	Relief not available to extent of value of any disqualified assets
Time for Filing	2 years from 1st collection activity[3] after 7/22/98	2 years from 1st collection activity[3] after 7/22/98	2 years from 1st collection activity[3] after 7/22/98		2 years from 1st collection activity[3] after 7/22/98
Consideration in Courts	Tax Court; if full-paid, District Court or Court of Federal Claims	Tax Court; if full-paid, District Court or Court of Federal Claims	Tax Court review under abuse of discretion standard; if full- paid, District Court or Court of Federal Claims	Tax Court review; if full-paid, District Court or Court of Federal Claims	Tax Court review if part of deficiency proceeding or under Collection Due Process proceedings or under §6404 abatement of interest case; if full- paid, District Court or Court of Federal Claims

3 Collection activities that put the taxpayer on notice that the IRS intends to collect the tax from the taxpayer. (Levy, seizure, refund offset, judicial suit or claim, etc.)

CREDITS AND REFUNDS

SUMMARY

PROBLEM

In general, Internal Revenue Code section 6015(g) allows refunds or credits when relief is granted from joint and several liability under IRC § 6015. However, IRC § 6015(g)(3) specifically excludes the issuance of a refund under the IRC § 6015(c) "separate liability" election. In addition, in developing the regulations and guidance on allowing refunds under IRC § 6015(f) (equitable relief), the Secretary has applied a very narrow interpretation of the general refund provisions of IRC § 6015(g) and significantly limited refunds when relief is granted under IRC § 6015(f).

Taxpayers who make this election may be making payments under a previously agreed upon installment arrangement. If the taxpayer remains in compliance with this agreement while his innocent spouse claim is being processed, and he is granted relief under IRC § 6015(c), the Service cannot refund any part of the installment agreement payments he made during the processing of his case.

If relief is granted under IRC § 6015(f), current regulations allow refunds on payments made under an installment agreement. However, claimants cannot receive relief when their refund has been used to offset the outstanding liability or where assets have been seized for sale. If relief is subsequently granted, in these situations, any prior payment of tax will not be refunded or credited.

EXAMPLES

- A taxpayer owes $25,000 attributable to a married filing joint return. The taxpayer files a claim for relief under IRC § 6015(c). After 16 months of processing time, the claim is granted. Prior to filing the innocent spouse request, the taxpayer had an installment agreement requiring payments of $833 per month. While the taxpayer's innocent spouse claim was being processed, he continued to make monthly payments timely, totaling $13,328. Because a refund cannot be issued under IRC § 6015(g)(3) for a determination made under IRC § 6015(c), the taxpayer in the installment agreement has paid $13,328 more even though the Internal Revenue Service determined this person is not liable for the taxes.
- In April 2001, a taxpayer discovers that a tax liability on a joint return with her ex-husband was not paid. She first learned this when her 2000 refund for $2,500 was offset and applied to the earlier tax debt. At the time the return was filed, the taxpayer wrote a check to her husband to pay the tax liability. The taxpayer files a claim for equitable relief under IRC § 6015(f) in May 2001. The IRS grants her relief but cannot return her $2,500 tax refund under current IRS procedures.

JOINT AND SEVERAL LIABILITY

RECOMMENDATION

- Amend Internal Revenue Code section 6015(g)(3) so that, when relief is granted in full or in part under IRC § 6015(c), payments made after the date of filing an innocent spouse claim can be refunded.
- Modify the language of Internal Revenue Code section 6015(g) to provide guidance to the Secretary for developing a broader interpretation of the issuance of refunds under IRC § 6015(f).

CREDITS AND REFUNDS

DETAILED EXPLANATION

PRESENT LAW

In general, the provisions of Internal Revenue Code section 6015(g) allow refunds of tax when the taxpayer has been determined to be eligible for relief from joint and several liability. However, IRC § 6015(g)(3) specifically prohibits the issuance of refunds for taxpayers granted relief under the "separate liability" provisions of IRC § 6015(c).

Further, the Service has interpreted the general provision of IRC § 6015(g) to mean that the Service may use its discretion when allowing refunds under the equitable relief provisions of IRC § 6015(f). The Service's current published guidance provides that a requesting spouse is eligible to be considered for IRC § 6015 relief in the form of a refund of liabilities for (a) amounts paid on or after July 22, 1998, and on or before April 15, 1999; and (b) installment payments, made after July 22, 1998, pursuant to an installment agreement entered into with the Service and with respect to which an individual is not in default, that are made after the claim for relief is requested.[67]

REASONS FOR CHANGE

The provisions of IRC § 6015(g) specifically authorize refunds. However, the Service has interpreted the phrase "unpaid tax or any deficiency" in IRC § 6015(f) to mean that refunds were not intended under this subsection. We believe that the language of IRC § 6015(g) and the allowance for equitable relief under IRC § 6015(f) is sufficiently broad and provides credible evidence that this provision was not intended to be construed as narrowly as the Internal Revenue Service is currently interpreting it.

The procedures set forth in Revenue Procedure 2000-15 regarding refund rules under IRC § 6015(f) can prevent taxpayers who qualify for innocent spouse relief from receiving complete relief from joint and several liability. Particularly with respect to cases in which the tax was not paid with the original return, a taxpayer may first learn of the outstanding liability when a collection action occurs. To deny a refund of that collected amount to a taxpayer who otherwise qualifies for equitable relief is in itself inequitable.

Internal Revenue Code section 6015(g)(3) excludes the refund of payments as a result of an election under IRC § 6015(c). This rule causes problems if, while the innocent spouse claim is being considered, the claimant is in an installment agreement, her refunds are applied to the outstanding liability, or her property is subject to a federal tax lien. Taxpayers are encouraged to maintain installment agreements while the claim is being considered. However, taxpayers are later penalized for this compliance when IRC § 6015(c) relief is granted but the refund of these payments is not allowed under IRC § 6015(g)(3).

[67] Rev. Proc. 2000-15, 2000-1 C.B. 447.

For example, a taxpayer, recently divorced, needed to sell her home to reduce her living expenses. Her house was subject to a federal tax lien arising from a joint debt. She filed an innocent spouse claim and requested that the lien be released so that she could sell the house. Her claim had been in process for 18 months when she used a recently acquired death benefit payment of $10,000 to pay the tax liability. The Internal Revenue Service released the lien and her house was sold. Six months later, the IRS made a determination of relief in her favor under IRC § 6015(c). The taxpayer's $10,000 payment could not be refunded.

Under present law, the taxpayer must default on his installment agreement in order to avoid making payments that will not be refunded if he is entitled to relief under IRC § 6015(c). However, if the taxpayer is ultimately denied relief under IRC § 6015(c), he will owe more penalties and interest because he stopped making installment payments while his claim was being considered.

The proposed amendment to IRC § 6015(g)(3) will enable a taxpayer to make payments towards a joint tax debt while seeking innocent spouse relief without risking the loss of those funds if relief is ultimately awarded. The amendment also encourages taxpayers to remain in compliance while they pursue their legal options for relief from joint and several liability.

EXPLANATION OF RECOMMENDATIONS

Modify the language of Internal Revenue Code section 6015(g) to provide guidance to the Secretary and the Internal Revenue Service to expand the scope of refunds under IRC § 6015(f) to include those refunds available to the taxpayer under the refund limitation rules described in IRC §§ 6511(a) and (b). Thus, a taxpayer qualifying for equitable relief under IRC § 6015(f) should be entitled to the same refunds as a taxpayer qualifying for "traditional innocent spouse" relief under IRC § 6015(b).

Amend Internal Revenue Code section 6015(g)(3) to allow refunds of payments made after the date on which the claim for relief under IRC § 6015(c) was filed, when relief is granted in full or in part under that provision.

FINAL DETERMINATION RIGHTS

SUMMARY

PROBLEM

Internal Revenue Code section 6015 does not specifically authorize the IRS to rescind its final determination as to relief from joint and several liability. It is not clearly stated in IRC § 6015 whether the Service may make an additional determination in order to correct an error after it has issued the final determination letter.

In general, a taxpayer has the option to petition the United States Tax Court after the notice of final determination is issued when he or she does not agree with a determination made by the IRS. Taxpayers may miscalculate the final date to petition the court because of holidays and weekends. Further, IRC § 6015(e) does not explicitly grant the taxpayer a right to petition the Court if the request for relief under IRC § 6015(f) is denied.

EXAMPLE

A person who lives in a battered women's shelter or who moves frequently may be unable to timely forward necessary information to the IRS. The IRS may issue a determination letter following its normal procedures, only to receive the taxpayer's relevant information a few days later. It is unclear whether the Service may make an additional "final" determination in such a case.

The taxpayer's only recourse is to petition the Tax Court. If the date is not specified in the notice of final determination, the taxpayer may not understand the final due date for the petition. Since the IRS may not rescind the final determination, the taxpayer must file a petition in the Tax Court to protest the determination, even though the Service may agree with the taxpayer based on the additional information.

The ability to rescind a notice of final determination should be available if additional information is secured, if other factors warrant reconsideration, or if the IRS made an error in making the determination. Under IRC § 6212(d), the Secretary may, with the consent of the taxpayer, rescind a notice of deficiency mailed to the taxpayer. The current proposal would grant taxpayers the same opportunities for relief in the administrative processing of innocent spouse claims that they have in audit determinations and other claims.

JOINT AND SEVERAL LIABILITY

RECOMMENDATION

- Amend Internal Revenue Code section 6015 to allow the Internal Revenue Service to rescind a determination letter issued under IRC § 6015 with the agreement of the taxpayer, as permitted under IRC § 6212(d).[68]
- Amend Internal Revenue Code section 6015(e)(1)(A) to require the IRS to provide in the notice of final determination the last date to petition the Tax Court. Also, provide for the taxpayer to be able to petition the Tax Court by the later of the date the Secretary specifies in the notice of final determination or 90 days from the date of the notice. Include in IRC § 6015(e)(1)(A)(ii) language that would allow taxpayers outside the United States 150 days to petition the Tax Court, as is currently provided taxpayers who receive a notice of deficiency.
- Amend Internal Revenue Code section 6015(e) to allow the taxpayer the right to petition the United States Tax Court in determinations made under IRC § 6015(f).

68 Section 6015(c) provides for taxpayer who are no longer married or living together to separate their portion of tax liability for any liability which is assessed with respect to the return. Section 6015(g)(3) specifically states that no credit or refund shall be allowed as a result of an election under subsection (c).

FINAL DETERMINATION RIGHTS

DETAILED EXPLANATION

PRESENT LAW

Rescission of Notice of Final Determination Under IRC § 6015

Internal Revenue Code section 6015 authorizes for the Secretary to make a determination for relief from joint and several liability and to issue a notice of final determination to the taxpayer. Currently, the IRS does not include the final date for filing a petition with the Tax Court in the notice because if the IRS supplies an incorrect date, the law does not provide a remedy to the taxpayer who relies on that date.

Clarification of Last Date to Petition the Tax Court

Currently, IRC § 6015(e)(1)(A) provides the taxpayer up to 90 days to petition the United States Tax Court from the date the Secretary mails the notice of final determination for relief, or the date which is six months after the election for relief is filed. No provision requires the Secretary to specify the date to petition the Tax Court in the notice of final determination. Further, taxpayers who are outside of the United States at the time a notice of final determination is mailed do not have an extended period of time to file a petition. Internal Revenue Code section 6213(a) provides taxpayers living outside the United States 150 days to file a petition to respond to a notice of deficiency.[69]

Provide Judicial Review for Determinations Made Under IRC § 6015(f)

Internal Revenue Code section 6015(e) allows the taxpayer to petition the Tax Court when a spouse elects relief under IRC § 6015(b) or (c). The Tax Court has held that when a taxpayer elects relief under IRC § 6015(b) or (c), the Tax Court also has jurisdiction to review the Secretary's determination of relief under IRC § 6015(f).[70] The Tax Court has not yet issued an opinion as to whether it has jurisdiction to review any determination of relief made under IRC § 6015(f).

REASONS FOR CHANGE

Rescission of Notice of Final Determination

Internal Revenue Code section 6015 does not specify that the notice of final determination can be rescinded. It is not clear whether the Internal Revenue Service has the ability to rescind the determination letter. Thus, the IRS does not have the flexibility to consider information received after a notice of final determination for innocent spouse relief is issued. The IRS should be able to rescind the notice of final determination if supplemental facts are submitted but not timely.

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69 IRC § 6212(d) Authority to rescind notice of deficiency with taxpayer's consent. The Secretary may, with the consent of the taxpayer, rescind any notice of deficiency mailed to the taxpayer . Any notice so rescinded shall not be treated as a notice of deficiency for purposes of subsection (c) (1) (relating to further deficiency letters restricted). §6213 (a) (relating to restrictions applicable to deficiencies, petitions to Tax Court),…

70 IRC § 6213(a) states, " … Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the notice of deficiency authorized in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency."

A person who has unstable home circumstances or who moves frequently may be unable to timely forward necessary information. The IRS may issue a determination letter denying the claim before the relevant information arrives.

This proposal could avoid the taxpayer's having to petition the Tax Court when the Internal Revenue Service and the taxpayer agree the additional information would change the original determination. It could also help in cases where the IRS makes an error in processing the claim for relief or other factors contribute to an incomplete determination of relief. Although the number of taxpayers impacted is relatively small (154,900 claims for relief filed since 7/22/98), providing an administrative way to address these cases would spare the taxpayer, the Internal Revenue Service, and the court system expenses associated with litigation.

The National Taxpayer Advocate recognizes that it is important to both the taxpayer and effective tax administration to provide closure and avoid unnecessary delays in finalizing the determination. Therefore, the Secretary should provide guidelines for administering the re-determination process.

Clarification of Last Date to Petition the Tax Court

Taxpayers can miss their opportunity to petition the United States Tax Court in "stand-alone" innocent spouse cases because of the difficulty in calculating the final date to petition the Tax Court. It would be helpful for taxpayers if the notice of final determination provided the last date to file a petition with the Tax Court. Currently, the IRS does not include this date in the notice because, if the incorrect date is entered, the law does not provide a remedy to the taxpayer who relies on that date. Consequently, taxpayers may miscalculate the time period for petitioning the Tax Court.

Currently, IRC § 6213(a) requires the IRS to provide the last date to petition the United States Tax Court in response to a statutory notice of deficiency. Thus, taxpayers who request relief under IRC § 6015 as part of an administrative audit or appeals proceeding receive notice of the final date by which they must file a Tax Court petition, while taxpayers who seek IRC § 6015 relief in a stand-alone proceeding do not receive such notice.

Under the National Taxpayer Advocate proposal, it is intended that IRC § 6015(e)(1)(A) be consistent with the provisions of IRC § 6213(a) with respect to the inclusion of a petition due date in the determination letter and with respect to the extended filing deadline for taxpayers outside the United States.

Internal Revenue Code section 6015(e)(1)(A) does not require a determination letter to provide the last date for filing a petition in the Tax Court, as it does in IRC § 6213(a). If the Secretary includes a date in the notice of final determination and it is incorrect, the taxpayer could be late in filing his or her petition with the Tax Court.[71]

[71] Butler v. Commissioner, 114 T.C. 276 (2000); Fernandez v. Commissioner, 114 T.C. 324 (2000).

This provision affects taxpayers who do not receive their desired relief administratively. Approximately 50 percent of innocent spouse claims are allowed administratively. Thus, this proposal would potentially affect the 50 percent that are denied. It is significant for those individuals whose claims are denied because their ability to timely petition the Tax Court determines whether or not they are able to exercise their right to a hearing.[72] The Court no longer keeps records of orders of dismissal; therefore, we do not have statistics on how many petitions were untimely.

Judicial Review of Determinations Made Under IRC § 6015(f)

Internal Revenue Code section 6015(e) allows the taxpayer to petition the Tax Court when a spouse elects relief under IRC § 6015(b) or (c). The Tax Court has held that when a taxpayer elects relief under IRC § 6015(b) or (c), the Tax Court also has jurisdiction to review the Secretary's determination of relief under IRC § 6015(f).[73] The Tax Court has not yet issued an opinion as to whether it has jurisdiction to review any determination of relief made under IRC § 6015(f). This does not ensure, however, that the Tax Court will take the same position on this issue or that appellate courts will sustain the position of the lower court. The IRS is not challenging the Tax Court's jurisdiction over cases raising issues solely under IRC § 6015(f).

In certain situations, the dispute may not involve the tax reported on the joint return. Rather, the taxpayer may be disputing his or her obligation to pay the correctly reported but unpaid tax liability. This individual's only course for relief is under IRC § 6015(f) and, if the IRS does not grant relief, the individual may or may not be able to obtain Tax Court review. Taxpayers who can afford legal counsel may be able to petition the Tax Court in an underpayment case by electing relief under IRC § 6015(b) or (c), even though the taxpayer would not qualify for relief under those provisions. Less sophisticated taxpayers who are not aware of the Tax Court's recent holdings on this issue would not know to elect relief under IRC § 6015(b) or (c) and may not be able to petition the Tax Court.

The following table represents the cases by code section that have been through an administrative appeal before an IRS Appeals Officer. The table shows that close to 50 percent of the claims made under IRC § 6015(f) were denied relief administratively. If these individuals did not apply for relief under (b) or (c), they would not be entitled to take their case to the Tax Court.

[72] IRC § 6213(a) states, "Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed."

[73] In Fiscal Year (FY) 2000, 13,676 petitions were filed with the Tax Court; in FY 2001, 15,440 petitions were filed.

TABLE 2.2.6 APPEALS DETERMINATIONS AS OF 11.25.2001

	IRC SECTION	NUMBER	APPROVED		PARTIAL		DENIED		
Service Wide		4132	1648		687		1797		
Service Wide	6013(e)	96	26	27.08%	9	9.38%	61	63.54%	100%
Service Wide	6015(b)	907	412	45.42%	95	10.47%	400	44.10%	100%
Service Wide	6015(c)	487	237	48.67%	151	31.01%	99	20.33%	100%
Service Wide	6015(f) Deficiency	424	157	37.03%	56	13.21%	211	49.76%	100%
Service Wide	6015(f) Other	2196	809	36.84%	374	17.03%	1013	46.13%	100%
Service Wide	66(c) (second sentence)	17	5	29.41%	2	11.76%	10	58.82%	100%
Service Wide	66(c) (first sentence)	5	2	40.00%	0	0.00%	3	60.00%	100%

The request for relief under IRC § 6015 does not suspend the running of the period of limitations on collection.[74] Currently, the Internal Revenue Service does not collect on these individuals unless the statutory collection period has nearly run, as a matter of tax administration policy. However, by including IRC § 6015(f) claims in the IRC § 6015(e) provision granting Tax Court jurisdiction, the IRS would be restricted from collecting and the statute of limitations period for collection of tax would be tolled.

EXPLANATION OF RECOMMENDATIONS

Rescission of Notice of Final Determination

Add a new section under Internal Revenue Code section 6015 that would allow the Internal Revenue Service to rescind a determination letter, with the agreement of the taxpayer, similar to the authority in IRC § 6212(d).[75]

Clarification of Last Date to Petition the Tax Court

Amend Internal Revenue Code section 6015(e) to require the Secretary to provide the final date on which the taxpayer can petition the Tax Court in the notice of final determination. Amend IRC § 6015(e)(1)(A) to allow the taxpayer to petition the Tax Court the later of the date the Secretary specifies in the determination letter or 90 days from the date of the letter. Include in IRC § 6015(e)(1)(A)(ii) language that at the time of the notice would give taxpayers outside the United States 150 days to petition the Tax Court.

74 Butler v. Commissioner, 114 T.C. 276 (2000); Fernandez v. Commissioner, 114 T.C. 324 (2000).

75 Prop. Reg. § 1.6015-7(a)(2)(ii) states that "If a requesting spouse seeks only equitable relief under § 1.6015-4, the restrictions on collection of paragraph (c)(1) of this section do not apply. The request for relief does not suspend the running of the period of limitations on collection."

Judicial Review of Determinations Made Under IRC § 6015(f)

Amend Internal Revenue Code section 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.

This amendment will generally prevent the IRS from collecting and will toll the statutory limitation period for collection during the pendency of the suit.

RECOMMENDATIONS

3

ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

DID YOU KNOW?

- The Alternative Minimum Tax (AMT) is so complicated that many taxpayers are not aware that they may be subject to it.
- The AMT has drifted from its goal of ensuring that wealthy Americans pay at least some tax.
- Last year, some individuals with income below $50,000 were required to pay AMT.
- Employees exercising incentive stock options may fall under the AMT.
- Unlike the standards for income tax, AMT thresholds are not adjusted and indexed for inflation.
- In 1998, 75 percent of the taxpayers subject to AMT paid only 19 percent of total AMT revenues.
- As many as 35.5 million taxpayers may be subject to AMT by 2010.
- The AMT is too complicated for most taxpayers to calculate without paid professional help. For tax year 1998, tax professionals prepared approximately 53.4 percent of all individual income tax returns.
- Between keeping records, studying the law, preparing and mailing the form, a taxpayer may need almost 12 hours just to deal with the AMT.
- Taxpayers may have to read ten pages of instructions, fill out a 13-line worksheet and a 54-line form – then find out they owe little or no alternative minimum tax after all.

ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

SUMMARY

The National Taxpayer Advocate recommends that the individual Alternative Minimum Tax be repealed.

PROBLEM

The individual Alternative Minimum Tax (AMT) is a separate and complex tax structure originally designed to reduce the effect of certain tax provisions used frequently by high-income taxpayers and infrequently by other taxpayers to reduce their tax liabilities, and to ensure that these wealthy individuals paid some federal tax.[1] Congress enacted a minimum tax in 1969 following testimony by the Secretary of the Treasury that 155 people with adjusted gross income (AGI) of $200,000 or more had paid no federal income tax for the 1966 tax year.[2]

Today, the impact of the AMT extends beyond the narrow group of taxpayers originally subject to the tax in 1969 when it was first enacted. High state taxes, large capital gains or unreimbursed employee business expenses or a large number of dependents can trigger the AMT today. The individual AMT requires taxpayers to compute their income tax liability twice, first using the regular tax system and then using the AMT system. Because of its complexity, taxpayers today often do not know that they are subject to the AMT. [3]

The instructions for Form 1040 require taxpayers to complete a thirteen-line worksheet, not to determine AMT, but simply to find out if they are liable for AMT. If they are liable, they must then determine their AMT liability using Form 6251, Alternative Minimum Tax – Individuals which contains 54 lines. In many cases, taxpayers complete this form only to find that they are not subject to the tax after all.

The AMT increases the time taxpayers need to determine their final tax liability by almost 12 hours. The IRS estimates taxpayers will spend six hours to compute the AMT portion of their liability.[4] If taxpayers are entitled to claim the credit for prior year minimum tax, they will spend an additional five hours and 58 minutes calculating their credit using Form 8801, Credit For Prior Year Minimum Tax – Individuals, Estates, and Trusts.[5]

It has been estimated that by 2010, 35.5 million taxpayers will be affected by AMT.[6] This projected growth in AMT coverage, coupled with its complexity, will add significantly to the overall compliance burden on taxpayers. This increased coverage will also affect the

1 Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (JCS-3376), December 29, 1976 at 105.

2 The 1969 Economic Report of the President: Hearings Before the Joint Economic Comm., 91st Cong., 1st Sess., pt. 1, at 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury).

3 Tax Code Complexity: New Hope for Fresh Solutions: Hearings before the Senate Comm. on Finance, 107th Cong., 1st Sess. 80 (2001) (statement of Pamela J. Pecarich, American Institute of Certified Public Accountants).

4 Instructions for Form 6251, Alternative Minimum Tax -Individual, (rev. 2001) p. 8.

5 Instructions for Form 8801, Credit for Prior Year Minimum Tax – Individuals, Estates, and Trusts (rev. 2001) p. 4.

6 U. S. Congress, Joint Committee On Taxation, Estimated Effects of the Conference Agreement for H.R. 1836{1}(JCX-51-01) p. 8.

distribution of the tax burden and may change the economic incentives created by the tax system. Additionally, under current law, AMT could neutralize future changes to the regular tax system.[7]

EXAMPLES

The following examples illustrate the impact of AMT upon individual taxpayers:

- A mother of five earned $45,000 in tax year 2000. She must pay $1,850 in AMT due to the number of her personal exemptions.[8]
- A taxpayer files a joint return claiming two exemptions for tax year 1999. The taxpayer has an AGI of $190,000 and itemized deductions which are limited by phase-outs. The taxpayer lives in a high tax state and must pay $10,194 in AMT due to state and local income taxes of $47,000.
- Currently, residents of several states are able to include settlement amounts in gross income net of attorney fees.[9] In other states, taxpayers must include the entire settlement amount in gross income and claim a miscellaneous itemized deduction for the attorney fees. The deduction triggers the AMT, which in turn reduces or eliminates the tax benefit of the deduction.
- A taxpayer accepts a job offer with a compensation package that includes incentive stock options to supplement his salary. In order not to lose his vested options, the taxpayer exercises them. The AMT is calculated on the value of the shares at the time the taxpayer exercised the options, not on the depressed share price when he actually sells them. Although the transaction may generate thousands of dollars in AMT credits, the taxpayer cannot use them against future income tax since he will not recognize significant gain from the sale of his depressed stock.

RECOMMENDATION

Repeal the provisions of Internal Revenue Code sections 55, 56, 57, 58 and 59 which pertain to the Alternative Minimum Tax for individuals.

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7 U.S. General Accounting Office, Alternative Minimum Tax: An Overview of its Rationale and Impact on Individual Taxpayers, Report to the Chairman, Senate Comm. on Finance (2000).

8 Tax Code Complexity: New Hope for Fresh Solutions: Hearings before the Senate Comm. on Finance, 107th Cong., 1st Sess. 80 (2001) (statement of Pamela J. Pecarich, American Institute of Certified Public Accountants). While not specified in the testimony, further research indicates that the taxpayer was required to use the married filing separate status as she was separated from her spouse for less than six months.

9 IRC § 61

ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

DETAILED EXPLANATION

PRESENT LAW

The AMT was originally designed to reduce the effect of certain provisions frequently used by high-income taxpayers and infrequently by other taxpayers to reduce their tax liability. Thus, the AMT has provisions covering deductions for drilling oil wells, farm tax shelters, interest from tax-exempt private activity bonds, and other items generally unfamiliar to the average taxpayer.

The tax law provides for preferred treatment of some kinds of income, and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from these provisions may have to pay a minimum amount of tax through the AMT. All taxpayers who are subject to the AMT for individuals must file a separate form - IRS Form 6251, Alternative Minimum Tax – Individuals. They must complete this form and supplemental worksheets even if it turns out, after all the calculations are computed, that they owe no AMT.

CALCULATING THE AMT IS A FIVE-STEP PROCESS:

- First, taxpayers calculate their regular income tax.
- Second, they determine whether the AMT may apply. Some taxpayers may be subject to the AMT if they claim certain preference items, such as accelerated depreciation and tax exempt interest.[10] These taxpayers go straight to the third step. Other taxpayers may be subject to the AMT if their taxable income in 2001 plus certain other items exceeds $49,000 for married couples filing a joint return (half that for each spouse if they file separately), or $35,750 for a single filer or head of household.[11] Those taxpayers complete a 13-line worksheet provided in the instructions to IRS Forms 1040 and 1040A. If the worksheet indicates that the AMT may apply, those taxpayers go on to the third step.
- Third, taxpayers use Form 6251, which contains 28 lines in Parts I and II, to recalculate taxable income using the rules of AMT instead of regular income tax rules. The result of this calculation is called alternative minimum taxable income (AMTI).
- Fourth, taxpayers subtract their applicable AMT exemption amount from their AMTI to calculate their tentative minimum tax.
  - However, if taxpayers have capital gains, they must complete Part IV of Form 6251 using maximum capital gains rates to calculate their tentative minimum tax, adding 26 additional lines to the calculation.

[10] IRC § 55(b)(2)(B)

[11] These exemption amounts, increased by the Economic Growth and Tax Relief Reconciliation Act of 2001" (P.L. 107-16), are in effect through 12/31/04.

- When applicable, taxpayers subtract the alternative minimum foreign tax credit to arrive at their tentative minimum tax.

- Finally, taxpayers compare their regular tax (minus any tax from Form 4972, Tax on Lump-Sum Distributions, and any foreign tax credit from Form 1040) with their tentative minimum tax, and pay whichever is greater. Technically, the AMT is not the whole amount of tax calculated under AMT rules; it is only the difference between tentative minimum tax and regular income tax.

The AMT has two rates. A tax rate of 26 percent applies if AMTI minus the exemption amount does not exceed $175,000. Each dollar above $175,000 is taxed at 28 percent. While these rates do not exceed the highest regular income tax rate, the AMT allows fewer ways to reduce tax liability than the regular income tax. It also applies as a flat rate to all AMT, as opposed to the progressive rates (27 – 30 – 35 – 38.6) applied to income brackets in the regular tax system. Thus, it raises additional revenue despite its relatively low rates.[12]

Once taxpayers are subject to the AMT, they accrue AMT credits. However, these credits may be applied only to timing items, and not to exclusion items. Timing items are those that are accounted for in different tax years in the regular tax and AMT systems. Exclusion items are adjustments and tax preference items that result in the permanent exclusion of income for regular income tax purposes, such as the standard deduction, personal exemptions and certain itemized deductions. Additionally, these credits can be used only when the regular tax liability reduced by other nonrefundable credits exceeds the tentative minimum tax for the tax year.

There are instances when a taxpayer may not be able to use a minimum tax credit. A taxpayer whose AMT liability stems from the exercise of an Incentive Stock Option (ISO) may not be able to use some or all of the minimum tax credit. For example, as a result of exercising an ISO, a taxpayer has an AMT liability of $1000 in year 1 and in year 2. Due to a decline in the value of the stock, the regular tax liability when his stock is sold is $100. Only $100 of the minimum tax credit can be used. Thus, the taxpayer recovers just $100 of the $1000 AMT he has paid.

REASONS FOR CHANGE

The AMT is rapidly becoming a problem for low-income and middle-income taxpayers. Congress originally enacted the minimum tax in 1969 following testimony by the Secretary of the Treasury that 155 people with adjusted gross income above $200,000 paid no federal income tax on returns for tax year 1966.[13] Adjusted for inflation, $200,000 in

12 U.S. Congress, Joint Economic Committee Study, The Alternative Minimum Tax for Individuals: A Growing Burden, May 2001.

13 The 1969 Economic Report of the President: Hearings Before the Joint Economic Comm., 91st Cong., 1st Sess., pt. 1, at 46 (1969) (Statement of Joseph W. Barr, Secretary of the Treasury).

1966 equals about $1.1 million today. But because the AMT is not indexed for inflation, individuals with an AGI well below $200,000 can be liable for AMT. [14]

Several personal, nonrefundable regular tax credits were either directly or effectively not allowable against the AMT, including the child tax credit, adoption credit, child and dependent care credit, and education credits. A temporary provision enacted in 1998 prevented taxpayers from having their personal tax credits limited by the AMT. This provision expires December 31, 2001.[15] The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16) permanently extended the child tax credit and adoption tax credit against AMT liability. H.R. 3090 has been introduced to allow the other nonrefundable credits against regular and minimum tax liability.

For tax year 1998, approximately 53.4 percent of all returns were completed by a paid preparer. However, 83.4 percent of all 1998 returns reporting an AMT liability were completed by paid preparers.[16] The AMT's complexity places it beyond the basic tax preparation skills of most taxpayers subject to its provisions.

Each year the National Associate of Enrolled Agents surveys its members on the problems of the filing season and asks them to choose the most complex item in the Internal Revenue Code, which is labeled ''the tax headache of the year." The overwhelming winner in 2001, for the second year in a row, was the individual alternative minimum tax.[17]

The individual AMT no longer serves the purpose for which it was originally enacted. The present structure of the individual AMT expands the scope of its provisions to taxpayers who should not be drawn into the complex concepts, calculations and recordkeeping required of AMT taxpayers. The AMT system imposes a significant burden on taxpayers who bear no resemblance to those whom the minimum tax originally attempted to reach. It creates taxpayer confusion and anger because it catches taxpayers unaware, often operates in a counter-intuitive fashion, and penalizes certain transactions that serve public policy goals (e.g., attorney fees for awards in employment discrimination cases, or the use of incentive stock options to encourage employee engagement and investment in companies).

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14 Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, 2001 Tax Return Filing Season Hearing, 107th Cong., 1st Sess., (2001) p. 84 (Statement of Claudia Hill, National Association of Enrolled Agents).

15 IRC § 26(a)(2)

16 Tax Year 1998 Compliance Research Information System (CRIS), Model IFM 2000.

17 Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, 2001 Tax Return Filing Season Hearing, 107th Cong., 1st Sess., (2001) p. 86 (Statement of Claudia Hill, National Association of Enrolled Agents).

EXPLANATION OF RECOMMENDATION

The repeal of the individual AMT would greatly simplify the tax code. It will eliminate the burden taxpayers experience when completing two different tax computations and maintaining the related books and records, including information about AMT credit carry forwards.

AMT repeal will also reduce the use of IRS compliance resources in administering this provision. IRS research indicates a marked increase in court cases involving the AMT. From 1969 to 1979, there were a minimal number of these cases. However, since 1990, at least 260 cases involving individual AMT have been heard in the United States Tax Court.[18]

Over the last six years, lawmakers from both parties and both houses of Congress have introduced at least 25 pieces of legislation proposing repeal of the individual AMT.[19]

The repeal of the individual AMT will require that Congress address the treatment of unused prior year minimum tax credits.

ALTERNATE PROPOSALS TO LIMIT THE IMPACT OF THE INDIVIDUAL AMT

Alternate Proposals to Limit the Impact of the individual AMT

If full repeal of the individual Alternative Minimum Tax (AMT) is not possible, it should be restructured to restore it to its original scope and application. The National Taxpayer Advocate recommends at least one of the following changes be made to the individual AMT.

Index the individual Alternative Minimum Tax Exemptions to current dollars.

In 1982, Congress established levels of alternative minimum taxable income that would be exempt from the AMT.[20] For a married couple filing jointly the exemption was $40,000. The AMT exemption amounts have been adjusted twice since 1982. If adjusted for inflation, the exemptions first used in tax year 1983 would be $65,600 for married filing jointly, $49,200 for Single or Head of Household and $32,800 for Married Filing Separate in 2001.[21]

If the 1983 AMT exemption amounts had been indexed for inflation and applied to 1998 tax returns, 552,016 taxpayers[22] would not have had an AMT liability in 1998.

18 Lexis-Nexis® research

19 HR 275 sec 5, 1/30.01, Sam Johnson; HR 437, 2/6/01, English

20 The Tax Equity and Fiscal Responsibility Act of 1982 changed the structure of the AMT system for individuals, eliminating the "tiered system" and among other changes, established exemption amounts.

21 Tax Year 1998 Compliance Research Information System (CRIS), Model IFM 2000.

22 Id.

Establish a gross income threshold (indexed for inflation), for individual Alternative Minimum Tax that can be taken directly from the tax return.

Eighty-one percent of the total AMT revenues of $5,034,802,540 in tax year 1998 came from 212,960 tax returns that had an Adjusted Gross Income (AGI) median of $295,707. These returns represent only 25 percent of the total 894,564 returns showing an AMT liability for that tax year.[23] In other words, 75 percent of the returns reporting an AMT liability in 1998 accounted for only 19 percent ($942,660,496) of the AMT revenues.

This proposal would have eliminated the AMT liability for 504,058 to 818,903 taxpayers in 1998 depending upon the threshold amount selected.[24]

Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual Alternative Minimum Tax purposes.

The current AMT rules include adjustments for deductions and credits that are now available to many taxpayers. Thus, middle-income taxpayers are increasingly subject to the AMT provisions. The proposed changes would alleviate the AMT burden for taxpayers with large families, who live in locales with high state and local taxes, and those who incur high miscellaneous itemized deductions.

This recommendation would have eliminated the AMT liability in 1998 for 731,074 taxpayers.[25]

INDEX THE AMT EXEMPTIONS TO CURRENT DOLLARS

DETAILED EXPLANATION

EXPLANATION OF RECOMMENDATION

Some form of an individual minimum tax system – designed to ensure that wealthy people pay at least some tax – has been part of the Internal Revenue Code since 1969. Changes to the minimum tax laws in 1978 and 1982 served as the basis for the current Alternative Minimum Tax system for individuals.

In 1969, the minimum tax exemption amount was generally $30,000. In 1982, Congress established levels of Alternative Minimum Taxable income (AMTI) that would be exempt from the AMT. The exemption amounts, subtracted from AMTI in tax year 1983, based on filing status, were $40,000 for Married Filing Joint or Qualifying Widow(er), $30,000 for Single or Head of Household and $20,000 for Married Filing Separate. The exemption amounts were increased in 1993 to $45,000, $33,750 and $22,500 respectively. The Economic Growth and Tax Relief Reconciliation Act of 2001 temporarily increases the exemption amounts by $4,000 for married taxpayers filing joint returns and $2,000 for all other taxpayers for the tax years 2001 through 2004.

23 Id.

24 Id.

25 Tax Year 1998 Compliance Research Information System (CRIS), Model IFM 2000.

ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

Historically, the alternative minimum tax system affected relatively few people. That situation is changing rapidly. It is estimated that, for tax year 2001, 1.5 million taxpayers will be subject to AMT, 29.1 million for tax year 2008 and 35.5 million taxpayers in tax year 2010.[26]

There are several reasons for the creeping impact of the AMT. Taxpayers who itemize deductions and live in high tax states will be affected. Also, the increasing use of incentive stock options for employee compensation draws many taxpayers into the alternative minimum tax system.

However, the primary reason for AMT creep is that the AMT thresholds are not adjusted and indexed for inflation. One method of correcting this situation would be to adjust and index the exemption amounts for inflation.

Adjusting the exemption amounts for inflation using 1983 as a base year and 1998 tax return data, the IRS has projected how taxpayers and tax revenue might be affected by this recommendation. The IRS has determined that the exemption amounts in 1998, based on filing status, would have been $65,600 for Married Filing Jointly or Qualifying Widow(er), $49,200 for Single or Head of Household and $32,800 for Married Filing Separate. The IRS then projected the impact this would have on the number of taxpayers subject to the individual AMT in 1998.[27]

The following table contains the results of this projection:

TABLE 2.3.1: 1998 TAX RETURN AND AMT REVENUE DATA ADJUSTED FOR INFLATION

1998 Actual Number of Returns with AMT Liability	Projected Number of Returns with AMT Liability	Projected Decrease in AMT Revenue
849,564	297,548	24%

[26] U. S. Congress, Joint Committee on Taxation, Estimated Effects of the Conference Agreement for H.R. 1836{1} (JCX-51-01) p. 8.

[27] Tax Year 1998 Compliance Research Information System (CRIS), Model IFM 2000

RECOMMENDATION

As an alternative to AMT repeal, the individual Alternative Minimum Tax Exemptions should be indexed for inflation.

ESTABLISH A GROSS INCOME THRESHOLD FOR AMT

DETAILED EXPLANATION

EXPLANATION OF RECOMMENDATION

The individual Alternative Minimum Tax (AMT) now impacts millions of taxpayers who were not within its original scope. By tax year 2010, 35.5 million taxpayers will be affected by AMT.[28]

Taxpayers filed 124 million individual tax returns in 1998. Of that total, 6.4 million returns required computation of a Form 6251, Alternative Minimum Tax - Individuals; 4.4 million such returns were actually filed. Of the 4.4 million, more than 3.4 million of those taxpayers included Form 6251 just to demonstrate that they did not owe AMT.[29]

By establishing a gross income AMT test that could be determined from the face of the original tax return, at least 3.4 million taxpayers each year may not have to perform AMT calculations and complete the Form 6251 just to show that they owe no tax. This is a substantial reduction in taxpayer burden.

Additionally, based upon IRS data for tax year 1998, 81 percent of the total AMT revenues of over $5 billion came from 212,960 returns reporting a median Adjusted Gross Income (AGI) median of $295,707. These returns represent only 25 percent of the total 894,564 returns showing an AMT liability for that tax year. In other words, 75 percent of the returns reporting an AMT liability in 1998 accounted for only 19 percent ($942 million) of the AMT revenues.[30]

Establishing a gross income AMT test indexed for inflation will remove many middle-income taxpayers from the alternate minimum tax system. Using 1998 tax return data, the IRS has projected the number of taxpayers who could be impacted by AMT and the possible tax revenue if this recommendation is implemented.[31] As the following table suggests, it would also be possible to minimize the impact of AMT upon low-income and middle-income taxpayers by establishing a gross income AMT test that is indexed for inflation.

28 U. S. Congress, Joint Committee on Taxation, Estimated Effects of the Conference Agreement for H.R. 1836{1} (JCX-51-01) p. 8.

29 Tax Year 1998 Compliance Research Information System (CRIS), Model IFM 2001

30 Id.

31 Id.

TABLE 2.3.2: GROSS INCOME FROM 1998 TAX RETURN DATA INDEXED FOR INFLATION

1998 Gross Income Greater Than...	Number of Taxpayers Liable for AMT	Total AMT Liability (in billions)
$1,000,000	30,661	$1.8
$500,000	74,357	$2.4
$250,000	252,393	$3.5
$200,000	345,506	$4.0

RECOMMENDATION

As an alternative to repeal, the individual AMT should be restructured to establish a gross income threshold (indexed for inflation) below which the taxpayer would not be subject to AMT. Initial applicability would be determined by the gross income reported on the face of the individual's tax return. Thus, many individuals would not have to complete Form 6251 and related worksheets to determine if they were subject to the individual AMT.

ELIMINATE CERTAIN ADJUSTMENT ITEMS FOR INDIVIDUAL AMT

DETAILED EXPLANATION

EXPLANATION OF RECOMMENDATION

The individual alternative minimum tax was originally devised to limit the tax benefit of certain preference items (adjustments, deductions, and credits) used frequently by high-income taxpayers and infrequently by others.[32] The current AMT includes certain adjustments that are available to most taxpayers. Consequently, the AMT now impacts middle-class taxpayers by eroding the value of credits and exemptions that were intended to aid them in the first place.

In testimony before the United States Senate Committee on Finance, the American Bar Association Section of Taxation projected that by tax year 2007, almost 95 percent of the revenue from AMT preferences and adjustments will be derived from four items that are "personal" in nature – the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions.[33] The IRS projects that by tax year 2005, 75.8 percent of AMT revenue will be attributable to these four adjustment items.[34]

32 Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969 (JCS-16-70), December 3, 1970, at 105.

33 U. S. Senate, Committee on Finance, Tax Simplification Hearings , 26 April 2000, (Statement of Richard M. Lipton on behalf of the American Bar Association Section of Taxation.

34 Tax Year 1998 Compliance Research Information System, Model IFM 2000.

If personal exemptions, the standard deduction, state and local taxes and miscellaneous itemized deductions are eliminated as adjustment items for the purpose of computing AMT, the number of 1998 individual income tax returns with an AMT liability would be 118,490 (a decrease from 849,564) with AMT revenue of $1,393,312,123 (a decrease from $5,034,802,540).[35]

A recent United States Tax Court case illustrates the AMT's expanding reach and the burden it places on taxpayers. [36] A taxpayer filed a Form 1040 for tax year 1997, claiming married filing separate status. He claimed two personal exemptions and reported an AGI of $37,850, consisting solely of wages from employment. He claimed total itemized deductions of $28,403, including miscellaneous itemized deductions of $26,903 for unreimbursed employee expenses. The taxpayer calculated his tax liability, not thinking he was subject to the AMT. He reported a taxable income on his return of $4,147 and a tax liability of $619. Since he was subject to AMT, his correct tax liability was $2,982. Nevertheless, the taxpayer contended that he was not the type of person who should be liable for alternative minimum tax, and this tax system was not meant for him because he was not wealthy and had no items of tax preference. The Tax Court sustained the Commissioner's position.

In reaching its conclusion, the Court said:

> *Absent some constitutional defect, we are constrained to apply the law as written, … and we may not rewrite the law because we may "deem its effects susceptible of improvement," … Accordingly, petitioner's appeal for relief must, in this instance, be addressed to his elected representatives. "The proper place for a consideration of petitioner's complaint is the halls of Congress, not here." (citations omitted)*[37]

RECOMMENDATION

Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual Alternative Minimum Tax purposes.

35 U. S. Congress, Joint Comm. On Taxation, Estimated Effects of the Conference Agreement for H.R. 1836{1} (JCX-51-01) p. 8.

36 Birts v. Commissioner, T.C. Summary Opinion 2001-77, No. 3914-00S [4 June 2001], Tax Analysts 2001 TNT 108-10.

37 Birts v. Commissioner, T.C. Summary Opinion 2001-77, No. 3914-00S [4 June 2001], Tax Analysts 2001 TNT 108-10.

4

PENALTY AND INTEREST ISSUES

INTRODUCTION

When federal tax liabilities are not timely paid, the Internal Revenue Code provides for the accrual of interest and certain penalties. Interest compensates the federal government for the taxpayer's continuing use of funds that have not been paid into the Treasury as required. Penalty provisions in the Internal Revenue Code are intended to foster compliance with the tax laws. However, taxpayers who believe they have done all they can or know to do in order to comply with the tax law have difficulty in understanding why they are charged interest and penalties that may exceed the tax liability.

In this section of the report, we focus on three key issues that research indicates cause many problems for taxpayers and the IRS. They are:

- Interest Rate and Failure to Pay Penalty
- Interest Abatement on Erroneous Refunds
- First-time Penalty Waiver

In the "Additional Issues" section of this Report, we identify two other penalty and interest issues that require legislative action and may be further developed in future reports. They include:

- Federal Tax Deposit (FTD) Avoidance Penalty
- Adjustment of Estimated Tax Penalty in Accordance with Amended Returns

We have also identified the need for a uniform safe harbor exception and a "reasonable cause" exception to the individual estimated tax penalty in this Report's "Potential Issues" section.

It is my hope that these recommendations will result in penalty and interest reform that will reduce complexity and encourage the application of common sense to these situations by both taxpayers and the IRS.

INTEREST RATE AND FAILURE TO PAY PENALTY

SUMMARY

PROBLEM

At one time, a simple, set interest rate was the only charge on underpayment of taxes. This simple rate appeared to make the government the preferred "lender" on tax underpayments. Enactment of the failure to pay penalty in 1969 increased the cost of "borrowing" from the government. However, further changes to the interest rate structure in 1982 and 1986 have not made the government a less desirable lender, even with the addition of the failure to pay penalty. The computation for the underpayment interest rate is not consistent or competitive with outside lenders. In addition, charging a compounded interest rate and a failure to pay penalty is confusing to taxpayers and creates additional complexity.

EXAMPLE

Taxpayers requesting installment agreements typically owe from $4,000 to $6,000.[1] The typical allowable period for establishment of an installment agreement is 36 months, not including penalty and interest charges.[2] The following table shows an analysis of the options available to taxpayers for financing an unpaid tax of $4,000.00 and the approximate months needed to fully pay the total finance costs.

TABLE 2.4.1 — FINANCE COST COMPARISON

Source of funds	Home Equity Loan	IRS	Unsecured Bank Loan	Credit Card
Amount of debt	$4,000	$4,000	$4,000	$4,000
Rate of interest	8.11%	7%	13.8%	15.76%
Monthly Payment	$125.00	$125.00	$125.00	$125.00
Interest Charge	$568.67	$570.13	$1,012.84	$1,155.10
Failure to Pay Penalty	$0	$314.27	$0	$0
Total interest and penalty	$568.67	$884.40	$1,012.84	$1,155.10
Approximate Length of Time to Pay-Off	38 months	40 months	42 months	43 months
Total Cost	$4,568.67	$4,884.40	$5,012.84	$5,155.10

Loan and credit card interest rates are taken from www.banx.com.

RECOMMENDATIONS

Repeal the failure to pay penalty provisions of Internal Revenue Code section 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.

1 Installment Agreement Cumulative Report, Part 1 - IA's, Period Covered: Oct-Mar FY 2001

2 IRC § 6159 (c) requires the Secretary to enter into installment agreements where the aggregate amount of liability (without regard to interest, penalties, additions to tax, and additional amounts) does not exceed $10,000, the taxpayer has a good compliance history over the last five years and is financially able to pay liability, and full payment of liability can be made within 3 years.

INTEREST RATE AND FAILURE TO PAY PENALTY

DETAILED EXPLANATION

PRESENT LAW

Generally, individual taxpayers must file their income tax returns and pay any tax due on those returns by April 15 each year.[3] If a taxpayer is unable to fully pay the amount due on that return, any unpaid balance will be assessed interest charges[4] and a failure to pay (FTP) penalty.[5] Interest and penalty charges are computed from the due date of the return without regard to extensions of time for filing.[6] The FTP penalty is charged at the rate of 0.5 percent per month on the unpaid balance, up to a maximum of 25 percent of tax due,[7] while the interest charge is computed at a quarterly adjustable rate based on the federal short-term rate plus three percent.[8] The IRS charges a lesser FTP penalty while taxpayers are in compliance with an installment agreement.[9]

Interest accrues daily on unpaid tax and penalties.[10] In 1982, the method of interest calculation changed. Where there was once a simple interest computation, deficiency interest computations were revised to compound daily as a better reflection of commercial practice.[11] This change also allowed for the accruing of interest charges on interest, as well as the aforementioned tax and penalties.

REASONS FOR CHANGE

Until the 1970's, the interest provisions of the Code were relatively uncomplicated. The interest rates on tax underpayments and overpayments were identical at a statutorily prescribed six percent simple interest rate. This structure remained in existence from 1954 until 1969, when Congress first enacted a failure to pay penalty. At that time, the combination of the FTP penalty and the interest rate on unpaid tax obligations was intended to equate to a market rate of interest so that taxpayers would not have an incentive to pay other creditors before paying their tax debts.[12] Thus, the enactment of the failure to pay penalty made borrowing from the government appear much less attractive.

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3 IRC§ 6072(a). Provides guidance on filing of tax returns. Generally, individual income tax returns are due by the 15th day of the fourth month after the end of the fiscal or calendar year.

4 IRC § 6601(a).

5 IRC § 6651(a)(2) generally states if payment of tax does not occur on or before the due date, an additional amount of 0.5 percent per month will be added, not to exceed 25 percent of original underpayment.

6 IRC § 6601(b)(1) and § 6651(a)(2).

7 IRC § 6651(a)(2).

8 IRC § 6621(a)(2).

9 IRC § 6651 (h) allows for a reduction in the failure to pay penalty from 0.5 percent per month to 0.25 percent per month during the terms of an installment agreement.

10 IRC § 6601(e)(2) contains provisions for assessment of interest in respect to additions to tax and any assessable penalty. Also see footnote 2 regarding interest charges.

11 Department of the Treasury, Office of Tax Policy, Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code, October 1999, 33

12 Department of the Treasury, Office of Tax Policy, Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code, October 1999, 32, 33

Despite many legislated changes in the interest rate and FTP penalty structures, the interest rate charged on tax debts, combined with the FTP penalty, does not approximate a market rate of interest charged on unsecured loans to most consumers. This is one reason why many taxpayers continue to pay other creditors before paying their tax debts.

This current system of penalty and interest computations is not consistent with today's business practices. Financial institutions often charge a fixed rate of interest on both secured and unsecured loans. A penalty is not charged unless a late installment payment is received.[13] This type of late payment penalty encourages timely payment of the installment.

Due to the higher market interest rates charged by financial institutions for unsecured debts, the IRS remains the lender of choice. The complexity in the penalty structure might also make the penalty system seem unfair, or weaken the deterrent effect of penalties.[14] In addition, the FTP penalty has not proven to be a deterrent for late payment of taxes as the total cost of borrowing from the IRS is still lower than most unsecured creditors.

The FTP penalty accounts for 57.9 percent of all penalties charged individual income taxpayers. In 2000, the IRS assessed FTP penalties totaling $1.4 billion against 11.2 million accounts. For the same year, assessments of the FTP penalty accounted for less than 1 percent of revenues.[15] FTP penalties can be removed for reasonable cause.[16] Through further contacts with the taxpayer in 2000, the IRS reconsidered assessment and removed $187.8 million in FTP penalties charged against 1.2 million accounts.[17] These abatements constituted 6.11 percent of all penalties assessed in 2000. The large number and dollar amount of abatements is further evidence that the current FTP system is not working as intended.

13 12 CFR Part 226, Banks and Banking, allows for assessment of a late payment fee for exceeding a credit limit, or for delinquency, default, or a similar occurrence.

14 Department of the Treasury, Office of Tax Policy, Report to The Congress on Penalty and Interest Provisions of the Internal Revenue Code, October 1999, 39

15 Internal Revenue Service, 2000 Data Book, Department of the Treasury. Comparison of Gross Collections (Table 7) to Total Individual Failure to Pay Penalties assessed (Table 26).

16 Treas. Reg. § 301.6651-1 stipulates that an FTP penalty can be removed or non-assessed if due to reasonable cause and not willful neglect. Reasonable cause considerations include (but are not limited to); Death or serious illness, unavoidable absence, destruction of records by fire or other casualty and are outlined in IRS Policy Statement P-2-7.

17 Internal Revenue Service, 2000 Data Book, Department of the Treasury, Table 26.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate proposes that Congress repeal the FTP penalty provision of Internal Revenue Code section 6651 and charge taxpayers an interest rate equivalent to a market rate of interest on unsecured loans. In their 1998 report, the Joint Committee on Taxation recommended an interest rate equal to the short-term AFR plus 5 percentage points.[18]

Elimination of the FTP penalty would reduce the number of reasonable cause abatements, reducing the burden on both the IRS and taxpayers. This proposal will also put the government on an equal footing with commercial lending institutions and encourage taxpayers to borrow from other lenders, where they have more flexibility in payment options, loan terms, and a potential for a negotiable interest rate. This would decrease IRS costs in maintaining installment agreement programs and increase the collection of tax dollars sooner. A single interest charge will be a direct charge, reducing taxpayer confusion concerning their payment options and eliminating some of the complexity of the current penalty provisions.

18 Joint Committee on Taxation, Study of Present-Law Penalty and Interest Provisions as Required by Section 3081 of the Internal Revenue Service Restructuring and Reform Act of 1998, Vol. 1, 76-77, (JCS-3-99)

INTEREST ABATEMENT ON ERRONEOUS REFUNDS

SUMMARY

PROBLEM

Interest on an erroneous refund (i.e., a refund of tax to which an individual taxpayer is not entitled) must be abated until the date that the Internal Revenue Service (IRS) asks to be repaid, unless the taxpayer caused the refund or the refund amount is greater than $50,000. If the refund amount is greater than $50,000, the taxpayer must pay interest from the date of the refund, even if he or she did nothing to cause it. Thus, taxpayers with larger erroneous refunds are treated differently from those with smaller ones, even though their circumstances are otherwise identical.

EXAMPLE

- Mr. Jones received an erroneous refund check for $5,000 on January 15, 2000. He did not take any action that caused the refund to be issued to him. On March 1, 2000, he received a notice demanding repayment of the refund. On March 15, 2000, within 21 days of the notice, he repaid the full amount by sending a check for $5,000. He was not required to pay any interest even though he had use of the funds for two months.
- Ms. Smith received an erroneous refund check for $60,000 on January 15, 2000. She did not take any action that caused the refund to be issued to her. On March 1, 2000, she received a notice demanding repayment of the refund. On March 15, 2000, within 21 days of the notice, she repaid the full amount by paying $60,791.98, including $60,000 for the refund, plus interest of $791.98, that she was required to pay from the date of issuance of the erroneous refund.

RECOMMENDATION

Amend Internal Revenue Code section 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.

INTEREST ABATEMENT ON ERRONEOUS REFUNDS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code section 6602 imposes interest on any erroneously refunded tax, interest, penalty, or additions to tax that are recoverable by suit under IRC § 7405.[19] An erroneous refund is defined as "any receipt of money from the Service to which the recipient is not entitled."[20] Such a refund may be caused by some action taken by the taxpayer or a related party, or it may be due to an error made by the IRS. If the taxpayer did nothing to cause the refund, interest must be abated on the refund from the date of issuance until the date demand for repayment is made, unless the erroneous refund exceeds $50,000.[21] Consistent with IRC § 6601(e)(3), the taxpayer is provided with an additional 21 days from the demand date to repay the full amount without incurring any interest charges.[22]

If the refund amount is greater than $50,000, the taxpayer must pay interest from the date of the refund, even if the money was refunded through no fault of the taxpayer. If the refund amount is from $50,001 to $99,999, the taxpayer will still be given 21 days from the demand date to pay the full amount of the refund, including interest from the refund date to the demand date, without incurring any additional interest. If the refund is $100,000 or more, the taxpayer is given only 10 days after demand in which to fully repay the total amount without incurring additional interest charges.[23]

Internal Revenue Code section 7405 authorizes the United States to seek recovery of erroneous refunds by bringing suit in a United States district court. This suit generally must be filed within two years of the date of issuance of the erroneous refund.[24]

Additionally, many of these refunds are not considered to be tax debts, because they result from the Service's clerical or ministerial errors and do not involve a redetermination of the tax liability. This type of refund is referred to as a non-rebate erroneous refund.[25] Since a non-rebate erroneous refund is not a tax debt, the Service cannot use its deficiency

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19 IRC § 6602 states that such interest shall accrue at the underpayment rate established under IRC § 6621 from the date of the payment of the refund.

20 Internal Revenue Manual 21, Customer Account Services, § 21.4.5.2(1)

21 IRC § 6404(e)(2) requires abatement of interest on an erroneous refund under § 6602 until the date demand for repayment is made, unless: (a) the taxpayer (or related party) has in any way caused the erroneous refund or (b) such erroneous refund exceeds $50,000.

22 IRC § 6601(e)(3) states that payments made within 21 calendar days (10 business days if the amount for which such notice and demand is made equals or exceeds $100,000) after the notice and demand, interest shall not be imposed.

23 Id.

24 IRC § 6532(b) states that the recovery of an erroneous refund by suit under § 7405 shall be allowed only if such suit is begun within 2 years after the making of such refund, except that such suit may be brought at any time within 5 years from the making of the refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

25 See O'Byrant v. United States, 49 F.3d 340, 342 (7th Cir. 1995); Internal Revenue Manual 21, Customer Account Services, § 21.4.5.3(1).

procedures or its administrative collection procedures to recover the erroneous refund. The Service may file suit under IRC § 7405 or recover the refund amount through the principle of common law offset.[26]

REASONS FOR CHANGE

Prior to 1987, there was no provision for the abatement of interest when IRS issued erroneous refunds to taxpayers. In 1986, Congress limited interest abatement to erroneous refunds in amounts not greater than $50,000.[27] The House and Senate committee reports for the bill both recommended that interest on erroneous refunds be abated where the refund was not caused by the taxpayer and the refund did not exceed $1,000,000.[28] The conference agreement limited the amount to $50,000.[29]

Under present law, if an erroneous refund of over $50,000 is directly deposited into a taxpayer's savings account and the taxpayer only receives quarterly statements from his or her bank showing the savings account transactions, it could be three months before the taxpayer has actual notice of the erroneous refund. If the taxpayer calls the IRS immediately upon receiving his or her savings account statement showing the erroneous deposit, that taxpayer will still be charged interest from the date on which the refund was issued.

On the other hand, consider the treatment of a taxpayer who receives an erroneous refund of $5,000 and who learns of this refund from his or her account statement received 30 days after the refund was deposited. Under current law, this taxpayer is able to use the funds without incurring any interest charges until the Service identifies the erroneous refund on its own and subsequently sends a demand for payment to the taxpayer. Under common law, a person who comes into possession of money not his own has the duty of safeguarding that money and returning it to its rightful owner. To take on that duty, a person must first realize that he has funds that do not belong to him.[30] The present law seems to recognize that a taxpayer is less likely to realize that he has received an erroneous refund when it involves a small amount of money. The larger the erroneous refund, the more likely the taxpayer is to be aware that he has received a refund in error.

The National Taxpayer Advocate believes that a taxpayer who is on notice of the receipt of a tax refund that is unexpected and thus might not belong to him or her has the duty to make some inquiry of the Internal Revenue Service, regardless of the amount of the refund. The critical concept in this proposition is "notice." A taxpayer who receives a

26 See United States v. Munsey Trust Co. of Washington, 332 U.S. 234, 239 (1947) (the government has the same right as any other creditor to apply funds owed to his debtor against a debt owed to him.)

27 Tax Reform Act of 1986, Public Law 99-514, Section 1563(a).

28 House and Senate Committee Report No. 99-841, Public Law 99-514, Volume II, 810-811.

29 House and Senate Conference Report No. 99-841, Public Law 99-514, Volume II, 811.

30 D.C. Legal Ethics Opinion No. 256, footnote 9. That footnote states as follows: "At common law, a finder of lost property, if he takes custody of it, is responsible to the owner of the property for its safekeeping and return. Cf. Costello v. Ten Eyck, 49 NW 152 (Mich. 1891); Fisher v. Klingenberger, 576 NYS2d 476 (Rochester City Ct. 1991). See also, 1 Am. Jur. 2d Abandoned, Lost and Unclaimed Property, at section 21 (1994); 36A C.J.S. Finding Lost Goods at sections 7 and 8.

refund of $500 or $1,000 may reasonably believe that he made a math error or omitted a tax payment on his return. However, the National Taxpayer Advocate believes that it is reasonable to expect a taxpayer who learns of an unexpected refund of $5,000, as well as one who learns of a $51,000 unexpected refund, to call the IRS within a reasonable period of time and attempt to determine the reasons for the refund.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that a taxpayer, regardless of the amount of the erroneous refund, should have interest abated from the date of the refund until the date of the Service's demand for payment. In order to eliminate the disparity in treatment of taxpayers based solely on the amount of the refund, IRC § 6404(e)(2) should be amended to allow abatement of interest on an erroneous refund due to an IRS error without regard to the size of the refund. For tax year 1999, this proposal would have allowed the abatement of interest on approximately 200 cases with refunds greater than $50,000. The interest on those cases amounted to approximately $1,200,000.[31]

The availability of interest abatement should be limited by two conditions. First, as under present law, the taxpayer (or a related party) cannot have caused the erroneous refund. Second, the Secretary of the Treasury should have the discretion to impose interest where the Secretary can show that the taxpayer had actual notice of the erroneous refund and did not take reasonably prompt action to notify the IRS and learn the reasons for the refund. This is particularly important in light of the Service's limited ability and limited time period to administratively collect non-rebate erroneous refunds. The proposal adopts a 30-day interval after notice as a reasonable period within which the taxpayer should contact the IRS and inquire about the unexpected refund.

The National Taxpayer Advocate anticipates that for reasons of administrative convenience and efficiency the Secretary will not exercise his or her discretion except where it is clear that the taxpayer decided to "wait and see" if the Service would discover that funds were paid in error and then come looking for him or her. Thus, where an erroneous refund was directly deposited into a savings account which provides the taxpayer with quarterly account statements, the 30 day period might begin running from the date of the bank statement on which the refund appears (plus allowance for a reasonable period for mailing the statement). This rule will permit the Secretary to design clear guidelines for determining the date of notice, as when a taxpayer was unable to review his bank statements because of hospitalization. The Secretary may also establish *de minimis* thresholds for applications of this second condition.

[31] Tax Year 1999 Compliance Research Information System (CRIS), IFM Model 2001.

In summary, the National Taxpayer Advocate recommends that IRC § 6404(e)(2) be amended to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such erroneous refund. Further, the Secretary should have the 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.

FIRST TIME PENALTY WAIVER

SUMMARY

PROBLEM

First time filers and taxpayers who have an excellent compliance history, and who make reasonable attempts to comply with the tax system are sometimes faced with tax penalties that are disproportionate to the minor errors they commit. There is no provision in current law that allows the IRS to provide penalty relief to such taxpayers.

EXAMPLE

A taxpayer mailed his 2000 return on April 15 with a check for $200,000, which was in full payment of the balance due on his return. On April 20 the return was sent back to him for insufficient postage – the required postage was $1.50, but he mistakenly put $1.40 on the envelope. Subsequently he mailed the return with the required postage on April 21 but the tax return was deemed late. The taxpayer was assessed the failure to file penalty in the amount of $10,000, as well as the failure to pay penalty.

RECOMMENDATION

Amend Internal Revenue Code section 6404 to authorize the Secretary of the Treasury to grant a one-time abatement of the Failure to File Penalty (IRC § 6651(a)(1)), and Failure to Pay Penalty (IRC § 6651(a)(2)) for first time filers and taxpayers with a consistent history of compliance where no countervailing factors are present.

FIRST TIME PENALITY WAIVER

DETAILED EXPLANATION

PRESENT LAW

Present law provides the Secretary of the Treasury with limited authority to abate tax, penalties, and interest. In general, any tax (or any liability associated with the tax) may be abated where the assessment is excessive, or the tax was assessed after the expiration of the period of limitation, or the tax was assessed after the expiration of the period of limitation, or the tax was erroneously or illegally assessed.[32]

Generally, interest charged on a tax debt is not intended to be punitive in nature but is intended to compensate the government for the time value of money. For this reason, there is no allowance in the Internal Revenue Code for reasonable cause abatements of interest, and the situations in which interest can be abated are narrowly defined. For example, interest may be abated where the IRS officer's or employee's ministerial or managerial act has caused an unreasonable error or delay.[33] The IRS must abate all interest accrued, prior to the IRS's demand for repayment, on an erroneous refund of $50,000 or less if the taxpayer did not cause the erroneous refund.[34]

Internal Revenue Code section 6651(a)(1) imposes a penalty for failure to file a tax return on the required due date unless such failure is due to reasonable cause. The failure to file penalty is imposed at the rate of 5 percent for the first month and 5 percent for each additional month (or fraction thereof) for as long at the return is not filed. The total failure to file penalty cannot exceed 25 percent of the tax shown on the return.

Another penalty is imposed when the taxpayer fails to pay any tax shown on the return[35] or which is later assessed and is not paid within 21 days of notice and demand for payment.[36] This penalty is imposed on the unpaid tax at the rate of 0.5 percent per month for the first month with an additional 0.5 percent for each additional month that the tax remains unpaid, but cannot exceed 25 percent of the tax shown on the return.

The penalties are calculated on the net amount of the tax due.[37] Where both a failure to file and failure to pay penalty are triggered, the failure to file penalty for each month will be reduced by the amount of the failure to pay penalty imposed.[38]

32 IRC § 6404(a)

33 IRC § 6404(e)(1)

34 IRC § 6404(e)(2)

35 IRC § 6651(a)(2)

36 IRC § 6651(a)(3)

37 See IRC § 6651(b) and Treasury Regulation § 301.6651-1(d) for rules pertaining to the net amount of ta due.

38 IRC § 6651(c)

Treasury Regulation § 301.6551-1(c) and Internal Revenue Manual Section 120.1.1.3.1 provide guidance for when certain penalties can be abated for reasonable cause. Reasonable cause is based on all the facts and circumstances in each situation and allows the Internal Revenue Service to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but is unable to comply with those obligations. Any reason that establishes a taxpayer exercised ordinary business care and prudence but was unable to comply with the tax law may be considered for penalty relief.

Internal Revenue Manual section 120.1.1.3.1.1 lists several standards that IRS may use in determining whether reasonable cause has been met. The standards listed are:

- Ordinary Business Care and Prudence
- Mistake was Made or Forgetfulness (Generally, this is not in keeping with the ordinary business care and prudence standard and does not provide a basis for reasonable cause. However, the reason for the mistake may be a supporting factor if additional facts and circumstances support the determination that the taxpayer exercised ordinary business care and prudence.)
- Death, Serious Illness, or Unavoidable Absence
- Unable to Obtain Records
- Undue Hardship
- Advice
- Written Advice from the Service
- Oral Advice from the Service
- Advice from a Tax Advisor
- Fire, Casualty, Natural Disaster, or Other Disturbance
- Official Disaster Area
- IRS error

Treasury Regulation § 301.6651-1(c) sets forth examples in establishing reasonable cause. A failure to file penalty will be considered due to reasonable cause if the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay penalty will be considered due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he paid on the due date. Treasury Regulation § 1.6161-

1(b) defines undue hardship. The term undue hardship means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer from making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. Thus, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability.

REASONS FOR CHANGE

There are situations in which the authority to abate penalties would promote voluntary compliance, effective tax administration, and fairness and equity but that do not fall under any of the current provisions for abatement in the Internal Revenue Code. In many instances, a taxpayer's minor negligence results in the imposition of a penalty that is disproportionate in relation to the underlying error.

In *Edward R. Stolz II v. Commissioner*,[39] additions to tax and penalties arose from a substantial understatement of taxes owed. The Tax Court held impositions of additions to tax and penalties would not violate a settlement entered by the parties. The court held the accountant's error in affixing insufficient postage did not absolve petitioner of additions to tax. Reliance on an agent for timely filing did not constitute reasonable cause for late filing.

In *Stolz,* the taxpayer's accountant erred by not affixing the correct postage. Under the first time penalty waiver proposal, IRS would have a basis for abating the penalty as long as the taxpayer has had a good compliance history.

[39] TC Memo 1999-404

PENALTY AND INTEREST PROVISIONS

In its October, 1999, report to Congress on Penalty and Interest Provisions of the Internal Revenue Code, the Department of Treasury discussed that the late filing penalty could be abated for "first time offenders" where willful noncompliance is not involved or other countervailing factors are not present. In those circumstances, Treasury suggested that waiver of the penalty, contingent on future compliance, could be considered, although it ultimately decided not to recommend this approach.[40]

EXPLANATION OF RECOMMENDATIONS

The recommendation would authorize the Secretary to grant one-time abatement of the Failure to File Penalty and Failure to Pay Penalty for first time filers and for taxpayers who have a history of compliance. Abatement would be considered appropriate when the taxpayer made reasonable attempts to comply with the tax system and where no other countervailing factors are present.

Granting taxpayers with an excellent compliance history a one-time penalty abatement will help foster future voluntary compliance, and will create a more positive and reasonable image of the IRS for all taxpayers. We note that many businesses allow their customers a one-time waiver of late fees for mistake or oversight.[41]

The purpose of this abatement authority is to permit the Service to educate the taxpayer about required behavior and provide the compliant taxpayer with relief for a first-time error. Thus, the taxpayer would have the opportunity to learn from the mistake and to amend his or her behavior in certain circumstances without incurring a penalty the first time the taxpayer errs. The waiver would be particularly appropriate when the penalty is disproportionate to the error committed by the taxpayer.

40 Report to the Congress on Penalty and Interest Provisions of the Internal Revenue Code, Department of the Treasury, Office of Tax Policy, October 1999, page 67

41 It seems to be an acceptable business practice to allow someone one-time relief for paying a bill late.

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HOME-BASED SERVICE WORKERS

SUMMARY

PROBLEM

Home-based service workers (HBWs) help disabled or elderly persons with personal care or household chores. The persons receiving these services are, in most cases, considered to be the employers of the workers.[1] However, in some cases these workers are either treated as and/or may be self-employed independent contractors.[2] Confusion about a worker's employment status may result in different tax treatment of similarly situated taxpayers. Home-based service workers may also incur federal tax debts because they do not know they are being treated as self-employed.

An HBW who works for several service recipients in any one year and is treated as an employee of the service recipients still may not be eligible for social security coverage. In 2002, unless the HBW earns at least $1,300 per year from his or her employer for performing domestic service, the employer is not liable for Federal Insurance Contributions Act (FICA) tax.[3]

EXAMPLES

- An HBW, a single mother with one child, earns $15,600 per year. She works for an elderly man who is disabled because of diminished capacity. He pays her on a weekly basis. At the end of the year, he does not file a Schedule H, Household Employment Taxes, nor does he issue her a Form W-2. The worker believed her employer was withholding taxes from her check. Now, she must file and pay self-employment tax of $2,204.21. If she were treated as an employee, the taxpayer's share of FICA would only be $1,193.40. The current arrangement costs her more than $50.00 per month in additional taxes.
- An HBW performs domestic service for ten different employers during the calendar year, each of whom pays him less than $1,300 per year. No FICA taxes are imposed on those wages even if the worker earned $12,990 in wages (10 x 1,299). On the other hand, if an HBW earns $1,300 annually performing services for one employer, those wages are subject to FICA. Finally, if the HBW is self-employed, the HBW will pay Self-Employment Contributions Act (SECA) tax on net earnings from self-employment of $400 or more.[4]

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1 Flanagan, S.A., and Green, P.S., Consumer-Directed Personal Assistance Services: Key Operational Issues for State CD-PAS Programs Using Intermediary Service Organizations, prepared for the Office of the Assistant Secretary for Planning and Evaluation, U.S. Department of Health and Human Services, by The MEDSTAT Group, Cambridge, MA, 1997, p.12.

2 Id., p. 24.

3 IRC § 3121(a)(7)(B). A corresponding provision in the Social Security Act provides that the worker is not eligible for social security coverage, unless the $1,300 limit is met. This limitation is imposed on an employer-by-employer basis. Social Security Act § 215.

4 IRC § 1402(b)(2).

HOME-BASED SERVICE WORKERS

RECOMMENDATIONS

Amend Internal Revenue Code section 3121(d)(3) to clarify that HBWs are employees rather than independent contractors.

Amend the Internal Revenue Code by enacting a new section that removes liability for employment taxes from the common law employer (here, the service recipient) and deems the administrator of HBW funding (defined as states, their agencies, or intermediate service organizations, regardless of the original source of funding) as the responsible party to withhold, report, and pay employment taxes on behalf of HBWs.

HOME-BASED SERVICE WORKERS

DETAILED EXPLANATION

PRESENT LAW

Under certain circumstances, states administer or provide funds for in-home household or personal care services for disabled and elderly individuals.[5] The persons performing such services are referred to here as home-based service workers (HBWs).[6] The precise arrangements under which services are performed vary from state to state.

For example, some states may provide funds to the disabled or elderly individual who then uses the money to obtain in-home assistance. In other cases, the HBW may be paid by the state, or the state may pay an intermediary service organization (ISO) to act as an agent for the recipient of the service. A variety of other payment arrangements also may be used.[7] The HBW may also be treated as an independent contractor.

The determination of who is liable for withholding, paying, and reporting of employment taxes begins with the identification of who is the common law employer. A worker is a common law employee of the entity that has the right to direct and control the method and means by which he or she performs the services.[8]

Liability for withholding, payment, and deposit of employment taxes rests with the common law employer.[9] If the HBW is considered the employee of the recipient of the services, then that individual is generally responsible for applicable Federal Insurance Contributions (FICA), Federal Unemployment Tax (FUTA), and Federal Income Tax withholding (FITW) under the rules applying to household employees. FITW on household employees is required only if the employer and employee agree to withholding. Under current law, if the HBW does not earn at least $1300 per year from his or her employer no FICA taxes are imposed on those wages. FUTA taxes are due on the first $7000[10] of

5 Sources of funds include, but are not limited to: Medicaid; Grants to States for Old-Age Assistance (42 USC, Chapter 7, Subchapter I), Grants to States for Medical Assistance Programs (42 USC, Chapter 7, Subchapter XIX), and Social Services Block Grant (SSBG) (42 USC, Chapter 7, Subchapter XX). Funds may also be provided directly from State revenues.

6 Home-based services are those in-home services or activities provided to individuals or families to assist with household or personal care activities that improve or maintain adequate family well-being. These services may be provided for reasons of illness, incapacity, frailty, absence of a caretaker relative, or to prevent abuse and neglect of a child or adult. Major service components include homemaker services, chore workers, home maintenance services, and household management services. (45 CFR Part 96 [2000]).

7 States directed more Social Services Block Grant funds to home-based services than almost any other category (over $277 million). (The Social Services Block Grant FY 1997 Expenditure Report). California spent over $1.5 billion dollars on home-based services; over $48 million of this came from the SSBG. (A Report by The Title XX Coalition. September 1999). Available information does not identify how many HBWs are paid by public funds. However, it is estimated that there were 300,500 individuals employed as personal and home care aides in 1999. (U.S. Bureau of Labor Statistics. 1999 National Occupational Employment and Wage Estimates, ONLINE. 2001. Bureau of Labor Statistics. Available: http://stats.bls.gov/oes399021.htm [22 June 2001]).

8 IRC § 3121(d)(2). Under the common law rules, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and relationship of the parties. (Publication 15-A, Employer's Supplemental Tax Guide. Rev. January 2001).

9 IRC §§ 3102(a), 3111(a) and (b), 3301 and 3402(a).

10 IRC § 3306(b)(1)

wages per employee if the employer pays more than $1000[11] per quarter in cash wages for domestic services. FICA, FUTA, and any FITW are reported annually by household employers on Schedule H.

The fact that a state or local government (or its health and welfare agencies) pays wages to the HBW does not mean that the state or agency is treating the HBW as its own employee. These entities are generally acting as an agent for the common law employer (here, the service recipient), as described in IRC § 3504.[12]

An agent may also be considered an IRC § 3401(d)(1) employer. These rules apply when someone other than the common law employer is in control over the payment of wages. Whether or not a payor is in fact an IRC § 3401(d)(1) employer requires a specific understanding of the payment arrangement between all parties involved.[13]

Internal Revenue Code section 3121(d) defines four categories of employees for purposes of FICA. A worker is an employee if he or she is one of the following:

- a common law employee – IRC § 3121(d)(2)
- a corporate officer – IRC § 3121(d)(1)
- a statutory employee – IRC § 3121(d)(3)
- an employee covered by an agreement under Section 218 of the Social Security Act – IRC § 3121(d)(4)

The common law test applies also for purposes of the FUTA, FITW, and the Railroad Retirement Tax Act.

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11 IRC § 3306(a)(3)

12 IRC § 3504 provides that the Secretary may prescribe procedures under which a person who has control, receipt, custody, or disposal of, or pays the wages of an employee is treated as the agent of the employee's employer. Except as otherwise provided by the Secretary, all provisions of law (including penalties) and regulations prescribed thereunder applicable to an employer are applicable to the agent and the employer remains subject to all provisions of the law (including penalties) and regulations prescribed thereunder. Revenue Procedure 70-6, 1970-1 C.B. 420, as modified by Revenue Procedure 80-4, 1980-1 C.B. 581, set forth the procedures to be followed in requesting authority to act as an agent. Revenue Procedure 80-4 contains rules applicable specifically to state and local health and welfare agencies wishing to act as agents of welfare recipients who become the employers of individuals furnished by the agencies to provide in-home domestic service.

13 If the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term ''employer'' means the person having control of the payment of such wages. (IRC section 3401(d)(1)). For example, a social service agency for a State administers the State's Medicaid programs. The agency manages a program which, using Federal and State funds, pays for HBWs for Medicaid clients who would otherwise have to be placed in nursing homes. The agency makes payments for the services directly to the HBWs. Direction regarding the HBW services and supervision of such services are provided by the care recipients who have the right to discharge their HBWs if they are dissatisfied with their services. The HBWs are the common law employees of the service recipients. However, since the agency has control of the payment of wages it is responsible for tax withholding. (Private Letter Ruling 9209002 [October 3, 1991]).

Internal Revenue Code section 3121(d)(3) further defines statutory employees as: certain agent or commission drivers, full time life insurance salesmen, home workers (individuals that produce an item working from their own homes) and traveling or city salesmen.

This section does not specifically include HBWs in the definition of employee for FICA purposes. In some instances, HBWs may be unwillingly classified as self-employed. These individuals do not have the bargaining power with state agencies that may be needed to insure they are treated properly as employees.

Some HBWs are treated as self-employed individuals. Self-employment may be entered into voluntarily or involuntarily. Many Low Income Taxpayer Clinics have reported representing clients who did not know they were being treated as self-employed.[14] Other HBWs prefer to be considered self-employed, since a self-employed worker can claim business deductions "above the line" on Schedule C, Profit or Loss from Business, and as a result will pay less income tax than an employee.[15] Such business expenses might include the cost of transportation between jobs, and licenses, where applicable. This compares to the way an outside full-time salesman is allowed to deduct his business expenses. IRC § 3121(d)(3)(D) defines a full-time outside salesman as an employee for FICA tax purposes. Such salespersons may deduct unreimbursed business expenses on Schedule A as a miscellaneous itemized deduction subject to the two percent floor. The National Taxpayer Advocate has also suggested that these expenses be allowed as deductions under IRC § 62(a)(2) in arriving at gross income (see the Additional Recommendations section of this report).

REASONS FOR CHANGE

Both the failure to specifically identify HBWs as employees and the failure to deem state or local entities as employers when they administer funds that pay for home-based services create confusion for HBWs, service recipients, and the entities. Some HBWs receive Forms W-2, Wage and Tax Statement, from either the service recipient or the agency. Others are treated as independent contractors and receive Forms 1099-MISC, Miscellaneous Income, from the service recipient or the agency.[16] In some instances, HBWs receive no end-of-year income reporting statement at all; thus, they are able to avoid paying any income tax.

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14 National Commission on Restructuring the Internal Revenue Service, A Vision for a New IRS (1997) (statement of Janet A. Spragens, February 26, 1997).

15 Employees can claim employee business expenses only as miscellaneous itemized deductions on Schedule A, Form 1040. Thus, these deductions are available only if the employee is able to itemize.

16 Flanagan, S.A., and Green, P.S. Consumer-Directed Personal Assistance Services: Key Operational Issues for State CD-PAS Programs Using Intermediary Service Organizations, prepared for the Office of the Assistant Secretary for Planning and Evaluation, U.S. Department of Health and Human Services, by The MEDSTAT Group, Cambridge, MA, 1997.

As an independent contractor, the HBW is required to file Schedule C, Profit or Loss from Business, and Schedule SE, Self-Employment Tax. These forms increase the complexity of the tax return. The IRS estimates that an additional 12 hours are required to complete and file Schedules C and SE.[17] These workers, who earn an average of $7.50[18] per hour, bear the burden of paying self-employment taxes at a rate of 15.3 percent versus the employee's share of FICA at 7.65 percent. Clarifying the status of these workers as employees would significantly reduce their burden in complying with the tax law.

Consider an HBW who is a single parent with one child and who averages $15,600 in income per year.[19] If the worker is treated as an independent contractor, she will be required to pay more than $50.00 a month in additional taxes. As Table 2.5.1 Tax Computation for Independent Contractor vs. Employee Tax Year 2000 demonstrates, the increase in the Earned Income Tax Credit (EITC) entitlement does not offset the increase caused by the self-employment tax. A worker earning 134 percent of federal poverty guidelines would be hard-pressed to save $502.21 to pay taxes on April 15th, 2001.[20]

TABLE 2.5.1: TAX COMPUTATION FOR INDEPENDENT CONTRACTOR VS. EMPLOYEE TAX YEAR 2000

	Independent Contractor [21]	Employee [22]
Gross Income	$15,600.00	$15,600.00
Adjusted Gross Income	$14,497.90	$15,600.00
Taxable Income	$2,447.90	$3,550.00
Federal Income Tax	$366.00	$536.00

17 Department of the Treasury. Internal Revenue Service. 2000 1040 Instructions, p. 56.

18 U.S. Bureau of Labor Statistics. 1999 National Occupational Employment and Wage Estimates, ONLINE. 2001. Bureau of Labor Statistics. Available: http://stats.bls.gov/oes399021.htm (22 June 2001).

19 $15,600 = $7.50/hr x 40 hrs/wk x 52 weeks.

20 $15,600 for a family of two equals 134 percent of HHS Poverty Guidelines. (66 Fed. Reg. 33 [16 February 2001]).

21 Computations for Independent Contractor are as follow: Gross Income of $15,600 less one-half of Self Employment (SE) Tax ($1,102.10) equals Adjusted Gross Income (AGI) of $14,497.90. AGI less standard deduction for Head of Household ($6,450) and exemptions ($2,800 x 2 = $5,600) equals Taxable Income of $2,447.90. Federal Income tax is from the 2000 tax tables. SE Tax: Earnings of $15,600 x 92.35percent = Net SE Earnings of $14,406.60 x 15.3 percent = $2,204.21 SE Tax. EITC based on earned income of $14,497.90.

22 Computations for Employee are as follows: Gross Income and AGI are the same since there are no adjustments in arriving at AGI. AGI of $15,600 less standard deduction for Head of Household ($6,450) and exemptions ($2,800 x 2 = $5,600) equals Taxable Income of $3,550. Federal Income tax is from the 2000 tax tables. Employees share of FICA: Earnings of $15,600 x 7.65 percent = $1,193.40. EITC computed on earned income of $15,600.

TABLE 2.5.1: TAX COMPUTATION FOR INDEPENDENT CONTRACTOR VS. EMPLOYEE TAX YEAR 2000 *continued*

Self-Employment Tax or Employee's Share of FICA[23]	$2,204.21	$1,193.40
Earned Income Tax Credit	($2,068.00)	($1,884.00)
Net Tax Liability	$502.21	($154.60)

Another area of concern is compliance with employment tax rules when the service recipient is required to withhold, pay, and report employment taxes for the home-based service provider. Many service recipients may have neither the resources nor the background to maintain records or complete IRS employment tax forms. Recipients are not a homogenous group in terms of their desire and ability to perform the fiscal and administrative tasks required to comply with employment tax laws.

In several states, recipients of services were initially solely responsible for withholding taxes and filing employment tax returns. Experience in these states proves that few recipients of services are able to achieve a satisfactory level of employment tax compliance.[24]

Most service recipients do not have sufficient income to require filing federal individual income tax returns because most state and federal benefits for home-based services are means tested.[25] Therefore, they would be required to file a stand alone Schedule H, Household Employment Taxes in order to report and pay withholding on the HBW wages. For tax year 1999, the IRS received only 4,326 stand alone Schedule H's.[26] While there is no reliable data regarding the number of service recipients who would be required to file, the Bureau of Labor Statistics estimates that 300,500 individuals were employed as personal and home care aides in 1999.[27] The small number of stand-alone Schedule H's indicates the possibility of non-compliance with employment tax filing requirements.

23 The recipient of the service receives federal funds that include the cost of paying the employer's share of the FICA taxes. Employee's weekly take home pay is reduced by their share of FICA.

24 Flanagan, S.A., and Green, P.S. Consumer-Directed Personal Assistance Services: Key Operational Issues for State CD-PAS Programs Using Intermediary Service Organizations, prepared for the Office of the Assistant Secretary for Planning and Evaluation, U.S. Department of Health and Human Services, by The MEDSTAT Group, Cambridge, MA, 1997.

25 To be eligible for SSBG benefits, individual and family income must be below the official poverty line as defined by the Office of Management and Budget. (Omnibus Budget Reconciliation Act of 1981, P.L. 97-35, Section 2605).

26 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

27 U.S. Bureau of Labor Statistics. 1999 National Occupational Employment and Wage Estimates, ONLINE. 2001. Bureau of Labor Statistics. Available: http://stats.bls.gov/oes399021.htm (22 June 2001).

If a Form W-2 or Form 1099-MISC is not issued, it is all too easy for a taxpayer to disappear into the cash economy and not pay taxes at all. A low-income taxpayer may not receive Earned Income Tax Credit for which he or she is eligible. The absence of substantiated earnings creates a vicious cycle, whereby the service worker remains in the cash economy and has limited ability to improve job status or security.

One example of federal funds for home-based services is the Social Services Block Grant (SSBG). States have directed more SSBG funds to home-based services than almost any other category. For 1998, approximately $277 million in SSBG funds was expended to provide home-based services to 243,738 recipients in 36 states.[28] The available information does not identify how many HBWs were paid with SSBG funds.

Unpublished research information from the Department of Health and Human Services indicates that the large majority of HBWs are being properly treated. However, this recommendation is made to insure all HBWs are treated similarly for federal employment tax purposes.[29]

EXPLANATION OF RECOMMENDATIONS

Amend Internal Revenue Code section 3121(d) to clarify that HBWs are employees rather than independent contractors. Specifically defining HBWs as employees would eliminate confusion as to worker status.

Amend the Internal Revenue Code by enacting a new code section that removes the liability for employment taxes from the common law employer (here, the service recipient) and deems the administrator of HBW funding (defined as states, their agencies, or intermediate service organizations, regardless of the original source of funding) as the responsible party to withhold, report, and pay taxes on behalf of HBWs.

As a result of the above amendments, HBWs who are common law employees of service recipients would be deemed for employment tax purposes[30] as:

- employees of the state,
- employees of the state agency, or
- employees of the Intermediate Services Organization.

28 The amount of SSBG funds expended does not include the cost of administering the program. (U.S. Department of Health and Human Services. Office of Community Services. Social Services Block Grant Program Annual Report on Expenditures and Recipients 1998. Washington: Government Printing Office, 2000).

29 Information provided by Office of the Assistant Secretary for Planning Evaluation, U.S. Department of Health and Human Services (12 September 2001).

30 The IRS is prohibited from issuing guidance relating to employee status. (Revenue Act of 1978 section 530). However, the IRS is currently drafting questions and answers to address and clarify issues related to employment taxes and the HBW.

Individuals who receive Forms W-2 are more likely to comply with filing and paying requirements, both at the federal and state level, than those who receive Forms 1099-MISC, the form used to report income to independent contractors.[31]

For states, improved compliance would result in increased revenues from state income taxes. However, growth in this revenue might be offset by higher state EITC entitlements.[32]

Increases in compliance would benefit the worker through greater eligibility for Social Security benefits[33] and earned income tax credits. Workers currently being treated as self-employed would benefit from being properly classified as employees. Rather than paying the full self-employment tax (15.3 percent), they would be liable for only the employee's share of FICA (7.65 percent). The worker's overall paperwork burden for filing tax returns would be decreased, as he or she would no longer have to file Schedule C or SE.

Increased compliance equates to increased confidence in the tax system. Taxpayers want assurance that their neighbors down the street are paying their proper share of taxes.[34]

31 A General Accounting Office (GAO) report stated that the IRS estimates tax reporting compliance for wage earners with withholding is about 99 percent, while tax compliance for individuals with income not subject to withholding is 41 percent. (United States General Accounting Office. TAX ADMINISTRATION: Tax Compliance of Nonwage Earners. [GAO/GGD-96-165]. August 1996, p.12).

32 Sixteen states now offer state EITCs based on the federal credit. In addition, two local governments – Montgomery County, Maryland, and Denver, Colorado – offer local EITCs. (Center on Budget and Policy Priorities, A HAND UP, How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001, Summary. October 18, 2001. ONLINE Available: http://www.cbpp.org/10-18-01sfp.htm [23 November 2001]).

33 Social Security Benefits cut nearly in half the gap between the poverty rate for elderly women and elderly men. Social Security reduced the poverty rate for elderly women from 52.6 percent to 14.7 percent. Three quarters of all elderly women receive the majority of their income from Social Security. Among elderly men, Social Security lowered the poverty rate from 40.8 percent to 8.2 percent. (Center on Budget and Policy Priorities. Social Security Reduces Proportion of Elderly Who Are Poor From Nearly One in Two to Less Than One in Eight. April 8, 1999. ONLINE. Available: http://www.cbpp.org/4-8-99socsec.htm [18 July 2001]).

34 U.S. House of Representatives. Committee on Ways and Means. President's Tax Relief Proposals Hearing, 13 February 2001. (Statement of Mortimer M. Caplin, Caplin & Drysdale); ONLINE. Available: http://waysandmeans.house.gov/fullcomm/107cong/2-13-01/record/caplin.htm. (19 July 2001).

6

RETURN OF LEVY OR SALE PROCEEDS

SUMMARY

PROBLEM

Occasionally, in the course of collecting tax due from taxpayers, the Internal Revenue Service commits flagrant or egregious errors, which violate either statutes or the IRS' own established administrative procedures, and cause severe harm to taxpayers. These types of errors occur most often in the context of levies or the seizure of assets, which are then sold. Once the errors are discovered, the IRS is often prevented from providing relief to these taxpayers because of expired statutory limitation periods for requesting the return of proceeds, or because there is no overpayment and thus no grounds for making a refund. Further, when an individual retirement account (IRA) or other qualified plan is levied upon, the taxpayer cannot restore any returned levy proceeds to the IRA and is still liable for the income tax on the distribution.

EXAMPLES

- The IRS misapplied payments made by a taxpayer. The Service then defaulted her installment agreement and levied $25,000 from her IRA. Later, the IRS located her missing payments and applied them to her account. The IRS then reinstated her installment agreement and returned the levied funds to the taxpayer. However, current law prevented the taxpayer from restoring the proceeds to her IRA. She was also required to include the $25,000 distribution in her taxable income for the year in which the levy occurred.
- The IRS assessed $120,000 of additional tax on five years of a couple's joint tax returns. In 1986, the couple entered into an installment agreement with the IRS.[1] The taxpayers made timely monthly payments of $500 each from 1986 to 1997. The husband died in 1994 and his widow, age 65, continued making the required payments to IRS.
- By December 1997, the taxpayer had paid $155,000 in taxes, penalties and interest. When the statutory period to collect the tax was close to expiration, the IRS asked her to sign an extension, lengthening the collection period. She refused to sign this waiver. The IRS then levied on her retirement funds, reducing her income resources to her monthly social security check. The IRS also began the process of seizing her home.

[1] At the time, the Service entered into non-full-pay installment agreements with taxpayers. This practice ceased in 1998. Today, taxpayers may submit deferred payment offers in compromise if they cannot fully pay their tax liabilities. IRC § 7122; IRS Form 656, "Offer in Compromise."

RECOMMENDATIONS

- Amend Internal Revenue Code section 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 will 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.
- Amend Internal Revenue Code sections 6532(c)(1) and (2) to extend the period of time within which a suit or proceeding under section 7426 shall begin from nine months to two years from the date of levy or agreement giving rise to such action.
- Amend Internal Revenue Code section 6343(d) to extend the period of time within which a taxpayer shall request a return of levied funds or the proceeds from the sale of levied property to a period of four years from the date of levy or sale of the levied property where the IRS' action with regard to that levy was in reckless or flagrant disregard of established IRS rules, procedures, or regulations and the taxpayer incurred significant harm as a result of that action. Interest shall be allowed and paid with respect to such levies as permitted under IRC § 6343(c).
- Amend the following code sections to authorize reinstatement of funds to retirement accounts and other pension plans where the IRS levied upon the plans in error or in flagrant disregard of established IRS rules, procedures, or regulations and the funds were returned under IRC § 6343(d):

§401	Qualified Pension, Profit Sharing, Keogh and Stock Bonus Plans
§408	Individual Retirement Account, SEP-Individual Retirement Account
§408A	Roth Individual Retirement Account

Further, amend these code sections to provide that the Service shall abate all tax and interest assessed as a result of the levy.

RETURN OF LEVY OR SALE PROCEEDS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code section 6343(b) provides that levied funds or cash proceeds from the sale of levied property may be returned at any time before the expiration of nine months from the date of the levy. Third parties have nine months from the date of a "wrongful levy" to request a return of levied funds or proceeds.[2] This relatively short time period was believed necessary because in the interim both the IRS and the taxpayer are relying on the levy as a payment (often, in full) of the tax liability and the statutory period for collecting the tax is not suspended during this interim period.

The Taxpayer Bill of Rights II[3] provided relief to taxpayers seeking a return of levy proceeds. Current law allows levied property to be returned to a taxpayer if he or she makes a request within nine months of the date of levy.[4] Internal Revenue Code section 6343(d) authorizes the IRS to return levied property or proceeds if the Secretary of the Treasury determines that one of the following conditions is met:

- The levy was premature or otherwise not in accordance with administrative procedures;
- The taxpayer entered into an installment agreement under IRC § 6159 (unless the agreement provides otherwise);
- The return of the levied property would facilitate the collection of tax; or
- With the consent of the taxpayer or the National Taxpayer Advocate, the return of the property would be in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

Internal Revenue Code section 6343(c) specifically precludes allowance and payment of interest on a return of levy proceeds under IRC § 6343(d). However, interest is allowable and payable on proceeds of a wrongful levy under IRC § 6343(b).

Third parties whose property has been wrongfully levied upon also have the right to initiate a civil action in federal district court to seek an injunction against levy or sale; recovery of specific property; payment of surplus proceeds or substituted sale proceeds; or substitution of value.[5] The third party must bring the suit within nine months of the date of levy.[6] The third party may recover damages under this provision if the court finds that an IRS officer or employee has "recklessly or intentionally, or by reason of negligence" disregarded any code section.[7]

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2 IRC §§ 7426(a)(1) & 6343.

3 Taxpayer Bill of Rights II; Public Law 104-168, § 501(b), added new IRC § 6343(d).

4 IRC § 6343(d), cross-referencing IRC § 6343(b).

5 IRC § 7426(a) and (b).

6 IRC § 6532(c).

7 IRC § 7426(h)(1). Under IRC § 7426(h)(2), the third party must pursue all administrative remedies and take steps to mitigate damages per IRC § 7433(d).

Where any officer or employee of the Internal Revenue Service, in connection with any federal tax collection matter concerning the taxpayer, either recklessly, intentionally, or negligently disregards any tax law or regulation, the taxpayer may bring a civil action in federal district court.[8] The taxpayer must have exhausted all administrative remedies available to him prior to bringing suit. Further, if the taxpayer fails to mitigate his damages, the damage award will be reduced by that amount. The taxpayer has two years from the date of action to bring suit. [9]

There is no current law authorizing the Internal Revenue Service to restore proceeds to an Individual Retirement Account (IRA) or other qualified retirement plan. The Service also cannot abate tax or interest arising from an erroneous levy of retirement plan proceeds.

REASONS FOR CHANGE

Under present law, a taxpayer and a third party have a limited period of time – nine months from the date of levy – to request the return of levied funds or proceeds of a sale of seized property. The provisions relating to taxpayers were added in 1996 and cross-referenced the nine-month period applicable to wrongful levies upon third party property.[10]

The National Taxpayer Advocate believes that, in some cases, nine months is an insufficient period of time within which a taxpayer or third party can discover a levy, determine the administrative remedies available to him or her, and begin to pursue those remedies. A standard two-year period for both taxpayer or third party requests for return of proceeds is much more reasonable.

Wrongful Levies and Levies on Taxpayer Assets

Tax debtors and non-tax debtors jointly own property, including bank and investment accounts, for a variety of reasons unrelated to tax planning. Spouses share accounts for convenience. Children of elderly parents share accounts both to care for their parents and to prepare for emergencies when a parent may be unable to perform financial transactions. In the business context, joint accounts are regularly established between business investors, joint ventures, and other commercial arrangements. In all these situations, it is possible for the funds of the entire account to be levied and applied to a tax debt of only one account co-owner. The other account owners may be completely unaware that such funds were levied until some time after the current nine-month limit for requesting release of wrongful levy proceeds. This lack of notice within the nine-month period may be perfectly reasonable and prudent under normal business practices.

8 IRC § 7433.

9 IRC § 7433(d)(3).

10 Taxpayer Bill of Rights II, Public Law 104-168, Sec. 501(b).

The National Taxpayer Advocate is cognizant of the need for a date certain on which the government can rely on collected taxes remaining in the Treasury and beyond which no claims for release or refund will be entertained. She recognizes that in wrongful levy cases the extension of the claim period to two years may result in the IRS finding itself in "whipsaw" situations. In these instances, where the IRS has ceased to collect from the taxpayer because it has applied "wrongful levy" proceeds in full payment of the tax liability and has not committed an act in reckless or flagrant disregard of its rules and regulations, it may be appropriate to suspend the limitations period for collections for the period of time the Service was prohibited from collecting.

The same concerns regarding the short time period to request a release of third party funds apply equally in the context of a taxpayer levy. Here, a taxpayer may feel that such a levy was inappropriate but may be afraid to pursue such action for fear that a protest will result in additional levies. Often, the taxpayer makes a claim after passage of time has helped him overcome his fears, or he has discussed the matter with family members or a tax professional. By then, the nine-month window has passed.

In IRC § 6343(d) situations where the statutory period for collection has expired or is about to expire, the Service can exercise its discretion and not return the levy proceeds to the taxpayer. Alternatively, where the statutory collection period is about to expire, the Service can ask the taxpayer to extend the statutory period as a condition for releasing the levy proceeds.

Levies in Reckless or Flagrant Disregard of IRS Rules or Regulations

It is impossible to anticipate or describe all circumstances in which a taxpayer might be affected by IRS errors in the course of collecting a tax liability. Often it is not easy to determine whether the Service's error alone caused the harm the taxpayer is complaining about. Further, some errors are essentially "harmless" errors; that is, even if the specific collection action was in error, the IRS would still have levied property under some other provision of law. Some "errors" are not errors at all, but are instead the results of reasonable judgment calls by persons authorized to collect taxes. Despite these concerns, there are clearly some instances where the Service's levy upon property is clearly improper, so much so that it would strike other taxpayers as irrational and inhumane if the levied funds or sale proceeds were not restored.

Therefore, a new provision should be added to the Internal Revenue Code to grant the IRS the authority to remedy the harm caused to taxpayers by a levy made in reckless disregard of IRS rules or regulations. This authority would extend to those errors that are flagrant or egregious in nature and would shock the conscience of taxpayers if not corrected.

Retirement Accounts and Other Qualified Plans

The Internal Revenue Manual instructs IRS employees to levy upon pension or retirement plan funds (as opposed to retirement income) "only in flagrant cases" because these funds provide for the taxpayer's future welfare. [11] When an IRA or other qualified retirement plan is levied, the taxpayer must pay income tax on the distribution.[12] If the IRS subsequently determines that it is in the best interests of the taxpayer and the Service to release the levy proceeds, the taxpayer cannot restore the funds to the IRA and is liable for the income tax associated with the distribution. In many instances, the IRS will base its decision regarding "best interests" on the taxpayer's economic need for these retirement proceeds. Thus, under present law the taxpayer will continue to be harmed by the original levy action even after the proceeds have been released to the taxpayer.

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends that the Internal Revenue Service's authority to correct errors in the levy context be expanded. We expect that few cases would fall under this provision; however, it is important that the IRS be able to correct these errors in order to maintain the public's confidence in the tax system.

The basic structure of this proposal is as follows:

- **Third party levies (IRC § 6343(b)):** Two years from date of levy to request release of levy proceeds; interest allowed and paid per IRC § 6343(c).
- **Taxpayer levies (IRC § 6343(d)):**
  - Two years from date of levy to request release of levy proceeds; no interest allowed and paid per IRC § 6343(c).
  - Four years from date of levy to request release of levy proceeds where levy was in reckless or flagrant disregard of IRS rules or regulations and taxpayer incurred significant harm as a result of levy. Interest allowed and paid per IRC § 6343(c).

Wrongful Levies and Release of Levy Proceeds to Third Parties and Taxpayers

Amend Internal Revenue Code section 6343(b) to allow third parties to request a return of levied funds or the proceeds from the sale of seized property within two years of the date of levy or sale of the seized property. This amendment will also extend the period within which taxpayers may request a return of levy funds or sales proceeds under IRC § 6343(d).

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11 IRM § 5.11.6.2(2)

12 IRC § 408(d)(1). Effective January 1, 2000, a taxpayer does not owe a 10 percent early withdrawal penalty on proceeds withdrawn from a retirement account pursuant to a notice of levy per IRC § 72(t)(2)(A)(vii).

We cannot predict the impact of this proposal to extend the statute under IRC § 6343(b) because at this time there is no universal method of coding these cases for data retrieval.[13] However, the Taxpayer Advocate Service is working on several cases involving this issue. There are also several court cases[14] and Chief Counsel opinions[15] holding that wrongful levies cannot be returned in some cases only due to the expiration of this nine-month statute. Extending this statute to a two year period would not only give the taxpayer or third party the necessary time to request a refund, but would also allow the IRS time to correct errors and reinforce the public's confidence in the tax system.

Reckless or Flagrant Disregard of IRS Rules and Regulations

The IRS sometimes makes flagrant or egregious errors, which can cause irreparable harm to taxpayers. The IRS should have the authority to correct such errors. It is very possible that a small number of taxpayers will view such an authority as an opportunity to delay the Service's appropriate and legitimate collection activities against them. We recognize that the circumstances in which the expanded authority would apply must be carefully delineated.

For example, it would be incumbent on the taxpayer seeking relief under the expanded authority to exercise reasonable business prudence in attending to his or her affairs. The taxpayer would also have to have "clean hands" when asking the Service for relief; that is, the taxpayer cannot have caused delay, obfuscation, or otherwise caused the wrongful or erroneous levy to occur. The Service should also consider whether at the time of the erroneous levy, the IRS would have been able to reach the same result by following other collection alternatives available at that time.

The term "flagrant" is defined as "conspicuously bad" or "offensive".[16] The IRS and the Treasury Department have never rendered a definition of flagrant as it applies to other sections of the Internal Revenue Code.[17] The definition of flagrant appears to be closely related to the definition of "abuse of discretion" by the courts. Abuse of discretion in judicial proceedings occurs when the court does not apply the correct law, or rests its decision on a clearly erroneous finding, or when the record contains no evidence to support its decision.[18]

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13 Tax Year 1999 Compliance Research Information System (CRIS), Model IFM 2001.

14 For example, Becton Dickerson & Company v. Wolckenhauer, 215 F.3d 340 (3d Cir. 2000).

15 Office of Chief Counsel Advice Memorandum, Levy Payments Refund/Application, ILM 200017044 (March 6, 2000).

16 Webster's II New Riverside University Dictionary, 1st Ed., The Riverside Publishing Company, Massachusetts, 1984.

17 60 Fed. Reg. 233 (5 December 1995)

18 U.S. v. Rahm, 993 F.2d 1405, 1410 (9th Cir. 1993), MGIC v. Moore, 952 F.2d 1120, 1122 (9th Cir. 1991), Dahn v. U.S., 127 F.3d 1249 (10th Cir. 1997); Wine Brenner v. U.S., 924 F.2d 851 (9th Cir. 1991).

Although these descriptions of abuse of discretion refer to judicial proceedings, they should be applicable in defining egregious or flagrant errors made by the IRS. Further, as IRS abuse of discretion case law develops under IRC § 6015(f) (equitable relief from joint and several liability) and IRC §§ 6320 and 6330 (Collection Due Process Hearings), these standards can be applied to the erroneous levy context.

"Egregious" is defined as "outstandingly bad" or "blatant."[19] While there is no current regulatory or procedural definition of egregious behavior, we suggest that either a flagrant or egregious error by definition would shock the conscience of taxpayers if not corrected by IRS.

Retirement Accounts and Other Pension Plans

Amend the following Internal Revenue Code 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:

- §401 – Qualified Pension, Profit Sharing, Keogh and Stock Bonus Plans
- §408 – Individual Retirement Account, SEP-Individual Retirement Account
- §408A – Roth Individual Retirement Account
  The amendment to these code sections would also require abatement of the tax directly resulting from these wrongful levies.

To repair the harm caused by wrongful levies of retirement and pension plans, special provisions must be added to the appropriate sections of the tax code. The new provisions would allow the taxpayer to restore the retirement account. Upon receipt of the released levy proceeds, the taxpayer must redeposit the entire amount into the retirement account within 60 days of the date of release. If the taxpayer does not redeposit the full amount within the 60-day period, the amount refunded may be taxable, depending upon the type of retirement plan.

[19] Webster's II New Riverside Dictionary, *supra*, note 128.

PARTIAL PAYMENT INSTALLMENT AGREEMENTS

SUMMARY

PROBLEM

Internal Revenue Code section 6159 does not permit the IRS to enter into installment agreements with taxpayers who cannot fully pay the tax liability. Section 6502(a) permits the Service to obtain an extension to the statutory period for collection for as long as necessary to full pay what is owed. Current IRS policy permits full-pay installment agreements to run for the life of the statutory period for collection plus one five-year extension.[20]

EXAMPLE

A married couple owes $120,000 in income taxes. They have equity of $150,000 in their house and two vehicles. The house has a quick sale value of $400,000 encumbered by a $300,000 mortgage. The two vehicles are free and clear with combined equity of $50,000. The husband was recently laid off and the couple is living on the wife's salary. Because only the wife is working, the banks will not agree to refinance their house in order to access the equity. They would not be able to afford the additional payments until the husband started working again.

There are eight years left on the statutory limitation period for collection of the tax liability. The couple's financial statement indicates they could afford to pay $800 per month toward the liability. This would allow approximately $76,800 to be applied to the liability. The Service cannot enter into an installment agreement because the tax liability will not be fully paid within the statutory limitation period for collection. The couple cannot afford an offer in compromise (deferred payment offer in compromise) that includes the collection potential from the equity in their assets as well as their current ability to pay. Although the couple can send payments to the Service voluntarily, the IRS may proceed to levy against their bank accounts and the wife's salary.

RECOMMENDATION

Amend Internal Revenue Code section 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 Service.

[20] IRM § 5.14.1.7.

PARTIAL PAYMENT INSTALLMENT AGREEMENTS

DETAILED EXPLANATION

PRESENT LAW

Internal Revenue Code section 6159(a) authorizes the Secretary to enter into written agreements with any taxpayer to satisfy their full tax liability in installment payments.

Section 6502 allows the IRS ten years from the date of assessment to collect the tax. A taxpayer can voluntarily extend this ten-year period by signing a waiver. It is the policy of the IRS that extensions be limited to five years beyond the original ten-year period.[21]

The determination that the IRS may not enter into an installment agreement with a taxpayer unless the full amount of tax due will be paid is based on a legal interpretation of the interplay between IRC § 6159 (installment agreements) and IRC § 7122 (offers in compromise). According to IRS Chief Counsel, a taxpayer may resolve a tax liability for less than the full amount of the tax due only through IRC § 7122.[22] Counsel further advises that IRC § 6159, the installment agreement provision, does not supersede IRC § 7122.[23]

REASONS FOR CHANGE

A taxpayer may be willing and able to submit monthly payments, but the IRS lacks the authority to enter into an installment agreement that will not full pay the liability. If the taxpayer has no assets which would be subject to enforced collection action and virtually no income in excess of allowable and necessary expenses, the account will likely end up in a "currently not collectible" status.[24] No enforced collection action will be taken while the account is in this status, but any overpayments from other tax accounts will offset to the liability.[25] If the taxpayer's financial situation does not improve before the statute of limitations expires, nothing else will be collected.

For example, a 60-year-old self-employed plumber and his wife owe $28,000 in back taxes. The couple owns a personal residence with a quick sale value of $60,000.[26] They have $16,000 equity in the home. The husband has no regular source of income other than his individual plumbing jobs, which depend on a volatile housing market. His wife is not employed. The taxpayers are unable to secure a loan and draw down the equity in their home due in part to his age and employment status. The IRS determines that they have the ability to pay $200 per month from their income. The taxpayers would like to enter into an installment agreement for that amount. There are 63 months left before the

21 IRM § 21.9.1.5.4.7

22 Joint Committee on Taxation. Report of the Joint Committee on Taxation Relating to the Internal Revenue Service as Required by the IRS Reform and Restructuring Act of 1998. (JCX-33-01), May 4, 2001. See footnote n. 254, p. 65.

23 Id. See Appendix, (letter dated April 27, 2001 from Charles O. Rossotti, Commissioner), Question 10(h), p. 95.

24 IRM §5.16.1.2.1

25 IRM §§ 5.16.1.1 and 5.14.1.4(2).

26 The quick sale value of the home is 80 percent of the fair market value. (IRM § 5.8.5.3.1(2)).

collections statute of limitation period expires, and the taxpayers could pay $12,600 over that time. However, the IRS cannot enter into an installment agreement because the account will not be fully paid before the period to collect expires. Even if a five year extension is signed by the taxpayers so that they would pay an additional $12,000, not all of the penalties and interest accruing on the tax would be paid. With penalty and interest added, the taxpayers would owe $37,600. It would take the taxpayers 188 monthly payments of $200 to fully satisfy this liability.

To qualify for an offer in compromise, the couple would have to make a lump sum payment of $16,000 and pay $200 a month for the next 63 months. The taxpayers do not want to sell their home and cannot borrow against their equity in the home. Even if they submitted an offer in compromise based on doubt as to collectibility, claiming special circumstances, it is unclear whether their situation amounts to an economic hardship such that the Service would agree to a reduction of $16,000 in the reasonable collection potential.[27]

In this example, the IRS cannot enter into an installment agreement and the taxpayers cannot pay the full amount of the offer. Although the taxpayers can voluntarily send the IRS monthly payments of $200, they will have no guarantee that the IRS will not undertake additional collection actions, including levying upon bank accounts. If the IRS had authority to establish a partial payment installment agreement, the Service could collect $24,600 toward the tax debt. Currently, where the taxpayers are unwilling or unable to submit an offer, the IRS has no option but to either proceed with enforced collection action or place the account in currently not collectible status.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Internal Revenue Code section 6159 be amended to authorize the Secretary to enter into installment agreements that do not

taxpayers who have some ability to make monthly payments and who also have assets which for one reason or another the taxpayer cannot liquidate or borrow against and against which the Service would be unlikely to initiate collection action. Certain financial requirements would have to be met before a non-full payment agreement could be established.

Taxpayers would be required to complete a financial statement disclosing all their assets. If the taxpayer wants to make monthly payments in an amount that would not fully satisfy the tax liability, the IRS should be able to establish an installment agreement for less

[27] IRM §§5.8.4.2 and 5.11.2.1(3)

than full payment as long as the amount being paid reflects the difference between the taxpayer's income and reasonable and necessary allowable expenses. Further, the IRS

that there are assets which can reasonably be collected against or the agreement is sought to delay the ultimate collection of tax.

The Service would take whatever actions are required to protect its priority with respect to any assets, including, where appropriate under IRS policies, the filing of a federal tax lien. As with all installment agreements, the taxpayer would be advised that the IRS may increase the payments if the taxpayer's ability to pay improves.[28] An internal financial review would be conducted on an annual basis; the IRS would contact the taxpayer for additional information where the internal review indicates a favorable change in the taxpayer's circumstances.

The National Taxpayer Advocate considers the non-full pay installment agreement to be an additional and necessary vehicle with which the Service can collect outstanding tax liabilities. It would provide an additional avenue for both taxpayers and the IRS. Taxpayers could achieve compliance with current obligations and stay in compliance while sorting out past liabilities.

From the standpoint of collecting tax obligations, it is better to get people into a payment mode early, even if they cannot pay the entire balance over 10 or 15 years. A review of the individual master file (IMF) accounts in the Accounts Receivable Delinquency Inventory (ARDI) shows that the amount of dollars collected decline steadily as the accounts age. For example, approximately $790 million was collected from $2.4 million individual taxpayers on accounts that were one year old, or $322.51 per taxpayer. For accounts six years old and older, $143 million was collected from approximately 3.2 million taxpayers, an average payment of $44.65 per taxpayer. See Table 2.6.1.

[28] IRC § 6159(b)(3) and IRM § 5.14.1.6

TABLE 2.6.1 – AVERAGE DOLLARS COLLECTED FROM DELINQUENT ACCOUNTS[29]

Account Age	Number of Modules	Approximate Number of Individual Taxpayers [30]	Total Dollars Collected	Average Collected from each Taxpayer
1 year	4,163,219	2,448,952	$789,812,143	$322.51
2 years	2,615,953	1,538,796	$220,810,877	$143.50
3 years	2,219,277	1,305,457	$132,559,621	$101.54
4 years	1,696,013	997,655	$ 78,792,701	$ 78.98
5 years	1,349,346	793,733	$ 49,884,220	$ 62.84
6 years & older	5,458,242	3,210,731	$143,367,650	$ 44.65

FAMILY STATUS ISSUES

EDUCATION CREDITS AND INCENTIVES

PROBLEM

Congress has expanded the resources available to help finance a college education. IRS Publication 970, Tax Benefits for Higher Education, is a 36-page document that includes instructions for the following nine credits: Hope Credit; Lifetime Learning Credit; Education IRA; Traditional and Roth IRA's; Student Loan Interest; State Tuition Programs; Education Savings Bond Program and Employer's Educational Assistance Program.

In June of 2001, Congress enacted new provisions for assistance to families funding higher education, as well as certain breaks for elementary and secondary school.[1] Most of these provisions supplement existing law, and include income and other limitations.[2]

Many people who are saving for or paying higher education costs for themselves and members of their families need to become familiar with education financing and financial planning for higher education. Many taxpayers who do not utilize a tax preparer may miss these opportunities. The number of options available and the different rules make tax planning for education a hopelessly complicated issue for all but the most tax-sophisticated taxpayers.

EXAMPLE

Table 2.7.1 from IRS Publication 970 – Highlights of Tax Benefits for Higher Education is reproduced, for illustration purposes only, on the next page. These are only the highlights of each program.

RECOMMENDATION

The National Taxpayer Advocate recommends these provisions be simplified by making uniform certain aspects of the educational tax incentives, including uniform income phase outs, a single defined scope of qualified educational opportunities (including professional non-degree programs), and a simple definition of "student." Congress should also explore the feasibility of replacing all of these education incentives with a universal program.

29 Accounts Receivable Delinquency Inventory (ARDI) Data File, IMF Module Table, Extract Cycle 200112. (open and closed cases).

30 Based on the average relation of entities to modules which is approximately 1.7 modules to 1 entity.

1 Although most of the new tax law doesn't become effective until on or after January 1, 2002, families need to start now to familiarize themselves with these provisions to better plan their education financing and thereby take full advantage of these tax breaks and maximize their savings.

2 Most of the provisions in this new legislation are to "sunset" December 31, 2010, requiring Congress to act to extend such provisions. The pre-existing law would remain intact if no action were taken.

TABLE 2.7.1: HIGHLIGHTS OF TAX BENEFITS FOR HIGHER EDUCATION

	HOPE CREDIT	LIFETIME LEARNING CREDIT	EDUCATION IRA1 IRAS1	TRADITIONAL AND ROTH INTEREST	STUDENT LOAN PROGRAMS	STATE TUITION BOND	EDUCATION SAVINGS ASSISTANCE PROGRAM1	EMPLOYER'S EDUCATION UNIFORMITY PROGRAM1	PROPOSAL TO ALLOW
What is your benefit?	Credits can reduce the amount of tax you must pay		Earnings are not taxed	No 10% additional tax on early withdrawal	You can deduct the interest	Earnings are not taxed	Interest is not taxed	Employer benefits are not taxed	Benefits stay the same for each program
What is the annual limit?	Up to $1,500 per student	Up to $1,000 per family	$500 contribution per beneficiary	Amount of qualifying expenses	$2,000	None	Amount of qualifying expenses	$5,250	Limits stay the same for each program
What expenses qualify besides tuition and required enrollment fees?	none		Books Supplies Equipment Room & board if at least a half-time student Payments to state tuition program	Books Supplies Equipment Room & board if at least a half-time student	Books Supplies Equipment Room & board Transportation Other Necessary Expenses	Books Supplies Equipment Room & board if at least a half-time student	Payments to education IRA's Payments to State tuition programs	Books Supplies Equipment	**Books Supplies Equipment** **Payments to education IRA's** **Payments to State tuition programs**

	HOPE CREDIT	LIFETIME LEARNING CREDIT	EDUCATION IRA1 IRAS1	TRADITIONAL AND ROTH INTEREST	STUDENT LOAN PROGRAMS	STATE TUITION BOND	EDUCATION SAVINGS ASSISTANCE PROGRAM1	EMPLOYER'S EDUCATION UNIFORMITY PROGRAM1	PROPOSAL TO ALLOW
What education qualifies?	1st 2 years of under-graduate	All undergraduate and graduate						Under-graduate	**All under-graduate and graduate**
What are some of the other conditions that apply?	Can be claimed only for 2 years Must be enrolled at least half-time in a degree program		Cannot contribute to education IRA and state tuition program in the same year Must withdraw assets at age 30		Applies to 1st 60 months of required interest Must have been at least half time student in a degree program	Beneficiary must pay tax on withdrawn earnings	Applies only to qualified series EE bonds issued after 1989 or series I bonds	Expires for courses beginning after December 31, 2001	Conditions remain the same for each program
In what income range do benefits phase out?	$40,000 – $50,000; $80,000 – $100,000 for joint returns		$95,000 – $110,000; $150,000 - $160,000 for joint returns	There is no phase-out	$40,000 – $55,000; $60,000 - $75,000 for joint returns	There is no phase-out	$54,100 – $69,100; $81,100 - $111,100 for joint returns	There is no phase-out	**Make all phase-outs the same**

[1] Any nontaxable withdrawal is limited to the amount that does not exceed qualifying educational expenses

FAMILY STATUS ISSUES

CREDIT FOR THE ELDERLY OR THE PERMANENTLY AND TOTALLY DISABLED

PROBLEM

During the last 10 years, the number of taxpayers claiming the credit for the elderly or the permanently and totally disabled has declined significantly. In tax year 1990, 339,818 taxpayers claimed the credit[3] compared to 180,473 taxpayers in tax year 1998.[4]

The credit threshold amounts have not changed since 1983. Most elderly or permanently and totally disabled taxpayers' adjusted gross incomes and Social Security benefits now exceed the amounts that would make them eligible for the credit.

EXAMPLE

The following example and table illustrate taxpayers' decreasing ability to claim the credit for the elderly or the disabled. The taxpayers were 65 years old in tax year 1990. They had a few investments, generating $1,000 in investment income, and both receive small pensions ($11,000) and nontaxable Social Security benefits ($5,000).

Adjusting their income for inflation, Table 2.7.2, Diminishing Benefits from the Credit for the Elderly or the Permanently and Totally Disabled, demonstrates how the couple lost the benefit of the credit and paid additional taxes with the passage of time. As their taxable income and Social Security benefits increased to keep up with the cost of living, the taxpayers paid more taxes because they no longer qualified for the Credit for the Elderly or the Permanently and Totally Disabled.

[3] IRS, Statistics of Income, Individual Income Tax Returns 1990, Publication 1304

[4] Id.

TABLE 2.7.2: DIMINISHING BENEFITS FROM THE CREDIT FOR THE ELDERLY OR THE PERMANENTLY AND TOTALLY DISABLED

Tax Year	Adjusted Gross Income[5]	Taxable Income Social	Non-Taxable elderly Security[6]	Credit for the Credit Taxpayer	Tax	Tax After
1990	12,000	1,150	5,000	225 (max =174)	174	0
1991	12,505	1,205	5,222	154	182	28
1992	12,881	881	5,415	$101.54	133	36
1993	13,266	966	5,593	$ 78.98	144	103
1994	13,606	856	5,785	0	129	129
1995	13,991	941	5,972	0	141	141

At first the taxpayers had no tax liability, because the credit eliminated their tax debt, but they found themselves increasingly burdened by having to pay taxes on their meager retirement income (1995 = $141).

RECOMMENDATION

Amend Internal Revenue Code section 22 to adjust the current threshold amount for past inflation and provide for future indexing for inflation.

5 Adjusted Gross Income is increased by the Consumer Price Index

6 Social Security benefit is increased according to Social Security Bulletin, Annual Statistical Supplement, 1999

JOINT AND SEVERAL LIABILITY

COMMUNITY PROPERTY LAWS

PROBLEM

Internal Revenue Code section 6321 creates a lien against any taxpayer who, after notice and demand, fails to pay a tax. This lien in favor of the United States attaches to all property and rights to property belonging to that taxpayer.

Generally, under state community property laws, one-half of each spouse's assets are considered to be the property of the other spouse. Thus, In community property states a spouse can receive relief from the obligation to pay tax on community property under Internal Revenue Code sections 6015 or 66 but still have his or her property subject to collection of the tax.

EXAMPLE

A spouse embezzled funds from her employer and used the money for trips to see her mother and other personal needs. She was charged, convicted, and sentenced for the embezzlement. The IRS assessed additional taxes on her jointly filed return resulting from the unreported embezzlement proceeds. The husband applied for and was granted relief from liability for the tax on the embezzlement proceeds. Since the husband lives in a state with community property laws, one-half of his property is considered to be his wife's property. The IRS can thus proceed to collect against one-half of the husband's property (including income) in spite of his being granted relief from joint and several liability for the tax year at issue.

RECOMMENDATION

Amend Internal Revenue Code section 6321 to disregard state community property tax laws in applying Internal Revenue Code section 66.

PENALTY AND INTEREST

ADJUSTMENT OF ESTIMATED TAX PENALTY IN ACCORDANCE WITH AMENDED RETURNS

PROBLEM

Internal Revenue Code section 6654 provides for an estimated tax penalty based on the tax reported on the taxpayer's original tax return. When a taxpayer files an amended return, and the IRS accepts it, the estimated tax penalty is not revised based on the tax as reported on the amended return. In some instances, an amended return might indicate that no estimated tax penalty is due.

EXAMPLE

A couple filed their original tax return, reporting tax of $20,000. They later discovered an error in the capital gains computation. They then promptly filed an amended return reporting the correct tax of $8,000.[7] The estimated tax penalty computation was based on the original tax of $20,000 and was not refigured for the correct tax on the amended return.

Had the taxpayers underreported their capital gains on their original return, there would be no corresponding increase in the estimated tax penalty after the amended return, reporting the increase in the tax liability, was filed and was accepted by the Service

RECOMMENDATION

Amend Internal Revenue Code section 6654 to clarify that, for purposes of the estimated tax penalty, the return for the taxable year is the original return or any subsequently filed amended return.

[7] Per IRC § 6511, the amended return was filed within the statute of limitations.

PENALTY AND INTEREST

FEDERAL TAX DEPOSIT (FTD) AVOIDANCE PENALTY

PROBLEM

Internal Revenue Code section 6656 provides a four-tiered penalty rate structure focused primarily on the untimely deposit of federal tax liabilities. The penalty rates range from 2 percent to 15 percent. This penalty also applies if a taxpayer is required to collect and pay over tax on behalf of the government and fails to do so in the required manner. Specifically, a 10 percent penalty may be applied if a taxpayer fails to deposit using the correct method through authorized depositories.

Any taxpayer required to deposit taxes may, in fact, do so timely and in the correct amount, yet still be subject to a 10 percent penalty for failing to use the correct method of deposit and/or pay the tax through the correct depository. Perceptions both within and outside the Internal Revenue Service are that the 10 percent penalty rate is disproportionate to the nature of the error committed.

EXAMPLE

An employer ran out of federal tax deposit coupons and was unable to make a deposit at his bank. He personally took his deposit of $2,000 into the local IRS office. He was charged a 10 percent penalty of $200 because he did not make the deposit through his bank, the authorized depository.

RECOMMENDATION

Amend Internal Revenue Code section 6656 to reduce the current 10 percent penalty rate for failure to make a deposit in the manner prescribed to a 2 percent penalty rate.

EMPLOYMENT TAX ISSUES

HEALTH INSURANCE DEDUCTIONS FOR SELF-EMPLOYED INDIVIDUALS

PROBLEM

Internal Revenue Code section 162(l)(4) disallows a deduction for the cost of health insurance in computing the net earnings of a sole proprietor for self-employment tax purposes. Under present law, self-employed individuals do not share the same tax advantages for health insurance as wage earners. Many wage earners can participate in benefit plans that allow them to pay for their health insurance with pre-tax dollars.

Although self-employed individuals can reduce their taxable income by the cost of their health insurance, they still must pay self-employment tax at the rate of 15.3 percent on this amount.[8] Wage earners who participate in pre-tax plans do not pay Social Security tax on their health insurance payments.

EXAMPLE

A self-employed individual had a net profit of $50,000 in tax year 2000 before deducting health insurance premiums. He paid $3,600 for medical insurance for himself and his wife. He may not deduct this expense in computing his net earnings from self-employment (SE). He owes SE tax of $7,064.78.[9] If he were allowed to deduct the medical insurance premiums in computing earnings for SE tax purposes, his SE tax liability would be $6,556.11,[10] a saving of $508.67. A wage earner who paid $3,600 for health insurance premiums with pre-tax dollars saves $275.40 in FICA taxes, and his employer's savings would be the same.[11]

RECOMMENDATION

Repeal Internal Revenue Code section 162(l)(4) to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment for self-employment tax purposes.

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8 IRC §1401

9 SE Earnings of $50,000 x 92.34% = Net SE earnings of $46,175 x SE Tax Rate of 15.3% = $7,064.78 SE Tax Liability.

10 SE Earnings of $46,400 x 92.34% = Net SE earnings of $42,850.40 x SE Tax Rate of 15.3% = $6,556.11 SE Tax Liability.

11 $3,600 x Employees share of FICA of 7.65% = $275.40. $3,600 x Employer's share of FICA of 7.65% = $275.40. Total savings = $550.80.

SMALL BUSINESS ISSUES

DEDUCTION FOR UNREIMBURSED EMPLOYEE BUSINESS EXPENSES

PROBLEM

A taxpayer who does not itemize deductions cannot deduct any of his or her unreimbursed employee business expenses. If a taxpayer does itemize, the unreimbursed employee business expenses are limited to the amount that exceeds two percent of Adjusted Gross Income.[12] Self-employed taxpayers with similar work-based expenses, such as independent contractors, can deduct these expenses without limitation.

The proposal would promote consistent treatment of wage earner taxpayers and self-employed taxpayers with similar type expenses incurred in the course of their work. Unreimbursed employee business expenses include, but are not limited to:

- Automobile expenses
- Education that is employment related
- Dues to a professional association
- Employer-required uniforms and protective clothing
- Business liability insurance premiums
- Damages paid to a former employer for breach of an employment contract
- Depreciation on a computer or cellular telephone required by the employer

The two percent floor limiting miscellaneous itemized deductions was originally added to the law by the Tax Reform Act of 1986. The limitation was intended to simplify the record-keeping requirements of taxpayers as well as reduce the IRS administrative burden in examining returns claiming such expenses. As a result of these changes, only taxpayers with expenses exceeding the limitation would be required to maintain records. However, taxpayers still have the burden of keeping records to determine if their expenses exceed the two percent limitation. Further, by including these expenses in miscellaneous itemized deductions, taxpayers face an increased likelihood of being subject to the Alternative Minimum Tax.

[12] IRC § 63(d) provides for itemized deductions. Section 67 subjects unreimbursed employee business expenses to the two percent of adjusted gross income limitation.

EXAMPLE

A single wage earner has approximately $3,000 of unreimbursed employee business expenses. The taxpayer maintains records of these expenses because he believes he should be able to deduct them in order to reflect his correct net wage income. He has adjusted gross income (AGI) of $41,000 and claims a standard deduction. None of the unreimbursed employee business expenses are allowed as a deduction under current law because he does not itemize deductions. However, if the expenses were allowed as a deduction in arriving at AGI, the taxpayer would receive a tax benefit of approximately $450.

RECOMMENDATION

Amend Internal Revenue Code section 62(a)(2) to allow unreimbursed employee business expenses as a deduction to arrive at adjusted gross income.

SMALL BUSINESS ISSUES

INCOME AVERAGING FOR COMMERCIAL FISHERMEN

PROBLEM

Commercial farmers are permitted to income average over a period of three years.[13] Income averaging is not available to commercial fishermen.

Income averaging evens out the economic misfortunes and booms that farmers regularly experience. Their current tax liability is calculated by averaging, over the previous three years, all or part of their current taxable income. The availability of income averaging compensates for certain variables associated with farming that are beyond the farmer's control. Fishermen must deal with these same variables, including weather, changing markets and prices, and environmental disasters.

EXAMPLE

A commercial salmon fisherman in Alaska reported a loss in each of the last three tax years due to low catches and low market prices. In 2000 he has a bumper year and is able to get top dollar for his fish. He is currently in the 31- percent tax bracket with a fishing income of $115,000 and a taxable income of $140,000. If he were able to income average, he could spread $99,000 of income over the previous three years in which he was in a lower tax bracket. Without income averaging, his taxes will be approximately $34,800. If he income averages, he would owe approximately $21,400 in 2000 income taxes, with a tax savings of $13,400.

RECOMMENDATION

Amend Internal Revenue Code section 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers.

[13] IRC § 1301(a)(2).

OTHER ISSUES

DISCLOSURE PROVISIONS REGARDING SUICIDE THREATS

PROBLEM

In situations where there is an immediate danger of death or physical injury to any individual, Internal Revenue Code section 6103(i)(3)(B)(i) allows disclosure of tax return information to a Federal or State law enforcement agency. The Code's disclosure provisions limit the release of confidential taxpayer information to others. The IRC does not allow IRS employees to provide information to local law enforcement authorities, such as county, city or town police, or to local suicide prevention authorities.

In areas where there is no state or federal authority, the response time in emergency situations may be shorter for the local authorities. If the person receiving the threat determines that help is needed, time will be of the essence. The disclosure authority for suicide threats should be extended to local law enforcement and suicide prevention authorities so that the person in need receives assistance from whatever entity can provide it in the shortest time.

EXAMPLE

When a taxpayer threatens suicide as part of a tax-related communication, the IRS employee who hears the threat is prevented from contacting local law enforcement or suicide prevention authorities, who are often closest to the situation. They are in closer contact with suicide hot lines and other social agencies that may be available to help the individual. The taxpayer's address, available to IRS employees through various records, is the information that would most aid a local law enforcement agency. Providing this information to that agency could save the life of an individual who may be suffering a serious life-threatening situation.

RECOMMENDATION

Amend Internal Revenue Code section 6103(i)(3)(B) to allow 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.

The Taxpayer Advocate Service (TAS) serves the public by helping to resolve problem cases and by recommending systemic solutions to make the tax process easier for everyone. The IRS Restructuring and Reform Act of 1998 (Public Law 105-206) created TAS as a unique, independent entity within the Internal Revenue Service. During Fiscal Year (FY) 2001, TAS built on, developed and refined this new status, undertook significant initiatives, and expanded its partnership with other IRS divisions and units.

The two components of our mission, casework and systemic advocacy, are complementary. By working individual cases, TAS often uncovers specific problems that affect large numbers of taxpayers and which can only be solved by changing administrative policies or procedures or by changing the tax law itself. One of the most common complaints we encountered this past fiscal year is the tangle of criteria for children to qualify a taxpayer to claim the Earned Income Tax Credit (EITC) or other benefits. Accordingly, we are addressing EITC concerns through advocacy projects and recommending legislative changes that would apply the EITC definition of a qualifying child to other Internal Revenue Code provisions related to family status, thus eliminating a great deal of taxpayer confusion.

Although many of our individual cases covered the same issues TAS had dealt with in prior years, the 2001 fiscal year brought new challenges as well. We reacted quickly to critical events, helping resolve tax problems that emerged from the September 11 tragedy and several natural disasters. TAS is also working on advance payment cases resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001.

In all, TAS reviewed and resolved more than 272,000 cases in FY 2001, an increase of some 16,000 cases from the previous fiscal year. We have stepped up our outreach programs to make more taxpayers aware of our services, and have improved our database, the Taxpayer Advocate Management Information System (TAMIS). Additionally, we prepared a systemic analysis of our casework inventory during FY 2001 and shared the initial report with the Commissioner and the IRS Wage and Investment and Small Business/Self Employed Operating Divisions. The analysis and report enabled us to focus Taxpayer Advocate Service initiatives on specific problems and programs.

Some may believe an advocate for the taxpayer must inevitably be the adversary of others throughout the IRS. This is not the case. The Taxpayer Advocate Service and its views were and are represented on a wide range of IRS teams and task forces, covering matters such as disaster relief, due process in collections, and Innocent Spouse cases.

TAXPAYER ADVOCATE SERVICE
CASEWORK

RECEIPTS

The Taxpayer Advocate Service received over 270,000 new cases in fiscal year 2001. They came from taxpayers, practitioners, and as referrals from the IRS Operating Divisions and congressional offices. Forty percent of the new receipts arose from four IRS program areas: Earned Income Tax Credit (EITC) examinations due to the Revenue Protection Strategy, processing of claims or amended returns (including Injured Spouse claims), processing of refunds, and initial processing of original paper or electronic individual returns.

Our data indicate that most taxpayers contact TAS because of systemic or procedural problems, including delays. Table 3.1.1 illustrates TAS case receipts broken down by Taxpayer Advocate criteria:

TABLE 3.1.1

	TAXPAYER ADVOCATE CRITERIA	APPROXIMATE NUMBER OF CASES	PERCENT OF CASES
1	Taxpayer suffering or about to suffer significant hardship.	26,200	9.7%
2	Taxpayer is facing an immediate threat of adverse action.	4,500	1.7%
3	Taxpayer will incur significant costs if relief not granted.	3,100	1.1%
4	Taxpayer will suffer irreparable injury or long-term adverse impact.	3,500	1.3%
5	Taxpayer experienced delay of more than 30 calendar days in resolving an account-related problem or inquiry.	79,100	29.3%
6	Taxpayer did not receive a response or resolution by the date promised.	47,800	17.7%
7	A system or procedure has either failed to operate as intended or failed to resolve the taxpayer's problem.	89,900	33.2%
8	Congressional duplicate of any criteria or non-criteria case already in the Taxpayer Advocate Service.	2,000	0.7%
9	Any issue/problem not meeting the above criteria but kept in the program for handling and resolution.	14,300	5.3%
	TOTAL	**270,400**	**100.0%**

The Taxpayer Advocate Service received approximately 79 percent more EITC cases in FY 2001 than in FY 2000. This is a direct result of an IRS effort to eliminate error or fraud in the EITC program. The IRS systemically freezes refunds to some taxpayers who claim the EITC until the case is reviewed and the audit determination is made. Taxpayers call the Taxpayer Advocate Service because they need the refund.

As in years past, refund issues make up a significant portion of case receipts in the Taxpayer Advocate Service. The Taxpayer Advocate Service has recently received a number of cases related to the Economic Growth and Tax Relief Reconciliation Act of 2001. We began tracking these cases early in August 2001 and in two months received nearly 1,900 such cases. Taxpayers are generally seeking assistance with issues including understanding IRS notices, the amount of the refund received, the inability to reach an IRS representative on toll-free lines and questions about the law.

The Taxpayer Advocate Service uses the Taxpayer Advocate Management Information System (TAMIS) to track Taxpayer Advocate cases. Table 3.1.2 provides details for the ten most frequent issues identified in TAS case receipts.

TABLE 3.1.2

DESCRIPTION OF ISSUE	APPROXIMATE COUNT
Revenue Protection-EITC	34,500
Processing claims/amended returns	29,000
Refund inquiry including expedited requests	24,700
Initial Processing of IMF returns	20,200
Other Penalties	14,900
Problems with payments/credits (other than federal tax deposits/electronic federal tax payment system, & excess collection.)	10,800
Examination of tax return in progress prior to assessment on Audit Information Management System	9,400
Audit Reconsiderations	9,000
SS4 Application & Entity changes	8,200
Underreporter process-includes both open & closed cases	7,900

CLOSURES

The Taxpayer Advocate Service closed over 272,000 taxpayer cases this past fiscal year. Approximately 248,000 of the closed cases originated as Applications for Taxpayer Assistance Orders (ATAOs) (Form 911 or an acceptable substitute) in FY 2001 or in prior fiscal years. We provided relief in more than 168,900 cases, did not provide relief in approximately 72,400 cases, and determined that relief was not required in approximately 6,800 cases.

Table 3.1.3 provides additional details regarding the disposition of Application for Taxpayer Assistance Order cases that we closed during this past fiscal year.

TABLE 3.1.3

APPLICATION FOR TAXPAYER ASSISTANCE ORDER (ATAO) DISPOSITION OF CASES	APPROXIMATE NUMBER	PERCENT OF TOTAL
Relief Granted-Including Taxpayer Assistance Orders	168,900	68.1%
No Relief Granted-Advocate does not deem relief appropriate.	53,200	21.4%
No Relief Granted-No response from taxpayer.	11,800	4.8%
No Relief Granted-Hardship not validated or documentation/verification that the Advocate deems necessary not provided by taxpayer.	5,400	2.2%
No Relief Granted-Advocate determined relief appropriate, but current law prevents granting relief.	1,900	0.8%
Advocate Relief Not Required-Relief provided by Operations prior to receipt of ATAO or relief determination.	6,300	2.5%
Advocate Relief Not Required-Taxpayer rescinds ATAO, no longer requires Advocate relief.	400	0.1%
Advocate Relief Not Required-Taxpayer hardship did not involve in any way the administration of the Internal Revenue Code.	100	0.1%
TOTAL	**248,000**	**100.0%**

TAXPAYER ASSISTANCE ORDERS

In general, Internal Revenue Code section 7811 authorizes Taxpayer Advocates to issue Taxpayer Assistance Orders (TAOs) when a taxpayer is suffering or about to suffer a significant hardship as a result of the IRS' administration of the tax laws. TAS issues two types of TAOs. We issue Direct TAOs to direct an IRS unit to take an action that is specifically authorized by IRC § 7811(b). We issue Review TAOs to require that an IRS organizational unit expedite consideration of a taxpayer's case, review and reconsider its own determination, or review a determination at a higher level in that unit.

During FY 2001, TAS issued a total of 18 TAOs on the following types of cases: Offer in Compromise (3), Federal Tax Lien (1), Refunds (4), Levies (4), Innocent Spouse (1), Earned Income Tax Credit (2), Amended Return (1), and Payments or Credits (2).

We issued 12 TAOs in accordance with Internal Revenue Code § 7811(b) and IRS Operating Division personnel took the requested action(s) in all but one case. The IRS Operating Division appealed this case and the TAO was later rescinded by the Taxpayer Advocate Service.

Internal Revenue Code § 7811(b) provides that the terms of the Taxpayer Assistance Order may require the Secretary to take an action within a specified timeframe. IRS Operations failed to meet the specified time frame on eight of the Taxpayer Assistance Orders issued. In five of these cases, the Taxpayer Assistance Orders included a specified timeframe of less than 48 hours. IRS Operating Division personnel completed the requested action within seven calendar days in all but one of these eight cases.

We issued six TAOs during FY 2001 where the requested action(s) were not the appropriate subjects of a Direct TAO under IRC § 7811(b). The IRS Operating Division(s) appealed, and the Taxpayer Advocate Service rescinded, three of these TAOs. IRS Operating Division personnel took the requested action(s) on the other three cases.

CONGRESSIONAL CASEWORK

The Taxpayer Advocate Service responds to all tax account related inquiries sent to IRS by members of Congress, even when these inquiries do not otherwise meet TAS criteria. The Taxpayer Advocate Service closed over 17,000 congressional inquiries in FY 2001. Table 3.1.4 highlights the case disposition of these inquires. Table 3.1.4 does not include duplicate cases or those cases that do not meet TAS hardship criteria.

TABLE 3.1.4

CONGRESSIONAL CASE DISPOSITIONS	APPROXIMATE VOLUME	PERCENT OF TOTAL
Relief Granted	8,600	57.8%
No Relief Granted-Advocate does not deem relief appropriate.	5,400	36.2%
No Relief Granted-Advocate determined relief appropriate but current law prevents granting it.	300	2.0%
Advocate Relief Not Required-Relief provided by Operations prior to receipt of ATAO or relief determination	600	4.0%
TOTAL	**14,900**	**100.0%**

The most frequent issues raised by taxpayers seeking congressional intervention in FY 2001 include: refund issues, abatement of penalties, requests for tax law interpretations, offers in compromise, processing of original individual returns, IRS responses, processing of claims and amended returns, collection notices, inability to make payments, requests for forms, and requests for copies of returns or transcripts.

SENATE FINANCE COMMITTEE CASEWORK

While the Senate Finance Committee continues to receive Internal Revenue Service-related correspondence, the amount has significantly declined from prior years. In FY 2001, we received 68 new Senate Finance Committee cases. This represents only .02 percent of total TAS case receipts.

In FY 2001, we closed and responded to 191 Senate Finance Committee cases. Table 3.1.5 depicts a breakdown of the closed case results. The most frequent issues raised by taxpayers seeking assistance from the Senate Finance Committee in FY 2001 include: questioning the legality of the tax system, taxpayer treatment, offers in compromise, audit reconsideration, abatement of penalties, examination of tax return prior to assessment, requests for determination (liability, filing status, etc), levies, processing of claims and amended returns, and refund issues.

The Taxpayer Advocate Service has closed a total of 4,843 Senate Finance Committee cases from the beginning of the program, February 13, 1998, through September 30, 2001.

TABLE 3.1.5

SENATE FINANCE COMMITTEE CASE DISPOSITION	VOLUME	PERCENT OF TOTAL
Relief Granted	61	31.9%
No Relief Granted-Advocate does not deem relief appropriate.	102	53.4%
No Relief Granted-Advocate determined relief appropriate, but current law prevents granting relief.	12	6.3%
Advocate Relief Not Required-Relief provided by Operations prior to receipt of ATAO or relief determination.	2	1.0%
Advocate Relief Not Required- General Assistance	14	7.3%
TOTAL	**191**	**100.0%**

INITIATIVES

During FY 2001, TAS identified areas causing concern for taxpayers through analysis of our casework inventory. The Taxpayer Advocate Service worked cooperatively with IRS Operations to determine the underlying causes of problems and to improve the performance of IRS systems to prevent problems from recurring. The following initiatives were taken by the Taxpayer Advocate Service to improve taxpayer services and Internal Revenue Service responsiveness.

EARNED INCOME TAX CREDIT

Nearly twenty million taxpayers claimed the EITC in each of the past several years. [1] While the IRS is engaged in providing taxpayer assistance to low-income taxpayers and ensuring that the EITC program benefits eligible taxpayers, the EITC is a complex and confusing provision. Taxpayers contact TAS for assistance either because their refunds have been delayed or because of difficulties in understanding IRS requests for information when their EITC claims are subject to audit.

The Taxpayer Advocate Service received approximately 39,000 EITC cases in FY 2001, a 79 percent increase from the number of cases received in FY 2000. We closed approximately 32,900 cases that were received in FY 2001 and prior fiscal years. Based upon the increased number of cases, TAS has increased its focus on EITC issues. The Taxpayer Advocate Service established a project team to work with the IRS to address the needs of

[1] United States General Accounting Office. Testimony Before the Committee on Finance, United States Senate, Federal Taxes – Information on Payroll Taxes and Earned Income Tax Credit Noncompliance. (GAO-01-487T). 7 March 2001.

[2] Approximately 6,900 of these cases were not granted relief because the taxpayer did not respond to a request from the Taxpayer Advocate Service or because the documentation provided by the taxpayer did not support the claim for the Earned Income Tax Credit.

this diverse population of taxpayers. We are also working with Treasury and IRS as they plan to expand the use of math error notices in the EITC program. Table 3.1.6 details the disposition of EITC cases closed by TAS during FY 2001.

TABLE 3.1.6

EITC CASE DISPOSITION	APPROXIMATE NUMBER OF CASES		
	MATH ERROR	REVENUE PROTECTION STRATEGY EXAMINATION	TOTAL
Relief Granted	2,200	13,800	16,000
No Relief Granted-Advocate does not deem relief appropriate.	1,400	15,000	16,400 [2]
No Relief Granted-Advocate determined relief appropriate, but current law prevents granting relief.	20	60	80
Advocate Relief Not Required-Relief provided by Operations prior to TAS relief determination.	50	300	350
TOTAL	**3,670**	**29,160**	**32,830**

In addition to the projects described below, TAS undertook EITC initiatives including review of letters, notices and forms, EITC audits, math error notices, the Federal Case Registry, injured spouse claims processing, and publicity about the revised definition of a foster child.

REVENUE PROTECTION STRATEGY – 1999 REFUNDS

During February 2001, the Taxpayer Advocate Service identified over 100,000 taxpayers whose Earned Income Tax Credit refunds were delayed as a result of the IRS Revenue Protection Strategy Program. This volume included tax year 1999 refunds (many of which were delayed for more than a year) and tax year 2000 refunds for those taxpayers awaiting the outcome of the 1999 audits. Of greatest concern to TAS was a large inventory of unprocessed correspondence that could contain information from taxpayers needed to resolve the claims. These taxpayers are low income and often depend on their tax refund to meet basic living expenses. Some taxpayers sought the assistance of the Taxpayer Advocate Service.

The Taxpayer Advocate Service worked with IRS Operations and the EITC Project Office staff. IRS substantially reduced the 1999 backlogs in examination inventory by the end of May 2001. Operations added resources to process the correspondence received to assist in determining eligibility and to facilitate the resolution of these claims. IRS Operations and TAS developed an action plan and IRS Operations directed service centers to handle all remaining EITC claims for taxpayers in hardship situations promptly.

RECERTIFICATION REQUIREMENTS FOR TAXPAYERS WITHOUT A QUALIFYING CHILD

Internal Revenue Code section 32(k)(2)[3] provides that taxpayers denied EITC in a prior year are required to demonstrate eligibility for the credit for the next taxable year in which the credit is claimed. This "re-certification" must take place even if, in a subsequent year, a taxpayer claims the credit based on income only with no qualifying child. During this process, the taxpayers' refunds are delayed until recertification procedures are completed and an audit determination made.

The Taxpayer Advocate Service began a study to determine the feasibility of streamlining the recertification procedures for those taxpayers who do not claim a qualifying child and in subsequent years appear to be eligible for the "childless credit" (the maximum credit is $364.00 in tax year 2001) for the EITC under IRC § 32(c)(1)(A)(ii). TAS developed and elevated a proposal to automate the screening process for these taxpayers during the processing of the tax return. The proposal was considered during discussions with the Wage and Investment Operating Division and Chief Counsel. The Treasury Inspector General for Tax Administration (TIGTA) made a similar recommendation to Treasury suggesting that IRS be permitted to reconsider the existing practice of requiring recertification in these circumstances. [4]

As a result, the IRS issued final regulations (T.D. 8953) effective June 25, 2001. These regulations, and other provisions, permit the IRS to modify the existing EITC Program to limit the requirement for an individual denied the EITC in one year to establish eligibility the next time he or she claims the credit based solely on the reason the claim was originally denied. The EITC Program Office and IRS Operations are in the process of implementing this recommendation and issuing clarifying guidance. A TAS automation recommendation will also be considered.

[3] The Omnibus Budget Reconciliation Act of 1993, Public Law 103-66 [H.R. 2264], Title XII, Chapter 1, Part III, § 13131 (Aug. 10, 1993) amended IRC § 32 to allow the EITC to persons based on income only (no qualifying child).
[4] Treasury inspector General for Tax Administration. Report: Improvements Are Needed in the Earned Income Credit Recertification Program (Ref. Number 2001-40-030). December 2000.

INNOCENT SPOUSE PROGRAM

The Taxpayer Advocate Service has taken a special interest in the innocent spouse program, particularly since the IRS Restructuring and Reform Act of 1998 (RRA 98) expanded the provisions for innocent spouse relief under IRC § 6015.[5] IRS has received almost 160,000 innocent spouse claims affecting approximately 84,000 taxpayers since the enactment of this legislation. The Taxpayer Advocate Service noted an increase in inquiries to its offices from taxpayer experiencing hardship as awareness of the new innocent spouse provisions grew. Other indicators caused TAS to form its own project team to look at innocent spouse issues and to elevate concerns and recommendations for program improvements to IRS Operations.

The Taxpayer Advocate Service partnered with the Innocent Spouse Project Office beginning in the summer of 2000 to implement procedures and policies, and jointly resolve program concerns. IRS implemented many changes to streamline the processing of innocent spouse claims. Specifically IRS Operations:

- Strengthened the timeliness and frequency of communications with taxpayers in this program. IRS now contacts taxpayers upon receipt of their claim, and continues providing updates every 90 days thereafter;
- Centralized innocent spouse claim processing to one primary location to provide program management and consistency in determinations;
- Increased staffing at the centralized site; and
- Developed computer-based training that leads the examiner through the complex decision making process.

As a result, TAS Innocent Spouse case receipts decreased approximately 33 percent in FY 2001 from the number received in FY 2000. Additionally, the average number of days that a case remains open within TAS has dropped from a high of 170 days to 80 days during FY 2001. The drop in the average number of days that a case remains open in TAS is significant because TAS does not work directly on Innocent Spouse claims. TAS assists taxpayers in preparing and documenting a claim, but employees in the IRS Operations perform the actual casework.

The Taxpayer Advocate Service continues to work with IRS Operations to identify and address issues that cause taxpayer burden. The National Taxpayer Advocate met with the Innocent Spouse Project Manager and Innocent Spouse employees to assist TAS and IRS Operations in gaining a better understanding of the relationship between innocent spouse claim processing, legislation, and communication concerns. On June 18, 2001, the

5 Before the enactment of IRC § 6015 (June 22, 1998), taxpayers had some limited relief under IRC § 6013(e) originally enacted in 1971. Section 66, enacted in 1980, provides protection for spouses living in community property states.

National Taxpayer Advocate and Commissioners from both the Wage and Investment and Small Business/Self-Employed IRS Operating Divisions issued a memo providing clarification on handling innocent spouse case inquiries and TAS case processing.

The Taxpayer Advocate Service reviewed and provided comments about the notice of proposed rulemaking for innocent spouse regulations that the IRS published in 2001. We requested a Chief Counsel opinion concerning IRS' procedures for determining if payments may be returned to taxpayers granted innocent spouse relief under IRC § 6015(f). The Taxpayer Advocate Service also asked for a Counsel opinion on taxpayers' rights to appeal an IRS determination of the amount to be refunded. We are currently developing proposals to address the competing interests and rights of the petitioning and non-petitioning spouse.

DISASTER RELIEF

During FY 2001, Local Taxpayer Advocates provided staff at Federal Emergency Management Administration (FEMA) Disaster Sites. The Taxpayer Advocate Service was also involved in community outreach efforts to ensure taxpayers impacted by disasters were provided information concerning their rights as residents of a federally declared disaster area. The Taxpayer Advocate Service accepted cases that were not resolved through normal disaster procedures. Most taxpayers contacted the Taxpayer Advocate Service because penalties and interest were assessed when the return was filed by the due date as extended under disaster declaration provisions. Taxpayer Advocate Service also provided assistance to taxpayers by:

- Expediting hardship refunds;
- Replacing lost checks and payments;
- Assisting taxpayers to obtain tax return information, and to prepare and file returns to meet FEMA loan eligibility requirements;
- Assisting in deposit reallocations when appropriate;
- Coordinating expedited processing for taxpayers filing claims in disaster losses;
- Alerting IRS Operations to problem trends in disaster processing and assisting in resolving the problems; and
- Helping design an IRS-wide action plan to assist victims in understanding the tax issues surrounding the Cerro Grande Fire Assistance Act.

The Taxpayer Advocate Service is working with IRS to provide better support to taxpayers and more coordination with federal and state agencies when a disaster is declared. The National Taxpayer Advocate is represented on an IRS team that is revising disaster procedures in light of IRS modernization. In addition, TAS contributed to the redesign of publications offered to assist victims of disasters. A 265-page Disaster Kit was modified into two smaller, manageable documents, each tailored to the specific needs of the individual or business taxpayer.

SEPTEMBER 11, 2001 DISASTER RELIEF

The Taxpayer Advocate Service participates in a high-level technical working group that has dealt with and will continue to address tax related issues and questions arising from the September 11, 2001 terrorist attacks. As the issues are raised and answered, the answers are available to all employees of the Internal Revenue Service. The Taxpayer Advocate Service has volunteered to support the Killed in Terrorist Action coordinator program. The coordinators are assigned the accounts of individuals who perished in the attacks on September 11. We have agreed to provide backup coordinators, if needed, to each of the IRS campuses (formerly IRS Service Centers) involved in this program.

In addition, TAS has provided assistance to our Brooklyn and Manhattan Local Taxpayer Advocate offices. Following the terrorist attacks, TAS immediately routed cases to offices that were not directly affected by the attacks to ensure that taxpayers served by the affected offices continued receiving assistance.

OFFERS IN COMPROMISE

The National Taxpayer Advocate is actively contributing to the Small Business/ Self-Employed Operating Division effort to improve the effectiveness of the Offer in Compromise program (OIC).

In February 2001, the Commissioner convened a task force to address the increasing delays and growing backlogs in processing offers. The National Taxpayer Advocate appointed an analyst to serve on the sub-team that worked to streamline offer processing. The task force identified many deficiencies in the program, but two critical ones were (1) inconsistent management views regarding the goal of the Offer in Compromise program and (2) the inability to identify the default rate of offers in compromise.

The National Taxpayer Advocate provided a white paper raising key issues of concern such as clarifying the goals of the offer program and the “effective tax administration” offer criteria within IRS and with outside stakeholders. The paper made suggestions regarding streamlining the offer process. It also raised issues requiring legislation seeking IRS authority to grant installment agreements for less than full payment and to use administrative processes other than offer in compromise to abate interest.

The team recommended a new process in which cases meeting certain dollar and asset criteria would be expeditiously processed. This process involves minimal contact with the taxpayer and uses electronic research to more effectively verify the taxpayer’s ability to pay. The Small Business/Self-Employed Operating Division implemented new procedures

to streamline OIC processing and to strengthen consistency of casework and program management.

The National Taxpayer Advocate provided language to clarify effective tax administration criteria to assist both tax practitioners and the IRS in reaching a common understanding of this provision of the Internal Revenue Code. The National Taxpayer Advocate also worked with external stakeholders to solicit suggestions and examples to assist in clarifying Treasury Regulations.

The IRS is considering a proposal to charge a user fee for filing an Offer in Compromise. The purpose of the fee is to provide supplemental funding to improve the offer program. The fee would be based on the costs associated with the often complex, resource intensive investigative and monitoring requirements. While the imposition of a fee would distribute costs only among those who file offers, the National Taxpayer Advocate raised concerns that any fee system should be designed with safeguards to waive the fee for low-income taxpayers. At the request of the National Taxpayer Advocate, the Small Business/Self-Employee Operating Division is developing a paper clarifying the IRS position regarding Offer in Compromise user fees. The paper will explain when and how user fees will be collected, and how the user fees apply to low-income taxpayers. The National Taxpayer Advocate will distribute the paper to external stakeholders for comment.

FEDERAL PAYMENT LEVY PROGRAM

The Federal Debt and Improvement Act of 1996 [6] authorized federal agencies to offset federal payments against federal debts. The IRS is authorized to levy up to 15 percent of various federal payments to taxpayers who have federal debts. The program began with the July 2000 implementation of levies on Office of Personnel Management (OPM) payments and federal vendor payments. This phase included payments to federal retirees. The second phase was implemented in May 2001 for Federal travel payments.

The current phase includes levies on Social Security benefits and federal employees' wages. TAS worked with IRS Operations to mitigate potential adverse impact in implementing this law. The National Taxpayer Advocate identified concerns about building appropriate protections for taxpayers in the design of the Benefit Payment Offset Program (i.e., levies on SSA benefits). The concerns focused primarily on ensuring that plans were in place to prevent levies on benefits of elderly and disabled taxpayers who may suffer substantial hardship as a result of a levy. The Taxpayer Advocate Service worked with IRS Operations to establish a threshold income below which enforced collection of social security income will not occur.

6 Section 1024 of the Taxpayer Relief Act of 1997 (Public Law 105-34) created Internal Revenue Code § 6331(h) which authorizes the IRS to levy up to 15 percent of certain specified payments

Additionally, the National Taxpayer Advocate worked with the Small Business/Self-Employed Operating Division and IRS Communications and Liaison to ensure that targeted communication and outreach strategies were developed. In October 2001, IRS sent notices to approximately 232,000 social security recipients who owe Federal debts. The notice advises taxpayers that levies will begin in February 2002. News releases were issued nationally, and TAS coordinated targeted outreach activity to key organizations at the local level.

The National Taxpayer Advocate met with congressional leaders to ensure they were aware of the potential hardship situation for low-income taxpayers. She advised congressional leaders that IRS implemented an income threshold for enforced collection although this was not legislatively mandated.

ADDITIONAL TAXPAYER ADVOCATE AUTHORITIES

On January 17, 2001, the Commissioner of the Internal Revenue Service delegated additional authorities to the National Taxpayer Advocate. This delegation includes the accounts management authorities of the Customer Service function of the IRS. The authorities enable TAS employees to perform many Customer Service related functions on routine cases. Delegation of these additional authorities enables TAS to provide more efficient service to taxpayers. The National Taxpayer Advocate redelegated the authorities to TAS employees on October 1, 2001 following a 32-hour all-employee training program.

In addition to the new authorities, the National Taxpayer Advocate issued a revised Taxpayer Advocate Service Internal Revenue Manual in September of 2001. The revision included the new delegated authorities and enhancements to case processing guidelines that will improve service to the taxpayer. The September 2001 revision is the first in a series of planned TAS IRM improvements.

SYSTEMIC ADVOCACY

INTRODUCTION

The Taxpayer Advocate Service receives suggestions from taxpayers, tax practitioners, Citizen Advocacy Panels (CAPs), and IRS employees. During FY 2001, TAS initiated 92 advocacy projects. Of that total, 35 involved business taxpayer issues, 36 related to individual taxpayer issues and 21 addressed issues affecting taxpayers in both groups. The following advocacy projects highlight the issues TAS addressed during FY 2001 and reflect the contributions of many employees throughout the IRS. Many of the projects described here required coordination between Local Taxpayer Advocates, TAS systemic advocacy and casework advocacy organizations, and the IRS Operating and Functional Divisions.

ORAL AGREEMENT AUTHORITY

The Commissioner convened a task force in March 2001 to consider the suggestion to seek legislative authority for IRS to accept oral agreements for an increase in tax. In sharing her reservations with the Commissioner, the National Taxpayer Advocate developed a briefing paper describing issues that should be considered in seeking and administering oral agreement authority. Of foremost concern is maintaining safeguards of taxpayer rights. The National Taxpayer Advocate identified workable alternatives and suggested modifications of existing practices.

PENALTY AND INTEREST ADMINISTRATION

The penalty provisions in the Internal Revenue Code cause problems for both individual and business taxpayers. The Taxpayer Advocate Service created a cross-functional team as part of a strategy to assist in developing a consistent approach to penalties and to educate taxpayers so that they do not inadvertently incur penalties. The project team worked with the Wage and Investment and the Small Business/Self-Employed Operating Divisions to identify and address a number of penalty and interest issues, including:

- Correcting inaccuracies in the computation of the Child Tax Credit for Estimated Tax penalty purposes.
- Identifying computer discrepancies and system programming errors regarding interest and penalty computations and issuing guidance to IRS employees.
- Correcting a systemic problem affecting estimated tax penalty and interest amounts for taxpayers filing Schedule H for household employees, to allow non-assertion for the Estimated Tax Penalty on Schedule H under certain conditions.
- Suggesting changes in IRS penalty and interest-related notices to improve clarity and effectiveness.
- Eliminating inconsistencies in Internal Revenue Manual provisions and issuing employee alerts advising of these corrections.
- Serving on a cross-functional team engaged in reviewing the assessment and abatement process for Federal Tax Deposit (FTD) penalties.

PENALTIES ON SMALL PARTNERSHIPS

Many small partnerships (fewer than 10 partners) are unaware that they may qualify for an abatement of the late filing penalty. [7] The Pacific Northwest Citizen Advocacy Panel (CAP) suggested that the IRS send a letter to small partnerships informing them of the

[7] IRC § 6231(a)(1)(B) Tax Treatment of Partnership Items; Definitions and Special Rules; Exception for Small Partnerships

reasonable cause provisions. [8] TAS sought and received Chief Counsel advice regarding the imposition of the late filing penalty on small partnerships. [9] TAS also confirmed with the IRS Research Office that nationwide a large number of penalties are being assessed, and subsequently abated, on small partnerships. [10] As a result, TAS, in coordination with IRS Operations, is developing an information notice for small partnerships to clarify this penalty waiver provision.

ESTIMATED TAX PENALTY SCHEDULE C – FARMERS/FISHERMAN

Internal Revenue Code section 6654(i) extends special rules for self-employed farmers and fishermen in making estimated tax payments. So long as the taxpayer receives at least two-thirds of his or her income from farming or fishing, and files and pays his or her tax by March 1 in the following year, no estimated tax payments are required during the tax year. IRS erroneously assessed estimated tax penalties on taxpayers meeting these requirements. Approximately 8,000 accounts were affected for tax year 2000.

Taxpayers enter a business code on the tax return to identify themselves as farmers or fishermen. A computer-programming problem affected the proper application of these codes in processing tax returns of farmers and fishermen. In a collaborative effort with the Office of Penalty and Interest Administration, IRS Operations, and TAS, the IRS corrected this problem for future filing years. Another program is scheduled to systemically correct the 12,000 accounts assessed erroneous penalties for the years 1998-2000.

SUPPORT FOR QUALIFIED LOW INCOME TAXPAYER CLINICS

The IRS Restructuring and Reform Act of 1998 (RRA 98) authorized federal funding of Low Income Taxpayer Clinics (LITCs) to provide for representation of low income taxpayers and education and outreach to taxpayers for whom English is a second language. [11]

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8 IRC § 6031 Return of Partnership Income and IRC § 6698(a) Failure to File a Partnership Return

9 A committee Report on § 6698(a) states: " … The committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. Although these partnerships may technically be required to file partnership returns, the Committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance." With this Committee Report in mind, the IRS initiated Revenue Procedure 84-35, 1984-1 CB509, superseding Revenue Procedure 81-11, 1981-1 CB 509. Section 3.01 of the Revenue Procedure states that a domestic partnership of 10 or fewer partners, and coming within the exception outlined in § 6321(a)(1)(B), will not be subject to the penalty imposed by § 6698 for the failure to file a complete or timely filed partnership return, provided the partnership, or any of the partners, establishes, if so required by the IRS, that all partners have fully reported their shares of income, deductions, and credits on their timely filed income tax returns.

10 Compliance Research Information System 1998 data indicates that 552,357 partnership returns that satisfy the criteria in IRC § 6231(a)(1)(B) were late filed. Of those, approximately 19 percent were assessed penalty and interest and 44 percent of those assessed were later abated.

11 IRC § 7526

The National Taxpayer Advocate convened a cross-functional team to identify and address issues LITCs face in providing assistance to the low income taxpayers they serve. The team includes representatives from Wage and Investment Stakeholder Partnership, Education, and Communications (including the LITC Grant Administration Office), Chief Counsel, and TAS.

As part of this coordinated effort, TAS offered support for an IRS Operations initiative to display LITC promotional materials at taxpayer assistance centers throughout the country. IRS Operations authorized field employees to make information, including clinic posters and brochures, available to taxpayers at all taxpayer assistance sites and at outreach sessions targeted to low-income taxpayers. The National Taxpayer Advocate asked each Local Taxpayer Advocate to contact and visit the low income tax clinics in his or her area to offer assistance and to educate the clinics about the Taxpayer Advocate Service's work. The National Taxpayer Advocate was the keynote speaker at the American Bar Association Section of Taxation and American University Third Annual Workshop on Low Income Taxpayer Clinics in May 2001.

The Taxpayer Advocate Service collaborated with IRS Operations and the Director of Practice to ensure that student attorneys with Student Tax and Low Income Taxpayer Clinics can appropriately represent taxpayers in their dealings with the IRS. The team proposed revisions to the instructions to Form 2848, Power of Attorney and Declaration of Representation, to clarify the signature requirements. The team also proposed revisions to provide specific instructions for students and lead attorneys of qualified clinics in completing the declaration of representative section of the form. Additionally, proposed revisions to the Internal Revenue Manual will assist IRS personnel to properly process Power of Attorney forms and ensure all employees can interact with the named authorized representative. The changes and revisions are scheduled for publication in FY 2002.

HELPING OVERSEAS TAXPAYERS

TAS has undertaken a number of special projects to give added voice to the approximately 620,000 U.S. individual and 11,000 U.S. business taxpayers residing overseas. TAS worked with IRS Operations to schedule an earlier mailing date of tax packages. Generally, taxpayers with foreign addresses must file their tax returns and other forms with the Philadelphia IRS Campus (formerly Philadelphia Service Center). If a taxpayer mistakenly files at another campus, unnecessary contacts, processing delays, and potential penalties may result. TAS worked with IRS operations to revise a letter to taxpayers advising them of the importance of filing at the correct campus.

Notices sent to taxpayers with overseas addresses do not include an IRS telephone number; rather, taxpayers are advised to contact their nearest IRS office for assistance. TAS estimates that 312,000 notices were mailed to taxpayers residing overseas last year. TAS and IRS Operations agreed to place a non-toll free number on some redesigned notices sent to taxpayers residing overseas beginning in 2002. The telephone number on the notices will direct taxpayers to the Philadelphia IRS office, which is equipped to address specialized inquiries from taxpayers living abroad. IRS offices that are located in some foreign U.S. embassies are not staffed to handle the volume or nature of the calls expected. TAS will continue to partner with IRS Operations to resolve this issue on all appropriate overseas notices.

There is no toll free customer service assistance for taxpayers residing overseas. TAS is collaborating with IRS Operations to address this concern. TAS and the Electronic Tax Administration Office are also working together to include overseas enrolled agents in the testing of the Practitioner's secure Messaging System for e-mailing tax account related questions.

MISSING PAYMENTS AND/OR DOCUMENTS SENT TO THE PITTSBURGH LOCKBOX

Taxpayers send payments and tax returns to the IRS designated depositories (lockboxes) for processing. During processing year 2001, approximately 70,000 payments and documents sent to the Pittsburgh Lockbox, which services taxpayers in the northeast, were reported missing. The Treasury Inspector General for Tax Administration (TIGTA) is conducting an investigation into the missing documents.

To ensure that taxpayers received proper credits and to assist taxpayers who needed to replace missing documents, TAS worked with IRS Operations and the Andover IRS Campus (formerly Andover Service Center) to develop employee procedures. The procedures included instructions for the reimbursement of related bank charges that a taxpayer may incur. In addition, the National Taxpayer Advocate has worked and continues to work closely with IRS Operations and TIGTA to ensure that recovered returns are appropriately and timely processed. Developing procedures for the immediate processing of recovered returns ensured that many affected taxpayers received the advance payments of their 2001 tax credit.

Last year, TAS reported on "Stolen IRS Tax Payments". In processing year 2000, 73 tax payments were stolen from the Pittsburgh Lockbox. TIGTA investigated and the IRS sent information letters to the affected taxpayers. The IRS reimbursed bank charges and waived all penalty and interest charges. Although the 2000 and 2001 investigations involved the same facility, the circumstances surrounding the missing payments in 2000 and the miss-

ing payments and documents in 2001 were not the same. The investigation of the incident for 2000 resulted in an identity theft prosecution and conviction. The investigation for the 2001 processing year is on-going.

MISDATED POSTING OF PAYMENTS WITH TAX RETURNS.

Last year, TAS reported on efforts to intervene on behalf of 80,000 taxpayers incorrectly assessed interest and/or late payment penalties on 1999 tax returns because of misdated posting of payments made with tax returns. The incorrect dating of payments occurred around April 15, 2000. The Taxpayer Advocate Service worked with IRS Operations to correct the affected taxpayer accounts.

For filing season 2001, an IRS systemic change was applied to modify or correct the return received date when a related payment had previously been processed. These returns were not assessed interest or late payment penalties. However, during the 2001 filing season approximately 100,000 taxpayers were incorrectly assessed interest and/or late payment penalties if a misdated return was processed before the payment. IRS corrected these accounts. The Taxpayer Advocate Service continues to work with IRS Operations to identify and implement a systemic correction that will prevent another recurrence.

TELE-TIN

The IRS issued over four million Employer Identification Numbers (EINs) in FY 2000. Taxpayers and practitioners found the process of applying for EINs (Forms SS-4) cumbersome. To address this concern, the Small Business/Self-Employed Operating Division established a project team, which included Taxpayer Advocate Service representation. As a result of this initiative, the IRS implemented the following programming enhancements to the Tele-TIN program to improve timeliness, communication, and customer satisfaction:

- Created a new web site to post procedural and contact information.
- Revised the paper Form SS-4 and instructions.
- Placed a fillable version of the Form SS-4 on the IRS web site.
- Corrected inconsistent processing procedures.
- Consolidated program responsibility from ten to three sites with standard hours of operation.
- Implemented a nationwide 1-800-telephone number.
- Established a 4-day processing standard for all Forms SS-4.

DIRECT DEPOSIT REFUNDS

Taxpayers who provide erroneous account information for direct deposit refunds have no recourse for relief with the IRS if the IRS deposits the funds to the account designated by the taxpayer. The Taxpayer Advocate Service worked with IRS Operations to alert taxpayers to be cautious when entering bank account information on a direct deposit refund request. The Taxpayer Advocate Service was instrumental in the development of an insert for the Form 1040 instructions concerning direct deposit refunds. The instructions now read, "You can check with your financial institution to make sure your direct deposit will be accepted and to get the correct routing and account numbers. The IRS is not responsible for a lost refund if you enter the wrong account information."

The Taxpayer Advocate Service also worked with IRS Operations to provide more complete information to taxpayers seeking to recover direct deposit refunds. IRS strengthened its procedures to provide instructions for taxpayers to follow in filing a complaint with the Office of the Comptroller, an agency of the U.S. Treasury. This procedure gives taxpayers an additional avenue to pursue when a bank has not been able to retrieve funds deposited into an account per the taxpayer's instructions. The Taxpayer Advocate Service is exploring other avenues to assist taxpayers who may make inadvertent errors in designating financial institutions on their tax returns.

INDIAN TRIBAL MISCELLANEOUS INCOME

The Taxpayer Advocate Service addressed concerns about delayed refunds for a group of Native American tribal members. Tribal members properly reported disbursements of tribal operating surpluses as "other income." IRS had questioned this reporting as part of an effort to clarify the nature of "other income" reported on all returns, and whether it should be subject to self-employment tax. Tribal membership, not services rendered, is the only requirement for receipt of this income, so the income is not subject to self-employment tax. The Taxpayer Advocate Service assisted IRS Operations in identifying the true nature of this income and in ensuring that future payments would be excluded from assessment of the self-employment tax. The IRS Operating Divisions are committed to work together to avoid a recurrence of the problem for the 2002 filing season.

TAXPAYER ADVOCATE SERVICE INVENTORY LIST OF TAXPAYER PROBLEMS

The following table outlines 23 broadly defined reasons why taxpayers contacted the TAS organization for assistance during FY 2001. The issues are taken from our Taxpayer Advocate Management Information System (TAMIS) database and are ranked by volume.

RANKING	ISSUE	DESCRIPTION OF ISSUE	VOLUME
1	Revenue Protection Strategy (RPS) Examination Projects to Protect Revenue	Taxpayers have issues with IRS holding their refunds until examinations regarding the taxpayers' eligibility for the Earned Income Tax Credit (EITC) are completed.	34,465
2	Processing of Claims or Amended Returns	Individual or business taxpayers do not receive answers to their claims or amended returns within the prescribed IRS timeframe of eight to twelve weeks.	29,090
3	Refund Inquiries	Taxpayers do not receive refunds within the IRS' published timeframes.This issue includes taxpayer requests for expedited refunds due to hardship. For example, taxpayers often experience financial hardship when a pre-refund examination of the Earned Income Tax Credit (EITC) causes the entire refund to be held or "frozen."	24,711
4	Processing Individual Income Tax Returns	Issues involve delays in processing original returns, possibly due to incomplete or missing information. Also includes taxpayers who either dispute or do not understand IRS math error notices.	20,213

RANKING	ISSUE	DESCRIPTION OF ISSUE	VOLUME
5	Penalty Issues (Other Than Federal Tax Deposit)	Taxpayers do not understand Estimated Tax Penalty, Failure to Pay Penalty, and other miscellaneous penalties.	14,863
6	Lost or Misapplied Payments	Taxpayers have problems resolving payment issues. For example, taxpayers may receive balance due notices when they believe their accounts are fully paid.	10,750
7	Open Examinations	Taxpayers need assistance with audits before the IRS assesses additional tax. For example, taxpayers may believe the IRS is ignoring evidence, may dispute the examiner's interpretation of law or may feel the audit is taking too long.	9,406
8	Requests for Reconsideration of Examination Assessments	Taxpayers experience problems when they request reconsideration of their audit because they disagree with the outcome of the examination of their tax return.	8,971
9	Requests for Employer Identification Number (EIN) or Requests for Entity Changes	Issues relate to taxpayers who did not receive the requested Employer Identification Number (EIN) within IRS' published timeframes. Includes other miscellaneous entity issues such as requests to change an address or changes to the type of return to be filed.	8,216

INVENTORY LIST OF TAXPAYER PROBLEMS

RANKING	ISSUE	DESCRIPTION OF ISSUE	VOLUME
10	Automated Underreporter Program (AUR) - Document Matching Program	Issues deal with questionable tax assessments resulting from the IRS' automated underreporter program (better known as the document matching program), where IRS compares income reported by individuals to information reported by third party payers of the income.	7,907
11	Lost or Stolen Refunds	Taxpayers do not receive refund checks, suspect the checks are lost or stolen, or believe the IRS is taking too long to process replacement checks.	6.582
12	Other Casework Issues	Variety of issues that cannot be classified in a specific area.	6,551
13	Requests for the IRS Individual Taxpayer Identification Number (ITIN)	IRS issues ITINs to individuals not eligible for a Social Security Number. Problems arise when taxpayers have not received their ITIN, do not understand why their request for an ITIN was denied or need assistance with completing the application form.	5,578
14	Requests for Forms, Copies of Returns, & Transcripts	Taxpayers experience problems due to untimely responses to requests for copies of tax returns and/or assessment documents from various IRS filing systems. Also includes untimely response to requests for account transcripts or tax forms.	4,604
15	Offer in Compromise Issues	Issues regarding denied offers, delays in processing offer applications, and IRS requests for updated information.	4,412

RANKING	ISSUE	DESCRIPTION OF ISSUE	VOLUME
16	Account or Notice Inquiries	Taxpayers request assistance in resolving balance due or other account-related notices.	4,319
17	Problems with Federal Tax Deposits, Electronic Fund Transfer Program System, Estimated Tax Payments/Credits	Issues deal with missing or misapplied payments related to the Federal Tax Deposit Program, Electronic Fund Transfer Program, or Estimated Tax Payments or Credits.	4,255
18	Levy Issues	Taxpayers face financial hardship when IRS has placed a levy on their income.	4,199
19	Federal Tax Deposit (FTD) Penalty Issues	Taxpayers do not understand the Federal Tax Deposit requirements.	4,026
20	IRS Criminal Investigation Freezes	Taxpayers' refunds are delayed when an IRS criminal investigation has suspended the processing of a taxpayer's tax return.	3,755
21	Earned Income Tax Credit (EITC) Issues	Issues relate to taxpayers' math errors in calculating the Earned Income Tax Credit (EITC).	3,666
22	Offsets	IRS has applied a taxpayer's refund to pay outstanding liabilities from another tax period, or to pay other federal or state liabilities.	3,552
23	Substitute for Return Assessments	Taxpayers dispute IRS' assessment of tax due when taxpayers fail to file returns.	3,505

POTENTIAL LEGISLATIVE ISSUES

Internal and external stakeholders have referred the following issues to the National Taxpayer Advocate. Over the next few years, we will review these issues to determine if legislative recommendations are appropriate to reduce taxpayer burden, or to improve the administration, equity, or efficiency of the tax system.

INDIVIDUAL TAX ISSUES	
ISSUE	**PROBLEM**
Credit for Child and Dependent Care Expenses	For many years, taxpayers were able to use only up to $2,400 for one child or $4,800 for two or more children in computing the credit for child and dependent care expenses. The credit amounts will increase in 2003, but will not be indexed for inflation. However, child and dependent care expenses continue to rise for families at all income levels.
Capital Gains Tax Rates	Capital gains are taxed at many different rates and the computation to calculate the tax is lengthy and confusing. This issue can be found in the section of this report entitled "The Most Serious Problems Encountered by Taxpayers."
Use of Identifying Numbers for Tax Purposes	Under current law, members of religious groups who do not believe in or participate in social welfare programs may be exempt from the Social Security System. However, some groups oppose the assignment of any identifying number, for religious reasons other than opposition to a social welfare program. Current tax law does not take these groups into consideration. As a result, their members are precluded from claiming qualifying dependents as exemptions on individual income tax returns, and/or claiming various credits if they or their dependents do not have a social security number.
Attorney Fees	Due to differences in state law and judicial interpretation, attorney fees with respect to monetary settlements are treated differently. Residents of several states are able to include in gross income the settlement amount after subtracting attorney fees. In other states, taxpayers must include the entire settlement amount in gross income and claim a miscellaneous itemized deduction for the attorney fees. This latter treatment could trigger the alternative minimum tax (AMT). Thus, taxpayers receive disparate treatment of similar items based on where they reside.

Community Property Trade or Business Income	Internal Revenue Code section 1402(a)(5) provides that for purposes of computing the net earnings from self-employment, there is a presumption that all gross income and deductions from a trade or business operated under community property laws shall be attributable to the husband unless the wife "exer cises *substantially all* of the management and control" of the trade or business (italics added). Section 879(a), which addresses the tax treatment of community income of a married couple, one or both of whom are nonresident aliens, states that trade or business income shall be treated as provided in IRC § 1402(a)(5).
Passive Activity Loss Limitation	Individuals and corporations with passive activity losses and credits are required to complete Form 8582, Passive Activity Loss Limitations, and Form 8582-CR, Passive Activity Credit Limitations, respectively. The time required to compute losses under the passive activity loss rules, and to complete and file the related forms, can be burdensome for taxpayers, especially for those with small passive losses resulting from one or a few flow-through entities. The estimated time for preparing Form 8582 is approximately four hours and the estimated time to learn about and prepare Form 8582-CR is approximately 16 hours.[1]
IRA Contribution Due Dates	Contributions can be made to an Individual Retirement Account (IRA) at any time during the year or by the due date for filing a return for that year, not including extensions. Taxpayers must calculate the allowable IRA deduction by the due date of their Form 1040, even if they have filed for an extension. Due to the various restrictions on IRA contributions, this can be a burdensome process and can cause excess contributions. By allowing taxpayers to contribute to an IRA by the due date including extensions, taxpayers will be able to more accurately determine the maximum allowable deductible and nondeductible IRA contributions.

[1] Paperwork Reduction Act

Repayments of Previously Reported Income	Current law allows an itemized deduction when a taxpayer is required to repay up to $3,000 of income that was reported as wages or other ordinary income in a previous year. Taxpayers who are not eligible to itemize deductions receive no tax relief for the repayment. Those who can itemize may not receive full benefit of the deduction because it is subject to the two-percent floor on miscellaneous itemized deductions. A taxpayer that repays over $3,000 is eligible for more favorable tax relief. The taxpayer can reduce the tax liability for the year of repayment by either recomputing the tax liability for the prior year of inclusion, or claiming the repayment as an itemized deduction.[2] If the repayment is claimed as an itemized deduction, it is not subject to the 2% floor.[3]
Home Office Deduction	In order to claim a home office deduction a taxpayer must use an allocable portion of his or her residence exclusively as the principal place of his or her trade or business, or as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his or her trade or business, or in the case of a separate structure which is not attached to the residence, in connection with the taxpayer's trade or business. In the case of an employee, an allocable portion of his or her residence can be claimed as a home office deduction only if the exclusive use of the residence is for the convenience of his or her employer. Many taxpayers are unable to claim a home office deduction because a small part of the space is not used exclusively for business purposes.

[2] IRC §1341

[3] IRC §67(b)

BUSINESS TAX ISSUES	
ISSUE	**PROBLEM**
Due Date for Filing Partnership Information Returns	Individual income tax returns and partnership information returns usually share the same due dates. If individual partners do not receive their partnership information schedule (Schedule K-1) prior to the due date of their Form 1040, they must file for an extension. This additional paperwork places a burden on the taxpayer and the IRS.
Simplification of Interest Income Computation on Low Interest Loans	Employers are required to compute a complex interest calculation on outstanding loans to employees on any day where the loan amount exceeds $10,000. To determine the amount of interest, a clear understanding of IRC §§7872 and 1274 is necessary as well as a knowledge of the applicable federal interest rates which change monthly. A number of decisions must be made in computing the interest including which rate to use and the type of loan.
Tax Credits for Research and Development	The original intent of this credit was to increase activity in research and development. However, the interpretation of expenses that qualify for the credit has been an issue of debate between taxpayers and the IRS. Taxpayers are required to compute the credit based on the increase in qualified research expense over a base period from 1984 to 1988. It is a burden on taxpayers to keep records from the base period, but if these records are not kept it is difficult for the taxpayer to substantiate the amount of credit allowable.
Form 11-C Filing Requirements	Current filing requirements of Form 11-C, Occupational Tax and Registration Return for Wagering, consist of varied filing requirements and dates for both the employees and the casinos depending on the facts of the situation. The varying due dates and purposes for this form make the filing process confusing and complex.

EMPLOYMENT TAX ISSUES	
ISSUE	**PROBLEM**
FUTA Deposit Requirements under IRC §6157(c)	Current law governing the required deposits of Federal Unemployment Tax (FUTA) contains a special rule that exempts businesses from making a deposit if their accumulated FUTA tax does not exceed $100 in any calendar quarter. This threshold amount is not indexed for inflation and has remained unchanged for many years. As a result, fewer small business taxpayers meet this special rule and more of them must make FUTA deposits.
Payments by State Welfare Agencies	State welfare agency payments to individuals for day care and other personal services are not always properly reported for income tax, and social security purposes. This situation is similar to the Key Recommendation in this report entitled "Home-based Service Workers."
PENALTIES AND INTEREST	
ISSUE	**PROBLEM**
Estimated Tax Penalty – Reasonable Cause Exception and Safe Harbor	Taxpayers are confused about the nature of the estimated tax penalty, which can be considered an interest charge. The failure to pay estimated tax penalty for individuals and corporations does not contain reasonable cause provisions. The estimated tax penalty for individuals also has a prior year safe harbor percentage, whereby taxpayers can avoid the imposition of the penalty. For taxpayers with income at or above certain AGI levels, the safe harbor percentage fluctuates from year to year, which increases complexity and the likelihood of error.
Overpayment Credits on Late Filed Returns	Current law does not permit the payment of interest on overpayments for any period prior to the filing of a delinquent tax return. However, interest is charged on an underpayment from the due date of the original return. This can result in a taxpayer having to pay interest for a period that the government has use of the taxpayer's money.
Interest on Installment Agreements	The IRS sets interest rates on a quarterly basis. Therefore, it is not possible to determine the payoff date or the final payment amount when a taxpayer enters into an installment agreement.

OTHER ISSUES	
ISSUE	**PROBLEM**
Registration of Federal Return Preparers	Anyone, regardless of his or her training, experience, skill, or knowledge, is able to prepare federal tax returns for others for a fee. Tax preparers are subject to the imposition of penalties under IRC §§ 6694 and 6695 when they prepare returns negligently or in reckless disregard of IRS rules or regulations. However, many tax preparers are not subject to any rules or standards of conduct, are not licensed by any state regulatory agency, and are not required to participate in continuing education programs. The only course of action that can be taken to enjoin an income tax preparer is the initiation of a civil action by the Secretary of the Treasury against the preparer in the District Court of the United States.[4] Such action is not only costly, but also time consuming and leaves questionable income tax preparers free to remain in business and potentially harm taxpayers if they continue to prepare income tax returns during the legal process of the civil action.
Authority to Reverse or Bypass Refund Offsets for Taxpayers with Significant Hardships	Under current law, the IRS can bypass federal tax obligations for taxpayers with hardships and issue a refund if the return has not been processed. However, taxpayers sometimes request hardship refunds after their returns are filed and the overpayments have already been applied to a balance due on another tax account. Also, there are no provisions for bypassing debts to other government agencies when the taxpayer is suffering a significant hardship nor is there any authority to "freeze" the offset pending resolution of taxpayer challenges to the underlying non-tax obligation.
Temporary Tax Law Extensions	Some temporary provisions of tax law have been extended with such regularity that the process has become a permanent component of the annual legislative agenda. This practice adds confusion and complexity to the law.

[4] IRC §7407

MOST LITIGATED ISSUES

Section 7803(c)(2)(B)(ii)(X) of the Internal Revenue Code requires the Annual Report to Congress to examine the ten tax issues most litigated by taxpayers. The National Taxpayer Advocate is required to annually identify these issues and include recommendations for mitigating these disputes. Analysis of the most litigated issues may reveal particular areas of the tax law that create burdens for taxpayers. This analysis also may reveal areas requiring simplification. However, we also recognize that many tax cases are tried because of legitimate interpretive and factual disputes.

METHODOLOGY

No one source records all issues in cases litigated in the primary courts that hear tax related controversies. The courts of original jurisdiction include the United States Tax Court, United States District Courts, United States Court of Federal Claims and the Bankruptcy Courts. These courts, the Office of Chief Counsel and the Department of Justice keep track of cases rather than the issues. Consequently, arriving at the most litigated issues requires a compilation of information from a variety of sources. The term "litigated" provides some additional definitional problems: is a case litigated when it is petitioned, when it is actually tried or when the judge enters a decision? Further, do litigated issues include settled cases, which never came to trial?

We developed the following methodology to quantify litigated issues and analyze the top ten. We worked with the Office of Chief Counsel to obtain a listing of the cases that the Office considered "litigated" in each of the first three quarters of fiscal year 2001. The Office of Chief Counsel used its case tracking system to identify all cases that were "submitted"; that is, the cases have been tried and are awaiting final disposition. Counsel then surveyed the attorneys who tried the cases and asked them to identify the primary issues.

We then researched each of the top ten issues, using a commercial electronic database to find cases addressing these particular issues that were decided between October 1, 2000, and August 30, 2001. If an issue appeared in less than twenty cases, we reviewed all cases found on the commercial electronic database. This method produced a few situations where the number of cases reported by IRS Chief Counsel was greater than the number of cases we were able to locate using the commercial electronic database. If an issue was the key factor in 20 cases or more, we reviewed a sample.

Our review focused on finding patterns related to the issues and why the issues ended up in court rather than being resolved in the administrative process.

MOST LITIGATED ISSUES

The top ten most litigated issues by taxpayers are:

Issue 1 – Unreported or Underreported Income

Issue 2 – Trade or Business Expenses

Issue 3 – Exemptions (Personal and Dependency)

Issue 4 - Accuracy Related Penalties

Issue 5 – Delinquency Penalty

Issue 6 – Collection Due Process

Issue 7 – Earned Income TAX Credit

Issue 8 - Innocent Spouse

Issue 9 – Entertainment Expenses

Issue 10- Trust CaseS (Generally Sham)

PATTERNS AND COMMENTS

ISSUE 1. UNREPORTED OR UNDERREPORTED INCOME

This issue involves Internal Revenue Code section 61 and deals with income reported and reportable on tax returns. The cases cover two types of income: unreported income that is omitted from a return, and underreported income that is not reported in its entirety on the return.

Counsel's automated tracking system identified fifty-nine cases involving this issue. We analyzed a sample of nineteen unreported and ten underreported income cases. Our analysis found very little systemic information that would indicate patterns or types of income that went unreported. However, it does appear that individual taxpayers generally challenged unreported amounts such as interest, dividends or nonemployee compensation, while business taxpayers challenged underreported amounts including additional gross receipts, illegal income and income attributable to a trust. Three cases involved corporate returns, two involved sole proprietorship (schedule C) income and one involved trust income. In the underreported income cases, four taxpayers represented themselves (i.e., pro se taxpayers) and attorneys represented six, while the unreported cases included seven self-representations and twelve attorney representations. Since these cases contain very unique fact patterns and legal arguments, we are unable to identify systemic reasons why these cases were litigated.

ISSUE 2. TRADE OR BUSINESS EXPENSES

Section 162 of the Internal Revenue Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade or business. This is one of the broadest areas of tax law, covering an extremely wide variety of expenses that are allowed as deductions.

Chief Counsel identified thirty cases containing a "Trade or Business" issue as the primary issue. Our analysis of a sample of fourteen cases shows there is no set pattern in the expenses challenged or the reasons for disallowance. In these cases, nine taxpayers represented themselves and attorneys represented five. The issues include the deductibility of uniform expenses, advertising, auto expenses and numerous other costs. In one case, the IRS challenged whether the taxpayer was engaged in a trade or business with the primary purpose of making a profit (i.e., a "hobby loss" issue under IRC section 183). In this case, the court ruled in favor of the taxpayer, allowing the loss claimed. The challenges to expenses raised in these cases are also extremely varied. Since these cases contain very unique fact patterns and legal arguments, we are unable to identify any systemic reasons as to why they were litigated.

ISSUE 3 – EXEMPTIONS (PERSONAL AND DEPENDENCY)

Under Internal Revenue Code sections 151 and 152, there are two types of exemptions: personal exemptions and exemptions for dependents. Both types of exemptions result in the same reduction of adjusted gross income; however, different definitions and eligibility rules apply to each. A taxpayer is allowed one personal exemption for him or herself and, if married, one personal exemption for the spouse. For dependents, a taxpayer is allowed one exemption for each person he or she can claim. Five tests must be met to claim an exemption for a dependent.

Chief Counsel identified twenty-eight exemption-related cases being litigated. We analyzed a sample of twenty. Twelve of the taxpayers represented themselves and attorneys represented eight.

A majority of these cases involve divorced parents who claim exemptions for their children. The key questions are:

1. Who provided a majority of the support?
2. How long did the child reside with each parent?

These are highly factual determinations that may require the court to look in detail at the taxpayer's living expenses and to weigh the credibility and probity of the taxpayer's evidence. Cases of this nature also place a heavy burden on taxpayers because they must produce extensive records to prove they are entitled to the exemptions claimed. The support and residency tests also invite both divorced parents to claim the children because the parents do not know the total support amount. This also puts a burden on the Internal Revenue Service because this type of test requires administrative review to determine which parent is entitled to the dependency exemption.

The dependency exemption tests beg to be simplified to limit the opportunities for these disputes. The National Taxpayer Advocate has proposed several legislative recommendations in this Report concerning dependency exemptions and other family status issues.

ISSUE 4 - ACCURACY RELATED PENALTIES

Section 6662 of the IRC provides for a 20 percent penalty on any portion of an underpayment of tax required to be shown on the return that is attributable to:

- the taxpayer's negligence or disregard of rules or regulations
- substantial understatement, substantial valuation misstatement, or substantial overstatement of pension liabilities
- substantial estate and gift tax valuation understatement

The Chief Counsel's Office identified twelve cases where the penalty was the primary issue. The office also acknowledges that this was a collateral issue in a number of other cases. We identified 134 cases involving litigation of this issue on the commercial electronic database. We then reviewed and analyzed a random sample of twenty-six cases to determine if patterns existed in the reasons taxpayers challenged penalty assessments in tax court.

Our review of cases concerning the accuracy-related penalty found no set pattern in the reasons taxpayers petitioned the court. The IRS assessed the penalty in association with various underlying deficiencies and additions to tax. These cases included penalties being proposed because of, disallowed employee business expense, underreported income, tax protest arguments, trust shams, disallowed S-Corp deductions, business determined not to be engaged in for profit, and assorted other reasons. In twelve of the twenty-six cases, taxpayers represented themselves, and attorneys represented the fourteen others. Since these cases contain very unique fact patterns and legal arguments, we are unable to identify systemic reasons as to why they were litigated.

ISSUE 5 – DELINQUENCY PENALTY

The delinquency penalty is assessed for failure to file a return and/or pay taxes timely. Section 6651 of the Internal Revenue Code states that in case of failure to file a return timely, there shall be added to the amount required to be shown as tax on the return five percent of the amount of the unpaid tax if the failure is for not more than one month; with an additional five percent for each additional month or fraction thereof during which failure continues, not exceeding 25 percent.

In the case of failure to pay taxes timely, a penalty will be assessed of one-half of one percent (.50%) of the unpaid taxes for each month, or part of a month after the due date that the tax is not paid. This penalty cannot be more than 25 percent of unpaid tax. The penalty can be abated if the taxpayer can show reasonable cause for filing and paying late.

The automated tracking system identified thirteen cases where these penalties were the primary issue. We analyzed the nine cases we found using the commercial electronic database to determine whether a pattern existed in the reasons the taxpayers petitioned the court. We found that generally these issues were raised in conjunction with other underlying deficiency issues. Usually, the taxpayers tried to establish that the lateness was due to reasonable cause. The reasons include a statement that a spouse would not turn over needed information, arguments that a return was mailed timely even though the postmark was substantially later, and that the required records were destroyed by fire. The decisions appear to be based on the judge's interpretation of the facts and the apparent credibility of the taxpayers. These cases are so factually intensive that we are unable to detect any useful pattern. In five of the nine cases, taxpayers represented themselves, and attorneys represented the four remaining taxpayers.

ISSUE 6 – COLLECTION DUE PROCESS (CDP)

Internal Revenue Code section 6330 provides that no levy may be made on any property or right to property of any person unless the Secretary has notified the person in writing of their right to a hearing. Under IRC § 6320, the Secretary shall notify in writing the person described in IRC § 6321 of the filing of a notice of lien under IRC § 6323. Section 6321 states,

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

While Chief Counsel identified 10 CDP cases, our research using a commercial electronic

database only identified six decisions issued by the Tax Court during the year. We determined that the arguments in those cases fall into two categories:

1. Cases where an administrative error was claimed
2. Cases that contained frivolous arguments

In three of the cases, the taxpayers represented themselves and the other three had professional representation. In five cases, the taxpayer was issued a Notice of Intent to Levy, while the remaining case involved a Notice of Federal Tax Lien.

The Tax Court upheld the government's position in all cases. In three cases, the Service requested that the court impose sanctions against the taxpayer under IRC § 6673 for delay, as the taxpayer's position was frivolous. The Tax Court may impose a penalty if the judge believes the proceedings were instituted by the taxpayer primarily for delay, that the taxpayer's position is frivolous, or that the taxpayer unreasonably failed to pursue available administrative remedies. The court may impose damages of up to $5,000. The court did not award sanctions in two cases and granted it in one case.

ISSUE 7 – EARNED INCOME TAX CREDIT

Under section 32 of the Internal Revenue Code, taxpayers may be entitled to a refundable credit on earned income.

Chief Counsel's tracking system identified nine cases where the primary issue was the Earned Income Tax Credit (EITC). We reviewed the nine Tax Court decisions dealing with this issue. The cases include a variety of reasons for disallowance: taxpayers claiming the EITC for a sibling; the length of time a claimed child lived with the taxpayer; gross income limitations; an inmate's earnings being specifically excluded from earned income for eligibility purposes; filing status issues; and cases where no evidence was submitted by the taxpayer.

Most of the cases also presented filing status and /or dependency issues in addition to the EITC. Our review did not reveal a common pattern in these cases. In eight of the nine cases, the taxpayers represented themselves and the remaining taxpayer hired a representative. In addition, we are aware that the different definitions in the filing status for dependency and earned income credits create problems. This issue is addressed in the National Taxpayer Advocate's legislative recommendations elsewhere in this report.

ISSUE 8 - INNOCENT SPOUSE

An individual who has filed a joint return may elect to seek relief from joint and several liability as an innocent spouse. The rules related to innocent spouse were changed and expanded by RRA 98 (RRA Section 3201(a)). The former section 6013(e) was repealed by RRA 98 for liabilities arising after July 22, 1998, and any liability for tax arising on or before 1998 but remaining unpaid.

Internal Revenue Code section 6015 provides three types of relief from joint and several liability to spouses who file a joint return. The three types of relief are:

- Internal Revenue Code section 6015(b) – Expanded Innocent Spouse Relief - An individual who has filed a joint return may elect to seek relief from joint and several liability as a "traditional" innocent spouse. On such a return there must be an understatement of tax, attributable to erroneous items which one individual filed on the joint return. If the other individual establishes that in signing the return he or she did not know, and had no reason to know, that there was such an understatement of income and it would be inequitable to hold that person liable for the tax, then that person may receive innocent spouse relief.

- Internal Revenue Code section 6015(c) - Separate Liability Election - A qualified taxpayer may elect to have the liability for any deficiency limited to the portion of the deficiency that is attributable to items allocable to that taxpayer under special rules. To qualify, at the time of the election, the taxpayer must be either: no longer married, widowed, or legally separated, or have lived apart at all times during the 12-month period prior to the election.

- Internal Revenue Code section 6015(f) - Equitable Relief – This section applies to underpayments as well as understatements of tax. Relief is available where tax was shown on a joint return, but not paid with the return and the taxpayer did not know or have reason to know that funds intended for the payment of tax were taken by the other spouse for that spouse's benefit. Relief may be available only if relief is not available under the expanded innocent spouse relief (IRC section 6015(b)) or separate liability election (IRC section 6015(c)) and if taking into account all the facts and circumstances, it is inequitable to hold the individual liable for all or part of a tax liability. Prior to the enactment of IRC section 6015, an underpayment of tax could not be considered for relief under the innocent spouse provisions nor could the liability be allocated.

We reviewed and analyzed eight innocent spouse cases for the 2001 fiscal year, covering a wide variety of issues. Below is a list of some of the court's holdings:

- Husband was convicted of tax evasion and willfully making false returns of income. The wife sought relief under IRC § 6015 (b).

  Holding – The court ruled in favor of the IRS because it was found that the wife knew about the fraudulent conveyance of funds to the trust.

- Husband was a retired teacher. Husband received retirement in the form of two checks. Husband died. Wife (petitioner) received a 1099-R but was not aware of the tax implications. Wife filed for relief under IRC § 6015(b)

  Holding – Tax Court ruled in favor of the IRS stating that the wife had actual knowledge of her husband's retirement account distribution. The Tax Court also looked at IRC § 6015(f) but ruled that the IRS did not abuse its discretion in denying relief to the petitioner.

- Husband sold sports memorabilia but did not claim all the income from the sales on their joint tax return. The wife stated she had no knowledge of the income.

  Holding – The court ruled that the Petitioners were liable for the entire income but wife qualified for relief under the IRC § 6015(b). The court reasoned that the wife did not have any knowledge that the income was not reported.

- The wife sought relief under IRC § 6015(b) regarding deficiencies based on distributive shares of tax shelter investments.

  Holding – The wife was not entitled to relief because the court found she possessed constructive knowledge of the understatement of tax giving rise to the deficiencies.

- Petitioners filed delinquent tax returns in 1986 and 1987. Wife sold some property during these tax years. Husband contends he had no knowledge of the property being sold.

  Holding - Relief was granted to the husband because the IRS conceded some items and did not prove that the husband had any knowledge of the amount of the contested items giving rise to the deficiency.

- A Joint Return was filed without reporting IRA distributions. The couple divorced. The husband contends that he had no knowledge of the IRA distributions.

Holding – The Court ruled in favor of the husband and stated the husband was entitled to be relieved of liability for tax attributable to the distributions.

Although IRC § 6015 is a relatively new provision and the fact patterns are unique, the "knowledge" factor was critical to the Court's holding in each case, irrespective of the subsection under which relief was granted or denied.

ISSUE 9 – ENTERTAINMENT EXPENSES

Internal Revenue Code describes the circumstances and extent to which certain entertainment and other expenses will be allowed. Chief Counsel's automated tracking system identified ten cases. We analyzed the six cases we found using the commercial electronic database. Four taxpayers represented themselves while the other two had attorneys. Our analysis found no distinguishable patterns; it appeared that the entertainment expenses were a minor part of each litigated case.

The major issues include whether the petitioner was liable for an addition to tax under IRC § 6651 (a) (1); liable for an accuracy-related penalty under IRC § 6662 (a); entitled to various deductions, including entertainment expenses, of Schedule C, Profit or Loss from Business, in excess of the amounts allowed by IRS; and entitled to a deduction on Schedule A, Itemized Deductions, for employer business expenses (which included entertainment expenses).

ISSUE 10- TRUST CASES (GENERALLY SHAM)

These cases involved the correct attribution of income and deductions under IRC § 671 – "Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantiated Owners."

Counsel's tracking system identified ten cases involving trusts. We reviewed the six cases we found using the commercial electronic database. The taxpayers represented themselves in two cases and were represented by attorneys in the other four cases. Our analysis reveals a pattern among the sampled cases: the court concluded that the taxpayers established trusts to avoid reporting personal income and paying personal income taxes.

In one case, the Tax Court determined that a sham trust had been established and attributed to the taxpayer the trust's income and expenses. In a second case, the court found the trust lacked economic substance and could be disregarded because the taxpayer used the trust's assets and income before and after the trust was established.

In other cases the court determined that taxpayers who established trusts as a mechanism to avoid tax were unsuccessful. The court determined the trust should not be respected for federal income tax purposes, and the income generated from the trust assets was taxable to the individual and not the trust. The court applied the assignment of income doctrine to determine the taxpayer was the true earner of money paid to a trust for services rendered.

In some cases, the court imposed penalties. Among the penalties imposed on taxpayers in these cases were the failure to file tax return penalty under IRC § 6651 (a) (1); failure to pay estimated income tax under IRC § 6654 (a); the accuracy-related penalty under IRC § 6662 (a); and sanctions for delay and frivolous court proceedings under IRC § 6673 (a) (1).

TABLE C.1

Some of the most litigated issues are also among the top problems faced by taxpayers, or are the subject of legislative recommendations described elsewhere in this report.

MOST LITIGATED ISSUES	RELATED LEGISLATIVE RECOMMENDATION	MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS
Unreported or underreported income		Automated Underreported (AUR) Tax Assessments
Personal Exemptions, including Dependency exemptions	Key Issue #1, Family Issues	Multiple Definitions of "Qualifying Child"
Earned Income Credit	Key Issue #1, Family Issues	◆ Determining Earned Income Tax Credit (EITC) Eligibility ◆ Documenting Earned Income Tax Credit (EITC) Eligibility ◆ Earned Income Tax Credit (EITC) Examinations
Innocent Spouse	Key Issue #1, Family Issues	Status of Innocent Spouse Claims

TABLE C.2

During our sample review of primary issues in cases, it became obvious that many of these cases also cover additional issues on the most litigated issue list. The following table should assist the reader to understand how intertwined many of these issues have become.

The left-hand side of the table shows the number of cases that were reviewed in analyzing each of the top ten issues. The right-hand side shows how many other top ten issues were also contained within those same cases. Although a case may have one major issue, that same case usually contains other issues.

MOST LITIGATED ISSUE DECISIONS	NUMBER OFCASES REVIEWED	RELATED LITIGATED ISSUES	NUMBER OF CASES AFFECTED
Unreported Income Underreported Income	19 10	Delinquency Penalty issues Accuracy-Related Penalty issues EITC issues Trade or Business Expenses issues Innocent Spouse issues Trust issues Entertainment Expense issues	4 7 3 3 5 6 6
Trade or Business Expenses	14	Entertainment Expense issues Accuracy-Related Penalty issues	5 3
Exemption Decisions	20	EITC issues Accuracy-Related Penalties issues Trust issue Unreported/Underreported Income issues Trade or Business Expense issues Entertainment Expense issues Delinquency Penalty issue	7 8 1 4 6 2 1

MOST LITIGATED ISSUE DECISIONS	NUMBER OFCASES REVIEWED	RELATED LITIGATED ISSUES	NUMBER OF CASES AFFECTED
Accuracy-Related Penalties	29	Unreported/ Underreported Income issues	8
		Innocent Spouse issues	2
		Trade or Business Expenses issues	12
		Delinquency Penalty issues	4
		Entertainment Expenses issues	4
		Trust issues	5
		Exemptions issues	1
		EITC issues	1
Delinquency Penalty	9	Unreported/ Underreported Income issues	4
		Trade or Business Expense issues	2
		Accuracy-Related Penalties issues	2
		Innocent Spouse issue	1
		Trust issues	3
		Entertainment Expense issues	2
Collection Due Process:	6	None	
Earned Income Tax Credit	9	Dependency exemptions issues	2
		Unreported/Underreported issues	1
		Accuracy-Related issues	1
Innocent Spouse	9	Underreported issues	3
		Delinquency Penalty issue	1
Entertainment Expenses	6	Trade or Business Expense issues	2
		Accuracy-Related Penalty issues	2
Trust Case	6	Accuracy-Related penalty issues	3
		Exemption issues	1

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You can reach the Taxpayer Advocate Service by calling our Toll-Free Number (1-877-777-4778) or by calling or writing to the Taxpayer Advocate Service Office nearest you.

TAXPAYER ADVOCATE SERVICE

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