

## MSP #17

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

### RESPONSIBLE OFFICIALS

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### DEFINITION OF PROBLEM

The IRS is responsible for collecting billions of dollars from millions of taxpayers who have delinquent tax accounts.<sup>1</sup> However, it does not attempt personal contact with these taxpayers (*i.e.*, by telephone or face-to-face) to find out why they are not paying and discuss collection alternatives until late in the collection process. While the current collection system has achieved moderate success (collecting \$64 out of every \$100 owed) by sending notices in the early stages of delinquency, this method is not effective for all taxpayers, particularly those with large debts or complex problems.<sup>2</sup>

The IRS annually sends over 34 million notices to taxpayers in the first stage of the collection process.<sup>3</sup> However, the average payment received from an individual taxpayer in response to a notice in fiscal year (FY) 2011 was just \$517 (which reflects mostly low-dollar cases).<sup>4</sup> In FY 2011, 3.7 million cases remained unresolved after this initial stage<sup>5</sup> and moved to the Automated Collection System (ACS), where the IRS traditionally spends only about three percent of its direct time making outgoing calls.<sup>6</sup> According to recent data, 60 percent of the cases in ACS have been there six months or longer.<sup>7</sup>

Cases unresolved after being processed by the ACS move into a queue where they remain until a field revenue officer is available to work them.<sup>8</sup> The dollar value of cases assigned to the queue has doubled in the last six years — to over \$56.2 billion at the end of FY 2011.<sup>9</sup> Making personal contact before sending the case to the queue could provide an opportunity

<sup>1</sup> At the beginning of fiscal year (FY) 2010, 4,031,093 taxpayers had delinquent accounts. Small Business/Self-Employed (SB/SE) division, Collection Activity Report NO-5000-2.

<sup>2</sup> IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011).

<sup>3</sup> *Id.*

<sup>4</sup> IRS, Collection Activity Report NO-5000-8, *IMF Collection Yield Report FY 2011*. The IRS received approximately \$9.9 billion from individual taxpayers (IMF) through 19,185,673 payment transactions.

<sup>5</sup> During FY 2011, the IRS collected nearly \$9.5 billion on nearly 2.7 million taxpayer accounts during the notice stream, but the Automated Collection System (ACS) received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011); IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>6</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010).

<sup>7</sup> At the conclusion of FY 2011, 2,454,770 ACS modules were in ACS less than six months, out of a total inventory of 6,080,835. Collection Activity Report NO-5000-2 (Oct. 2011).

<sup>8</sup> Internal Revenue Manual (IRM) Exhibit 5.19.5-9 (Dec. 1, 2007).

<sup>9</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

for the IRS to answer questions, discuss payment alternatives, and advise the taxpayer of potential enforcement if deadlines are missed. This approach is critical because different explanations for noncompliance require different approaches to case resolution.

The current approach of exhausting automated efforts before making human contact overlooks the fact that debt problems tend to worsen over time. The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year.<sup>10</sup> To make matters worse, businesses can accrue an average of two years of tax debt before the IRS even tries to make personal contact.<sup>11</sup>

Since 2004, the National Taxpayer Advocate has urged the IRS to adopt collection policies that emphasize personal contact, both by telephone and face-to-face.<sup>12</sup> Doing so might allow the IRS to resolve cases more quickly, a change sorely needed during a period in which the inventory of unpaid assessments has grown by 33 percent in the past five years.<sup>13</sup> In fact, an IRS pilot program that incorporates personal taxpayer contacts has resolved 40 percent more cases within six months than cases handled under the IRS's standard procedures.<sup>14</sup>

## ANALYSIS OF PROBLEM

### Background

#### *The Collection Process Begins with the "Notice Stream."*

When an assessment is made but no payment is forthcoming, the IRS begins a three-stage collection process.<sup>15</sup> In the first stage, known as the notice stream, the IRS sends the taxpayer a series of notices, beginning with a Notice and Demand for Payment.<sup>16</sup> If this notice

<sup>10</sup> BANXQUOTE Rx, Business Debt Restructuring Solutions, [www.banx.com/rx/](http://www.banx.com/rx/).

<sup>11</sup> *Hearing on How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth Before the Committee on Small Business*, 112th Cong. 21 (Apr. 13, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>12</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: An Analysis of the IRS Collection Strategy: *Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*), 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*), 110-129 (Most Serious Problem: *Levies*), 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (*One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2008 Annual Report to Congress 114-125 (*Navigating the IRS*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (*IRS Collection Strategy*).

<sup>13</sup> IRS, *Collection Process Study, Executive Summary 2* (Sept. 30, 2010). The data for the balance of unpaid assessments at the conclusions of FY 2010 was provided by SB/SE in an email message dated Dec. 14, 2010.

<sup>14</sup> Response to TAS information request (Sept. 28, 2011). The IRS is currently testing a streamlined offer in compromise (OIC) program that requires "out-bound" calls to taxpayers. Under the standard program, 48.07 percent of cases are resolved within six months. Under the streamlined program, 68.46 percent are resolved within six months, even though that figure includes cases that were already aged before being brought into the program.

<sup>15</sup> The IRS collection process begins with an assessment, which can occur through three different methods:

- Self-assessment by the taxpayer when a return is filed;
- IRS assessment based on deficiency procedures and after the taxpayer has exhausted (or failed to exercise) all appeal rights; or
- IRS-prepared "substitute for return" (SFR) where the taxpayer has failed to file a timely tax return (See Internal Revenue Code (IRC) § 6020(b)).

<sup>16</sup> IRC § 6303(a); IRM Exhibit 5.19.1-2 (Apr. 28, 2008). The IRS also refers to the Notice and Demand for Payment as the "first notice."

does not result in a payment or other resolution of the debt, the taxpayer may receive one to three additional notices, depending on the characteristics of the case.<sup>17</sup> During this time, the IRS does little to actively reach out to taxpayers and attempt to resolve their debt problems.<sup>18</sup>

In FY 2010, the IRS collected approximately \$28.4 billion through the notice stream, representing approximately 64 percent of the total yield on these collection accounts.<sup>19</sup> However, a closer analysis indicates notices may be most effective with taxpayers who owe relatively little, as the average payment received from individual taxpayers in response to a notice in FY 2011 was \$517.<sup>20</sup> Taxpayers who face more significant tax obligations may not be able to pay in full at this stage and may require a conversation to determine the appropriate collection alternative.

*The Automated Collection System is the Second Stage of the Process.*

For most taxpayers, the second stage of the collection process involves the ACS.<sup>21</sup> In FY 2011, nearly 3.7 million cases went to the ACS for processing.<sup>22</sup> Although the ACS was originally designed as an *outgoing* call program to contact taxpayers with delinquent accounts, it has devolved into what its name implies: an automated, impersonal process, relying on systemically-generated enforcement actions. Instead of reaching out to taxpayers, the ACS interacts with them mainly through incoming calls that are generally in response to the levies and liens it generates. As of September 2011, the dollar value of cases assigned to ACS was \$30.9 billion,<sup>23</sup> yet it spends less than three percent of its direct time making outgoing calls using a predictive dialer system.<sup>24</sup> The IRS fails to use a multi-faceted collection strategy, even at this stage of the delinquency process.

<sup>17</sup> Most cases involving individual income taxes reported on Form 1040, *U.S. Individual Income Tax Return*, receive up to three additional collection notices. Delinquencies involving employment taxes reported on Form 941, *Employer's Quarterly Federal Tax Return*, usually receive one additional notice.

<sup>18</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

<sup>19</sup> IRS, *Delinquent Accounts Receivable Yield Report, Fiscal Year Comparison Cum Thru FY 2011 October*; IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 3, 2011); IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 5 2011). In FY 2011, the IRS collected approximately \$16.8 billion on the initial collection notice, \$6.2 billion on the second thru final notices, and \$5.1 billion from installment agreements (IAs) issued by Accounts Management (AM) and Compliance Services Collection Operations (CSCO), totaling \$28.1 billion. Payments related to a notice account that were included in IAs established through the ACS or Collection Field Function (CF) operations were not included in the total.

<sup>20</sup> IRS, Collection Activity Report NO-5000-8, *IMF Collection Yield Report FY 2011*. The IRS received approximately \$9.9 billion from individual taxpayers (IMF) through 19,185,673 payment transactions.

<sup>21</sup> The ACS is a computerized inventory system and telephone call center that was designed to assign cases to contact representatives or tax examiners who interact with taxpayers about delinquent accounts. IRM 5.19.5.1 (Dec. 1, 2007).

<sup>22</sup> During FY 2011, ACS received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>23</sup> IRS, Collection Activity Report 5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>24</sup> TIGTA, Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010). IRM Exhibit 5.19.5-11 (Dec. 1, 2007). A predictive dialer system places calls without an attending agent on the originating line. If contact is made, the dialer transfers the call along with the ACS case to a waiting agent. Once the dialer makes two attempts to contact the taxpayer, the case is transferred to another ACS function for the next action, which could be a levy or lien.

***The Queue Receives Cases After the ACS Attempts to Resolve Them.***

While not technically a stage in the collection process, the queue is an electronic inventory file that holds balance due and delinquent return accounts until a field revenue officer is available to work the case.<sup>25</sup> The IRS generally moves taxpayer cases to the queue after the ACS makes some attempt to resolve the accounts (usually by lien or levy). Generally, the IRS takes no enforcement actions while cases reside in the queue (other than automated refund offsets), but the accounts continue to accrue penalties and interest. Moreover, the law only requires the IRS to send updated balance information about these accounts on an annual basis.<sup>26</sup> The dollar value of cases assigned to the queue has doubled in the last six years — to over \$56.2 billion at the end of FY 2011.<sup>27</sup>

***The Third Stage of the Process Involves the Collection Field Function.***

The Collection Field function (CFf) is the final stage of the collection process, and the first stage at which an IRS employee attempts to contact the taxpayer in person. Relatively few of the collection cases left unresolved by the notice stream and the ACS are actually assigned to the CFf.<sup>28</sup> Revenue officers (ROs) routinely work in the “field” contacting taxpayers by visiting their homes or places of business to discuss payment alternatives. If the taxpayer is not in when the RO visits, he or she will generally leave a “calling card”<sup>29</sup> with a deadline for the taxpayer to respond. If the taxpayer fails to call, the IRS response, especially in recent years, has been enforcement, with particular emphasis on levies, liens, and assessment of the Trust Fund Recovery Penalty (TFRP) for business accounts.<sup>30</sup>

**Business As Usual is No Longer Good Business**

Since 2004, the National Taxpayer Advocate has urged the IRS to reassess its collection strategy and has provided numerous recommendations to improve efficiency. In 2004, the National Taxpayer Advocate recommended a different collection philosophy that would recognize five important aspects of modern collection practices:

1. Prompt person-to-person contact with debtors;
2. Focus on the “why” of noncompliance;
3. An appropriate collection “touch” for the appropriate type of noncompliance;
4. A research-based approach to collection initiatives; and

<sup>25</sup> IRM Exhibit 5.19.5-9 (Dec. 1, 2007).

<sup>26</sup> IRC § 7524.

<sup>27</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011). A Taxpayer Delinquent Account (TDA) represents a balance due account for a specific taxpayer, tax return, and period.

<sup>28</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

<sup>29</sup> Revenue officers leave Form 2246, *Field Contact Card*, if contact with the taxpayer is not made during the first attempted field contact.

<sup>30</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (*TAS Research Study: An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*). The TFRP is a penalty provided by IRC § 6672 against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. IRM 5.7.3.1 (Nov. 12, 2010).

#### 5. Prevention of opportunities for noncompliance.<sup>31</sup>

In 2006, the National Taxpayer Advocate stressed the importance of personal taxpayer contacts in four Most Serious Problems (MSPs) discussing IRS collection practices and strategies.<sup>32</sup> This report included two especially important recommendations stating that the IRS should:<sup>33</sup>

- Place top priority on initiating personal contacts on current accounts (*i.e.*, delinquencies on recently due tax periods involving taxpayers who have not resolved their delinquencies through the collection notice process); and
- Find ways to expedite personal taxpayer contact on collection cases where it is evident such actions are needed for mutually successful resolutions.

The IRS has agreed that personal contact is an important tool for helping taxpayers return to compliance but indicated that its collection systems, including the notice process and other operations, are designed to direct as many taxpayers as possible to what it views as the least invasive and burdensome options.<sup>34</sup>

In 2008, the National Taxpayer Advocate offered five recommendations that would make it easier for the taxpayer to establish personal contact with a specific IRS employee.<sup>35</sup> To date, the IRS has rejected all five.<sup>36</sup>

Finally, in 2010, the National Taxpayer Advocate provided an in-depth analysis of the IRS collection strategy as well as several recommendations to increase revenue, improve taxpayer service, and further the IRS mission.<sup>37</sup> Unfortunately, in spite of these recommendations, the IRS has not fully adopted a more personal approach toward collection.

Many collection results have seen a marked decline over the past six fiscal years (2006–2011):

- The inventory of unpaid assessments has grown from approximately \$270 billion in FY 2006 to \$373 billion in FY 2011 — an increase of 38 percent.<sup>38</sup>

<sup>31</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

<sup>32</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*); 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*); 110-129 (Most Serious Problem: *Levies*); 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*).

<sup>33</sup> *Id.* at 80 (Most Serious Problem: *Early Intervention in IRS Collection Cases*).

<sup>34</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 76 (Most Serious Problem: *Early Intervention in IRS Collection Cases*).

<sup>35</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 125 (Most Serious Problem: *Navigating the IRS*). The recommendations included: 1. Revise the IRM to direct employees to accommodate taxpayer requests to speak to a particular employee whenever feasible. 2. Create a personnel directory for internal use, searchable by the same employee number that IRS employees give to taxpayers. 3. Create a personnel directory for internal use organized by business function. 4. Adjust the topical tax index on IRS.gov to include telephone numbers of offices associated with each topic, and 5. Establish a cognitive learning lab to test and observe taxpayers' experiences in navigating the IRS.

<sup>36</sup> Joint Audit Management Enterprise System (JAMES), *IRS Response to 2008 Annual Report to Congress* (Nov. 4, 2009).

<sup>37</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

<sup>38</sup> IRS, Accounts Receivable on the Compliance Data Warehouse (CDW).

- Dollars reported as currently not collectible (CNC) rose from \$16.2 billion in FY 2006 to \$32.3 billion in FY 2011 — an increase of 99 percent.<sup>39</sup>
- The number of taxpayer accounts reported as CNC increased by 73 percent — from 751,012 in FY 2006 to nearly 1.3 million in FY 2011.<sup>40</sup>
- The amount of TDA dollars reported as “surveyed” by the IRS more than tripled during this period — from approximately \$2.7 billion to \$8.8 billion.<sup>41</sup>

These data clearly indicate that the current IRS collection strategy is not working, and it is time for a new approach. Recognizing that the IRS’s resources are limited, it can still apply those resources in a different way. Under the current system, a great deal of time passes and interest and penalties accrue before the IRS attempts to make a personal contact with most delinquent taxpayers. If the IRS reaches out to a taxpayer early in the collection process, it may be able to reach a solution to the tax debt, where contact later in the process usually brings fewer resolution options.

To help the growing number of struggling taxpayers, the IRS announced the new “Fresh Start” program in February 2011. As part of this initiative, the IRS has increased access to installment agreements (IAs) and streamlined offers in compromise and has changed some lien policies and procedures. Although this initiative could potentially provide relief to many delinquent taxpayers, communication with the taxpayer is the first step. The IRS also has increased the number of special open houses it holds at its field assistance centers but has failed to adopt a multi-faceted strategy to initiate personal contact. Taxpayers must know what collection alternatives they have available. If the IRS reached out to more taxpayers early in the collection process through personal contacts, it could resolve some of the rising number of delinquent accounts, and be able to focus more of its limited resources on the remaining accounts.

#### **Talking with Taxpayers is a Core IRS Responsibility.**

Taxpayers have continually told the IRS, “We want to talk with you.”<sup>42</sup> In a 2006 IRS Oversight Board survey, *Taxpayer Customer Service and Channel Preference*, respondents consistently preferred phone or face-to-face contact to other types of assistance.<sup>43</sup> The IRS has a responsibility to talk with taxpayers to determine the reasons behind their tax liabilities. This approach is critical because different explanations for noncompliance require different approaches to case resolution. For example, a taxpayer who fell behind on tax payments because a heart condition kept him from working should be treated differently

<sup>39</sup> IRS, Collection Activity Report NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Oct. 2011).

<sup>40</sup> *Id.*

<sup>41</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 48 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*). Accounts reported as currently not collectible - “surveyed” represent situations where the IRS has chosen not to pursue collection, even though the collection statute remains open. Usually, these decisions are driven by the availability of IRS collection resources. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

<sup>42</sup> IRS Oversight Board, *Taxpayer Customer Service and Channel Preference* (Nov. 2006).

<sup>43</sup> *Id.*

from one deliberately trying to hide assets offshore or consistently underreporting income. The IRS must attempt to talk with the taxpayer to properly assess the reason for his or her unresponsiveness and determine what action is best.

The impact on taxpayers when the IRS sends notices instead of attempting to phone or visit can be significant. Not only can IRS notices be difficult to understand and misleading, but almost ten percent of them go undelivered, leaving taxpayers unaware that they may be facing liens or levies.<sup>44</sup> Making personal contact before sending the case to the queue could alleviate many of these issues. The IRS could answer questions, discuss payment alternatives, and advise of potential enforcement if deadlines are missed. Taxpayers may be misled by the lack of personal contact, especially when they are in the queue and receiving only an annual notice from the IRS, thinking that “no news is good news” and everything must be resolved or the IRS would call. Unfortunately, that is often not the case, as penalties and interest continue to accrue and the IRS may be moving forward with enforcement. The National Taxpayer Advocate has recommended abolishing the queue altogether. However, as long as the IRS considers it a necessity, it should do more than merely send out a notice. It should reach out personally to the taxpayers assigned to the queue, at least on an annual basis.

Personal contact becomes even more imperative for small business employers, which can accrue tax liabilities every quarter.<sup>45</sup> Looking at the life cycle of a tax liability on Form 941, *Employer’s Quarterly Federal Tax Return*, 47 percent of these liabilities are paid in response to the first notice. However, 55.3 percent of the 3.4 million returns assigned to the Cff (revenue officers) are paid in full when the ROs make personal contact.<sup>46</sup>

Although early intervention in collecting pyramiding Form 941 tax liabilities is critically important, businesses can accrue on average two years of tax debt before the IRS ever attempts personal contact.<sup>47</sup> Thirty-five percent of the payroll tax cases that entered the queue between FY 2004 and FY 2008 pyramided additional liabilities.<sup>48</sup> When the IRS has made no other attempt to notify or contact the taxpayer, 34 percent of the pyramiding accounts grew by three or more tax modules and 36 percent grew by amounts greater than \$10,000.<sup>49</sup>

<sup>44</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

<sup>45</sup> Employers file Form 941, *Employer’s Quarterly Federal Tax Return*, each quarter to report income and Social Security taxes withheld from the employees.

<sup>46</sup> IRS, *A Survival Analysis of IRS Collection Treatments for Unpaid Form 941 Employment Taxes* (June 2010).

<sup>47</sup> *Hearing on How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth before the Committee on Small Business*, 112th Cong. 21 (Apr. 13, 2011) (statement of Nina E. Olson, National Taxpayer Advocate). Of the BMF Trust Fund notices that were not resolved in the notice stream during FY 2010, approximately 23 percent were “closed” as “deferred” accounts, i.e., due to the relatively small dollar amounts of the delinquencies, the IRS systemically determined not to pursue them as taxpayer delinquent accounts (TDAs). IRS, *Collection Activity Report NO-5000-242, TDA Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

<sup>48</sup> SB/SE Research, “Happy Friday” (Oct. 29, 2010). In a study requested by SB/SE Collection Policy to support employment tax (ET) strategy, SB/SE Research provided information on pyramiding ET cases in the queue.

<sup>49</sup> *Id.*

Another situation where a personal conversation may yield positive results is when an individual or business taxpayer defaults on a payment plan. In FY 2011, the ACS received approximately 1.7 million tax modules with balances due that the taxpayers had originally agreed to pay through installment agreements, but which now the IRS considered in default — a default rate of 21 percent.<sup>50</sup> The IRS could resolve these accounts more efficiently with follow-up telephone contacts since it already has access to the taxpayers' information. Many of these taxpayers are attempting to pay what they owe but cannot adhere to the original terms due to unforeseen circumstances such as a job loss, medical emergency, or additional living expenses. In the 2010 Annual Report, the National Taxpayer Advocate recommended that the IRS revise its form letter for "streamlined" IAs to advise the taxpayer to contact the IRS if he or she cannot make the payments for any reason.<sup>51</sup> Still, few IRS collection procedures (outside of the Cff) require the IRS to proactively reach out and talk to taxpayers.

#### **Enforcement Should Not Be Used as a "Calling Card."**

Taxpayers who cannot pay their debts in full and do not contact the IRS because they do not know what to expect may be subject to increased burden or serious financial harm. The IRS has very powerful collection tools and can take actions such as levies and liens without first going to court to reduce the liabilities to judgments.<sup>52</sup> The IRS is not hesitant to use these tools, even during significant economic downturns. In FY 2011, the IRS filed over one million liens<sup>53</sup> and issued 3.7 million levies.<sup>54</sup>

However, the IRS incurs additional costs and work by enforcing first and asking questions later.<sup>55</sup> For example, the ACS might issue a Notice of Levy seizing all available funds in a taxpayer's bank account before anyone actually talks to the taxpayer. When the taxpayer learns he no longer has access to the money, he calls the ACS and explains why he does not owe the tax balance. The ACS researches the issue, determines the taxpayer is correct, releases the levy, and prepares paperwork to adjust the tax balance. If the ACS had phoned the taxpayer first, the levy and subsequent release might have been avoided, saving both the taxpayer and the IRS time and money.<sup>56</sup>

<sup>50</sup> IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2011); IRS, Collection Activity Report NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2011).

<sup>51</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 197 (Most Serious Problem: *IRS Collection Policies Channel Taxpayers Into Installment Agreements They Cannot Afford*).

<sup>52</sup> IRC § 6331.

<sup>53</sup> IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators* (Oct. 2011).

<sup>54</sup> *Id.*

<sup>55</sup> IRS, Collection Activity Report 5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011). Of the 1.6 million ACS full pay dispositions in FY 2011, 34,042 cases were closed to adjustments.

<sup>56</sup> Even when the IRS releases a levy, the taxpayer may still incur bank fees (e.g., for overdraft protection or insufficient funds in an account).

IRS rework is also found in the Automated Substitute for Return (ASFR) program, where the IRS prepares a return for the taxpayer.<sup>57</sup> Because the IRS does not have access to all of the taxpayer's deductions or expenses, the taxpayer usually ends up owing more on the IRS-prepared return. Once the taxpayer files an original return, the IRS must adjust the tax balance, penalty, and interest to reflect the accurate original return.<sup>58</sup> Based on this approach, the IRS spends excess time processing accounts, when a simple phone call early in the delinquency could resolve the problem faster and more efficiently.

### **IRS Has Achieved Success in Talking with Taxpayers.**

The IRS has already experienced some success with personal taxpayer contact in its ACS hybrid project as well as the streamlined Centralized Offer in Compromise (COIC) pilot program, which was expanded twice in FY 2011.<sup>59</sup> The IRS should use this knowledge and information to test personal taxpayer contact in other areas – for example, during the first six months of the debt, before moving a case from ACS to the Collection queue and before the default of an IA.

## **CONCLUSION**

The National Taxpayer Advocate believes effective personal contact at the earliest possible time should be the key focus of IRS collection work. Enforcement tools such as the lien and levy should be reserved for situations where a taxpayer is unwilling to cooperate or comply.<sup>60</sup> The taxpayer's failure to respond to an IRS notice is not necessarily indicative of the taxpayer's unwillingness to cooperate or comply. However, the current IRS collection strategy treats delinquent taxpayers as if they have consciously decided not to comply, using the "full force of the law" in a manner that may be premature, unnecessary, and counterproductive. A more effective collection strategy must place greater emphasis on providing timely attention to problems as they arise, actually talking to taxpayers about their individual problems, and helping taxpayers to comply with the tax laws.

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

1. Conduct a test by increasing use of the predictive dialer in making personal contacts in targeted segments of the collection workload (*e.g.*, higher-dollar notice accounts, notices involving "repeat delinquents," and potentially defaulting installment agreements and offers in compromise).

<sup>57</sup> IRM 5.1.11.6.3.1 (Jan. 15, 2010). See also Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*, *supra*.

<sup>58</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); see also Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*, *supra*.

<sup>59</sup> Response to TAS information request (Sept. 28, 2011).

<sup>60</sup> See National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*).

2. Revise the IRM to require additional attempts at personal taxpayer contact before the ACS takes an enforcement action or sends a case to the Collection queue.
3. Before defaulting an existing installment agreement or establishing a new streamlined IA (when the taxpayer has not indicated a monthly payment amount), attempt personal contact to determine what the taxpayer can actually pay for the new agreement or how to repair the defaulted one.

### IRS COMMENTS

The IRS uses a multi-faceted collection strategy to effectively maximize impact with available resources. This strategy includes issuance of notices and direct contact with taxpayers both telephonically and face-to-face. The IRS agrees that personal contact is an important part of assisting taxpayers to become compliant in both filing and paying their federal tax obligations; however, it is not the only effective means of providing information to taxpayers. If a taxpayer responds to one of the many notices issued, our campus collection employees are helpful and efficient in resolving the account. If a taxpayer does not provide contact information or respond to the multiple notices issued, then the IRS must initiate the next most cost-effective action.

In order to assist taxpayers with understanding their federal tax obligations, the IRS's Office of Taxpayer Correspondence (OTC) has worked closely with the Collection function on its notice redesign efforts over the last few years. The redesigned notices provide clearer, plainer language. This will result in more engagement with the taxpayer through higher response rates and liabilities collected earlier in the process (*e.g.*, installment agreements). The majority of collection notices were redesigned and implemented in January 2011. At this time, the impact cannot be quantified, but the OTC comprehension and perception testing showed an increase in understanding of notices by taxpayers.

The IRS strives to make communication clearer so the taxpayer understands and then can choose the appropriate option based on their unique situation. In the notice redesign, information was added about installment agreements earlier in the notice stream. On IRS.gov, we have included a web page, "Understanding Your IRS Notice or Letter," which includes a page for each redesigned notice that provides specific information about that notice including actions to take, Questions and Answers, Tips, and links to resources about payment options. In addition, the IRS is working on the redesign of Publication 594, *The IRS Collection Process*, which will provide clear and simple information on the collection process as well as payment options.

The IRS has also updated collection web pages on IRS.gov to provide improved information to taxpayers by expanding available resources; ensuring language is clear; creating collection links on the home page; creating a collection topics page; increasing the number of direct links to collection topics; and streamlining the process for paying tax liabilities online. The IRS developed and posted to IRS.gov a series of collection videos titled "Owe

Taxes? Understanding IRS Collection Efforts.” These videos were designed to improve taxpayer satisfaction by providing taxpayers with information they can use to resolve their collection issues independently as well as highlighting what they can expect when working with the IRS. The videos emphasize to the viewer the importance of communicating with the IRS and what information to have available when communicating with IRS about case resolution. Presented from the taxpayer’s perspective, the videos use clear language with many references to additional information.

In addition, the IRS has a self-help option on IRS.gov called Online Payment Agreement (OPA). The use of this web application enables taxpayer convenience in their home or office to do the following:

- Arrange for a short-term extension (11-120 days);
- Arrange monthly payments via payroll deduction or direct debit installment agreement (DDIA); and
- Revise existing agreements by:
  - Changing payment due date and/or amount;
  - Change existing extensions to a regular IA or DDIA; or
  - Change existing regular IAs to a Payroll Deduction IA or a DDIA.

The OPA application is available 24 hours a day, seven days a week.

A trend worth noting is that some taxpayers no longer publish their phone numbers or use landlines. Taxpayers are increasingly using cell phones as their only source of contact, which impedes the IRS in researching telephone numbers in an attempt to contact them. The IRS currently spends millions of dollars a year, through our Locator Service Contracts, attempting to locate new telephone numbers and addresses on taxpayers who no longer reside at their last known address. The IRS also licenses the National Change of Address data from the United States Postal Service (USPS). This database contains updated change-of-address information and is received regularly from USPS.

It is important to note, while cases are in the queue, they do receive an annual notice and are subject to refund offsets. As there is a finite amount of inventory that can be processed with our current staffing, there will continue to be a need for the queue based on resources available.

As mentioned earlier, the IRS uses a variety of methods as part of its overall collection strategy. To balance our staff and prioritize our inventory, the systemic predictive dialer calls are included as part of the overall collection strategy. The IRS balances cost and taxpayer burden in determining the best methodology to reach taxpayers who owe taxes. When taxpayers respond to their tax issues as they arise, and speak with the IRS about their individual problems, they are resolved quicker and with less expense. For this reason, the IRS

provides toll-free numbers and encourages taxpayers to contact us with any concerns in our early notifications to taxpayers.

The National Taxpayer Advocate makes three preliminary recommendations in the draft report. The IRS will take or has taken the following actions with respect to these recommendations:

The IRS agrees with running manned predictive dialer tests on accounts that already reside on the ACS system; however, based on current resources, we do not believe the cost of staffing additional predictive dialer calls that do not reside on the ACS system would be worth the potential benefits. Handling return calls for messages left by the predictive dialer would require shifting of personnel from their current activities assisting other taxpayers.

Based on current staffing and resources, requiring ACS employees to attempt personal taxpayer contact prior to taking an enforcement action, or sending the case to the Collection queue, is not practical at this time as we believe that the costs likely would outweigh any potential benefits. These costs include diverting the ACS employees from other calls of taxpayers asking for information. As always, the IRS will continue to look for ways to enhance our collection processes.

Prior to defaulting any existing installment agreement, the IRS does issue a notice to the taxpayer providing them the opportunity to either appeal it or contact the IRS to revise or reinstate their agreement. When the IRS receives correspondence in which a taxpayer requests an installment agreement, but does not provide a proposed monthly payment amount, we establish the installment agreement at the lowest streamline amount as a convenience. Otherwise, the taxpayer would remain in the collection stream and may be subject to further collection actions. The IRS is in the process of providing more clarity around this issue in the next version of the Form 9465, *Installment Agreement Request*.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes that the IRS must balance many competing concerns — it must collect billions of dollars from millions of taxpayers with limited resources, balancing the cost and benefits of providing quality service to taxpayers while collecting delinquent tax balances. The IRS has achieved moderate success with its current collection process by sending notices in the early stages of delinquency. However, the IRS misses opportunities to resolve accounts quickly and efficiently when it puts the onus of personal contact primarily on taxpayers.

Even during this time when our government is tasked with the difficult challenge of trying to accomplish more with fewer resources, the IRS can do a better job of allocating its resources more effectively. In its response, the IRS agrees that personal contacts are an important means to assist taxpayers in achieving filing and payment compliance. However, the IRS assumes that calling taxpayers before taking an enforcement action, putting them in the collection queue, or defaulting an installment agreement, is not a good use of its resources. Yet it has not launched any pilot programs to test its assumptions and determine if these approaches are in fact more cost-effective — both immediately and in the long-term — than its current approach of waiting for taxpayers to call or just letting accounts languish in the IRS collection inventory.

In the limited circumstances in which the IRS has employed personal taxpayer contact, such as in its streamlined Centralized Offer in Compromise pilot program, the data seem to indicate that the IRS may be undervaluing the effectiveness of such methods in resolving taxpayer collection issues. In the past year, the IRS has expanded the streamlined process twice, and with good reason. Since the streamlined process was implemented, the IRS has been accepting approximately one-third of offers — compared to about one-fourth previously.<sup>61</sup> More importantly, the use of personal contacts with taxpayers through the pilot program led to fewer unresolved accounts moving to Appeals, and fewer offers rejected.<sup>62</sup> These results contradict the IRS's assumptions about the utility of early personal contact.

The National Taxpayer Advocate remains extremely concerned about the IRS's use of the collection queue. Merely sending annual reminder notices (which are required by statute<sup>63</sup>) and offsetting refunds while a case lingers for years is unsatisfactory. The dollar value of cases assigned to the queue has doubled in the last six years, to over \$56.2 billion at the end of FY 2011. The IRS agrees that when taxpayers speak to them about their individual problems, their tax issues are resolved more quickly and with less expense. The disagreement is simply over who should be initiating the phone call, and the growing, aging queue indicates that it should be the IRS doing so.

<sup>61</sup> IRS, Collection Activity Report NO-5000-108 (Oct. 2011). In FY 2011, The IRS accepted 19,562 offers, up 41 percent over FY 2010.

<sup>62</sup> *Id.* The overall rejection rate for FY 2011 was 20 percent, down from 25 percent in FY 2009.

<sup>63</sup> IRC § 7524.

The IRS response notes that a growing number of taxpayers rely solely on cell phones as their primary means of communication and the IRS sometimes encounters difficulties in reaching those taxpayers. This change in the communication landscape presents a challenge to the private and public sector alike. Cell phones offer a greater range of communication options than land lines; however, obtaining accurate contact information for taxpayers may require a new approach. The IRS must work today to develop a strategy to reach taxpayers of the future. As part of this strategy, the IRS should examine how others in the private and public sector are communicating with taxpayers via cell phone and consider some of the available options. Additionally, the IRS should convene a task force to study how best to communicate with taxpayers who solely have cell phones. These are the taxpayers of the future and the IRS cannot give up on communicating with them simply because technology poses a challenge.

The National Taxpayer Advocate applauds the IRS's use of a multi-faceted collection strategy in order to accommodate the wide variety of taxpayers it services. The notice stream is a key element of that strategy, and the IRS has worked diligently to make taxpayer communication clearer by revising many notices and publications, and has increased accessibility via improvements to IRS.gov. These worthwhile initiatives should be accompanied by improvements to the IRS's methods for personally reaching out to taxpayers. There are a significant number of taxpayers for which this strategy has no substitute. A more effective collection strategy would place greater emphasis on providing timely attention to problems early on and at key turning points in the collection process.

## Recommendations

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

1. Conduct a test by increasing use of the predictive dialer in making personal contacts in targeted segments of the collection workload (*e.g.*, higher-dollar notice accounts, notices involving "repeat delinquents," and potentially defaulting installment agreements and offers in compromise).
2. Revise the IRM to require additional attempts at personal taxpayer contact before the ACS sends a case to the collection queue.
3. Conduct a study on how best to reach taxpayers with cell phones, including an analysis of how the private and public sectors reach customers.
4. Before allowing an existing installment agreement to default or establishing a new streamlined agreement (when the taxpayer has not indicated a monthly payment amount), attempt personal contact to determine what the taxpayer can actually pay for the new agreement or how to repair the defaulted one.

## MSP #18

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

### RESPONSIBLE OFFICIAL

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

### DEFINITION OF PROBLEM

The Federal Payment Levy Program (FPLP) is an automated system that matches IRS records against those of the government's Financial Management Service (FMS) and allows the IRS to issue continuous levies for up to 15 percent of federal payments due to taxpayers who have unpaid federal liabilities.<sup>1</sup> In January 2011, the IRS began applying a low income filter (LIF) to the FPLP to screen out taxpayers whose incomes are below 250 percent of the federal poverty level set by the Department of Health and Human Services.<sup>2</sup> This filter protects low income taxpayers from experiencing an economic hardship due to a levy on their Social Security old age or disability benefits and to ensure that the IRS does not issue levies that it would likely have to release immediately on the grounds of economic hardship.<sup>3</sup>

The National Taxpayer Advocate had urged the IRS for several years to implement this filter and is generally pleased with its development.<sup>4</sup> This filter has reduced the number of TAS FPLP cases.<sup>5</sup> However, its effectiveness has not yet been tested.<sup>6</sup> Further, the National Taxpayer Advocate is concerned that the filter still leaves some taxpayers subject to the FPLP, even though their incomes otherwise fit the guidelines.

Specifically, the filter does not protect:

- Taxpayers with delinquent unfiled returns;<sup>7</sup> and
- Taxpayers (or their spouses) who have debts on the IRS's Business Master File (BMF).<sup>8</sup>

<sup>1</sup> Internal Revenue Code (IRC) § 6331(h)(2)(A), as prescribed by the Taxpayer Relief Act of 1997 (Pub. L. 105-34) § 1024, authorizes the IRS to issue continuous levies on certain federal payments. FMS is the Department of Treasury agency that processes payments for various federal agencies. Payments subject to FPLP include any federal payments other than those for which eligibility is based on the income or assets of the recipients.

<sup>2</sup> Department of Health and Human Services, *The 2011 HHS Poverty Guidelines*, available at <http://aspe.hhs.gov/poverty/11poverty.shtml>. For 2011, an individual who makes \$10,890 or less is in poverty. This number is then multiplied by 250 percent to determine the 250 percent federal poverty threshold.

<sup>3</sup> IRC § 6343(a).

<sup>4</sup> See National Taxpayer Advocate 2007 Annual Report to Congress; National Taxpayer Advocate 2006 Annual Report to Congress 110-129, 141-156; National Taxpayer Advocate 2005 Annual Report to Congress 123-135; National Taxpayer Advocate 2004 Annual Report to Congress 26-263; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2001 Annual Report to Congress 202-209.

<sup>5</sup> Taxpayer Advocate Management Information System (TAMIS) (pulled Nov. 9, 2011). Since the IRS implemented the filter (from January through September 2011), TAS FPLP cases have declined by 26.6 percent compared to the same period in 2010.

<sup>6</sup> Email from Wage and Investment Division (W&I) senior analyst to TAS senior researcher (Oct. 11, 2011). The IRS will not complete a review of the FPLP LIF until fiscal year (FY) 2012.

<sup>7</sup> Internal Revenue Manual (IRM) 5.11.7.2.2.3(1) (Aug. 13, 2011).

<sup>8</sup> IRM 5.11.7.2.2.3(1) (Aug. 13, 2011).

In addition to questions about the effectiveness and design of the filter, the National Taxpayer Advocate has concerns about IRS policies on bank levies. The IRS can use bank levies to collect on 100 percent of a taxpayer's Social Security benefits, even if a continuous levy has been filed under the FPLP and the 15 percent limit (under IRC § 6331(h)(2)(A)) applies.<sup>9</sup> Neither the IRS nor the financial institution is required to investigate whether the funds in the account include Social Security benefits before the IRS files a bank levy, potentially creating an economic hardship for the taxpayer and running counter to Congress's efforts to limit the amount of Social Security benefits subject to levy. Using this authority may be particularly harmful now that the Department of the Treasury requires all federal payments, other than tax refunds, to be deposited with a banking institution.<sup>10</sup> If the IRS levies on a taxpayer's account, Social Security benefits are even more likely to be collected.

## ANALYSIS OF PROBLEM

### Background

#### *The Road to a Low Income Filter for the FPLP Program*

Under IRC § 6331(h)(2), the IRS has the authority to levy a variety of federal sources of income, including unemployment benefits, workman's compensation, and public assistance programs such as Supplemental Security Income. However, as a matter of policy, the IRS does not pursue these sources to collect delinquent taxes.<sup>11</sup> Most FPLP levies have historically been imposed on Social Security benefits, although the FPLP has recently been expanded to include Railroad Retirement Board benefits.<sup>12</sup> Initially, the IRS used an income filter to exclude taxpayers with income below a specified threshold from the FPLP, but the IRS gradually phased out the filter and eliminated it altogether in January 2006.<sup>13</sup> However, TAS continued to advocate for and emphasize the importance of a filter, and in response to the National Taxpayer Advocate's recommendation in past Annual Reports to Congress, the IRS worked with TAS to create the new low income filter that took effect in January 2011.

#### *The Identification of Taxpayers Who Should Be Filtered Out of FPLP Was Largely Based on a TAS Research Study, Which Developed a Proxy for Economic Hardship.*

The filter was intended to protect people likely to suffer the economic hardship described in IRC § 6343(a)(1)(D). That provision requires the IRS to release a levy when it would

<sup>9</sup> IRM 5.11.4.5 (Sept. 14, 2010). A review of IMF cases receiving an FPLP levy from January 1 until August 8, 2011 showed that over 31 percent of taxpayers who are subject to the FPLP program are also placed in the IRS Automated Collection System (ACS). Based on IMF data for taxpayers who received a levy.

<sup>10</sup> Individuals who apply for federal benefits, other than tax refunds, after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from paper checks to electronic payments by March 1, 2013. 31 C.F.R. § 208.

<sup>11</sup> IRM 5.11.7.2.1 (Aug. 12, 2011).

<sup>12</sup> IRM 5.11.7.2.1.1(2)(j) (Aug. 12, 2011). In June 2011, the IRS added Railroad Retirement Board benefits to the list of items that are subject to FPLP.

<sup>13</sup> This filter was known as the Total Positive Income (TPI) indicator and was implemented in January 2002 at the request of the National Taxpayer Advocate. For a more detailed discussion of this filter, see National Taxpayer Advocate 2005 Annual Report to Congress 123-135; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; and National Taxpayer Advocate 2001 Annual Report to Congress 202-209.

create an economic hardship due to the financial condition of the taxpayer. Treas. Reg. § 301.6343-1(b)(4) specifies that an economic hardship exists if a taxpayer cannot pay his or her basic living expenses.

When developing the filter to protect Social Security recipients, the IRS sought to determine how the Code's and regulations' definitions of economic hardship would apply to these taxpayers. Social Security benefits provide at least half of the total income for about 66 percent of aged beneficiaries and comprise 90 percent or more of total income for about 35 percent of this population.<sup>14</sup> A levy on Social Security benefits is likely to cause a hardship, and the impact may be worse during difficult economic times.<sup>15</sup>

Understanding the vulnerability of this group (*i.e.*, the elderly and disabled), TAS conducted a research study to determine how to identify when an FPLP levy would cause economic hardship for taxpayers who receive Social Security. The study, which was published in the 2008 Annual Report to Congress, found that after applying the IRS's 2008 allowable living expenses to their incomes, certain taxpayers would meet the IRS's definition of economic hardship if the IRS filed FPLP levies on their Social Security benefits.<sup>16</sup> TAS's model used taxpayers' income information from individual tax returns and payor documents supplied to the IRS to estimate the taxpayers' incomes. TAS used other tax return data to estimate the taxpayers' necessary living expenses routinely allowed by the IRS. Next, these two amounts were compared to determine the taxpayers' ability to pay the FPLP levy without experiencing economic hardship.

After conducting this analysis, TAS found that applying a screen of income not more than 250 percent of the federal poverty level excluded all taxpayers identified as experiencing hardship as a result of the levy.<sup>17</sup> Thus, the current use of the 250 percent of the federal poverty level exclusion serves as a proxy for establishing economic hardship and justifying the required levy release under IRC § 6343.<sup>18</sup> The IRS agreed with TAS that 250 percent of the federal poverty level fairly approximates the regulatory definition of significant hardship for Social Security recipients and makes it unnecessary to construct an algorithm to identify taxpayers who would experience economic hardship.<sup>19</sup>

<sup>14</sup> Social Security Administration (SSA), *Fast Facts & Figures About Social Security* (Sept. 2011).

<sup>15</sup> U.S. Census Bureau, *About Poverty Overview*, <http://www.census.gov/hhes/www/poverty/about/overview/index.html>. Recent census data showed that the number of low income citizens in 2010 was the largest number in 52 years (46.2 million).

<sup>16</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 46 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*). See also IRM 5.15.1.7 (Oct. 2, 2009). Allowable living expenses are expenses that are necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income. The expenses must be reasonable and establish the minimum a taxpayer and family need to live.

<sup>17</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 65 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

<sup>18</sup> *Id.* at 46. The study used IRS 2008 allowable living expense standards.

<sup>19</sup> Because the IRS believed this population would be unlikely to have large amounts of unreported income, the IRS was willing to use an algorithm based on IRP data. It later accepted the 250 percent of the federal poverty level as a proxy in lieu of constructing an algorithm.

### *The Final Design and Implementation of the FPLP Filter*

The LIF is designed to identify and remove from the FPLP delinquent accounts involving taxpayers whose incomes fall below 250 percent of the federal poverty level.<sup>20</sup> However, the LIF does not screen out taxpayers who meet one of the following exclusion criteria, leaving them exposed to the FPLP process even though they may experience economic hardship as a result of the levy:

1. The taxpayer's account shows delinquent unfiled tax returns under the primary Social Security number (SSN);
2. The account indicates a business debt under the taxpayer's or the taxpayer's spouse's SSN;
3. The name on the account does not match the name on the balance due module; or
4. The spouse's SSN is invalid.

Once the IRS determines a taxpayer meets one of these criteria, it does not conduct any further research into the taxpayer's situation or apply the 250 percent screen. Thus, the IRS risks imposing levies on taxpayers who will experience economic hardship, burdening them and the IRS, which must release the levy once economic hardship is established.

### **Exclusions to the LIF Filter Prevent It from Meeting Its Overall Objective and Cause Economic Hardship to Social Security Recipients.**

#### *Excluding Taxpayers with Unfiled Returns or Business Debts from the Filter Potentially Harms Low Income Taxpayers and Ignores the Tax Court's Holding in *Vinatieri*.*

As TAS recommended during the development of the LIF, the IRS should apply the filter to taxpayers who have unfiled returns or business debts (but meet all other exclusion criteria) and then analyze each case to see if it can be resolved. However, despite TAS's objections, the IRS has declined to apply the LIF to taxpayers with unfiled returns and business debts, all but guaranteeing that low income Social Security recipients will be harmed. In a representative sample of 435 cases where taxpayers are subject to the FPLP and have an unfiled return,<sup>21</sup> TAS found that 20.7 percent were below 250 percent of the poverty level.<sup>22</sup> These numbers illustrate that the IRS's current approach is harming taxpayers and raises concerns addressed in the *Vinatieri* case.<sup>23</sup>

In *Vinatieri*, the court held that proceeding with a levy would be unreasonable because IRC § 6343(a)(1)(D) (the economic hardship provision) would require its immediate release, and a levy that would cause demonstrated economic hardship had to be released even

<sup>20</sup> IRM 5.11.7.2.2.3 (Aug. 12, 2011).

<sup>21</sup> These cases had a levy sent or levy proceeds received during January 2011 through October 15, 2011).

<sup>22</sup> The sample has a confidence level of 95 percent with a margin of error (plus or minus) of about 4.7 percent.

<sup>23</sup> *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). The taxpayer's financial information showed that she could not pay her basic living expenses if the IRS levied on her wages. The settlement officer concluded that the levy would create an economic hardship but still proceeded with the levy because the taxpayer had not filed her 2005 and 2007 returns.

though the taxpayer had unfiled returns. Therefore, the determination to proceed with the levy was arbitrary, and the Court held the determination was incorrect as a matter of law and was an abuse of discretion.<sup>24</sup>

Similarly, when the IRS fails to filter out of the FPLP taxpayers whose incomes fall below 250 percent of the federal poverty level (the proxy for economic hardship under IRC § 6343(a)(1)(D)) because of an unfiled return or a business debt, it will have to release the levy later when the taxpayer shows that he or she is experiencing hardship as a result. That is, the IRS is unnecessarily harming low income Social Security recipients, because it could presume the presence of hardship if it looked at the income levels of taxpayers who had unfiled returns or a business debt instead of automatically excluding them from the LIF. Once the presence of economic hardship is fairly presumed, denying these taxpayers the benefit of the LIF contravenes the holding in *Vinatieri*.

In discussions with TAS on this issue, the IRS has indicated that a taxpayer's income dropping below the poverty level does not necessarily fall within the parameters of "economic hardship" set out in Treas. Reg. § 301.6349-1(b)(4).<sup>25</sup> However, the IRS worked carefully with TAS to design a filter – based on 250 percent of the federal poverty level – that would act as a proxy for economic hardship. Applying this proxy to taxpayers with filed returns, but not to those with unfiled returns or business debts, can cause economic harm for those taxpayers. This decision is contrary to the purpose for which the filter was created: to prevent Social Security recipients from experiencing economic harm. It makes even less sense since the IRS and its executives (including the then-Deputy Commissioner for Services and Enforcement) agreed with TAS that using 250 percent of the federal poverty level as a filter obviated building an algorithm to identify taxpayers who would experience hardship. Excluding nonfilers and businesses with tax debts defies logic and ignores the rationale of *Vinatieri*.

The IRS should look at the income of a taxpayer with an unfiled return or business debt before placing him or her back into the FPLP, and if the income falls below 250 percent of the federal poverty level, the IRS should filter the taxpayer out of FPLP, acknowledging that a levy would cause a hardship. The IRS also should try to resolve the unfiled return or business debt issue.

### *The IRS Collects on a Taxpayer's Liability Even When Excluded from FPLP.*

Filtering taxpayers out of the FPLP does not mean the IRS does not collect on their debts through refund offsets.<sup>26</sup> In fact, the IRS collected about \$1.5 billion through offsets in

<sup>24</sup> *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). The taxpayer's financial information showed that she could not pay her basic living expenses if the IRS levied on her wages. The settlement officer concluded that the levy would create an economic hardship but still proceeded with the levy because the taxpayer had not filed her 2005 and 2007 returns.

<sup>25</sup> Treas. Reg. § 301.6343-1(b)(4). An economic hardship condition exists when a levy will cause an individual to be unable to pay his or her reasonable living expenses. A determination as to reasonable living expenses will be made by an IRS director, considering information provided by the taxpayer.

<sup>26</sup> IRC § 6402.

2011.<sup>27</sup> Therefore, revising the LIF exclusion criteria to include taxpayers who have an unfiled return or an unpaid business debt does not necessarily mean the debt will go unpaid. The LIF exclusion simply prevents a levy from being filed against a low income taxpayer who could not pay basic living expenses if the IRS issued the FPLP levy.

### **The IRS's New FPLP Levy Release Procedures Will Prevent Additional Economic Harm to FPLP Taxpayers.**

In meetings with the IRS, TAS raised concerns about the timing of FPLP levy releases. For instance, a taxpayer's income may change after being subject to FPLP levies, causing him or her to be filtered out of the process. However, FMS may continue taking a portion of the taxpayer's Social Security benefits after the filter has applied due to a delay in the interaction between IRS and FMS systems.<sup>28</sup> Previously, there was no specific guidance to address this situation. TAS recommended that the amount collected after the levy release be returned to the taxpayer, and the IRS subsequently advised employees that they should generally return levy proceeds in these situations.<sup>29</sup> The IRS also agreed to change guidance to clarify that if TAS has an open case and requests a collection hold on the account, it may be necessary to block or release the FPLP levy until the case is resolved;<sup>30</sup> and if a Revenue Officer decides a taxpayer should not be part of FPLP, he or she needs to request a block or release on the levy.<sup>31</sup> The National Taxpayer Advocate is pleased that the IRS has adopted TAS's recommendations in its guidance.

### **Taxpayers' Social Security Benefits Are Subject to Numerous IRS Collection Actions.**

The IRS's policies reflect its position that it is authorized to file either a continuous levy under IRC § 6331(h)(2)(A), collecting on up to 15 percent of the taxpayer's Social Security benefits,<sup>32</sup> or a "paper" levy collecting 100 percent of the benefits.<sup>33</sup> The National Taxpayer Advocate is concerned that permitting a paper levy to collect 100 percent of a taxpayer's Social Security benefits does not reflect Congress's desire to limit collection against such benefits. In the 2009 Annual Report, she recommended that Congress impose a 15 percent limit on all types of Social Security levies.<sup>34</sup>

<sup>27</sup> TAS research used the IMF to identify who received a FPLP levy and who had refund offsets. The \$1.5 billion collected through refund offsets was part of a total of about \$18 billion in total liabilities in the FPLP program. Individual Master File refunds offset during 2011 and Account Receivable Dollar Inventory File.

<sup>28</sup> IRM 21.4.4.3.4 (Oct. 1, 2007). See also IRM 5.11.7.2.6 (7) (Aug. 12, 2011) for a description of the interface between the FPLP program and FMS when a FPLP levy is served to FMS.

<sup>29</sup> IRM 5.11.7.2.7 (Aug. 12, 2011).

<sup>30</sup> IRM 5.11.7.2.4 (Aug. 12, 2011).

<sup>31</sup> IRM 5.11.7.2.5 (Aug. 12, 2011).

<sup>32</sup> IRC § 6331(h)(2)(A).

<sup>33</sup> IRM 5.11.7.2.5.1 (Aug. 12, 2011).

<sup>34</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 371 (Legislative Recommendation: *Apply Uniform Limits and Extensions to Levy Actions on Social Security Benefits*).

In addition to the IRS having two methods to directly collect on a taxpayer's Social Security benefits, it may also be able to reach taxpayers' benefits by levying on taxpayers' other assets, including their bank accounts.<sup>35</sup> This collection action could impact taxpayers who have either been filtered out of the FPLP program by the LIF or are subject to a 15 percent levy. In fact, 31 percent of taxpayers who are subject to the FPLP program are also placed in the IRS Automated Collection System.<sup>36</sup> Further, collection employees are not instructed to investigate whether a taxpayer has been excluded from the FPLP by the LIF or is subject to FPLP prior to taking collection action. Proceeding with collection and filing a levy that would attach to a taxpayer's bank account could lead to the collection of a taxpayer's Social Security benefits, if the account holds them.<sup>37</sup> This type of scenario may be more likely now that all Social Security recipients receive their checks electronically.<sup>38</sup> The following examples illustrate the harm that these levies can cause:

**Example One:** A taxpayer is filtered out of the FPLP because his income falls below 250 percent of the federal poverty level, and his case returns to the normal IRS collection system. An IRS employee does not check to see if the taxpayer has been subject to FPLP or filtered out of the program by the LIF, and files a levy that attaches to the taxpayer's bank account, which holds his direct-deposited Social Security benefits.

**Example Two:** Fifteen percent of the taxpayer's Social Security benefit is levied through FPLP. The remaining 85 percent is directly deposited into the taxpayer's bank account, which is subject to a levy.<sup>39</sup>

*Before Taking Additional Collection Actions, the IRS Should Review Cases and Determine if the Taxpayer Is Subject to the FPLP Program or Has Been Filtered Out of the Program by the LIF.*

In an effort to prevent the situations above, the IRS should review each case before taking additional collection actions to find out if the taxpayer has been subject to the FPLP or filtered out. This review can be conducted through use of a systemic filter. If either situation exists, the IRS should evaluate the taxpayer's case and determine if he or she is eligible for an offer in compromise (OIC) or currently not collectible (CNC) status.

<sup>35</sup> IRC § 6331(a). See also *United States v. Marsh*, 89 F. Supp. 2d 1171, 1179 (D. Haw. 2000). IRC § 6331(h) "expand[ed] the right of the IRS to levy amounts previously exempt from levy"; however, this provision did not limit the IRS's existing authority to impose levies.

<sup>36</sup> TAS research used the following IRS databases to conduct this analysis: (1) Individual Master File Transaction history and (2) Status Code History Files for taxpayers who received a levy or had levy proceeds attached by the IRS as of August 8, 2011.

<sup>37</sup> IRC 6331(a). A levy can also attach to a stream of payments from a 401(k) plan, a certificate of deposit, or royalties.

<sup>38</sup> The Treasury Department has recently stopped issuing paper checks for all federal benefits. Individuals who apply for benefits after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from checks to electronic payments by March 1, 2013. These benefits will either be directly deposited into a bank account or into a debit card account. 31 C.F.R. § 208.

<sup>39</sup> IRC § 6331(a); IRM 5.11.4.5 (Sept. 14, 2010).

*The IRS Should Adopt Procedures Similar to Those in a Recent Treasury Regulation and the Debt Collection Improvement Act of 1996 and Exclude a Portion of Social Security Benefits from Collection.*

If the IRS files a 15 percent FPLP levy against a taxpayer and after reviewing the case decides to file another levy, it should ensure that a portion of the taxpayer's Social Security benefits is not subject to this second levy. The IRS could accomplish this by adopting an approach similar to that of a recent Treasury regulation, which requires financial institutions to investigate whether exempt benefits were directly deposited into a taxpayer's account before garnishing the funds for creditors other than the United States, among others.<sup>40</sup> If such benefits are in the taxpayer's account, a portion of the benefits must remain available to the taxpayer.<sup>41</sup> Although this regulation excludes levies issued by the United States or by state child support enforcement agencies, it does provide a framework for reconsideration of IRS policy on collecting benefits through bank levies.

Congress has adopted a comparable approach for nontax debts in the Debt Collection Improvement Act of 1996 (DCIA), which acts as a safeguard against excessive collection on an individual's Social Security benefits from those who are experiencing an economic hardship.<sup>42</sup> The IRS should adopt the general principle of protecting taxpayers' Social Security benefits, and more specifically the approach set out in the recent Treasury regulation, by working with financial institutions to determine what portion of the funds in the account are Social Security benefits and exclude a portion of those benefits from the levy. The IRS could do this by stating in the levy notice that the levy applies up to the amount of the tax debt, but if the account has received Social Security benefit payments, two months worth of benefits must be deducted from the tax debt. Adoption of this approach is especially prudent here since the IRS knows this is a vulnerable group of taxpayers who may also experience cognitive difficulties.

## CONCLUSION

The National Taxpayer Advocate is pleased that the IRS has implemented the FPLP low income filter, but believes it should be extended to taxpayers who have unfiled returns or business debts. Denying the LIF to these taxpayers effectively undermines the LIF and its primary objective. Additionally, once it excludes taxpayers from the FPLP, the IRS should refrain from any other collection action against these taxpayers. A further review of IRS collection policies regarding bank levies and their possible impact on Social Security benefits is necessary to address possible hardship situations.

<sup>40</sup> 31 CFR § 212.3. In this regulation garnishment includes a written order by either a court or a state child support agency.

<sup>41</sup> 31 CFR § 212. If the institution discovers exempt benefits, it must allow the account holder access equal to two months of payments or the current balance of the account, whichever is lower.

<sup>42</sup> Pub. L. No. 104-134 (1996); 31 U.S.C. § 3701 *et seq.* The DCIA provides that \$9,000 (\$750 times 12 months) of the debtor's annual Social Security benefit is exempt from offset. 31 U.S.C. § 3716(c)(3)(A)(ii). The regulations further limit the offset amount to the lesser of "(i) The amount of the debt . . . ; (ii) An amount equal to 15 percent of the monthly covered benefit payment; or (iii) The amount, if any, by which the monthly covered benefit payment exceeds \$750.00." 31 C.F.R. § 285.4(e).

## IRS COMMENTS

The IRS must continually balance the interests of taxpayers with our responsibility to collect federal taxes that are owed to the government. The IRS is committed to continually improving the Federal Payment Levy Program. As noted by the National Taxpayer Advocate, the IRS made FPLP policy and procedural changes to assist possible low income taxpayers by implementing the Low Income Filter and issuing additional guidance on FPLP levy releases.

The FPLP LIF was developed to determine which low income Social Security Administration taxpayers and Railroad Retirement Benefit beneficiaries should be excluded from the FPLP program. The use of the LIF is not a proxy for an economic hardship determination, nor is it determinative of whether the taxpayer has the ability to pay the delinquent taxes through any other collection means. The purpose of the LIF is to make a determination whether to use the FPLP to collect the liability. The taxpayers who bypass the FPLP program due to the LIF are processed through normal collection procedures. These normal procedures may include contact by an IRS employee or collection action, such as a levy.

The IRS decision to use 250 percent of the poverty level guidelines as the basis of whether or not to levy through FPLP was to ensure consistency with other collection alternative processes. The same poverty level guideline is used to determine if a taxpayer can afford to pay an offer-in-compromise (OIC) application fee or an installment agreement fee.

The National Taxpayer Advocate makes reference to the *Vinatieri* court case where a levy should be released if a case meets the economic hardship provision, even though there were unfiled returns. The IRS believes that this court case is not relevant to the FPLP LIF analysis since the LIF is not determinative of economic hardship or inability to pay. For an economic hardship determination to be made, all taxpayers (whether above or below the LIF income threshold) must provide a financial statement to the IRS since many taxpayers receive other income and assets of value. The FPLP LIF simply recognizes the indication of possible low income, which will still require taxpayer contact to make a hardship determination. If a hardship determination is made, the employee will follow the procedures established based on the *Vinatieri* decision.

The current FPLP LIF addresses a Government Accountability Office (GAO) report,<sup>43</sup> which concluded the methodology used to estimate income in the previous FPLP low income filter was problematic. The decision to not allow a taxpayer with delinquent tax returns or delinquent (sole proprietor) business tax debts to go through the FPLP LIF analysis was made to ensure that the most accurate and up-to-date information about a taxpayer is used in the analysis.<sup>44</sup> The determination whether a taxpayer has low income is based either

<sup>43</sup> GAO, GAO-03-356, *Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved* (Mar. 2003).

<sup>44</sup> The exclusion of these two areas is consistent with a recommendation by GAO in its 2003 report.

from the latest current year tax return or third-party reporting information. An important aspect in the LIF was to build or formulate an estimated income for the taxpayer using the most accurate and most current income information. If the FPLP were to include taxpayers with delinquent unfiled returns in the LIF analysis, then the FPLP may be relying solely on third party information without the benefit of allowing a taxpayer to provide their own tax return information, and also most recent information, to use as a basis for estimated income. To ensure the LIF uses the most accurate income information available, taxpayers with delinquent returns remain in FPLP and are put through the LIF once the delinquent returns are filed. In addition, the LIF does not have the capability of reconciling all information with respect to delinquent taxpayers with business tax debts; therefore, these cases must be excluded from the automatic determination.

In the draft report, the National Taxpayer Advocate makes conclusions from a sampling of FPLP taxpayers with delinquent unfiled returns. The IRS was informed that there is no official study or report on this sampling available for our review. Based on a discussion in which TAS explained its methodology, this sampling did not include FPLP taxpayers with business debts. Therefore, there is no documentation on which to rely to conclude taxpayers with business debts should be removed from the LIF.

The IRS will consider the views of the National Taxpayer Advocate as we analyze whether improvements in this area are warranted. The IRS is beginning a review of the LIF income model to determine the accuracy of the estimated income formula in comparison to a taxpayer's actual financial information. The IRS will assess the impact of excluding taxpayers with outstanding delinquent returns and business debts from the LIF. Small Business/Self-Employed Research will assist in completing this more in-depth analysis of the LIF model to determine its accuracy. Any changes to the program will take place after a careful analysis is completed to determine whether the estimated income model varies greatly from a taxpayer's true financial condition.

The National Taxpayer Advocate makes four preliminary recommendations regarding the FPLP. The IRS is taking or has taken the following actions with respect to the recommendations:

While we continue to take into account the recommendations made in the draft report, at this time the IRS does not believe it is appropriate to eliminate criteria that exclude taxpayers with unfiled delinquent returns or business debts from the FPLP LIF. The LIF is not able to make an accurate calculation of low-income for taxpayers with delinquent returns or business debts. Once the delinquency is resolved, the LIF will be utilized.

The IRS does not agree a review is necessary in all cases, before taking any further collection action, to determine if the taxpayer is a good candidate for the streamlined OIC process or meets currently not collectible criteria when a taxpayer is subject to a 15 percent FPLP levy, or has been filtered out of FPLP by the LIF. As previously discussed, the LIF fails to take into consideration the taxpayer's current assets and equity in those assets which

results in an incomplete picture of the taxpayer's true financial condition. An OIC requires the submission of a current financial statement to verify the taxpayer's financial position. Similarly, the IRS cannot determine if a taxpayer meets CNC criteria without a current financial statement. As with all taxpayers who have unpaid taxes, the IRS will work with taxpayers in this situation to determine if they are eligible for streamlined OICs or if they meet CNC criteria.

The IRS does not believe it should refrain from collection action based solely on a case being filtered out of FPLP. The LIF is only an indicator and does not provide the financial information needed to make accurate and complete financial conclusions. The LIF fails to take into consideration current equity in assets. The complete financial statement, which serves as the basis for the taxpayer's OIC and CNC determination, provides a true picture of the taxpayer's current financial situation, including possible sources of equity in assets which can be used to satisfy the taxpayer's tax liability.

The IRS is mindful of economic hardship issues, but does not believe that it is appropriate to revise the levy notice to financial institutions to exempt a portion of the taxpayers Social Security benefits from levy in all cases. Prior to issuing a notice of levy the IRS attempts multiple contacts with the taxpayer through notices and phone calls or face-to-face meetings to determine the taxpayer's ability to pay the tax liability. If the taxpayer is unresponsive, or chooses not to cooperate, the IRS will consider issuing a notice of levy in an attempt to bring the case to resolution. If the taxpayer is not cooperative, the IRS will not know if the Social Security benefits are the taxpayer's sole source of income. IRS internal guidance procedures address economic hardship pursuant to Internal Revenue Code (IRC) § 6343(a)(1)(D) where a taxpayer's income is deposited into a bank account and all the money is attached by a notice of levy.<sup>45</sup> If the IRS determination is that a notice of levy on the taxpayer's bank account causes the taxpayer to be unable to pay reasonable basic living expenses, thus creating an economic hardship, IRC § 6343(a)(1)(D) requires immediate release of such notice of levy causing the economic hardship.

<sup>45</sup> IRM 5.11.4.5(2) ("When an entire paycheck is deposited, an economic hardship may exist because all of the money is levied. If this happens, release the levy in whole or in part, as appropriate, to avoid creating an economic hardship....").

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is generally pleased with the recent implementation of the FPLP filter and knows it will help many taxpayers who would otherwise experience hardship while reducing significant IRS rework. Further, the National Taxpayer Advocate is encouraged that the IRS will research the effectiveness of the filter and expects that the IRS will include TAS in this evaluation. However, in its response, the IRS is attempting to rewrite history by declaring that “[t]he use of the LIF is not a proxy for an economic hardship determination.” The National Taxpayer Advocate cannot allow this mischaracterization to stand.

The National Taxpayer Advocate was personally involved in all aspects of the negotiations surrounding the implementation of the LIF. She personally briefed the Deputy Commissioner of Services and Enforcement and the Commissioner of Wage and Investment, and personally worked with the W&I Director of Campus Compliance to put the LIF into effect. The IRS agreed with TAS that for the Social Security population — composed of the elderly and disabled persons — there was a low risk of significant unreported income. In other words, most of the income of this population would be reported to the IRS through third-party reporting. Therefore, the IRS could use Information Returns Processing (IRP) data to reconstruct this population’s income with a high degree of accuracy.

In the TAS study, after establishing the taxpayer’s income through the most recent return or IRP data, TAS used the taxpayer’s household size to determine the amount of allowable and necessary expenses under the IRS’s own schedules. These are the very same schedules IRS personnel use to calculate installment agreement or OIC terms or to determine whether a taxpayer should be put into CNC status.<sup>46</sup> Thus, for purposes of the TAS study, a “determination” was made in each case as to whether the taxpayer met the IRS definition of economic hardship and thus should be excluded from the FPLP levy program, since the IRS would be *required* to release the levy under IRC § 6343.

In their discussions, the National Taxpayer Advocate and IRS senior leaders considered the possibility of building an algorithm that would pull in the taxpayer’s return or IRP data and compare that total to the allowable and necessary living expenses for that income and household category. In lieu of building such a challenging algorithm, IRS senior leadership requested the National Taxpayer Advocate identify an easy-to-apply poverty level factor that could be screened against the taxpayer’s household size and income as reported on the most recent year’s tax return or IRP data. After several runs of different poverty-level factors, the IRS Deputy Commissioner for Services and Enforcement determined that 250

<sup>46</sup> IRM 5.11.7.2.2.3(1) (Aug. 12, 2011). The definition of economic hardship under IRC § 6343 is broader than “allowable and necessary”, so by using the latter schedules, TAS applied a more conservative standard in its test.

percent of the federal poverty level (FPL) was the best measure to ensure that no taxpayer who met the definition of economic hardship would be subject to an FPLP levy.

In fairness, the decision to use 250 percent FPL as a proxy for economic hardship was made before the Tax Court issued its opinion in *Vinatieri*. But the sole basis for the IRS using 250 percent FPL was not, as the IRS inaccurately asserts, “to ensure consistency with other collection alternative processes.” The reason for using 250 percent FPL was that it excluded from the FPLP those taxpayers for whom it had been determined, under IRS procedures, to meet the definition of economic hardship. The use of the LIF filter was based on a statistically representative study of FPLP taxpayers receiving Social Security benefits, and the establishment of 250 percent FPL as the filter level was derived from the actual results of that study. The IRS cannot stand history on its head and ignore the well-documented basis for this decision, at least not as long as this National Taxpayer Advocate is around.

The National Taxpayer Advocate agrees that the LIF does not take into consideration equity in assets — nor do the IRS’s procedures for determining whether a taxpayer meets CNC-hardship status. She concedes that it is possible for a taxpayer to be excluded from FPLP by the Low Income Filter even though he or she may have significant assets. In fact, the TAS study attempted to reconstruct the asset picture for taxpayers in its study by identifying those who had real estate or who received significant amounts of investment income, which would indicate a large corpus generating that income. It was the IRS that chose not to develop an algorithm that would factor in this information.

Nevertheless, the National Taxpayer Advocate agrees that where a taxpayer has been excluded from FPLP on the basis of the LIF, the IRS should have the ability to run that account through its normal collection processes. She notes, however, that when W&I reviewed the results of our study, the then-Director of W&I Campus Compliance noted that at least half of the taxpayers in TAS’s study who were actually being levied upon in FPLP would be under the “tolerance” level for the Automated Collection System (ACS) and would not be selected for collection. Thus, the National Taxpayer Advocate is unclear as to why the IRS is so insistent today on going after this group of taxpayers.

However, allowing for the fact that one-half of the excluded base of FPLP taxpayers might meet the criteria for assignment to ACS, what the National Taxpayer Advocate is proposing is a “rule of reason.” That is, the IRS should look at these taxpayers, who have already been screened to meet the level of economic hardship, and see whether they are good candidates for OICs or streamlined IAs. We are proposing that the IRS reach out and communicate with these taxpayers, since we have very good evidence that they are in the highest risk group for incurring economic hardship as a result of our enforced collection actions.<sup>47</sup> We

<sup>47</sup> The National Taxpayer Advocate respectfully disagrees with the IRS’s statement that “[p]rior to issuing a notice of levy the IRS attempts multiple contacts with the taxpayer through notices and phone calls or face-to-face meetings to determine the taxpayer’s ability to pay the tax liability.” See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*, for an extensive and detailed discussion of just how often the IRS fails to make effective, personal contacts with taxpayers.

are not proposing that the IRS automatically put these taxpayers into IAs or OICs. In fact, what we are suggesting is consistent with the Commissioner's vision for his "Fresh Start" initiative, which advocates for more expansive use of OICs and streamlined IAs.<sup>48</sup>

#### **The Current LIF Exclusion Criteria May Violate *Vinatieri*.**

The National Taxpayer Advocate disagrees that the *Vinatieri* case is not relevant to FPLP LIF situations and is disappointed that the IRS will not adapt the LIF to the principles that this case relies upon (*i.e.*, that proceeding with a levy is unreasonable when IRC § 6343(a)(1)(D) would require its immediate release, and that a levy that caused economic hardship had to be released even though a taxpayer had unfiled returns). The IRS is incorrect in stating that "[f]or an economic hardship determination to be made, all taxpayers . . . must provide a financial statement to the IRS." The burden of providing financial statements is precisely what the LIF is designed to address. Since the FPLP LIF presumes economic hardship, denying the benefit of the filter to taxpayers who fall within its income guidelines, but have an unfiled return, ignores the holding in *Vinatieri*. To abide by the spirit of *Vinatieri*, the IRS should not subject taxpayers to the FPLP (or any other collection action) once they have been identified by the LIF, regardless of filing status or outstanding business liabilities, unless the IRS has obtained new information that reveals additional sources of income for the taxpayer. Preferably, this information should be obtained through personal contact with the taxpayer.

#### **Having the IRS Make a Hardship Determination Based on Third-Party Data Is Better than Subjecting the Taxpayer to a Levy that Could Cause Economic Hardship.**

The National Taxpayer Advocate finds the IRS's explanation of why taxpayers with unfiled returns should not be included in the FPLP LIF unconvincing. In its response, the IRS states that it does not include taxpayers with an unfiled return in the LIF, because it would then be relying solely on third-party information without allowing a taxpayer to provide his or her own information as a basis for estimated income. However, the IRS is already relying solely on such information when deciding whether a taxpayer is eligible for the LIF. As stated in the IRS response, the IRS determines eligibility for the LIF by either the latest current-year tax return or third-party reporting information. Therefore, the IRS would merely be using the same practice for taxpayers with delinquent unfiled returns as it does for other taxpayers included in the filter.

#### **TAS Research Contained in this Most Serious Problem Is Accurate.**

In its response, the IRS questions the applicability of a TAS data review pertaining to nonfilers and the FPLP. For this Most Serious Problem, TAS looked at a representative sample of 435 cases where taxpayers had been excluded from the LIF because they had delinquent unfiled returns,<sup>49</sup> then reviewed the sample to determine what percentage of

<sup>48</sup> IRS, IR 2011-20, *IRS Announces New Effort to Help Struggling Taxpayers to Get a Fresh Start; Major Changes Made to Lien Process* (Feb. 24, 2011).

<sup>49</sup> These cases had a levy sent or levy proceeds received during October 2011 through about August 15, 2011.

these taxpayers would fall below 250 percent of the federal poverty level. TAS found that 20.7 percent were below 250 percent of the poverty level.<sup>50</sup> TAS provided the IRS with a written explanation of its methodology for this analysis on December 6, 2011, and further discussed this methodology on a conference call on December 21, 2011. Although business debts were not included in the unfiled return analysis, the National Taxpayer Advocate believes the exclusion of taxpayers with a business debt from the LIF is inconsistent with the overall purpose of the filter (*i.e.*, preventing taxpayers who fall below 250 percent of the poverty guidelines from experiencing an economic hardship).

The National Taxpayer Advocate notes that the IRS itself shows a singular lack of curiosity of how to eliminate from its work stream taxpayer cases that involve economic hardship and result in significant rework. She reminds the IRS that one of the drivers for the TAS research was that inclusion of these low income taxpayers in the FPLP not only harmed the taxpayers but also resulted in significant rework for TAS and the IRS and Low Income Taxpayer Clinics to unwind the damaging effects of the levies. The almost 27 percent reduction in TAS FPLP cases demonstrates the effectiveness of the LIF screen.<sup>51</sup> This same driver applies today to low income taxpayers who are nonfilers or who have BMF debts.

#### **The IRS Should Be Working with Taxpayers Who Are Subject to the FPLP or the LIF to Resolve Their Tax Debts.**

As noted above, TAS recommends that once the IRS identifies a case for the FPLP, it take an additional step to try to resolve the case. For instance, the IRS could be more active in reaching out to taxpayers who are either subject to the FPLP or filtered out by the LIF by sending them information regarding the offer in compromise program, and even invite the taxpayers to submit offers if they believe they qualify. Further, the National Taxpayer Advocate disagrees that the IRS needs a full Collection Information Statement to determine CNC status. Based on internal databases that can identify assets, the IRS should be able to determine how many of the taxpayers subjected to the FPLP are true hardship cases. In fact, this approach could be a better use of Collection resources than current procedures, *i.e.*, issuing levies and assigning cases to the Queue. Further, it would reduce the accounts receivable inventory. In cases where the taxpayer meets the low income criteria of the LIF, the IRS should also *actively* explore the possibility of an OIC or CNC. If the IRS believes a personal contact is necessary to make a CNC determination in these cases, it can do so as a proactive program decision. However, in these cases, the LIF has already provided the IRS with a sufficient indicator of the taxpayer's economic hardship status to curtail enforced collection actions, in accordance with the *Vinatieri* decision. The National Taxpayer Advocate believes the prudent business decision in these cases is to allow the LIF to act as a proxy for economic hardship, and make the CNC decision without the unnecessary and potentially wasteful investment of additional Collection resources.

<sup>50</sup> The sample has a confidence level of 95 percent with a margin of error (plus or minus) of about 4.7 percent.

<sup>51</sup> TAMIS (pulled Nov. 9, 2011). Since the IRS implemented the filter (from January through September 2011), TAS FPLP cases have declined by 26.6 percent compared to the same period in 2010.

**Collection on Taxpayers' Social Security Benefits Should Be Restricted.**

The National Taxpayer Advocate is concerned that the IRS is not fully considering the demographics of taxpayers who receive Social Security. These payments provide at least half of total income for about 66 percent of aged beneficiaries and comprise 90 percent or more of total income for about 35 percent of this population.<sup>52</sup> Since Social Security recipients are more vulnerable to economic hardship, the National Taxpayer Advocate believes it is appropriate to exclude a portion of all taxpayers' Social Security benefits from collection actions, including bank levies. This approach would properly reflect Congress's desire to limit collection against such benefits. A taxpayer's other assets would still be subject to collection action, and even the proposed exclusion would cover only two months of benefits. This type of exclusion would preserve Social Security benefits that many taxpayers depend on for day-to-day living expenses.

**Recommendations**

In conclusion, the National Taxpayer Advocate offers these recommendations:

1. Eliminate criteria that exclude taxpayers with unfiled returns or business debts from the LIF.
2. If a taxpayer is subject to a 15 percent FPLP levy, or has been filtered out of FPLP by the LIF, IRS employees should review the case before taking any further collection action to determine if the taxpayer is a good candidate for the streamlined OIC process or meets CNC criteria.
3. Revise levy notices to financial institutions to state that if the account holds Social Security benefits, a portion of the benefits should be exempt from the levy.

<sup>52</sup> SSA, *Fast Facts & Figures About Social Security* (Sept. 2011).

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

MSP #19

MSP #19

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

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### DEFINITION OF PROBLEM

The IRS uses the Excess Collection File (XSF) to store remittances when a taxpayer's payment or credit has not been identified or resolved. Unidentified remittances (*i.e.*, payments where the IRS cannot determine the identity of the person or entity making the payment or the account to which it should be applied) are systemically transferred to the XSF when they remain unresolved after one year. Other transfers occur when the IRS cannot refund credits because taxpayers failed to file returns or otherwise timely claim the credits. Payments transferred to the XSF are held for an additional seven years before dropping out of the IRS's electronic system entirely.<sup>1</sup> Once it moves credits to the XSF, the IRS generally does not attempt to identify the taxpayers to apply the credits to their accounts, and the credits ultimately provide no benefit to taxpayers as payments and are not accounted for as tax receipts.<sup>2</sup> In May 2006, the XSF contained over \$3.5 billion in unapplied credits, and as of January 2010 had grown to over \$4.7 billion — a 34 percent increase over the past four years, and more than double its 1999 balance.<sup>3</sup> Moreover, taxpayers with annual income of less than 250 percent of the poverty level (*i.e.*, low income taxpayers) accounted for 60 percent of the open cases in the XSF. Almost all of the open cases are transfers of less than \$5,000.<sup>4</sup>

The Treasury Inspector General for Tax Administration (TIGTA) has estimated that more than half of the transfers to the XSF result from IRS errors.<sup>5</sup> For example, the IRS may fail

<sup>1</sup> Internal Revenue Manual (IRM) 3.17.220 (Jan. 1, 2011).

<sup>2</sup> Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 16 (Jan. 2005).

<sup>3</sup> TIGTA, Ref. No. 2011-30-020, *Taxpayer Payments Were Improperly Transferred to the Excess Collections File* 1 (Mar. 2, 2011); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* 2 (June 2000).

<sup>4</sup> Only 1,411 (1,351+35+25) out of 41,919 transfers (three percent) were for more than \$5,000. Open cases refer to credits transferred to the XSF within the last three years.

<sup>5</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 3 (Jan. 2005).

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

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to release a levy on a taxpayer's wages after the assessment identified in the levy is paid in full, and offset the surplus levy proceeds to another liability.<sup>6</sup> Because the taxpayer may have no idea this occurred, he or she may not contest the other liability or request a refund of the surplus levy amounts applied to the other liability before the statutory period for doing so expires (*i.e.*, prior to the Refund Statute Expiration Date or RSED). Moreover, IRS studies have shown that even minimal efforts to research taxpayers' whereabouts and contact them personally could prevent many of the transfers. The IRS requires such additional effort in some cases.<sup>7</sup> However, it reserves these procedures for "high-dollar" cases (in which the credit is \$100,000 or more) even though more than half of the transfers to the XSF for which a taxpayer identification number was found came from low income taxpayers and almost all are for less than \$5,000, and even though the IRS is aware that it would be cost-effective to extend the enhanced procedures to all accounts.<sup>8</sup>

Despite being the subject of a prior analysis in the National Taxpayer Advocate's Annual Report to Congress, four TIGTA audits, two IRS task forces, and multiple recommendations since 1999, the administration of the XSF remains a struggle for the IRS.<sup>9</sup> Improper transfers to the XSF, coupled with the IRS's inability to timely address and resolve these payments and their underlying issues, unduly burden taxpayers and generate costly rework for the IRS.

<sup>6</sup> IRM 5.11.5.5(2) (Sept. 14, 2010) ("Surplus levy proceeds are an offset under IRC 6402(a) and therefore levy proceeds received, in excess of the periods covered by the levy, may be applied to liabilities not listed on the levy." If liabilities not covered by the original levy remain outstanding, the IRS must "release the original levy and prepare and issue a new notice of levy to the levy source for the remaining liabilities." These procedures are not always followed. See National Taxpayer Advocate 2006 Annual Report to Congress 161-162. If the taxpayer failed to file a timely return, the IRS may have made a return, referred to as a substitute for return (SFR), as authorized by Internal Revenue Code (IRC) § 6020(b), based on information reported to the IRS. The SFR may reflect income reported by third parties, but allow only the standard deduction, one exemption, and a filing status of single or married filing separately. See IRM 4.12.1.25.3 (Oct. 5, 2010); IRM 4.12.1.24.12 (Oct. 5, 2010). See also *Allowable Expenses in an SFR*, available at <http://mysbse.web.irs.gov/reflibrary/kts/supparticles/14979.aspx>. Surplus levy proceeds may be applied to liabilities assessed pursuant to an SFR. If the taxpayer files a return claiming and substantiating additional deductions so that the tax is less than that shown on the SFR, the IRS may abate some of the tax assessed pursuant to the SFR.

<sup>7</sup> IRS, *Excess Collection Task Group Report 7*, 8 (Mar. 6, 2006).

<sup>8</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* 8 (Jan. 2005); IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress* 2, 4 (Apr. 22, 2009), on file with TAS. See, e.g., IRM 21.5.8.1(9) (Oct. 1, 2009).

<sup>9</sup> National Taxpayer Advocate 2006 Annual Report to Congress 171; TIGTA, Ref. No. 2011-30-020, *Taxpayer Payments Were Improperly Transferred to the Excess Collection File* (Mar. 2, 2011); TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution* (Jan. 2005); TIGTA, Ref. No. 2001-30-124, *Increased Oversight Is Needed to Ensure Taxpayers Receive Credit for Millions of Dollars in Excess Collections Accounts* (July 2001); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers* (June 2000); IRS, *Excess Collection Task Group Report 7*, 8 (Mar. 6, 2006).

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## ANALYSIS OF PROBLEM

### Background

The IRS uses the XSF to store two types of credits: 1) unidentified remittances more than a year old, and 2) credit balances in taxpayers' accounts for which the taxpayers have not requested a refund before the RSED expires.<sup>10</sup>

Accounting for the first type of XSF transfer (unidentified remittances) begins when the IRS receives a payment from or on behalf of a taxpayer, deposits it, and attempts to apply the credit to the taxpayer's account. If the IRS cannot determine the appropriate account, it credits the payment to the Unidentified Remittances File (URF), where employees work to identify and resolve the credit issue. If the account remains unidentified after a year, the IRS transfers the payment from the URF to XSF Account 6800. The second type of XSF transfer (an expired RSED) arises when amounts credited to a taxpayer's account exceed the taxpayer's liability. When the period for claiming a credit or refund expires without the taxpayer filing a return or otherwise claiming the credit, the IRS likewise transfers these statute-expired credits to XSF Account 6800. The IRS does this systematically on a weekly basis, and handles it manually when an employee determines the transfer is required.<sup>11</sup>

At the end of each fiscal year, the IRS transfers the balance in XSF Account 6800 to XSF Account 9999, where the credits are accessible using the Integrated Data Retrieval System (IDRS) for seven years.<sup>12</sup> However, once the IRS completes the move to Account 9999, it generally no longer attempts to identify and contact taxpayers to resolve the credits. Moreover, IRS employees may not realize during a routine review of a taxpayer's accounts (*e.g.*, when a taxpayer calls customer service for information or assistance) that a transfer has occurred. This information will emerge only if the employee happens to review the specific tax module containing a detailed record of the transfer, enabling the employee to inform the taxpayer of the transfer and help determine if the taxpayer can recover the

<sup>10</sup> Generally, taxpayers must request a refund within three years from the date their return was filed, or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). If taxpayers meet the three-year requirement, they can recover payments made during the three years preceding the date of the refund claim, plus any extension period for filing the return. However, taxpayers who do not meet the three-year requirement can recover only payments made during the two years preceding the date of the refund claim. IRC § 6511(b)(2).

<sup>11</sup> For example, a taxpayer may file a return showing a balance due or no tax due, after amounts withheld from income, estimated tax payments, or various tax credits are taken into account. Because the account does not have a credit balance, it will not systemically shift to XSF. However, if the taxpayer files an amended return more than three years after the original return was filed and the amended return causes a credit balance in the account, the taxpayer cannot recover any of the tax already paid through withholding, estimated tax payments, or claimed credits, and an IRS employee properly transfers the excess to the XSF.

<sup>12</sup> The IRS uses IDRS to manage taxpayer accounts in its system of databases.

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funds before the RSED lapses.<sup>13</sup> After seven years, the IRS transfers unresolved payments from XSF Account 9999 to a paper file (“XSF 50 Dropped Listing”).<sup>14</sup>

TAS requested information about the characteristics of the XSF account that was not forthcoming from the IRS. Some information, such as the amount in XSF that resulted from levies that were not released when the accounts were fully paid, and the type of levy, was not obtainable because the IRS does not record it. Other information, such as a breakdown of the amounts each operating division transfers to the XSF account, stratification of amounts in the account by \$5,000 increments, and breakouts of the amounts in the account by source, could be obtained, but would require the operating division to submit a Uniform Work Request (UWR).<sup>15</sup> The IRS responded, “At this time, a current UWR will not be requested due to budgetary issues.”<sup>16</sup> The National Taxpayer Advocate finds it astonishing that the IRS will not conduct research where there is clear evidence of harm to taxpayers or to improve programs and reduce taxpayer and IRS burden, when doing so requires a Uniform Work Request. The administration of the XSF is an ongoing problem, and the IRS needs to submit this Uniform Work Request. TAS is more than willing to assist the IRS in any way to develop it.

While nearly all IRS functions can request transfers, the Wage and Investment division (W&I) controls and monitors the administration of the XSF account.<sup>17</sup> The chart below shows the change in the balance of the XSF from fiscal year (FY) 2004 through FY 2010.

<sup>13</sup> An IRS employee responding to a taxpayer telephone inquiry typically uses IDRS command codes (e.g., ENMOD, INOLE, SUMRY, or IMFOL) that generate a computer screen with a “snapshot” of the taxpayer’s account for all tax years. These snapshots do not indicate that an XSF transfer has been made. Only if the employee accesses specific tax modules (i.e., the IRS record for specific tax years) will the XSF transfer appear. For example, the IRS is required to post an XSF indicator (using TC 971 Action Code 296) to the tax module containing the credit at the time of the transfer. IRM 3.17.220.2.2.1.2(2)(b) (Jan. 1, 2011). This signifies that employees have completed the required research to contact a taxpayer, and averts duplication of effort in researching the account in the future. However, the IRS is required to document that these procedures were followed only for transfers of \$100,000 or more. IRM 21.5.8.1(9) (Oct. 1, 2009).

<sup>14</sup> See email responses from W&I XSF subject matter expert (June 8 and 23, 2011) on file with TAS. IRM Exhibit 1.15.29-1 (July 1, 2005) provides that the underlying XSF source documents are maintained, and the payments can be recovered for 30 years. “Once it has been established that a credit can be re-applied, to re-add the credit to the file and re-apply it to the taxpayer’s account can be completed within days.” Unapplied payments otherwise remain in XSF (Account 9999) indefinitely; they are not accessible using IDRS after seven years and are never accounted for as tax receipts. IRM 3.17.220.2 (Jan. 1, 2011); IRM 3.17.63.15.48 (Jan. 1, 2011); IRM 3.8.44.2 (Jan. 1, 2011); IRM 1.15.29-1 282, Job No. NC1-58-82-9, Item 162 (Oct. 1, 2010); IRM 3.17.220.1.8 (Jan. 1, 2011).

<sup>15</sup> IRS response to TAS information request (July 14, 2011). Examples of sources of transfers include amounts that resulted from withholding credits, advanced earned income tax credit, payments with the return, subsequent payments, advance payments on a deficiency, and estimated tax payments (specifically the USDA Discrimination Settlement Payments, a.k.a. Pigford payments).

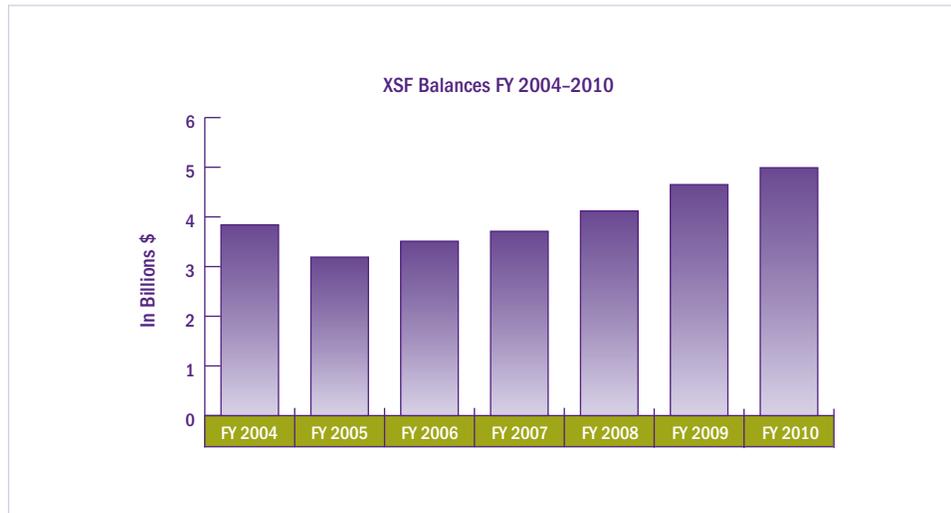
<sup>16</sup> IRS response to TAS information request (July 14, 2011).

<sup>17</sup> IRM 3.17.220.1 (Jan. 1, 2011); IRM 2.3.45.1 (Jan. 1, 2003).

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**FIGURE 1.19.1, Growth in the Excess Collection File (FY 2004–FY 2010)<sup>18</sup>**



The 2010 balance of almost five billion dollars is the result of steady increases of between five and 13 percent each year for each of the past five years.

Table 1.19.2 below reflects the composition of the XSF account as of October 2003, in terms of tax modules and dollars, based on data obtained by TIGTA.<sup>19</sup>

**TABLE 1.19.2, Dollars by Tax Module in the XSF as of October 2003**

Tax Module Ranges <sup>20</sup>	Modules	Dollars <sup>21</sup>
\$25,000 - \$49,999	5,109	\$ 173,517,277
\$50,000 - \$99,999	2,080	\$ 140,909,261
\$100,000 - \$249,999	1,006	\$ 148,385,202
\$250,000 - \$499,999	302	\$ 104,902,076
\$500,000 - \$999,999	118	\$ 79,353,674
\$1,000,000 and over	96	\$ 1,019,593,411
<b>Total</b>	<b>8,711</b>	<b>\$ 1,666,660,901</b>

Source: Data extract obtained by TIGTA as of October 2003.

<sup>18</sup> Based on URF 60 (XSF) File Analysis Reports (Accounts 6800 and 9999) FY 2004 through FY 2010, IRS response to TAS information request (July 14, 2011). TAS requested data from 2001 to parallel the years described in TIGTA reports, but the IRS responded that it cannot provide data earlier than FY 2004 without a Uniform Work Request.

<sup>19</sup> TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution 8* (Jan. 2005).

<sup>20</sup> The designation "Tax Module Ranges" refers to the amounts of credits transferred in a specific tax year.

<sup>21</sup> All figures are rounded. TIGTA did not report on tax modules of less than \$25,000.

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As Table 1.19.2 shows, most tax *modules* with credits transferred to XSF were in the \$25,000-\$49,999 range, and if we leave aside cases involving credits of one million dollars or more, these “small dollar” cases represented the single greatest category of *dollars* transferred to the XSF.

The IRS is unable to show amounts in the XSF account broken down into \$5,000 increments, but it did provide data about “open” XSF cases (*i.e.*, credits transferred to XSF within the last three years). If these credits were erroneously transferred before the RSED expired, the IRS might be able to refund them to taxpayers.<sup>22</sup> Open cases account for about one percent of the total credits in XSF.<sup>23</sup> An analysis of open cases shows that the lower the amount transferred to the XSF, the more often the taxpayer is low income. Moreover, the data shows that almost all transfers are of “*small-dollar*” amounts, and suggests that *more than half* are associated with *low income taxpayers*, as shown in the following table.

**TABLE 1.19.3, Credits in XSF That Were Transferred From 2007-2010 From Low Income Taxpayers<sup>24</sup>**

Credits Range	Income of 250% of Poverty Threshold or Less		
	Total	Count	% of Total
\$0 to \$250	20,588	13,476	65.46
\$251 to \$500	7,247	4,738	65.36
\$501 to \$750	3,298	1,949	59.10
\$751 to \$1,000	2,309	1,329	57.56
\$1,001 to \$2,000	4,081	2,094	51.31
\$2,001 to \$3,000	1,713	843	49.21
\$3,001 to \$4,000	730	280	38.36
\$4,001 to \$5,000	542	211	38.93
\$5,001 to \$50,000	1,351	369	27.31
\$50,001 to \$100,000	35	9	25.71
Over \$100,000	25	10	40.00
<b>Total</b>	<b>41,919</b>	<b>25,308</b>	<b>60.37</b>

Source: IRS URF4501 Part 3 Reports FY 2007-2010, Account Receivable XSF/Open Report for Month Ending 9/30.

<sup>22</sup> See IRM 3.17.220.2.15 (Jan. 1, 2011). In 2005, TIGTA reported that 65 percent of the transfers in cases it reviewed resulted from employee errors that could have been avoided with increased managerial oversight, additional account research, and taxpayer contact. In an earlier audit, TIGTA reported that the number of XSF cases with outstanding liabilities was nearly equally divided between erroneous adjustments and transfers that were made because taxpayers failed to file returns or request a refund before the RSED expired. TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File Could Improve Case Resolution 1* (Jan. 2005); TIGTA, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collections Accounts Could Be Credited to Taxpayers 3, 4* (June 2000).

<sup>23</sup> Conference calls with IRS XSF Subject Matter Experts (Aug. 30, 2011, and Sept. 28, 2011).

<sup>24</sup> TAS Research. The table describes the 41,919 open cases in the URF4501 Part 3 Report from 2007 to 2010 for which TAS was able to determine the amount of the taxpayer's total positive income from a filed Form 1040. TAS was able to determine the income of a taxpayer with an open case, where the taxpayer identification number is identified, about 52 percent of the time. The count column identifies taxpayers whose total positive income was less than or equal to 250 percent of the U.S. weighted average poverty threshold by family size, by year of their income. Total positive income (TPI) is the sum of Non-Business TPI, Business Income (positive Schedule C amounts), and Farm Income (positive Schedule F amounts). Only total positive values from the income fields listed are used. Income fields are (a) Wages, (b) Interest, (c) Dividends, (d) Other Income, (e) Distributions, (f) Schedule-C Net Profits, (g) Schedule-F Net Profits. Losses are treated as a zero.

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The Department of Health and Human Services issues annual poverty guidelines that are used to determine financial eligibility for certain federal programs, including the low income taxpayer clinic (LITC) program.<sup>25</sup> According to IRC § 7526(b)(1)(B), taxpayers with income of less than 250 percent of the poverty level (*i.e.*, less than \$27,075 in 2009) were low income taxpayers for purposes of qualifying for LITC assistance. Table 1.19.3 (above) shows that taxpayers with annual income of less than 250 percent of the poverty level (*i.e.*, low income taxpayers) accounted for 60 percent of the open cases in the XSF. Almost all of the open cases are transfers of less than \$5,000.<sup>26</sup>

**Personal Contact with Taxpayers Prevents Transfers to the XSF, but the IRS Reserves Enhanced Procedures for Locating and Contacting Taxpayers for High-Dollar Cases.**

In January 2004, the IRS commissioned the Excess Collection Task Group (XSFTG) to evaluate TIGTA's findings. In 2006, the group reported that early intervention with non-filers could be key to reducing return-filing delinquencies and transfers to the XSF.<sup>27</sup> The report also described an earlier IRS study involving large-dollar cases (where the credit was \$100,000 or more) which revealed that where the IRS takes minimal research steps, it locates taxpayers, brings them into filing compliance, and resolves payments that otherwise would be destined for the XSF.<sup>28</sup> In 2006, the National Taxpayer Advocate recommended the IRS extend the same treatment to small-dollar cases, noting:

From a taxpayer-focused point of view, the need for a \$1,000 refund to a low or middle income taxpayer is as great as (and possibly even greater than) a refund of \$100,000 for a Fortune 500 company. Accordingly, we believe the IRS should provide this same service to all taxpayers, regardless of the dollar amount.<sup>29</sup>

In response, the IRS conducted a study and in 2009 found the results “warrant a recommendation that the large dollar process be expanded for all credit balance accounts.” The study found that no additional staffing would be required to work smaller-dollar accounts nationwide and that applying the credit rather than transferring it to XSF meant expending fewer resources on subsequent notices and staff time.<sup>30</sup> For taxpayers, personal contact resulting from enhanced research could mean another chance to become compliant and fewer dollars lost to expiring RSEDs. Especially in view of TAS's analysis showing that

<sup>25</sup> See Dept. of Health and Human Services, Annual Update of the Poverty Guidelines, 73 Fed. Reg. 4199 (Jan. 23, 2009), available at <http://aspe.hhs.gov/poverty/09fedreg.shtml>. For example, under the guidelines, the 2009 poverty level for a single person was \$10,830.

<sup>26</sup> Only 1,411 (1,351+35+25) out of 41,919 transfers (three percent) were for more than \$5,000.

<sup>27</sup> IRS, *Excess Collection Task Group Report 2*, 7 (Mar. 6, 2006).

<sup>28</sup> *Id.* at 7, 8 (Mar. 6, 2006). The 2005 TIGTA report had arrived at the same conclusion. TIGTA, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collection File could Improve Case Resolution* 3, 5, 6 (Jan. 2005).

<sup>29</sup> National Taxpayer Advocate 2006 Annual Report to Congress 166. The IRS initially rejected this recommendation, citing preliminary results from a sample study pointing to a decrease in employee productivity and less favorable results than experienced with large-dollar cases. Joint Audit Management Enterprise System (JAMES), 2006 Annual Report to Congress Scorecard.

<sup>30</sup> IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress 2*, 4 (Apr. 22, 2009), on file with TAS.

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open XSF cases are likely to involve a small-dollar transfer from a low income taxpayer, the IRS should implement its own recommendation.

### **IRS Guidance and Oversight Are Insufficient for Handling XSF Transactions.**

In 2001, IRS managers told TIGTA that employees were not trained to apply credits properly to a taxpayer's account and that the IRS had not established performance measures or program goals to monitor XSF activity.<sup>31</sup> In the 2006 Annual Report to Congress, the National Taxpayer Advocate discussed the lack of clarity regarding the research procedures required to verify that an RSED had expired prior to transferring credits to the XSF.<sup>32</sup> The research procedures range from requiring virtually no research to requiring verification that the refund period has expired to simply noting that detailed analysis "may be required" and that "[i]f the taxpayer has been injured because of IRS action or failure to act, his/her rights may be restored."<sup>33</sup> Despite concerns the National Taxpayer Advocate raised five years ago, the IRS has yet to clarify its conflicting instructions or establish written XSF procedures for its Criminal Investigation function, as it committed to do by August 1, 2007, in its formal response to the 2006 Annual Report.<sup>34</sup>

Even where a taxpayer makes a claim for a refund (which should prevent a transfer to the XSF account), a transfer may nonetheless occur if the claim is informal and IRS employees do not recognize its validity. The IRS's Office of Chief Counsel advises that a taxpayer's attempts to dispute the underlying invalid assessment, coupled with the IRS's record of the dispute, constitute a valid informal claim.<sup>35</sup> The IRS could reduce the number of improper transfers to the XSF by training employees to recognize, develop, and resolve the underlying issues in XSF cases, such as RSED determinations, and to recognize and handle informal claims.

## **CONCLUSION**

Despite numerous recommendations from TAS and TIGTA over the past 11 years, as well as the IRS's own efforts to reduce the balance in the XSF account, the fund continues to grow. Oversight and proper application of taxpayer payments and credits is a fiduciary trust that

<sup>31</sup> TIGTA, Ref. No. 2001-30-124, *Increased Oversight Is Needed to Ensure Taxpayers Receive Credit for Millions of Dollars in Excess Collections Accounts* 5 (July 2001).

<sup>32</sup> National Taxpayer Advocate 2006 Annual Report to Congress 164, 547-548.

<sup>33</sup> Compare IRM 3.17.220.1.5(2) (Jan. 1, 2011) with IRM 3.17.220.2.2(4)-(6) (Jan. 1, 2011) and IRM 3.17.220.2.7.1.1.1(1) (Jan. 1, 2011).

<sup>34</sup> JAMES, 2006 Annual Report to Congress Report Card; IRS response to TAS information request (July 21, 2011).

<sup>35</sup> IRS, Office of Chief Counsel Memorandum, POSTF-129756-10 (Aug. 19, 2010) (current IRS procedure is to allow a refund if a written product created by IRS personnel sufficiently details an oral claim for refund); IRM 4.90.7.2 (June 30, 2007); IRM 25.6.1.10.2.6.3 (Oct. 1, 2007). A formal claim is a request for refund that identifies the tax years and provides sufficient detail to establish the basis for the claim. Taxpayers would typically use IRS Forms 843, 1040X, or 1120X to make a formal claim of refund that was not claimed on an original return. An informal claim is a request that does not meet all of the statutory requirements of a formal claim, but is perfected at a later date. See *U.S. v. Kales*, 314 U.S. 186 (1941); *Newton v. U.S.*, 163 F. Supp. 614 Ct. Cl. (1958). Claims for refund must be in writing. However, the Court of Federal Claims has held that a contemporaneous writing created by IRS personnel from a taxpayer's oral statements may satisfy the written component of the claim. See *New England Elec. System v. U.S.*, 32 Fed. Cl. 636 (1995). Current IRS policy is that whenever a claim provides the necessary information, whether formal or informal, it is handled as a valid claim for refund. IRS, Office of Chief Counsel Memorandum, POSTF-129756-10 (Aug. 19, 2010).

the IRS should take seriously. The IRS's inability to resolve credits in a timely fashion creates unnecessary taxpayer burden, impedes taxpayers from obtaining their rightful refunds, and ultimately can erode taxpayers' confidence in the system. The problem is amplified by the IRS's policy of only employing enhanced research procedures to resolve high-dollar transfers, because most transfers are for less than \$5,000 and more than half are associated with low income taxpayers. The National Taxpayer Advocate offers these preliminary recommendations for improving the XSF:

1. Require use of the same enhanced procedures to locate and contact taxpayers currently in place for large-dollar credits for all accounts destined for transfer to the XSF.
2. Clarify IRM requirements for researching statute-expired credits and handling informal claims.
3. Develop additional guidance to prevent overpayments resulting from a levy from causing transfers to the XSF.
4. Train employees to determine RSEDs accurately and to recognize and properly handle informal claims.
5. Establish performance goals and measures for the overall XSF process and require each affected operating division to report on its own specific XSF activities, including the dollar amount it transferred to XSF, in each of its quarterly Business Performance Reports.
6. Implement and publish XSF procedures for the Criminal Investigation function.
7. Establish an XSF indicator on the entity module that will appear in response to general IDRS command codes (*e.g.*, ENMOD, INOLE, SUMRY, or IMFOL) to alert employees to the amounts and years of XSF transfers without having to access specific tax modules, and train employees to discuss XSF transfers with taxpayers.

## IRS COMMENTS

The IRS developed the IRS Excess Collection File to contain receipts that cannot be identified or applied. Two general ledger accounts, 6800 and 9999, were established to separate these files from the receipts that can be identified and applied to the appropriate accounts. Account 6800 is used for credits initially transferred to the XSF. This file rolls up into Account 9999, Revenue Clearance Accountability, at fiscal year end. Any unapplied credits will remain in the XSF file for up to seven years from the received date of the payment/credit. The IRS does not use the income level of taxpayers to determine what funds are transferred into XSF.

There are several situations that result in a transfer of credits to the XSF. The more common reasons include:

- Unidentified Remittances, which are payments where the IRS is unable to determine the appropriate account to which the payment applies that are under one year old.

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- Expiration of the refund or assessment statute of limitations, which then precludes the IRS from applying or refunding any payments made on a taxpayer account.
- Payment or credit for which there is no return filed or the IRS is unable to locate or secure a return within the Statute of Limitations (for refunds).

There are also instances, such as bankruptcy or a wrongful levy, when the credit cannot legally be applied. These credits must be placed in the XSF. In addition, credits related to cases in which the Refund Statute Expiration Date or Assessment Statute Expiration Date has expired are placed in the XSF. If the credit is placed in the XSF file for legal reasons, no further action is taken.

The IRS has developed and made improvements to the system of controls to ensure taxpayer's payments and credits are identified and properly applied. This includes generating transcripts for certain freeze conditions and sending notices to the taxpayer as a follow up. Further, in response to recommendations by TAS and TIGTA, the IRS has established procedures that require additional taxpayer contact and managerial oversight, and apply XSF account indicators for identification. The IRS also assembled a task force for further review. Additional training has been provided to employees and IRM provisions have been revised to clarify instructions and documentation requirements.

- IRM 3.17.220, *Excess Collections File*
- IRM 25.6.1, *Statute of Limitations Processes and Procedures*
- IRM 21.2.4, *Master File Accounts Maintenance*

After the first year, open XSF cases are assigned to a tax examiner and worked for resolution. A listing of unresolved "open" cases is generated and worked every six months by researching for new or additional information available for follow up with the taxpayer. If the payment or credit continues to be unidentified or the taxpayer does not claim the credit, it remains in XSF. Whenever a payment or credit can be reapplied to the taxpayer's account, the originator notifies XSF personnel who will reapply the amount to the taxpayer's account.

We will consider opportunities to enhance our processes in this area. Comments on the preliminary recommendations are below.

The IRS agrees to conduct a study of the XSF file open cases that have smaller dollar credits to determine if the enhanced procedures and additional research needed to locate and contact taxpayers proves to be beneficial and cost effective. The study will include a process for differentiating and quantifying valid credits from invalid credits. Invalid credits would include unsubstantiated credits transferred to the XSF as a result of pre-refund intervention processes. Based on the findings the IRS will consider implementation of additional efforts on these cases.

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The IRS agrees with clarifying IRM requirements in this area. We plan to review the following IRMs and identify any areas where clarification is necessary and take action to rewrite the provisions:

- IRM 3.17.220, *Excess Collections File*
- IRM 21.2.4, *Master File Accounts Maintenance*
- IRM 21.5.3.2, *What are Claims for Credit, Refund, and Abatement?*
- IRM 25.6.1, *Statute of Limitations Processes and Procedures*
- IRM 25.6.1.7.2, *Time When Payments and Credits are Considered to be Made*
- IRM 25.6.1.10.2.6.3, *Informal Claims*

The IRS questions whether additional guidance regarding the offset of levy proceeds is necessary. Under IRC § 6402(a), levy proceeds received in excess may be applied to liabilities not listed on the levy. Once the levy proceeds post to the account paying the account in full, the excess will be refunded unless someone places a hold on the account or the excess proceeds are offset to another account that is cross-referenced to the taxpayer.

With respect to training, the IRS continually seeks opportunities to improve training and we will take steps in this area. Course 34002, *Statute Awareness*, includes a lesson for determining the RSED and is mandatory for Accounts Management Continuing Professional Education in 2012. Course 34002, *Statute Awareness Lesson 2, Refund Statute Expiration Date (RSED)*, contains examples and procedures for determining the RSED accurately. The IRS anticipates including a lesson for addressing and properly handling informal claims in FY2013.

Subject to available data and resources, we will consider the development of specific reports by business division that could be used to ensure upstream processes are functioning properly so credits are correctly sent to the XSF.

Regarding the recommendation to publish procedures for the Criminal Investigation function, a reorganization occurred in 2009 moving the CI function, which performed account adjustment work on individual returns, to the Wage & Investment organization. That operation is now under the Accounts Management Taxpayer Assurance Program (AMTAP), which follows procedures in IRM 3.17.220.2.2 for transferring credits to the XSF. As stated above, we will review IRM 3.17.220 to determine if additional clarification is needed.

We will consider the recommendation to establish an XSF indicator on the entity module in the future that would assist the customer service representative in providing the correct information to the taxpayer on a credit that may no longer be available to them. Note that this would necessitate an extensive system change that would require prioritization based on capacity issues and the availability of resources.

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## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for its commitment to improve its administration of the XSF. We are encouraged by plans to train employees to make accurate RSED determinations (slated for delivery in FY 2012), and to develop new training that will equip employees to protect taxpayers by identifying and properly handling informal claims for refund (slated for development in FY 2013). We ask that the IRS share both of these trainings with TAS in advance so that we may make suggestions for improvement, where warranted.

We are pleased that the IRS agrees it needs greater clarity in existing IRM guidance, and that it will consider developing performance reports for each operating division to monitor XSF activity. We are also pleased that the IRS will consider requiring an XSF indicator on the entity module, which will enable customer service representatives to inform taxpayers of expiring RSEDs, guide them in submitting claims for refund, and prevent payments and credits from being lost. Despite the reprogramming this change may require, it will save significant IRS rework and prevent serious harm to taxpayers, and should be undertaken as soon as possible—we are holding the taxpayer's money, after all.

In addressing the National Taxpayer Advocate's concern that the IRS makes disproportionately little effort to prevent transfers from low income taxpayers, the IRS points out that it does not base decisions to transfer credits on the amount of income. The National Taxpayer Advocate does not believe that the IRS singles out low income taxpayers for transfer of credits to XSF. However, transferring a credit belonging to a low income taxpayer to the XSF has a disproportionate economic impact compared to transferring the same amount belonging to a higher-income taxpayer. We welcome the IRS's commitment to include, in a study of small-dollar cases, a process for differentiating and quantifying valid credits from invalid ones. However, we would reiterate that in 2009, the IRS's own experts recommended expanding the procedures to locate and contact taxpayers in large-dollar cases to low-dollar cases as well, finding that no additional IRS resources would be needed.<sup>36</sup> Accordingly, the National Taxpayer Advocate urges the IRS to implement the recommendation of its experts without delay.

The IRS questions whether it needs additional guidance regarding the offset of levy proceeds, noting, "levy proceeds received in excess may be applied to liabilities not listed on the levy."<sup>37</sup> However, the IRS fails to mention its statutory obligation to release levies promptly,<sup>38</sup> and as the National Taxpayer Advocate noted in her 2006 Annual Report to Congress:

<sup>36</sup> IRS, *Report on Excess Collections Most Serious Problem Identified in 2006 National Taxpayer Advocate Report to Congress* 2, 4 (Apr. 22, 2009), on file with TAS.

<sup>37</sup> IRC § 6342(b) provides that "any surplus proceeds...shall...be credited or refunded...to the person or persons legally entitled thereto."

<sup>38</sup> IRC § 6343(a)(1)(A) requires the IRS to release a levy "the liability for which such levy was made is satisfied."

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

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TAS has identified situations where the IRS did not follow its published guidance and continued to offset overpayments against liabilities without issuing additional levies. These offsets were not one-time occurrences but were situations where the IRS applied levy payments for two to three years or longer. In many cases, the taxpayer may not have been notified of the application since current procedures require no personal contact or correspondence. The application of such payments to a module not listed on the original levy is of particular concern to the National Taxpayer Advocate because the taxpayer may not have received a CDP notice or other recent notice for this additional collection activity.<sup>39</sup>

TAS recently witnessed the harm the IRS can cause when it fails to release a levy promptly (i.e., after the liabilities subject to the levy have been fully paid), applies excess levy proceeds to a liability not listed on the levy, and then transfers the funds to the XSF. If the IRS applies excess levy proceeds to a liability assessed under its substitute for return (SFR) authority without fulfilling its statutory requirement to notify the taxpayer of the offset, the taxpayer may not be aware of the account activity for the SFR year. The taxpayer may later file a delinquent return showing a lesser tax liability than the SFR assessment, which the IRS may accept and reduce the liability. The taxpayer will not be able to recover any of the overpayments resulting from the offset if the statutory period for requesting a refund has expired. The IRS would be required to transfer the funds, which the taxpayer did not owe, and which the IRS should never have collected, to the XSF. Additional guidance that alerts employees to this possibility could help prevent this unnecessary burden on taxpayers.

In 2007, the IRS agreed to establish written XSF procedures for its Criminal Investigation function by August 1, 2007.<sup>40</sup> The IRS points out that in 2009 it merged the criminal investigation adjustment work on individual returns into the Accounts Management Taxpayer Assurance Program, which adheres to the XSF transfer procedures in IRM 3.17.220.2.2. TAS reviewed the IRM, including IRM 3.17.220.2.2, but found no reference to the reorganization, no AMTAP procedures, and no source code for tracking criminal investigation XSF activity. The IRS indicates that it plans to review the IRM to determine if it needs further clarification.

<sup>39</sup> National Taxpayer Advocate 2006 Annual Report to Congress 121. Moreover, TAS identified instances in which the IRS transferred excess levy proceeds directly to the XSF rather than refunding them to the taxpayers. *Id.* at 161-162.

<sup>40</sup> JAMES, 2006 Annual Report to Congress Report Card; IRS response to TAS information request (July 21, 2011).

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## Recommendations

To improve the administration of the XSF, the National Taxpayer Advocate recommends that the IRS:

1. Require use of the same enhanced procedures to locate and contact taxpayers currently in place for large-dollar credits for all accounts destined for transfer to the XSF.
2. Develop additional guidance to prevent overpayments resulting from a levy from causing transfers to the XSF.
3. Establish performance goals and measures for the overall XSF process.
4. Require each affected operating division to report on its own specific XSF activities, including the dollar amount it transferred to XSF, in each of its quarterly Business Performance Reports.
5. Implement and publish XSF procedures for criminal investigation work, whether carried out by the CI function or by another IRS function.
6. Establish an XSF indicator on the entity module that will appear in response to general IDRS command codes (*e.g.*, ENMOD, INOLE, SUMRY, or IMFOL) to alert employees to the amounts and years of XSF transfers without having to access specific tax modules.
7. Train employees to discuss XSF transfers with taxpayers.

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

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**DEFINITION OF PROBLEM**

The IRS is required by the Freedom of Information Act (FOIA) to disclose all “instructions to staff that affect a member of the public,” unless an exemption applies.<sup>1</sup> It does not always consistently and timely do so.<sup>2</sup> This deprives taxpayers and their representatives of information that could help them prevent or resolve tax problems and disputes; leaves them uncertain about whether they can rely on information from IRS employees; increases the risk the IRS will act or be perceived as acting arbitrarily and inconsistently; and deprives the IRS of valuable comments from stakeholders that could improve its procedures.

When the IRS fails to make guidance available to the public, it often fails to vet (or “clear”) the guidance as well. While we understand the IRS often needs to proceed quickly, such shortcuts can result in ill-advised guidance and procedures that, in some cases, violate the law. The primary problems are that the IRS:

- Sometimes establishes or changes procedures by issuing memos or using an internal system called SERP (the Servicewide Electronic Research Program) without making the new or updated procedures available to the public;<sup>3</sup>

<sup>1</sup> See generally 5 U.S.C. § 552.

<sup>2</sup> For a discussion of IRS transparency, see National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*); National Taxpayer Advocate 2008 Objectives Report to Congress xxi-xxvii (*Update on Transparency of the IRS*); and National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*). As discussed below, the IRS has made significant improvements since our last report.

<sup>3</sup> These documents may include “interim guidance memos” (IGMs) or “interim procedural updates” (IPUs), as discussed below.

- Sometimes changes procedures without writing them down or by issuing SERP “alerts”—notices that appear only on the internal SERP system—that sidestep the normal clearance and disclosure process;<sup>4</sup>
- Has no procedure for clearing frequently asked questions (FAQs) posted on its website; and
- Does not disclose instructions to computers (called “functional specifications”). Thus, the IRS will become less transparent as computers replace employees, and undisclosed and uncleared instructions to computers replace disclosed and cleared instructions to employees.

In addition, decentralized responsibility for disclosure, problems with decision-making tools, and a lack of oversight, accountability, and training may exacerbate the IRS's FOIA compliance challenges, as follows.

- At the end of fiscal year (FY) 2010, the Internal Revenue Manual (IRM) contained 1,923 sections written by approximately 646 authors, whose FOIA determinations were subject to little oversight;<sup>5</sup>
- Although the IRS has automated decision-making tools to help authors determine if items should be disclosed and is taking steps to improve them, these tools could lead to under-disclosure;
- The IRS does not require all authors to attend FOIA training; and
- No single IRS function regularly measures or is responsible for the accuracy of the authors' FOIA or clearance determinations.

While it is difficult to ascertain the extent to which IRS authors improperly fail to disclose and clear instructions to staff, this difficulty stems from the IRS's failure to measure compliance. Moreover, the lapses described below occurred over a short period, suggesting the IRS should do more to evaluate and address the problem.

## ANALYSIS OF PROBLEM

### Background

#### *The Freedom of Information Act*

The Freedom of Information Act requires the IRS to make available to the public all “administrative staff manuals and instructions to staff that affect a member of the public,” unless an exemption applies.<sup>6</sup> Exemptions apply to instructions that: (1) “could reasonably

<sup>4</sup> SERP “alerts” are not subject to the clearance or disclosure process because they are not supposed to be used for issuing new procedures. See, e.g., IRM 1.11.8.7.2 (Jan. 3, 2011).

<sup>5</sup> Response to TAS information request (June 24, 2011).

<sup>6</sup> See 5 U.S.C. § 552(a)(2)(C). FOIA requires the agencies to disclose of a wide variety of materials, but this discussion focuses primarily on the requirement to disclose “staff manuals” and “instructions to staff.”

be expected to risk circumvention of the law,” or (2) are “related solely to internal personnel rules and practices.”<sup>7</sup> Amendments adopted in 1996 (called E-FOIA), require agencies to make items available electronically (*e.g.*, on the Internet).<sup>8</sup> The President recently committed to “an unprecedented level of openness in Government,” directing agencies to “adopt a presumption in favor of disclosure” and “take affirmative steps to make information public,” using modern technology to do so “timely.”<sup>9</sup> The Office of Management and Budget (OMB) and Department of Justice (DOJ) issued similar directives.<sup>10</sup>

In seeking to comply with E-FOIA and these directives, the IRS posts both the IRM and other non-exempt “instructions to staff” to its Electronic Reading Room (ERR), on the IRS.gov website.<sup>11</sup> If an item is not properly posted and indexed, it may not be “relied on, used, or cited as precedent” by the IRS against a taxpayer unless the taxpayer has actual and timely notice of its terms.<sup>12</sup> Accordingly, items should be indexed or at least organized in a logical manner on the ERR, rather than other parts of IRS.gov.

***Disclosing guidance allows it to be vetted, encourages comments from stakeholders, and helps taxpayers obtain consistent and fair results.***

As discussed in prior reports, if the IRS knows it will be posting its instructions to staff on the ERR, this sunshine provides an incentive for the IRS to develop reasonable instructions and vet them, incorporating comments from internal and external stakeholders.<sup>13</sup> Posting items also helps IRS employees identify and follow applicable procedures, promotes consistency, helps taxpayers and their representatives resolve tax problems and disputes with the IRS, and often prompts the public, or internal stakeholders (including TAS), to submit comments, which help the IRS improve its procedures.<sup>14</sup>

<sup>7</sup> 5 U.S.C §§ 552(b)(7)(E) and (b)(2). See also IRM 1.11.1.3.1.2.1 (Sept. 4, 2009).

<sup>8</sup> Electronic Freedom of Information Act Amendments of 1996, Pub. L. No. 104-231, § 4, 110 Stat. 3048 (Oct. 2, 1996).

<sup>9</sup> President of the United States, *Memorandum on Transparency and Open Government* (Jan. 21, 2009), [http://www.whitehouse.gov/the\\_press\\_office/Transparency\\_and\\_Open\\_Government/](http://www.whitehouse.gov/the_press_office/Transparency_and_Open_Government/); President of the United States, *Memorandum on the Freedom of Information Act* (Jan. 21, 2009), <http://www.gpo.gov/fdsys/pkg/FR-2009-01-26/pdf/E9-1773.pdf>.

<sup>10</sup> Office of Management and Budget (OMB), *Memorandum on Open Government Directive* (Dec. 8, 2009), <http://www.whitehouse.gov/open/documents/open-government-directive>; The Attorney General, *Freedom of Information Act* (Mar. 19, 2009), <http://www.justice.gov/ag/foia-memo-march2009.pdf>.

<sup>11</sup> The Electronic Reading Room is at <http://www.irs.gov/foia/article/0,,id=110353,00.html>. If material is not properly referenced, or is on the IRS website but omitted from the ERR, it may still be difficult for taxpayers to find. Perhaps for this reason, FOIA requires the material to be indexed. See 5 U.S.C. § 552(a)(2)(flush).

<sup>12</sup> See 5 U.S.C. § 552(a)(2)(flush) (emphasis added).

<sup>13</sup> The public notice and comment rulemaking process produces similar benefits. See 5 U.S.C. § 553. For this reason, courts give greater deference to regulations that have been subject to notice and comment procedures. See, e.g., *Mayo Found. for Med. Educ. and Research v. U.S.*, 131 S. Ct. 704 (2011). In addition, TAS needs to be able to review all of the IRS's instructions to staff to be able to fulfill its statutory duty to “identify areas in which taxpayers have problems in dealings with the Internal Revenue Service [and]... propose changes in the administrative practices of the Internal Revenue Service to mitigate [these] problems,” as it does when items are subject to the clearance process and posted. IRC §§ 7803(c)(2)(A)(ii)-(iii). When the IRS is not following “published” administrative guidance, the National Taxpayer Advocate is also required to construe the factors taken into account in determining whether to issue a Taxpayer Assistance Order in the manner most favorable to the taxpayer. IRC § 7811(a)(3). For a legislative proposal to improve the National Taxpayer Advocate's ability to advocate for taxpayers in connection with published guidance, see *Codify the Authority of the National Taxpayer Advocate to File Amicus Briefs, Comment on Regulations, and Issue Taxpayer Advocate Directives*, *infra*.

<sup>14</sup> Even the Regulatory and Policy Division of the Organization for Economic Co-operation and Development (OECD) has noted that to improve regulation, member countries should “[E]nsure that administrative procedures for applying regulations and regulatory decisions are transparent...”. See *OECD Guiding Principles on Regulatory Quality and Performance* 5 (Apr. 25, 2005), <http://www.oecd.org/dataoecd/24/6/34976533.pdf>.

*The IRS has procedures for clearing and disclosing “staff manuals” and certain “instructions to staff.”***THE IRM IS CLEARED AND POSTED TO IRS.GOV.**

The IRM states that “[I]nstructions to staff found in other sources should be incorporated into the IRM,” making it the single “official source of IRS instructions to staff.”<sup>15</sup> If all instructions to staff were, in fact, immediately incorporated into the official IRM, IRS compliance with E-FOIA would be relatively easy because each time an IRM is updated, the IRS’s Media and Publications function posts it to the ERR.<sup>16</sup>

However, the IRS often needs to distribute new instructions to staff before it can incorporate them into the official IRM. IRS program owners are supposed to “clear” substantial changes to the official IRM with other affected IRS functions, and in some cases with “specialized reviewers,” such as the IRS Office of Chief Counsel and the Taxpayer Advocate Service (TAS).<sup>17</sup> This clearance process is very important because it improves the quality of these instructions and helps to prevent the IRS from adopting procedures that unnecessarily burden taxpayers, are illegal, or simply ill-advised. It took the IRS 84 days, on average, to clear an IRM in FY 2010.<sup>18</sup>

**TWO TYPES OF “INTERIM GUIDANCE” ARE CLEARED AND POSTED TO IRS.GOV.**

If IRS program managers need to issue guidance between IRM revisions, they can issue “interim guidance,” which is supposed to be cleared in less than 30 days.<sup>19</sup> Interim guidance can take the form of “interim guidance memos” (IGMs) or “interim procedural updates” (IPUs).<sup>20</sup> IGMs are memos that generally make changes to procedures described in the IRM.<sup>21</sup> An IPU is a change to the IRM that is immediately reflected in an unofficial version of the IRM maintained on an *internal* IRS system called the SERP. The IRS also uses the term IPU to refer to a separate document that either (1) contains the specific change to the SERP IRM, or (2) summarizes the change.<sup>22</sup> In other words, unlike IGMs, which always contain the specific updated instructions to staff, IPUs sometimes only summarize changes,

<sup>15</sup> IRM 1.11.2.2 (May 4, 2010).

<sup>16</sup> See IRM 1.11.10.6 (Sept. 4, 2009).

<sup>17</sup> See *generally* IRM 1.11.9.3 (Dec. 28, 2010); IRM 1.11.9.4 (Dec. 28, 2010). Changes to working conditions of “Bargaining Unit” employees are reviewed by the Office of Workforce Relations, which is also a specialized reviewer. IRM 1.11.9.4.4 (Sept. 4, 2009). Accordingly, such changes may require “impact and implementation” negotiations with the National Treasury Employees Union (NTEU) before they can be implemented. *Id.*; IRM 6.711.1.6 (Oct. 15, 2010).

<sup>18</sup> Response to TAS information request (June 24, 2011). The normal clearance process is supposed to take 30 to 60 days. IRM 1.11.1.7 (Apr. 29, 2008); IRM 1.11.9.6.2 (Sept. 4, 2009).

<sup>19</sup> IRM 1.11.10.5.2 (Sept. 4, 2009). Pursuant to expedited procedures, the IRM clearance process itself could be completed in less than 30 days. IRM 1.11.9.6.3 (Sept. 4, 2009).

<sup>20</sup> The IRS does not have servicewide data regarding how long it takes to clear IGMs or IPUs. Response to TAS information request (June 24, 2011).

<sup>21</sup> IRM 1.11.10.3 (Sept. 4, 2009).

<sup>22</sup> See, e.g., IRM 1.11.6.4.3 (May 7, 2010). Changes are reflected on SERP within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011).

the actual text of which appears only in the internal SERP IRM.<sup>23</sup> The IRS typically incorporates SERP IRM changes and IGMs into the official IRM the next time it is updated for the ERR, which could be more than a year later.<sup>24</sup> Thus, if the IRS did not disclose IGMs and IPU, the public would have no way to know what procedures the IRS was following during that period.

While the IRS has long been posting IGMs to the ERR, in 2010, it also began posting IPU.<sup>25</sup> Because IPU sometimes only provide a summary of the change, however, posting the IPU does not always provide the same level of transparency as posting IGMs.

### **The IRS has improved its transparency.**

The IRS has taken significant steps to improve its transparency since the National Taxpayer Advocate discussed the issue in her 2006 Annual Report.<sup>26</sup> It has improved internal guidance to eliminate erroneous references to a so-called “local guidance” exception to FOIA.<sup>27</sup> It has also incorporated instructions to staff from the formerly-separate and undisclosed Law Enforcement Manuals (LEMs) into appropriate IRMs. This allows taxpayers greater access to LEM information that does not need to be redacted.<sup>28</sup> In 2010, the IRS also began posting IPU to the ERR, as discussed above.<sup>29</sup> Finally, on September 22, 2011, the IRS improved the analytical tools that help IRS employees make disclosure decisions, incorporating some of the suggestions offered by TAS and IRS Counsel.<sup>30</sup>

### **Despite progress, challenges remain.**

#### *Decentralized responsibility for E-FOIA compliance remains a challenge.*

The Office of Servicewide Policy, Directives, and Electronic Research (SPDER) establishes procedures governing the IRM and other internal management documents (IMD), as well

<sup>23</sup> According to the Office of Servicewide Policy, Directives, and Electronic Research (SPDER) Annual Report, “[U]pdating the SERP IRM through SERP interim procedural updates (IPUs) risks compliance with FOIA requirements and creates multiple sources of guidance.” Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010).

<sup>24</sup> Each IRM author is supposed to review the IRM annually and must revise it to incorporate any changes. See, e.g., IRM 1.11.2.3 (Sept. 4, 2009).

<sup>25</sup> Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010). TAS previously recommended the IRS “ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov.” See National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*). While posting IPU is not the same as updating the public IRM, it is a significant step in the right direction. Once an IPU is issued, the IRS typically posts it to IRS.gov within seven days. Response to TAS information request (June 24, 2011).

<sup>26</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*) (recommending, among other things, that the IRS: eliminate or clarify the “local guidance” exception; post IRM and interim guidance that contain “official use only” information to the ERR in a redacted form; and ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov).

<sup>27</sup> See Response to TAS information request (Mar. 30, 2011) (“SPDER has revised its guidance and training to eliminate the ‘local guidance’ exception”). We remain concerned, however, that business units are still authorized to issue “local procedures” that are not required to be incorporated into the IRM and not subject to the normal clearance process. Response to TAS information request (June 24, 2011) (“Local procedures issued outside of the IRM are cleared according to internal business process. The business unit is responsible for disclosing the procedures to the public. See IRM 1.11.2”).

<sup>28</sup> Response to TAS information request (Mar. 30, 2011) (“In FY 2010, we incorporated content from Law Enforcement Manuals into the IRM as embedded ‘official use only’ information.”).

<sup>29</sup> Response to TAS information request (Mar. 30, 2011) (“Beginning in February 2010, SERP IPU meeting FOIA criteria have been posted to IRS.gov.”).

<sup>30</sup> The IRS continued to revise and improve the tool after this draft was finalized for IRS response.

as providing guidance on E-FOIA compliance.<sup>31</sup> However, each IRS program manager and author of “instructions to staff” is responsible for his or her own FOIA compliance.<sup>32</sup> At the end of FY 2010, the IRM contained 1,923 sections written by approximately 646 authors, whose E-FOIA determinations are subject to little oversight.<sup>33</sup> No single IRS function regularly measures or is responsible for the accuracy of the authors’ E-FOIA determinations.<sup>34</sup>

SPDER makes E-FOIA training available to authors, and IRS business units may develop their own training.<sup>35</sup> Technical specialists in the IRS Office of Disclosure are also available to answer E-FOIA questions. However, the IRS has no mandatory E-FOIA training for authors of instructions to staff.<sup>36</sup> As a result, some authors may not know about the requirement to post items to the ERR, and no particular IRS function is responsible for training the authors or identifying undisclosed materials that they should have posted.

*E-FOIA decision-making tools are helpful, but could lead to inconsistent interpretation and under-disclosure.*

To help authors identify instructions to staff that must be disclosed, the IRS has developed two decision-making tools, which pose relevant questions.<sup>37</sup> SPDER’s E-FOIA decision tool is available on the IRS’s intranet. A similar set of questions pops up when an author submits an IPU on SERP.<sup>38</sup> As noted above, the IRS updated (and mostly conformed) both tools on September 22, 2011. Except as otherwise indicated, the questions embedded in these tools as of July 12, 2011, and September 22, 2011, are shown in the table below.<sup>39</sup>

<sup>31</sup> See IRM 1.11.1.1 (Sept. 4, 2009).

<sup>32</sup> IRM 1.11.1.3.1.1 (Apr. 20, 2010); IRM 1.11.10.6 (Sept. 4, 2009).

<sup>33</sup> Response to TAS information request (June 24, 2011) (citing data from the ESN database, and stating that “[O]ne SPDER employee monitors the ERR for instructions to staff that are outdated and notifies the program owner. Compliance with the E-FOIA law is the responsibility of the program owners.”).

<sup>34</sup> Response to TAS information request (June 24, 2011) (indicating that “[A]ccuracy data are not available”).

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

<sup>36</sup> Response to TAS information request (June 24, 2011). The IRS could not provide the rate of turnover among IRM authors. *Id.*

<sup>37</sup> See, e.g., IRM 1.11.8.8.1.1 (Jan. 3, 2011) (SERP only); IRM 1.11.1.3.1.2.2 (Sept. 4, 2009).

<sup>38</sup> Use of the SERP decision tool became mandatory for IPU submissions on Feb. 1, 2010. SERP, New SERP IPU E-FOIA Training (2010). No similar questions appear when an author submits a “SERP alert” (described above).

<sup>39</sup> The IRS updated the SERP and SPDER tools on September 22, 2011. However, we have not removed our analysis of the prior versions of the tools because the versions that existed on July 12, 2011, may have contributed to the examples of under-disclosure we have identified. Moreover, the IRS may continue to update the tools in response to comments, potentially addressing some concerns while raising others. The September 22, 2011, versions have not addressed all of our concerns and we hope to continue working with the IRS to improve them.

**TABLE 1.20.1, SERP and SPDER E-FOIA Decision-Making Tools**

SERP (as of 7/12/2011)	SPDER (as of 7/12/2011)	SERP/SPDER (as of 9/22/2011)
<p>1. Does the change revise procedural guidance (instructions to staff)? [Y=continue; N=no disclosure].</p> <p><b>Procedural guidance:</b> Directions, guidelines, or standards used by employees in the performance of their assigned duties.</p> <p><b>Examples:</b> Changes to the criteria for accepting offers in compromise are procedural guidance. Changes to employee resources, guidelines relating to employee travel, closure of offices, or workplace information do not convey procedural instructions to employees for the performance of their assigned duties.</p>	<p>1. Does the document (e.g. memo) convey instructions to employees? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> The document provides directions, guidelines or standards used by employees in their assigned duties.</p> <p><b>Example:</b> An interim guidance memo issued by the Program Director, which revises the procedures for accepting offers in compromise is subject to E-FOIA. A memo to employees about the upcoming open benefit season, or office closure does not convey procedural instructions to employees in the performance of their assigned duties.</p>	<p>1. Does the guidance provide directions, guidelines or standards used by employees in their assigned duties? [Y=continue; N=no disclosure].</p> <p><b>SERP Directions:</b> To determine E-FOIA criteria, answer the following questions for each change identified on the SERP IRM Update (IPU). This decision tool applies to all types of Interim Guidance. The word "guidance" in each question refers to all types of Interim Guidance including Interim Guidance Memoranda, SERP IPU's or other approved types of Interim Guidance under IRM 1.11.10.2.3, Interim Guidance Format.</p> <p><b>SPDER Directions:</b> To determine E-FOIA criteria, answer the following questions for each change identified on the SERP IRM Update (IPU). This decision tool applies to all types of Interim Guidance. The word "guidance" in each question refers to all types of Interim Guidance including Interim Guidance Memoranda, SERP IPU's or other approved types of Interim Guidance under IRM 1.11.10.2.3, Interim Guidance Format.</p>
<p>2. Does the change restate procedures or guidance released to the public on IRS.gov in another format? [N=continue; Y=no disclosure].</p> <p><b>Definition:</b> The content in the SERP IRM Update is restated if it is already in an IRS document released to the public on IRS.gov, such as IRS News Release, IR Bulletin or in a published IRM on IRS.gov.</p> <p><b>E-FOIA Example:</b> Content in an SERP IRM Update is in an IRS News Release on IRS.gov.</p>	<p>2. Does the document restate procedures or guidance released to the public in another format? [N=continue; Y=no disclosure].</p> <p><b>Definition:</b> The content in the document is restated if it is available on IRS.gov.</p> <p><b>Example:</b> Memos conveying procedures or guidance already available in a published IRM on IRS.gov, an IRS News Release, or an Internal Revenue Bulletin are restatements.</p>	<p>2. Does the guidance affect how a member of the public files, pays, complies with their tax requirements or interacts with the Service? [Y=continue; N=no disclosure].</p> <p><b>Content that affects the public:</b></p> <ul style="list-style-type: none"> <li>■ New procedures revenue officers must follow prior to the seizure of a principal residence.</li> <li>■ Changes in the criteria for accepting offers in compromise.</li> <li>■ Changes to taxpayer documentation requirements for a refund trace.</li> </ul> <p><b>Content that does not affect the public:</b></p> <ul style="list-style-type: none"> <li>■ Internal administrative procedures, e.g., travel regulations, personnel guidance, or staffing.</li> <li>■ Internal processing instructions, such as internal coding, work assignment, or inventory.</li> <li>■ Content about building safety procedures.</li> </ul>

SERP (as of 7/12/2011)	SPDER (as of 7/12/2011)	SERP/SPDER (as of 9/22/2011)
<p>3. Does the change affect how the public files, pays, receives a refund, or complies with Federal income taxes? [Y=continue; N=no disclosure].</p> <p><b>E-FOIA Examples:</b> Changes to extensions to time to file a tax return would affect a member of the public. Changes to documentation needed for a refund trace would affect a member of the public.</p> <p><b>E-FOIA Exempt Examples:</b> Editorial changes where the revisions do not change the meaning of the content, do not affect a member of the public. Content relating to internal processing instructions, such as internal coding, work assignment, or inventory does not normally affect a member of the public.</p>	<p>3. Does the document affect a member of the public? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> If the content in the document affects how a member of the public files, pays, or complies with their tax requirements or interacts with the Service, then the document is considered to affect a member of the public.</p> <p><b>Example:</b> Content relating to internal administrative procedures, e.g., travel regulations, personnel guidance or staffing guidance does not affect a taxpayer. Editorial changes that do not change the meaning of the content also do not affect a member of the public.</p>	<p>3. Is the guidance available in full on the Electronic Reading Room (ERR) on IRS.gov? [N=continue; Y=no disclosure].</p> <p><b>Previously Released to the Public on the ERR:</b></p> <ul style="list-style-type: none"> <li>The guidance is in a published IRM on IRS.gov.</li> <li>The guidance is merely a reminder to employees to follow current procedures already in a published IRM on IRS.gov.</li> <li>A SERP IPU issued to revise the FUTA tax rate which is contained in an IRS Notice posted on the ERR.</li> </ul> <p><b>Not Previously Released to the Public on the ERR:</b></p> <ul style="list-style-type: none"> <li>Instructions to employees describing details for a new procedure on accepting returns previously outlined in a press release.</li> <li>A re-issued interim guidance memorandum that affects a member of the public.</li> <li>A SERP IPU which revises procedures for FUTA tax calculation not available on the ERR on IRS.gov.</li> </ul>
<p>4. Would failure to disclose the change adversely affect a member of the public or prevent them from pursuing an alternative course of action? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> A member of the public would be adversely affected or prevented from pursuing another action, if the information is not made available to them.</p> <p><b>E-FOIA Example:</b> A change in the failure to file penalty calculation would adversely affect the taxpayer, as the amount owed may be higher than expected. Not knowing about the change, the taxpayer is deprived of information that could alter their decision making.</p>	<p>4. If the document was not made available to the public, would the public be adversely affected or prevented from pursuing an alternative course of action? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> A member of the public would be adversely affected or prevented from pursuing another action, if the information was not made available to them.</p> <p><b>Example:</b> An interim guidance memo was issued on handling non-hardship effective tax administration Offers in Compromise. The procedures include new instructions on handling these offers. Absent this information, a taxpayer may not have filed an Offer and as a result be unduly harmed. If the taxpayer had known about this change, the taxpayer might have taken other actions.</p>	<p>4. Does the guidance contain material that has been designated (or should be designated) Official Use Only (OUO) content? [Y=continue; N=no disclosure].</p> <p><b>Definition:</b> "Official Use Only" is sensitive information, the disclosure of which is prohibited by law or could adversely affect the conduct of IRS programs or operations essential to the administration of tax laws. See IRM 11.3.12, <i>Designation of Documents</i>. The Service does not generally consider employee phone numbers and names OUO. If you are unsure if the document contains OUO content, contact your Disclosure Technical Advisor.</p> <p><b>Information which should be/is OUO:</b></p> <ul style="list-style-type: none"> <li>Tolerance amounts which if released would impair tax administration.</li> <li>Information that describes a law enforcement technique which if released could permit circumvention of the law.</li> <li>Data processing materials and codes that if released to the public could interfere with the tax administration process.</li> <li>Settlement ranges for negotiation purposes that are included in Appeals Settlement Guidelines.</li> </ul> <p><b>Information that should not be considered OUO:</b></p> <ul style="list-style-type: none"> <li>A Mail Stop number provided for routing purposes.</li> <li>Computer Transaction codes.</li> <li>Threshold amounts such as income levels for the Earned Income Credit or exemption amounts.</li> </ul>

SERP (as of 7/12/2011)	SPDER (as of 7/12/2011)	SERP/SPDER (as of 9/22/2011)
<p>5. Does the change contain Official Use Only (OUO) content? [Y=continue; N=disclose].</p> <p><b>Definition:</b> OUO material must be protected from disclosure under the Internal Revenue Code, the Privacy Act, or if public release of the material would demonstrably harm tax administration. The Service does not generally consider employee phone numbers and names OUO.</p> <p><b>Examples of OUO information:</b> Tolerance amounts; information that describes a law enforcement technique; data processing materials and codes which might prove useful to a person attempting to abuse the tax administration process; taxpayer information; pre-decisional process documents such as an attorney work product.</p>	<p>5. Does the document contain Official Use Only (OUO) content? [Y=continue; N=disclose].</p> <p><b>Definition:</b> "Official Use Only" is a designation for information of a sensitive nature, the disclosure of which could adversely affect the conduct of IRS programs or operations essential to administering the tax laws. Use OUO classification when material must be protected from disclosure under the Internal Revenue Code, the Privacy Act, or if public release of the material would demonstrably harm tax administration.</p> <p><b>Example:</b> Tolerance amounts; information that describes a law enforcement technique; data processing materials and data processing codes which might prove useful to a person attempting to abuse the tax administration process; taxpayer information; and pre-decisional process documents such as an attorney work product are all OUO. The Service does not generally consider employee phone numbers and names OUO.</p>	<p>5. Would the guidance be meaningless to the reader if the OUO content were redacted? [Y=do not disclose; N=disclose redacted].</p> <p><b>Guidance is meaningless when OUO removed:</b></p> <ul style="list-style-type: none"> <li>■ A SERP IPU where all the changes are designated as OUO.</li> <li>■ A memorandum providing settlement guidelines to employees would be meaningless if the OUO content was removed.</li> </ul> <p><b>Guidance provides information with the OUO information removed:</b></p> <ul style="list-style-type: none"> <li>■ A SERP IPU adding a new subsection on processing casework with one tolerance amount designated as OUO.</li> <li>■ A memo outlining an audit process for offshore accounts that includes an audit tolerance amount.</li> </ul>
<p>6. Is the change entirely OUO? [Y=no disclosure; N=disclose redacted].<sup>40</sup></p>	<p>6. Is the document primarily OUO? [Y=no disclosure; N=disclose redacted].</p> <p><b>Definition:</b> The document is primarily OUO if eliminating the sensitive content would render the document meaningless.</p> <p><b>Example:</b> A memo to employees revising an IDRS data processing code that indicates a criminal investigation is primarily OUO.</p>	

While these tools are helpful, they are more complicated than the FOIA law (quoted above) and contain differences that could lead to inconsistent results. As illustrated below, some of the questions could also lead to under-disclosure. The revisions seem likely to address some but not all of these problems.

<sup>40</sup> The IRS updated the SERP tool on June 9, 2011, and July 8, 2011. One of these revisions conformed the language of question #6 of the SERP tool to the language of the SPDER tool by changing "entirely" to "primarily." While this change could prevent the IRS from posting documents so redacted as to be meaningless, it addresses a problem that does not exist. The IRS has rarely posted documents that were so overly-redacted that they were meaningless. The change could, however, promote under-disclosure because an author would have to read the examples to know that "primarily" is broadly defined. The September 22, 2011, change, however, was a significant improvement in this regard.

For example, on February 24, 2011, the IRS announced to the press that it was planning to increase the threshold for automatically filing a lien.<sup>41</sup> The next day, analysts for the Wage and Investment (W&I) and Small Business/Self Employed (SB/SE) divisions issued IPUs, revising various sections of the SERP IRM to increase the lien filing threshold.<sup>42</sup> The W&I author classified the revised threshold as “official use only” (OUO), but the SB/SE author did not.<sup>43</sup> In addition, the IRS did not post either IPU to the ERR on IRS.gov.<sup>44</sup>

About a month later, when SB/SE issued an IGM to update lien filing thresholds contained in different sections of the IRM, it posted the IGM to the ERR and did not classify the thresholds as OUO.<sup>45</sup> Thus, the authors of the IPUs and IGM apparently reached different conclusions about whether they were required to disclose the change and whether the lien filing thresholds were OUO.

Several of the questions posed by the decision-making tools (above) could lead the authors of the IPUs to incorrectly conclude that disclosure was not required. In response to question #2, an author might believe the change had been described to the public (albeit in less detail) as part of the IRS news release; therefore, disclosure was not necessary.<sup>46</sup> Similarly, the author could decide in response to question #3 of the SERP tool that the change did not “affect how the public files, pays, receives a refund, or complies,” but rather how the IRS would enforce the rules or how taxpayers might obtain relief from enforced collection.<sup>47</sup>

In response to question #4, an author might conclude that the nondisclosure would not “adversely affect a member of the public or prevent them from pursuing an alternative course of action.”<sup>48</sup> The author might reason that nondisclosure would not adversely affect a taxpayer because the change was favorable to taxpayers; nor would it “prevent” the taxpayer from pursuing any alternative course of action with the IRS. For example, a taxpayer could still receive the benefit of the increased lien filing threshold, even if he or she did not know about it. It might not occur to the author that those taxpayers with liabilities below

<sup>41</sup> IR-2011-20 (Feb. 24, 2011), <http://www.irs.gov/newsroom/article/0,,id=236540,00.html>. Although not printed in the IRS release, the amount of the new threshold was announced by IRS officials and reported by the press. See, e.g., Jeremiah Coder, *ABA Section of Taxation Meeting: IRS Trying to Improve Penalty Process, Officials Say*, 131 Tax Notes 683 (May 16, 2011).

<sup>42</sup> SERP IPU 110444 (Feb. 25, 2011) updated the lien filing thresholds that appeared at IRM 5.19.4.5.2 (Mar. 8, 2010). SERP IPU 110460 (Feb. 25, 2011) updated the lien filing thresholds that appeared at IRM 5.19.1.7 (Nov. 3, 2010).

<sup>43</sup> SERP IPU 110460 (Feb. 25, 2011) (marking the threshold as OUO); SERP IPU 110444 (Feb. 25, 2011) (not marking the threshold as OUO).

<sup>44</sup> As of August 26, 2011, neither IPU was posted to the ERR as a change to IRM 5.19.

<sup>45</sup> See IGM SBSE-05-0311-039 (Mar. 28, 2011), <http://www.irs.gov/pub/foia/ig/sbse/sbse-05-0311-039.pdf> (updating the thresholds appearing at IRM 5.12.2.4 (Oct. 30, 2009)). TAS's inquiry regarding the IRS's non-disclosure of various materials could have influenced the IRS's handling of this IGM. Email from TAS to Disclosure (Mar. 17, 2011).

<sup>46</sup> The revised tools eliminated this ambiguity by requiring disclosure unless the item was available in full on the ERR. Except as otherwise indicated, our references to questions numbers are to the questions presented by the tools as of July 12, 2011.

<sup>47</sup> Question #3 of the SPDER tool (as of 7/12/2011) was less limiting because it provided that a document should also be disclosed if the change would affect how a taxpayer “interacts with the Service.” Because the term “interacts” is vague and limiting, however, this addition does not fully address the concern. Question #2 of the revised tools retained the language provided in question #3 of the SPDER tool (as of 7/12/2011).

<sup>48</sup> The revised tools eliminated this question.

the threshold, if aware of the change, could potentially take additional steps, such as seeking to have a lien filing withdrawn.

Finally, under FOIA, information compiled for law enforcement purposes is exempt from disclosure if it “could reasonably be expected to risk circumvention of the law.”<sup>49</sup> By contrast, under question #5 and the IRM’s seemingly broader definition, material is exempt as OOU if it includes, among other things, “[i]nstructions relating to enforcement strategies, methods, procedures, tolerances and criteria,” without regard to whether it could reasonably be expected to risk circumvention of the law.<sup>50</sup> This discrepancy could lead to under-disclosure and inconsistency, as illustrated above.<sup>51</sup>

Perhaps the W&I author viewed the threshold as a “tolerance,” which the decision tool suggests is always OOU. By contrast, the two SB/SE authors and the IRS officials who announced the threshold to the press may have believed it was not.<sup>52</sup> The National Taxpayer Advocate does not believe disclosure of the lien filing threshold “could reasonably be expected to risk circumvention of the law.” The IRS should at least encourage authors to ask this question, rather than relying on the untested assumption that they understand the difference between a threshold and a “tolerance.” Moreover, in light of the Presidential, OMB, and DOJ directives discussed above, it should resolve ambiguity in favor of disclosure. The revised tools are a step in the right direction because they do not provide a blanket exception for tolerances unless the disclosure “would impair tax administration.”

### *The IRS has no procedures for clearing and posting SERP Alerts and similar documents.*

Program managers sometimes communicate with IRS employees without issuing IGMs, IPUs, and IRM changes. For example, they may distribute email, training materials, and internal newsletters, and post “alerts” on SERP.<sup>53</sup> Such alternate forms of communication are not exempt from E-FOIA’s posting requirement. However, the IRS does not have procedures for posting them to the ERR because they are only supposed to contain information that does not have to be posted or is already described in documents that are posted.<sup>54</sup> For the same reasons, these alternate forms of communication are not subject to clearance

<sup>49</sup> 5 U.S.C. § 552(b)(7)(E). While there are other types of law enforcement exemptions, they are generally inapplicable in the context of this discussion. *Id.*

<sup>50</sup> IRM 1.11.2.12 (Sept. 4, 2009).

<sup>51</sup> As SPDER’s annual report notes, “[I]ncorrectly designating official use only material may place sensitive information in the public domain. Withholding more information than necessary may, however, violate the Freedom of Information Act (FOIA) requirements.” Director SPDER, FY 2010 Annual Report on the Internal Management Documents (IMD) Program (Dec. 2, 2010).

<sup>52</sup> IGM SBSE-05-0311-039 (Mar. 28, 2011) (revealing the new threshold to the public); Jeremiah Coder, *ABA Section of Taxation Meeting: IRS Trying to Improve Penalty Process, Officials Say*, 131 Tax Notes 683 (May 16, 2011) (same).

<sup>53</sup> See, e.g., IRM 1.11.6.4.3 (May 7, 2010); IRM 1.11.8.7.2 (Jan. 3, 2011). Changes are reflected on SERP within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011). So-called “newsflashes” and “hot topics” may also appear on SERP. See IRM 1.11.9.8(5) (Sept. 4, 2009); IRM 1.11.10.6.1 (Sept. 4, 2009).

<sup>54</sup> See, e.g., IRM 1.11.8.7.2 (Jan. 3, 2011) (“Use Alerts to notify users of system problems, changes, and information (e.g., Disaster Assistance Information) that do not require an IRM procedure/instruction change.”).

by other functions, such as TAS, as is required for IGMs and IPU.s.<sup>55</sup> Thus, uncleared and undisclosed SERP alerts can pose a problem when they discuss new procedures.

For example, in the first week of March, 2011, the IRS issued SERP alerts that communicated instructions to staff regarding the IRS's intention to expand the availability of in-business installment agreements and lien withdrawals, as previously announced in a February 24, 2011 press release.<sup>56</sup> The IRS sometimes disseminates this type of guidance internally by issuing alerts on SERP because it can do so more quickly than by issuing procedural updates or revising the IRM, which both require formal clearance.<sup>57</sup> As noted above, SERP alerts are not posted to the ERR. As a result, taxpayers remained unaware of the specific procedures they could have used to obtain installment agreements or lien withdrawals because the IRS used a SERP alert to issue the guidance.

As another example, on August 20, 2010, the IRS used a SERP alert to provide procedural protections to taxpayers, as required by a recent court decision.<sup>58</sup> The SERP alert instructed employees that if a taxpayer had an "economic hardship," the employee should put the account in "currently not collectible" (CNC) status to prevent further collection activity, even if the taxpayer had unfiled returns.<sup>59</sup> By contrast, then-applicable IRM provisions instructed "[D]o NOT report any cases as CNC (hardship) until all delinquent returns are filed."<sup>60</sup> Because this change was not disclosed, practitioners seeking to assist taxpayers facing economic hardships could not advocate for them as effectively. Moreover, some IRS employees could have been confused about how to reconcile the conflicting instructions. Such confusion could cause employees to take actions that harm taxpayers and open the IRS to legal challenge.

An alert issued on July 25, 2011, further illustrates the problem of using SERP alerts to bypass the clearance and E-FOIA procedures.<sup>61</sup> The text of the alert is reproduced as follows:

<sup>55</sup> IRM 1.11.9.8(1) (Sept. 4, 2009) (noting that interim guidance is subject to the same clearance procedures as the IRM, except it is subject to shorter clearance timeframes).

<sup>56</sup> SERP Alert 110191 (Mar. 1, 2011), SERP Alert 110187 (Mar. 2, 2011), and SERP Alert 110195 (Mar. 2, 2011). These alerts were not disclosed, but were inexplicably rescinded over three months later on June 17, 2011. In addition, the IRS did not disclose IPUs, which made similar changes to the SERP IRM. IPU 111039 (May 23, 2011); IPU 110446 (Feb. 28, 2011). These nondisclosures affected the public because the National Taxpayer Advocate cited the changes in her public statements and members of the public had to contact TAS to obtain the source documents that she cited.

<sup>57</sup> SERP alerts received by 3 p.m. are available the next day and IPUs are available within 24-48 hours. IRM 1.11.8.10 (Jan. 3, 2011). However, IPUs must be circulated for clearance by other functions. See IRM 1.11.9.8 (Sept. 4, 2009). The IRS can clear interim guidance, such as IPUs, in less than the 30 days it takes to clear an IRM, but clearance still takes time. IRM 1.11.10.5.2 (Sept. 4, 2009) (providing for clearance in less than the 30 days applicable to IRM updates).

<sup>58</sup> See *Vinatieri v. Comm'r*, 133 T.C. No. 16 (2009). For discussion of this case and the need for guidance, see National Taxpayer Advocate 2010 Annual Report to Congress 85-97 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*) (recommending the IRS "revise its IRM and other procedural guidance to clarify that all collection employees are authorized to ... place a taxpayer's account into CNC status based on economic hardship, without securing unfiled returns...").

<sup>59</sup> SERP Alert 100440 (Aug. 20, 2010). The IRS issued a similar alert on October 27, 2010. SERP Alert 100539 (Oct. 27, 2010). For procedures that TAS will follow in these cases, see IGM, TAS-13.1.10-0311-008 (Mar. 29, 2011), [http://www.irs.gov/pub/foia/ig/tas/tas\\_13.1.10-0311-008.pdf](http://www.irs.gov/pub/foia/ig/tas/tas_13.1.10-0311-008.pdf).

<sup>60</sup> IRM 5.19.1.7.1(8) (Mar. 25, 2009) (emphasis in original). The IRM was not formally revised to reflect the guidance provided by the alert until November 3, 2010. IRM 5.19.1.7.1.5 (Nov. 3, 2010).

<sup>61</sup> SERP Alert 110514 (July 25, 2011). The alert was revised on July 26, 2011, to add the following sentence: "If taxpayers disagree with the letter, follow procedures in IRM 21.6.3.4.2.11.6, *First-Time Homebuyer Credit Claims*." *Id.*

Last year, TIGTA identified some taxpayers who claimed the First-Time Homebuyer Credit with a purchase date prior to the date of enactment (04/09/08). For taxpayers claiming the Long-Time Residents Credit, the date of enactment was 11/06/09. **These taxpayers reported a timely date on their Form 5405, but 3rd party reporting shows an earlier date.**

**A bulk process is currently being used to reverse the FTHBC and issue a 105C disallowance letter.** The adjustments will be staggered over a 3-week period, which started July 18.... [computer codes omitted]

If taxpayers disagree with the letter, they must submit a HUD-1 statement. [Emphasis added.]

The IRS sent Letter 105C, *Claims Disallowed*, to 36,000 taxpayers.<sup>62</sup> However, the IRS did not have the authority to recover the FTHBC in this manner based solely on an apparent discrepancy between the purchase date reported on the return and the purchase date reflected in third-party data.<sup>63</sup> In other words, if the IRS determined to disallow these claims it was required to issue a “statutory notice.”<sup>64</sup> The statutory notice would have given the taxpayer the right to petition the Tax Court.<sup>65</sup> In addition, the language included in Letter 105C was confusing and misleading to taxpayers who had already received the credit. The letter stated a taxpayer could only appeal the IRS determination to Appeals if the IRS disallowed the claim because it was late.<sup>66</sup> These taxpayers had not filed late claims. If they had, they would not have received the FTHBC.

On July 27, 2011, after the National Taxpayer Advocate drew this matter to the IRS's attention, the IRS concluded it should not have been using Letter 105C.<sup>67</sup> It followed up on August 4, 2011, by drafting a letter for the 36,000 taxpayers who had received Letter 105C, apologizing for the confusion and indicating the credit was not disallowed.<sup>68</sup> If the IRS's procedures governing this “bulk process” had been properly documented, cleared, and

<sup>62</sup> Response to TAS information request (Sept. 13, 2011).

<sup>63</sup> The IRS was making an adjustment based on inconsistencies between the date of purchase shown on the return and the date of purchase reflected in third-party data. The IRS's general authority to make math error adjustments under IRC § 6213(g)(2)(C) only applies when one item on a return is inconsistent with another. We understand the IRS mistakenly believed, based on an informal discussion with Counsel, that it could use math error authority to make these reversals.

<sup>64</sup> IRC § 6212.

<sup>65</sup> IRC § 6213(a).

<sup>66</sup> Letter 105C, *Claim Disallowed* (May 3, 2010) (“You may appeal our decision with the Appeals Office (which is independent of our office) if we disallowed your claim because our records show that you filed your claim late.”).

<sup>67</sup> The IRS did not clear the procedures described in the alert. Rather, on July 26, 2011, TAS proactively identified these letters as problematic and convinced the IRS to stop sending them. Further, the IRS issued the alert only after it began sending out these letters. Response to TAS information request (Sept. 13, 2011).

<sup>68</sup> SERP Alert 110544 (Aug. 4, 2011). The IRS had problems systemically correcting the accounts. SERP Alert 110591 (Sept. 2, 2011).

disclosed, or if the SERP alert that described changes to those procedures had been cleared, the IRS is more likely to have avoided these problems.<sup>69</sup>

### FAQs ARE NOT CLEARED OR INCLUDED IN THE IRM, AND NEITHER ARE UPDATES TO FAQs.

The IRS often posts “frequently asked questions” (FAQs) on its website.<sup>70</sup> While some FAQs simply restate previously disclosed material, some do not.<sup>71</sup> For example, as noted above, the IRS recently described the procedures that both its employees and taxpayers should follow in connection with a settlement initiative—called the 2009 Offshore Voluntary Disclosure Program (OVDP)—using FAQs on its website rather than the IRM, an Announcement, a Notice, or a Revenue Procedure.<sup>72</sup> On March 1, 2011, the IRS, intending to clarify what it viewed as a common misinterpretation of one key FAQ (OVDP FAQ #35) by its revenue agents, sent them a “secret” memo that was not subject to the clearance process or timely released to the public.<sup>73</sup> The IRS’s reinterpretation of the seemingly unambiguous language of FAQ #35 led to charges that it had used “bait and switch” tactics, eroding trust for the IRS.<sup>74</sup> It also left the public with the impression the IRS was inconsistently and arbitrarily denying some taxpayers the benefits of FAQ #35, which remained unchanged on its website. Neither the FAQs nor the “secret” clarifying memo had been cleared by TAS. The IRS has no written procedures for clearing FAQs with any internal stakeholders.<sup>75</sup> Moreover, we understand that other technical interpretations of the FAQs were communicated by word of mouth, rather than by written documents that could be

<sup>69</sup> For a discussion of the problems with using summary procedures such as the math error process to deny (or recover) First-time Homebuyer Credits based on unreliable third-party data, see Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayers Rights*, *supra/infra*; *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the Senate Comm. on Finance Sen. Fin. Comm. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 100-103 (*Administrability Problems Specific to the First Time Homebuyer Credit*); National Taxpayer Advocate 2002 Annual Report to Congress 185 (Legislative Recommendation: *Math Error Authority*).

<sup>70</sup> Jeremiah Coder, *How Do FAQs Fit into the Guidance Puzzle?* (Mar. 31, 2011) (noting that a simple search of the phrase “frequently asked questions” on the IRS website returned more than 1,300 results.).

<sup>71</sup> *Id.* (discussing the wide variety of FAQs that represent the IRS’s only public statement addressing various issues, and raising questions about reliance, the review process, judicial deference, and the lack of any way to search for archived FAQs).

<sup>72</sup> See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (OVDP FAQ). The IRS has continued to use this FAQ approach for new settlement initiatives. See IRS, 2011 *Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (Aug. 19, 2011) (first posted Feb. 8, 2011) (OVDP FAQ). In contrast, previous settlement initiatives have been promulgated using vehicles such as revenue procedures and announcements, which are published in the Internal Revenue Bulletin. See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative); Ann. 2004-46, 2004-1 C.B. 964 (“Son-of-Boss” settlement initiative). Such documents are subject to significantly more internal clearance and commentary than changes to the IRS.gov website. For a more detailed discussion of this problem, see Most Serious Problem, *The IRS’s Offshore Voluntary Disclosure Program “Bait And Switch” May Undermine Trust for the IRS and Future Compliance Programs*, *supra/infra*.

<sup>73</sup> Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDP Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011). For a discussion of the resulting damage to the tax system, see Most Serious Problem: *IRS Offshore Voluntary Disclosure Program “Bait and Switch” May Undermine Trust for the IRS and Future Compliance Programs*, *supra/infra*. To be clear, the March 1 memo was not designated as “secret” or ODU. The IRS eventually posted it in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March 1 memo is available at [http://www.irs.gov/pub/irs-drop/ovdi\\_memo\\_use\\_of\\_discretion\\_3-1-11.pdf](http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf).

<sup>74</sup> See, e.g., Pedram Ben-Cohan, *IRS’s Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

<sup>75</sup> Response to TAS information request (June 24, 2011) (“Frequently asked questions (FAQs) on IRS.gov are not internal management documents. Therefore, SPDER is not responsible for providing guidance on clearing and disclosing these documents.”).

cleared and disclosed.<sup>76</sup> The content of both the OVDP FAQs and the clarifying memo, and the IRS's overall handling of the problem could have been improved if the material had been subject to normal clearance and disclosure procedures.

#### APPLYING FOIA IN THE 21<sup>ST</sup> CENTURY: PROCEDURES FOLLOWED BY IRS COMPUTER PROGRAMS ARE NOT CLEARED OR POSTED.

As we reported last year, the IRS also establishes policies and procedures by embedding them in its computer systems, without subjecting them to internal clearance or disclosure.<sup>77</sup> IRS program managers communicate these policies and procedures to computer programmers by creating so-called “functional specifications” for the programs. As such, functional specifications may constitute instructions to staff (*i.e.*, the programmers, the computer operators, and the computers themselves) that should be disclosed if they affect the public, at least to the extent they are not OOU. *Moreover, if the IRS is required to disclose the decision-making processes that a human employee uses to make a determination, the same processes should not be immune from disclosure simply because they are embedded in software or carried out by machines.* For example, a program called the “reasonable cause assistant” (RCA) automatically determines if a taxpayer’s failure to meet certain requirements was due to “reasonable cause.”<sup>78</sup> If so, the IRS will abate the penalty that would otherwise apply. The program bases these determinations on answers to relevant questions that were probably included in the functional specification. The IRS suggested in its response to last year’s report that its computer programming simply automates existing policies and procedures that have already been subject to clearance and disclosure. Thus, it argued, these policies and procedures do not need to be disclosed.

However, the questions posed by the RCA program, updates to these questions, and other functional specifications are not subject to the clearance process and are not available to the public even in redacted form. In each case, disclosure would help the taxpayer identify what facts are relevant in making the case for penalty abatement. We continue to believe the IRS should disclose its functional specifications along with any changes to them, provided they affect the public and are not exempt from disclosure. If the IRS does not disclose functional specifications, it will become less and less transparent in the 21st century, as technological advances increasingly allow computers to replace staff and instructions to computers to replace instructions to staff. As they do, instead of automating existing policies, the IRS will more often automate new policies and procedures that were never cleared or disclosed to the public before.

<sup>76</sup> An unpublished internal newsletter stated, however, that “[E]xaminers assigned OVDI cases have access to guidance on a secured OVDI SharePoint site. Technical Services Reviewers may access the secured ARI SharePoint site for additional guidance and contacts.” SB/SE Technical Services, *Keys to Success 2* (Dec. 2010).

<sup>77</sup> National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*).

<sup>78</sup> See, e.g., IRM 20.1.1.3.6 (Dec. 11, 2009); IRM 5.1.15.16.1 (Apr. 16, 2010); IRM 21.2.2.4.5.1 (Jan. 20, 2010).

## CONCLUSION

The IRS has taken a number of important steps to improve its transparency since our last report. However, decentralized responsibility for disclosure, inadequate training, a lack of accountability, and opportunities to improve internal decision-making tools remain challenges.

Failures to timely and properly disclose instructions to staff that affect the public not only violate FOIA and directives from the President, DOJ, and the OMB, but can have serious negative consequences. In such cases, taxpayers, practitioners, and IRS employees are less likely to be aware of the IRS's current procedures. As a result, they will be less effective in resolving tax problems and disputes. Additionally, the IRS is more likely to act or be perceived as acting arbitrarily and inconsistently, and is less likely to receive valuable comments from internal and external stakeholders that it could use to improve its procedures. As the examples above demonstrate, the failure to timely follow the clearance and disclosure rules, can result in guidance or procedures that are ill-advised, damage the tax system, deprive taxpayers of procedures designed to protect them, and possibly even violate the law.

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

1. Assign one office within the IRS the responsibility to measure and improve the accuracy of E-FOIA and clearance determinations;
2. Require all IMD authors to attend E-FOIA training;
3. Continue efforts to improve internal SERP and SPDER E-FOIA decision-making tools;
4. Require employees submitting SERP alerts to use a decision-making tool to determine if the alert should be disclosed or issued as an IPU or IGM;
5. Establish a transparent process for periodically selecting a random sample of IMD and SERP alerts (and other internal communications, if practical) to identify the magnitude and source of the IRS's E-FOIA compliance challenges;
6. Establish a process for clearing FAQs; and
7. Establish a process for disclosing functional specifications.

## IRS COMMENTS

### Overview

The IRS takes very seriously the obligation to be transparent to taxpayers. Compliance with the Freedom of Information Act and the Open Government Initiative are of utmost importance to the agency. FOIA requires administrative staff manuals and instructions to staff that affect a member of the public to be made available to the public in an electronic form (unless an exemption applies). The Open Government Initiative encourages agencies to exercise their discretion to make a broader range of records available beyond the minimum required by statute. The IRS strives to continuously improve its processes and

procedures to ensure compliance. We disagree with the assertion that current practices may violate the law. We have consulted with the Office of Chief Counsel and confirmed that current practices are fully compliant with the legal requirements.

The Internal Revenue Manual totaling over 82,000 pages is the primary, and largest, source of the IRS's instructions to staff. The IRM, with sensitive information redacted, is automatically published to the Electronic Reading Room on IRS.gov and available to the public within 14 days of revision. Interim guidance, issued through memoranda or as a SERP Interim Procedural Update, is used to convey immediate, time-sensitive, or temporary changes to operations or instructions to employees prior to incorporation into the IRM. Interim guidance is evaluated for disclosure under FOIA 5 U.S.C 552(a)(2)(C) and is posted, as applicable, to the Electronic Reading Room on IRS.gov, typically within 14 days of issuance. In FY 2011, the IRS issued approximately 1,900 IPU's and 133 interim guidance memorandums. The IRS posted 103 interim guidance memorandums and 29 SERP IPU's. Based upon a statistically valid sample of SERP IPU's, 96.1 percent were correctly classified.<sup>79</sup> When the issues are identified with respect to the IRS's overall compliance with FOIA, the IRS takes actions as appropriate.

### Significant Improvements

In August 2011, the Deputy Commissioners issued a memorandum to all IRS employees confirming our commitment "to implementing openness in Government to ensure the public trust and establish a system of transparency, public participation, and collaboration." IRS employees were directed to respond timely to requests for records and agency information. The IRS actively pursues solutions and implements improvements to comply with the FOIA and with the Open Government Initiative.

A number of significant improvements have been made in recent years. Some of these include the following. In 2008, the IRS established a task team that reviewed clearance procedures for Internal Management Documents, identified problem areas, and recommended solutions which included expansive guidance and extensive training. In 2009, the IRS published significantly revised guidance for authoring, clearing, and publishing "instructions to staff." New in-depth IRMs were published on Clearance (IRM 1.11.9) and Interim Guidance (IRM 1.11.10). Also in 2009, a servicewide task force convened to identify problems relating to issuing and clearing interim guidance. In 2010, the IRS implemented procedures for evaluating SERP IPU's for E-FOIA determination and posting the content to the ERR on IRS.gov. In 2010, the IRS also implemented significant changes to the clearance procedures for "instructions to staff" to address concerns from the National Taxpayer Advocate. In January 2011, the IRS launched Open Government Initiative on IRS.gov. In September 2011, the IRS issued revised procedures for FOIA compliance of instructions to staff based on guidance from Chief Counsel. The SPDER and SERP E-FOIA decision tools were revised in accord with these procedural changes. In October 2011, the IRS published

<sup>79</sup> The sample was selected from 1,983 SERP IPU's issued from July 1, 2010, through June 30, 2011. Margin of error is three percent.

revised E-FOIA guidance and clearance procedures in the IRM. IRM 1.11.10, *Interim Guidance Process*, clarifies the requirements for clearing interim guidance memoranda and SERP IPU and revises the E-FOIA determination. The IRS also revised the SPDER and SERP E-FOIA decision tools to address concerns from the National Taxpayer Advocate.

With respect to specific areas raised by the report of the National Taxpayer Advocate, the IRS would like to note the following.

#### *Decentralized Responsibility of Disclosure*

The Office of Disclosure is responsible for the policies governing the disclosure of IRS documents. The Office of Servicewide Policy, Directives and Electronic Research is responsible for developing the policies and procedures for managing “instructions to staff.” These offices work collaboratively and effectively, with Chief Counsel, to ensure that IRS complies with FOIA. The responsible program owner has responsibility to disclose content that meets E-FOIA. Technical training on general FOIA issues and the specific decisions required in determining whether or not to publish instructions to staff is available to IRS employees with these duties. Because the IRM is automatically redacted and disclosed to the public, only authors who issue interim guidance must determine whether the content should be published. In FY 2011, more than 200 employees attended E-FOIA training.

#### *E-FOIA Decision Tool*

The National Taxpayer Advocate Annual Report to Congress discusses the previous E-FOIA decision tools, which the IRS no longer uses because improvements were incorporated into a revised version. The current revised E-FOIA decision tool, October 12, 2011, is not evaluated in this report. The report discusses content in previous E-FOIA decision tools that has been eliminated or has been rewritten, with examples, specifically to address the National Taxpayer Advocate’s concerns. Thus, for example, the criticism of former question 4 (whether nondisclosure would prevent a taxpayer from seeking an alternative course of action) is moot as the question has been removed entirely from the decision tool. Comments about former question 2 (whether a document merely restates guidance already released) focus on the prior version of the decision tool. The current tool provides that only documents already published in full in the ERR of IRS.gov can be considered previously released for E-FOIA purposes. The examples for this question in the current tool address the concern cited by the National Taxpayer Advocate. Similarly, in discussing former question 3, while the report states that an instruction changing a lien threshold amount might not be considered by an employee to “affect how the public files, pays, receives a refund, or complies,” the report fails to note that the question as currently written includes the catch-all phrase “or [how a member of the public] interacts with the Service.” The current tool specifically includes an enforcement procedure as an example of an instruction topic that affects how the public “interacts” with the Service.

The IRS welcomes and responds to recommendations to its procedures and recognizes that there may be instances when there is room for improvement. While the report does

acknowledge some of the changes to the tool in footnotes, much of the discussion in the report has been addressed by improvements we have made. The IRS believes that the revised E-FOIA decision tool, with its specific examples, makes the publication requirement of the FOIA easier, not more difficult, for employees to understand.

### *SERP Alerts*

SERP Alerts notify users of system problems, changes, or information such as disaster assistance that do not require an IRM procedure/instruction change. SERP Alerts do not change current procedures or guidelines issued in the IRM or via a SERP IPU.<sup>80</sup> They are not a type of document that requires E-FOIA determination. While the IRS issued a SERP Alert to inform employees of the availability of in-business installment agreements and lien releases as announced in a February 24, 2011 Fresh Start Initiative press release, related IPUs were also issued. Some of these IPUs did not meet E-FOIA criteria, and thus were not posted to the ERR. Interim guidance memoranda pertaining to the Fresh Start initiatives were posted to the ERR. The Fresh Start Initiative press release also disclosed this information to the public. The SERP office in September 2011 changed procedures relating to SERP Alerts. The SERP office returns all Alerts changing IRM content to the author to be issued as a SERP IPU.

### *Frequently Asked Questions (FAQs) on IRS.gov*

The clearance and approval requirements for content on IRS.gov are governed by Online Services per IRM 2.25.101.4.2, *IRS.gov Content Management Guidelines, Pre-CMA Approval*. Per these instructions, Frequently Asked Questions posted on IRS.gov are reviewed and approved by the Operating Division and Functional area.

### *Disclosure of Functional Specification*

The National Taxpayer Advocate recommends the IRS establish a process for disclosing functional specifications for the purpose of being transparent. Necessary transparency should, and already does, take place distinct from the programming of systems. IRS systems should not define or create new policy decisions, only reflect and implement established policy and law. The IT systems development life cycle provides the process and mechanism to review and confirm the policy and law are accurately programmed. Programming is based on procedures and processes available to the public. In the event the IRS learns that programming reflects a procedure or policy not available to the public, changes are made accordingly so that appropriate transparency exists.

### **Response to Recommendations**

The IRS agrees that measuring and monitoring “instructions to staff” (See 5 USC § 552 (a)(2)(C)) is essential to ensuring compliance with E-FOIA. The Office of SPDER is responsible for managing instructions to staff and works closely with the Office of Disclosure and

<sup>80</sup> IRM 1.11.8.7.2, *Adding Alerts* (Jan. 3, 2011).

Chief Counsel to ensure compliance with E-FOIA. The Office of SPDER has conducted sample reviews of IPU, clearance, and other processes related to managing instructions to staff. The Office of SPDER, in coordination with the Office of Disclosure and the operating divisions, will continue to conduct random sample reviews of interim guidance for FOIA compliance. As resources permit, the IRS will consider the appropriateness of a more formalized program for monitoring and measuring compliance rates.

The IRS is committed to improving the decision-making process through tools and training. For example, a tool exists to aid authors to determine if information belongs in the IRM. If the content is determined to be guidance or procedural instructions, the author is advised to include the issue in the IRM. Alternately, the author may issue it as interim guidance. In addition, the SERP IPU process has a built-in process that mandates the use of E-FOIA decision-making tool. The IRS will continue to evaluate our decision-making tools and welcomes suggestions for improvement.

The IRS supports technical training on E-FOIA compliance to interim guidance authors. Virtual training is available and offered to employees with responsibilities to evaluate content for disclosure. In FY 2011, more than 200 employees attended classes on E-FOIA. Authoring “instructions to staff” is a collateral duty and this responsibility may be reassigned. To ensure that employees with these responsibilities have proper training, the Office of SPDER is developing web-based training on topics, including E-FOIA and clearance, related to managing “instructions to staff.” Due to budget constraints, training and travel funds must be prioritized.

Frequently Asked Questions posted on IRS.gov should also adhere to the clearance and approval requirements per IRM 2.25.101.4.2, *IRS.gov Content Management Guidelines*. The IRS agrees that FAQs, not based on established policy and procedures, but designed to guide staff in how to administer a law or regulation that affects the public, should follow the established policies and procedures for “instructions to staff.”

As discussed, functional specifications are based upon established policy and law that are already available to the public. In the rare case that programming reflects a procedure or policy that is not publically available, changes are made as appropriate.

In conclusion, the IRS demonstrates our commitment to accountability and transparency. We continually strive to administer the FOIA in favor of disclosure.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for (1) working with TAS to update its guidance regarding clearance and disclosure of IGM and IPU's, (2) adopting many of TAS's suggestions for improving the SERP and SPDER E-FOIA decision making tools, (3) offering virtual training to employees, (4) working to develop web-based training, (5) sampling IGM and SERP IPU's issued between July 1, 2010, through June 30, 2011, to determine if they were properly categorized and disclosed, (6) committing to conduct random sample reviews of interim guidance for FOIA compliance, provided funding is available, and (7) establishing a procedure to help prevent the IRS from using the SERP alert process (rather than the IPU or IGM process) to change IRM content.

The National Taxpayer Advocate also commends the IRS for training 200 employees on E-FOIA. As noted above, however, there are about 646 IRM authors whose duties may change or who may change jobs. Moreover, the IRS's interpretation of the E-FOIA requirements has been evolving and it has repeatedly revised its decision support tools. Thus, it is important for all IMD authors to receive consistent E-FOIA training based on the IRS's most current interpretation of the law. Such training does not need to be expensive. The IRS could deliver training through web-based systems, which would eliminate any barriers to making this training mandatory for guidance authors.

In addition, the National Taxpayer Advocate commends the IRS for being responsive to many of the concerns expressed by TAS during the preparation of this report. It revised the E-FOIA decision-making tools several times – most recently after the last revision of the Most Serious Problem (MSP) discussion (above) was finalized. After TAS formally requested data on the accuracy of disclosure determinations regarding IGM and IPU's, the IRS conducted a sample.<sup>81</sup> After TAS expressed concern that the IRS sometimes used SERP alerts to modify the IRM, the IRS established a process to help address the problem. The National Taxpayer Advocate hopes that the IRS's responsiveness to transparency concerns continues.

However, certain statements in the IRS comments require clarification. First, the IRS response states that interim guidance is typically posted within 14 days of issuance. The IRS does not cite any data to support this assertion, but we understand it is from internal reports compiled by SPDER. Moreover, the IRS has indicated that it does not track the accuracy of interim guidance disclosure determinations.<sup>82</sup> Thus, the IRS appears to have no way of knowing if this statement is correct – some guidance may not be posted.

<sup>81</sup> TAS information request (May 31, 2011) ("Who is responsible for measuring the overall accuracy of E-FOIA determinations (*i.e.*, whether the proper disclosure determination was made) for SERP Alerts, SERP IPU's, and IG Memos? If available, please provide E-FOIA accuracy data for the past three fiscal years."); Response to TAS information request (June 24, 2011) ("Accuracy data are not available."). However, the IRS did not update its response once such data became available or inform TAS that it was conducting a sample.

<sup>82</sup> Response to TAS information request (June 24, 2011).

Second, the IRS response states that “current practices” are “fully compliant” with FOIA. However, the IRS’s recent statistical sample of IGMs and SERP IPU’s (described in the IRS comments), suggest that its current practices may result in mischaracterization and potential violations of the law up to seven percent of the time.<sup>83</sup> Moreover, the body of the MSP describes several instances where the IRS may have violated the law by failing to timely post items to the ERR on IRS.gov. Thus, we disagree with the suggestion that the IRS’s “current practices” are “fully compliant.”

Third, the IRS response states: “When issues are identified with respect to the IRS’ overall compliance with FOIA, the IRS takes actions as appropriate.” In fact, the IRS declined to disclose its “secret” March 1 memo (addressing OVDP FAQ #35, as described above) after TAS alerted the IRS that it should have been disclosed. TAS alerted the IRS on several occasions, including March 17, 2011, but the IRS waited until after the National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) on August 16, 2011, which formally elevated the matter to the operating division Commissioner level, before finally agreeing to do so.<sup>84</sup> Thus, while the IRS did *eventually* take “appropriate action,” this example suggests that the IRS may not always take timely action on its own.

Fourth, the IRS comments suggest that TAS’s analysis of the E-FOIA decision tool is obsolete because it revised the tool after TAS finalized the body of the MSP. While subsequent revisions to the tool did address many of TAS’s concerns, they did not address one important concern. In contrast to the tool, the statutory language is very broad, simple, and clear. It requires disclosure of all “instructions to staff that affect a member of the public,” unless an exemption applies.<sup>85</sup> Yet, as of this writing, the current version of the tool requires disclosure only if the instructions affect “how a member of the public files, pays, complies with their tax requirements or interacts with the Service.”<sup>86</sup> Thus, the tool remains narrower and more complicated than the statutory language.

Fifth, the IRS comments suggest that FAQs are subject to a clearance and approval process that is set forth in IRM 2.25.101.4.2. This statement could be misinterpreted. IRM 2.25.101.4.2 discusses in general terms that changes to certain portions of the IRS website require approval by the IRS’s Communications and Liaison function. It does not reference or address a clearance process applicable to FAQs. As the IRS has previously

<sup>83</sup> If 96.1 percent were correctly categorized with a 3 percent margin of error, then up to 6.9 percent ( $100 - 96.1 = 3.9$ ;  $3.9 + 3 = 6.9$ ) may have been incorrectly categorized. Even if the IRS’s sample is statistically valid, TAS has questions about its analysis: How was the sample identified? What criteria was used to evaluate it (e.g., which version of the E-FOIA tool, the IRM, or the law)? Given the IRS’s evolving interpretation of the law, even if the law were the benchmark, which interpretation of the law was used? Who were the reviewers and what knowledge did they have about the substantive subject matter and the FOIA law? How many taxpayers were affected by the guidance that was mischaracterized or improperly withheld?

<sup>84</sup> E-mail from TAS to Disclosure (Mar. 17, 2011); Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

<sup>85</sup> See 5 U.S.C. § 552(a)(2)(C).

<sup>86</sup> The IRS comments also suggest that the TAS report overlooked the “interacts with the Service” portion of the revised tool. TAS did not. The charts above accurately reflect the July 12, 2011, versions of the tools. As shown above, the SERP tool did not include the “interacts” language. The SPDER tool included the language in the definitions section. Moreover, we footnoted the subsequent change to the tools, indicating that the changes did not fully address our concerns.

acknowledged, “SPDER is not responsible for providing guidance on clearing and disclosing these documents.”<sup>87</sup> Thus, FAQs are not subject to the normal clearance process that applies to other instructions to staff.

Finally, the IRS comments state:

Programming is based on procedures and processes available to the public. In the event the IRS learns that programming reflects a procedure or policy not available to the public, changes are made accordingly so that appropriate transparency exists.

The National Taxpayer Advocate has identified in two separate reports to Congress the IRS's failure to disclose the policies and procedures that are incorporated into the programming used by the Reasonable Cause Assistant.<sup>88</sup> However, the IRS has still not disclosed the specific policies and procedures that it uses. Moreover, the IRS incorporates policies and procedures into computer programming on a regular basis and these policies sometimes affect the public, but none are posted to the ERR. Thus, we do not agree that when the IRS learns that programming reflects a procedure or policy that is not available to the public, it takes appropriate steps to ensure that transparency exists.

However, the IRS could address the problems associated with undisclosed functional specifications and uncleared FAQs by requiring the authors of FAQ and functional specifications to use a decision-tree analysis tool, just like authors issuing IPU's. The tool could help identify those items that should go through a clearance process and/or be incorporated into the IRM.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Assign one office the responsibility to measure and improve the accuracy of IRS E-FOIA and clearance determinations.
2. Require all authors of FAQs, functional specifications, job aids, desk guides, SERP alerts, and IMD to attend E-FOIA training.
3. Continue efforts to improve internal SERP and SPDER E-FOIA decision-making tools.
4. Require employees submitting SERP alerts to use a decision-making tool to determine if the alert should be disclosed.

<sup>87</sup> Response to TAS information request (June 24, 2011).

<sup>88</sup> National Taxpayer Advocate 2010 Annual Report to Congress 71-84 (Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*).

5. Implement tentative plans to establish a transparent process for periodically selecting a random sample of IMD, job aids, desk guides, local procedures, and SERP alerts (and other internal communications, if practical) to identify the magnitude and source of the IRS's E-FOIA compliance challenges and post the results on the IRS website.
6. Establish a process for clearing FAQs and similar items posted on IRS.gov;
7. Establish a process for disclosing functional specifications that are equivalent to instructions to staff that would have to be disclosed.
8. Create new E-FOIA decision-making tools, or expand the existing tools, to assist authors of FAQs and functional specifications determine when items need to be cleared and/or incorporated into the IRM.

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

Beth Tucker, Deputy Commissioner for Operations Support  
Jodi Patterson, Director, Return Integrity and Correspondence Services

**DEFINITION OF PROBLEM**

In light of the recent significant decline in the market for refund anticipation loans (RALs), the IRS is properly positioned to protect the best interests of taxpayers as the commercial refund delivery product market continues to evolve. Taxpayer demand for a quick refund turnaround time will always exist, and as the market for one refund delivery product disappears, the markets for other products may expand or new ones may develop. With the implementation of the Customer Account Data Engine 2 (CADE 2), the IRS has the opportunity to make significant strides in meeting taxpayer demand by reducing refund processing times by an average of five days, but the agency should also focus on monitoring the evolving commercial market targeting unbanked and low income taxpayers.<sup>1</sup> Due to the impact commercial refund products have on tax compliance, it is in the best interest of tax administration to take a proactive oversight stance in this market.<sup>2</sup>

The IRS took an aggressive and much-needed step when it stopped providing the Debt Indicator to preparers and their associated financial institutions. The result of this decision was a sharp decline in the RAL market. However, the IRS should continue to protect taxpayers as the market evolves, as provided below:

- While the “Where’s My Refund” service benefits taxpayers by providing refund delivery and offset information, the IRS could better serve taxpayers by providing more accurate information regarding delays in refund processing due to compliance initiatives.
- The IRS is not aggressive enough in educating taxpayers about refund delivery options, including information about average turnaround times for lower cost and government-sponsored options. With the 2012 rollout of CADE 2, the IRS will be able to process returns five days quicker and refund turnaround times will be faster, which may impact taxpayers’ choices if the IRS provides clear and complete information.

<sup>1</sup> IRS, CADE 2 Overview Briefing 17 (Sept. 2011). Based on a 2009 FDIC survey, an estimated 7.7 percent of U.S. households, approximately nine million, are unbanked. At least 17 million adults reside in these unbanked households. In addition, an estimated 17.9 percent of U.S. households, roughly 21 million, are underbanked (households with checking or savings accounts, but still use alternative financial services, such as check cashing services and payday loans). Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households*, Executive Summary 3 (Dec. 2009).

<sup>2</sup> The use of commercial refund delivery products has been linked to noncompliance. Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation (June 1, 2008).

- While the IRS has partnered with several financial institutions to offer refunds on debit cards offered by Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) organizations, it claims it does not endorse any particular product. However, the IRS provides volunteer sites with CCH's TaxWise software free of charge. TaxWise incorporates a Western Union debit card product into the free software, and the terms associated with this particular product appear less favorable than for the other products.<sup>3</sup>
- The Treasury Department launched a debit card pilot program during the 2011 filing season to issue refunds via prepaid cards to up to 800,000 unbanked taxpayers.<sup>4</sup> The pilot was a necessary step to address the needs of the unbanked. After analyzing the preliminary results of the pilot, Treasury decided to discontinue the program due to low participation rates.<sup>5</sup> Despite low participation in the pilot as designed, the National Taxpayer Advocate believes it is in the best interest of taxpayers and tax administration to make a government-sponsored debit card available on a nationwide basis. Thus, the IRS should evaluate the methodology of the pilot, with a particular focus on the marketing campaign, to develop a more effective marketing strategy for a future government-sponsored debit card program.
- Taxpayers' demand for commercial products will remain high as long as they struggle to pay for return preparation fees before they receive their refunds. The IRS can address this need by evaluating the feasibility of enabling taxpayers to pay their return preparation fees through the split refund program, which provides convenience but will require strict safeguards to reduce risks of preparer-perpetrated fraud.
- Through revisions to Circular 230, Treasury and the IRS can leverage the return preparer program to ensure that taxpayers are better informed about their refund delivery options. Treasury and IRS should require preparers to clearly communicate the time-frames and costs associated with refund delivery options, with a particular emphasis on the lower cost and government-provided options.

## ANALYSIS OF PROBLEM

### Background

#### *Taxpayers Have Several Refund Delivery Options.*

Taxpayers have various refund delivery options, of which the most popular is a direct deposit into the taxpayer's bank account. When combined with e-filing, this method will get

<sup>3</sup> Western Union, *Tax Refund Prepaid Card Solution For: TaxWise*, available at <http://tax-coalition.org/program-tools/financial-services/asset-building/asset-building-products/debit-cards/western-union-moneywise-card/western-union-moneywise-card> (last visited Oct. 4, 2011); Government Accountability Office (GAO), GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 38 (Mar. 2011).

<sup>4</sup> Treasury also launched a companion pilot to encourage tens of thousands of current and potential payroll card users to direct deposit their 2010 federal tax refund onto existing payroll cards.

<sup>5</sup> Eric Kroh, *Treasury Won't Renew Debit Card Refund Program in 2012, Spokesman Confirms*, Tax Notes Today (Nov. 1, 2011).

a refund into the taxpayer's account in as few as ten days at no cost,<sup>6</sup> but it is not available to unbanked taxpayers. These taxpayers can choose to receive a paper check, which takes up to six weeks and may involve check cashing fees, or purchase a commercial product that may reduce the wait but typically involves high fees. Such commercial products include RALs, refund anticipation checks (RACs), and debit cards.<sup>7</sup>

*Commercial Refund Delivery Products May Harm Taxpayers and Tax Administration.*

The National Taxpayer Advocate has been raising concerns regarding various commercial refund products, RALs in particular, for several years.<sup>8</sup> These concerns include:

- Taxpayers incur high fees charged by financial institutions as well as the paid preparers who facilitate the sale of these products;
- Banks provide financial incentives to paid preparers who facilitate the sale of these products and create an opportunity for preparers to benefit by artificially inflating refund amounts;<sup>9</sup> and
- While a real demand for quick refunds exists, many taxpayers are not aware that they can avoid associated high fees if they wait just a few more days and receive a direct deposit from the IRS. The IRS is not taking a proactive role in educating taxpayers by clearly conveying all refund delivery options, the associated fees, and the average refund turnaround times for each.<sup>10</sup>

A study performed by the IRS Office of Research, Analysis, and Statistics supports these concerns. The study found that taxpayers' use of bank products such as RALs and RACs may have detrimental effects on tax administration. In particular, taxpayers who used RALs were found to be less compliant than others who did not. Specifically, audits of RAL

<sup>6</sup> IRS, Tax Tip 2011-19, *Want Your Refund Fast – Choose Direct Deposit* (Jan. 27, 2011). As of June 3, 2011, over 76 million refunds were delivered by direct deposit out of a total of over 102 million refunds issued to individual taxpayers. The number of direct deposit refunds increased by 5.9 percent from the same time in 2010, as compared to only 0.9 percent in the total number of refunds. IRS Filing Season Statistics, June 3, 2011.

<sup>7</sup> RALs are loans secured by a taxpayer's anticipated tax refund. RACs are temporary bank accounts established on behalf of a taxpayer into which the IRS can direct deposit a refund and out of which a bank typically issues a payment to the taxpayer.

<sup>8</sup> National Taxpayer Advocate 2008 Annual Report to Congress 427; National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, *The Role of the IRS in the Refund Anticipation Loan Industry, Vol. II* (June 30, 2006); *Tax Return Preparation Options for Taxpayers: Hearing Before S. Comm. on Finance*, 109th Cong. (Apr. 4, 2006) 1-5 (statement of Nina E. Olson, National Taxpayer Advocate); National Taxpayer Advocate 2005 Annual Report to Congress 162-79; *Fraud in Income Tax Return Preparation: Hearing Before Subcomm. on Oversight, H. Comm. on Ways & Means*, 109th Cong. (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>9</sup> See Department of Treasury, Notice of Proposed Rulemaking, REG-136596-07, *Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products in Connection with the Preparation of a Tax Return* (2008); Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation (June 1, 2008).

<sup>10</sup> For example, at the start of the 2011 filing season, the IRS encouraged taxpayers to direct deposit and pointed out that "[t]axpayers can automatically get their money in as few as 10 days," but never compared the direct deposit option to other options. IRS, IR-2011-4, *IRS e-file Launches Today; Most Taxpayers Can File Immediately* (Jan. 14, 2011).

users resulted in a change in net tax liability 88 percent of the time compared to the 76 percent for taxpayers who did not use a bank product.<sup>11</sup>

***The IRS Significantly Impacted the RAL Market When it Eliminated the Debt Indicator.***

In August 2010, the IRS stopped providing the Debt Indicator (DI) to tax preparers and their financial institutions. The DI was a service created in the early 1990s to encourage tax preparers to file electronically by indicating in the filed tax return's acknowledgment file whether a taxpayer's anticipated refund would be offset to satisfy certain debts to federal or state agencies under the Treasury Offset Program (TOP).<sup>12</sup> Now that the e-file rate is approaching 80 percent, the IRS no longer needs to provide this incentive.<sup>13</sup> After this development, RALs became much more risky ventures for the banks, because they were less certain whether the IRS would release the entire refund. The first bank to leave the market was JPMorgan Chase, one of the three largest RAL lenders. Subsequent actions taken by Office of Thrift Supervision, Office of Comptroller, and the FDIC led the remaining financial institutions to swiftly exit the RAL market.<sup>14</sup> Thus, taxpayers will no longer have the option of receiving their refunds through RAL products. This is a significant development, and the National Taxpayer Advocate commends the IRS and oversight agencies for taking the steps necessary to protect taxpayers from the high fees and other drawbacks associated with these products.

The commercial tax preparation firms and financial institutions that previously offered RALs lost revenues as a result of the government intervention. For example, H&R Block reported \$146.2 million in loan participation revenues in 2010. This number dropped to \$17.2 million in 2011. At the same time, fees earned from RACs increased \$94.1 million,

<sup>11</sup> The percentage of audit adjustments was 81 percent for RAC users as compared to 76 percent of taxpayers with no bank product. Interestingly, the use of a paid preparer did not impact compliance in the studied group. Finally, while the study found a higher incidence of noncompliance, it did not prove a causal relationship between RALs and noncompliance. Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, IRS Office of Research, Analysis, and Statistics, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance?*, Proceedings of the 101st Annual Conference on Taxation, Table 7 (June 1, 2008).

<sup>12</sup> The government's Financial Management Service (FMS) uses the TOP to manage liabilities owed by taxpayers to federal or state agencies and has statutory authority to offset federal income tax refunds against such debts. IRC § 6402(d). The acknowledgement file is a report generated by the IRS to the transmitter of electronically filed returns indicating whether transmitted returns were accepted or rejected by the IRS. For rejected returns, the report includes error codes. It also previously indicated if any claimed refunds were subject to offset.

<sup>13</sup> As of October 21, 2011, approximately 78 percent of individual returns were electronically filed in filing season 2011. Most e-filed returns are filed by October and any remaining returns filed during 2011 would be paper documents, so complete calendar year figures could show a slightly smaller percentage of e-filed returns. IRS, 2011 Filing Season Data – Return/Refunds, For Week Ending: 10/21/2011. IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010); Sandra Block, *IRS Rule to End Release of Debt Info Threatens Refund-Anticipation Loans*, USA Today (Aug. 6, 2010). Preparers who e-file a client's tax return receive in the acknowledgment file an indication of whether an individual taxpayer will have any portion of the refund offset for delinquent tax or other debts, such as unpaid child support or delinquent federally funded student loans.

<sup>14</sup> The Office of Thrift Supervision prohibited MetaBank, a potential new entrant into the RAL market, from making the loans and the Office of Comptroller issued a regulatory directive against HSBC (H&R Block's RAL partner bank) prohibiting it from making RALs. Subsequently, the FDIC notified the banks under its oversight that the making of RALs without the Debt Indicator is "unsafe and unsound." In May 2011, the FDIC initiated action against the last of the RAL lenders, Republic Bank & Trust (Jackson Hewitt's RAL partner bank) and issued an Amended Notice of Charges for an Order to Cease and Desist with a proposed \$2 million civil money penalty. Office of Thrift Supervision, *In the Matter of Metabank, Order to Cease and Desist*, Order No. CN 11-25 (Eff. July 15, 2011); FDIC, *Amended Notice of Charges for an Order to Cease and Desist; Notice of Assessment of Civil Money Penalties, Findings of Fact and Conclusions of Law; Order to Pay; and Notice of Hearing: Republic Bank & Trust Company, Louisville, KY*; FDIC-10-079b; FDIC-10-216k (May 3, 2011).

or 107.5 percent, between 2010 and 2011, which the company attributed as increased client demand for a RAL alternative.<sup>15</sup> While tax preparers may have successfully steered their clients to remaining commercial refund delivery products, it is only a matter of time before the market evolves and develops new products, especially ones targeting former RAL purchasers.

### **The IRS Continues to Pass Debt Indicator Information to the Taxpayer but Should Further Enhance the Service.**

While the IRS stopped releasing the DI through the acknowledgement file in 2010, the DI information is still available to taxpayers in the “Where’s My Refund” application. This information helps taxpayers estimate how much of their anticipated refund they will actually receive. The IRS continually improves this program and currently provides taxpayers with the date it will release such refund. The National Taxpayer Advocate believes the program should provide taxpayers with as complete information as possible, especially regarding delays in refund processing due to compliance initiatives.<sup>16</sup>

In the long run, the IRS could provide extremely beneficial service to the taxpayer if it designs the “Where’s My Refund” program to inform taxpayers that their return does not match third-party data. To give the program this capability, the IRS would need to overhaul its information return processing system to allow it to match documents before releasing refunds. Taxpayers would benefit by being able to correct the error early in the process and would avoid the accrual of interest and penalties.<sup>17</sup>

### **CADE 2 Has the Capacity to Meet Taxpayer Needs by Shortening Refunds but the IRS Needs to Be More Aggressive in Educating Taxpayers About Its Benefits.**

In 1999, the IRS initiated its current Customer Account Data Engine to provide a modernized system to process returns. Among the many benefits of CADE 2 (the revised version of CADE), the program allows the IRS daily processing capabilities (instead of weekly), which will translate into faster return processing and more timely account information.<sup>18</sup> Thus, the IRS can release refunds processed through CADE 2 on average five days earlier than if the returns had been processed through the Individual Master File.<sup>19</sup>

We commend the IRS for these efforts. However, to ensure that taxpayers are aware of the reduced processing times, starting in 2012, the IRS should run a marketing campaign at the beginning of every filing season providing details on average processing and refund

<sup>15</sup> H&R Block, 2011 Form 10-K, Fiscal Year Ending April 20, 2011, Item 7 at 20.

<sup>16</sup> In the 2008 annual report, the National Taxpayer Advocate made a legislative recommendation that the IRS include a Revenue Protection Indicator with compliance information in the “Where’s My Refund?” Program. National Taxpayer Advocate 2008 Annual Report to Congress 427-441.

<sup>17</sup> See Most Serious Problem: *Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration But Taxpayer Protections Must Be Addressed, infra.*

<sup>18</sup> The IRS will be able to process refunds within four days of receipt under CADE 2. IRS, *CADE 2 Overview Briefing 22* (Sept. 2011). GAO GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance 3* (Mar. 2011).

<sup>19</sup> The IRS will be able to process refunds within four days of receipt under CADE 2. IRS, *CADE 2 Overview Briefing 9, 22* (Sept. 2011).

turnaround times for different delivery options, and advise taxpayers to inquire about commercial product fees.

### **The IRS Is Not Taking a Proactive Role in the Debit Card Market to Protect Taxpayers.**

It is unclear how the commercial market for refund products will evolve following the decline in the RAL market. However, one product that continues to see high demand is the debit card — both commercial and government-issued.<sup>20</sup> Debit card programs, especially when government-sponsored, have the potential to benefit both tax administration and taxpayers. Unbanked taxpayers benefit by receiving refunds quicker than paper checks and, with the right terms, will not incur high fees. The government benefits by reducing the number and cost of paper checks. These programs also improve the financial literacy of taxpayers by providing the unbanked with access to an ongoing financial account to obtain banking services.<sup>21</sup>

The federal government, *outside of the tax system*, directly participates in the debit card market. It has offered cards as a way to receive benefits since 2008, and the Department of Treasury now requires all federal benefits and *nontax* payments to be made electronically.<sup>22</sup> The purpose of the requirement is to provide a safer, more convenient and cost-effective way for people to get federal benefits.<sup>23</sup> While the use of direct deposit into a bank account is the ideal method, Treasury is encouraging unbanked benefit recipients to apply for the Direct Express Debit MasterCard, which has been available on a nationwide basis to Social Security recipients since 2008 and piloted on a local basis since 2006. As of December 2010, more than 1.5 million beneficiaries had signed up for the program.<sup>24</sup>

The IRS has taken a less proactive approach in the debit card market. Since 2009, a small number of VITA sites encouraged unbanked taxpayers to obtain a debit card sponsored by a participating financial institution. In 2010, the IRS worked with several large institutions to offer debit cards at 20 VITA sites. In the 2011 filing season, almost all of the roughly

<sup>20</sup> Debit cards are also known as prepaid cards and stored value cards. For more information on debit cards, see <http://www.nbpc.org/en/What-Are-Prepaid-Cards.aspx> (last visited July 24, 2011).

<sup>21</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 4 (Mar. 31, 2011).

<sup>22</sup> Individuals who apply for nontax benefits after May 1, 2011 must choose an electronic payment option upon enrollment. All paper check recipients who applied for benefits before May 1, 2011 are required to switch from paper checks to electronic payments by March 1, 2013. 31 C.F.R. § 208. See also 31 U.S.C §§ 3332, 3336.

<sup>23</sup> Department of Treasury, *Electronic Payment Rule (31 C.F.R. § 208) Frequently Asked Questions*, available at [http://waysandmeans.house.gov/UploadedFiles/Congressional\\_FAQs\\_Final\\_2010.doc](http://waysandmeans.house.gov/UploadedFiles/Congressional_FAQs_Final_2010.doc) (last visited July 19, 2011).

<sup>24</sup> In December 2006, the Social Security Administration (SSA) launched a pilot program offering a debit card to 35,000 Old-Age, Survivors, and Disability Insurance (OASDI) and Supplemental Security Income (SSI) paper check recipients in Illinois. Based on the results of the pilot, the program went national in June 2008. FMS, U.S. Dept. of Treasury, *Treasury Extends Direct Deposit to Millions of Americans, Phasing out Paper Checks for Benefit Payments* (Dec. 21, 2010). In a 2009 survey, 95 percent of Direct Express cardholders expressed satisfaction with the card. Dept. of Treasury and Federal Reserve Bank, Go Direct Campaign, *Direct Express Satisfaction Survey*, KRC Research (July 2009).

12,000 VITA and Tax Counseling for the Elderly sites offered debit cards.<sup>25</sup> Despite its efforts to provide these no-cost and user-friendly debit cards to taxpayers, the IRS claims it does not endorse any financial product at volunteer sites. In addition, IRS employees working at these sites cannot offer any of these products to taxpayers.<sup>26</sup>

However, while the IRS may not directly endorse any particular commercial product, it provides the VITA and TCE sites with free CCH TaxWise preparation software, which has fully integrated the Western Union MoneyWise prepaid card. Moreover, CCH sends marketing materials with TaxWise, and the software lists the card as a refund delivery option. While the IRS does not require VITA sites to stock the prepaid cards, the IRS's provision of this software free of charge to VITA/TCE sites has certainly set the stage for TaxWise to market its affiliated products to the VITA/TCE organizations with a clear advantage over competitor products.<sup>27</sup> In addition, because volunteer sites can choose from a wide variety of programs, and there is no government-sponsored product available yet, the terms and fees associated with various options confuse taxpayers.<sup>28</sup>

In her 2008 Annual Report, the National Taxpayer Advocate recommended that Treasury develop a program to enable unbanked taxpayers to receive tax refunds on stored value cards (SVCs) or debit cards. Treasury began pilot testing a program in the 2011 filing season that offered tax refunds on debit cards to low income taxpayers.<sup>29</sup> Treasury mailed offers to approximately 808,000 taxpayers who likely made less than \$35,000 per year and were unlikely to have bank accounts. Taxpayers received cards on a Visa debit card platform from a contractor selected by Treasury, and randomly assigned one of eight offers to each recipient to test how they would respond to different offers. The offers vary by monthly fee (either no fee or \$4.95), whether the card has access to a savings account, and the promotion message (either convenience or safety). Treasury expected a low take-up rate for the pilot, as with most direct mailing campaigns, and it contracted with the Urban Institute to evaluate the program.<sup>30</sup> Unfortunately, Treasury decided to terminate the pilot and will not offer the cards during the 2012 filing season. Low participation was the reason

<sup>25</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 31 (Mar. 2011). For filing season 2011, the IRS worked with JP Morgan Chase, PNC Bank, U.S. Bank, and Western Union. Debit cards from Western Union are available through the VITA return preparation software. The other three banks offer debit cards at a limited number of VITA sites. None of the cards includes a monthly or activation fee, but may involve ATM fees. In addition, VITA partner organizations work with local banks to provide debit cards.

<sup>26</sup> IRS, *Fact Sheet: Offering Financial Products at VITA/TCE Sites* (Jan. 2011).

<sup>27</sup> Western Union, *Tax Refund Prepaid Card Solution For: TaxWise*, available at <http://tax-coalition.org/program-tools/financial-services/asset-building/asset-building-products/debit-cards/western-union-moneywise-card/western-union-moneywise-card> (last visited Oct. 4, 2011).

<sup>28</sup> For a list of the various fees charged by the debit cards offered at VITA/TCE sites, see GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 38 (Mar. 2011). For example, all of the programs have such favorable terms as free activation and monthly maintenance on all programs. However, the Western Union program seemed to have the highest transactional fees, with \$1.95 per ATM withdrawal fees, \$4.95 cash reload fees, and no relationship building with any financial institution.

<sup>29</sup> National Taxpayer Advocate 2008 Annual Report to Congress 427-441.

<sup>30</sup> GAO, GAO-11-481, *2011 Tax Filing: IRS Dealt with Challenges to Date but Needs Additional Authority to Verify Compliance* 17, 39 (Mar. 31, 2011); *Hearing on Financial Literacy: Empowering Americans to Make Informed Financial Decisions*, Subcomm. on Oversight of Government Management, the Federal Workforce, and the District of Columbia, S. Comm. on Homeland Security and Governmental Affairs, 112th Cong. (Apr. 12, 2011) (testimony of Acting Director Joshua Wright Office of Financial Education and Financial Access U.S. Department of the Treasury).

given for the decision — only 2,000 of the 800,000 people offered the cards in 2011 chose to use them.<sup>31</sup>

Without a nationally available government-sponsored card for taxpayers to use for their tax refunds, the IRS will continue to be at the mercy of the commercial debit card industry with respect to the electronic delivery of refunds to unbanked taxpayers. The IRS can do a better job at negotiating more favorable terms on various commercial programs made available to low income taxpayers, but it does not have the authority to regulate the providers of these commercial cards or require that all tax payments be made electronically. The recent Treasury pilot was an important first step in having the federal government take a more proactive role in this area as it has in other benefit payment areas. We are disappointed that Treasury ended the pilot due to low participation. However, we believe the IRS should evaluate the methodology of the pilot, with a particular focus on the marketing campaign, to determine a more effective marketing strategy for a future government-sponsored debit card program. In the meantime, the IRS can protect taxpayers by conducting a public awareness campaign to educate taxpayers about the information they should request before buying commercial debit cards.

#### **The IRS Will Better Serve Taxpayers by Providing a Method with Appropriate Safeguards to Split Refunds for Payment of Return Preparation Fees.**

A main reason taxpayers purchased RACs and RALs was to have a way to pay for tax preparation fees before the IRS released the refund.<sup>32</sup> Now that the RAL is no longer a real option, some taxpayers may struggle to pay preparer fees before they receive their refunds. When the IRS announced it was terminating the DI, it indicated that it would evaluate the possibility of providing taxpayers with a way to pay for preparation through the split refund program.<sup>33</sup> While this option would address the needs of taxpayers, it is certainly not without real risk to taxpayers and tax administration.

The most significant risk is that this initiative could facilitate preparer fraud. The IRS and TAS are currently receiving cases where the preparer prepares a return and tells the client he or she is due a refund of a certain amount. The preparer provides the taxpayer with a copy of what the taxpayer believes is the return the preparer will file, but the preparer later changes the return by increasing the size of the refund. The preparer then splits the refund, with the initial amount deposited into the taxpayer's bank account and the additional, fraudulent amount deposited into the preparer's account (making it appear as if the taxpayer owns the account).<sup>34</sup> If the IRS launches this proposed refund-splitting program

<sup>31</sup> Eric Kroh, *Treasury Won't Renew Debit Card Refund Program in 2012, Spokesman Confirms*, Tax Notes Today (Nov. 1, 2011).

<sup>32</sup> Urban Institute, *Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks: Briefing for the U.S. Department of the Treasury*, Slide 17 (Oct. 21, 2010).

<sup>33</sup> IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, IR-2010-89 (Aug. 5, 2010) ("In a related effort, the IRS plans to explore the possibility of providing a new tool for the 2012 tax filing season to give taxpayers a mechanism to use an appropriate portion of their tax refund to pay for the services of a professional tax return preparer.").

<sup>34</sup> See Taxpayer Advocate Service, *Interim Guidance on Recognizing and Assisting Victims of Return Preparer Theft* (Mar. 14, 2011).

without any safeguards, it may increase the opportunity for this type of fraud. An efficient and effective safeguard is a duly educated taxpayer, who can protect him- or herself from harm, first by choosing an honest preparer, and second by retaining copies of his or her unaltered returns with the preparer's signature and PTIN showing the amount of refund due.<sup>35</sup>

IRC § 6695(f) imposes a \$500 penalty on a preparer who negotiates a tax refund check or electronic payment issued to the taxpayer and deposits the money into the preparer's account. A refund splitting arrangement would work best if Congress amended the provision to permit refund splitting and impose the \$500 penalty when the preparer violates the rules. Because of the resulting increased risk of return preparer fraud, Congress should consider increasing the penalty amount to the greater of 100 percent of the amount misappropriated or \$500. Second, the Anti-Assignment Act may prevent the IRS from issuing a check or payment to an account not owned by the taxpayer.<sup>36</sup>

If the IRS and Treasury overcome the security and legal hurdles, taxpayers would benefit from having the following safeguards built into the program:

1. The IRS should require that the preparer enter his or her PTIN on Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*, in the space dedicated to splitting the refund to pay for preparation fees. This requirement would also benefit the IRS Return Preparer Program by encouraging preparers to obtain their PTINs if they want to receive payment for their services. In addition, it would enable the IRS to track preparation fees.<sup>37</sup> To be effective, however, the IRS must validate the PTINs entered on the form.
2. The IRS should require preparers to explain the split refund process and include a checkbox on Form 8888 where the taxpayer will indicate awareness that the preparer will receive part of the refund deposited into his or her account to pay return preparation and filing fees.

### **The IRS Should Proactively Regulate the Marketing of Products by Preparers.**

Finally, as the IRS recently launched a program to regulate return preparers, it is positioned to take a proactive oversight role in the marketing of refund delivery products by preparers. It can accomplish this by setting forth the appropriate standards in Circular 230 § 10.34, *Standards with respect to tax returns and documents, affidavits and other papers*. Such standards could require preparers to clearly communicate the options available for refund delivery, comparing them to lower-cost options, including those sponsored or provided directly by the federal government. The standards should require preparers to provide

<sup>35</sup> See Status Update: *The IRS Has Made Significant Progress in Developing and Implementing a System to Register and Test Return Preparers*, *infra*.

<sup>36</sup> See 31 U.S.C. 3727, 31 C.F.R. 240.

<sup>37</sup> By including this option and requiring the PTIN on Form 8888, the IRS could collect data on return preparation fees. The IRS can keep the data by preparer credential and geographic area and publish the data in the Statistics of Income. TAS could also publish the data in its Congressional Data Books. Thus, the IRS would not directly regulate fees, but would provide oversight through transparency.

accurate and updated information about the average time it takes the IRS to process returns, especially as IRS rolls out CADE 2, as well as the average length of time it takes the IRS to deliver a refund for private and government-sponsored refund options. Any reference to commercial products should clearly state the associated fees. Further, any preparer who steers clients to the higher-cost options without due regard to the lower cost options should face Circular 230 sanctions.<sup>38</sup> The IRS can ease the burden of this requirement on preparers by providing a plain-language information sheet that all preparers can use. Coupled with a consumer education marketing campaign, this approach arms the taxpayer consumer with the necessary information to make the best choice for him- or herself.

## CONCLUSION

While we believe the decline of the RAL market benefits taxpayers, we also acknowledge that taxpayers, especially the unbanked, will continue to search for a fast, low-cost refund delivery option. As the market evolves to meet this demand, it is in the taxpayers' and government's best interest that the IRS take a more proactive approach with respect to these products. Without the IRS taking such a role, private industry will compensate for the loss of the RAL market, possibly by developing other commercial products with high fees and potentially harmful consequences to taxpayers.

To assume a proactive role in the refund delivery market and protect taxpayers' interests, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Enhance "Where's My Refund" to include more detail about delays due to compliance initiatives;
2. Undertake an aggressive public awareness campaign educating taxpayers about the reduced return processing time as well as its impact on refund turnaround times for government-sponsored refund options. This campaign should also inform taxpayers about the questions they should ask before purchasing a commercial refund product, such as a debit card.
3. Require that CCH remove all references to the Western Union debit card product from the standard TaxWise software the IRS requires VITA/TCE sites to use, or negotiate terms for debit card services as part of its contracting for VITA/TCE tax preparation software;
4. Evaluate the possibility of providing taxpayers with the ability to assign a portion of refunds to preparer bank accounts as long as the IRS modifies Form 8888 to require the preparer to enter the PTIN and adds a checkbox indicating the taxpayer's awareness of the refund splitting arrangement;

<sup>38</sup> 31 C.F.R. § 10.50.

5. Partner with Treasury and the financial sector to offer a Treasury-sponsored debit card for tax refunds, and use the results of the Treasury debit card pilot to design a more desirable product and develop a more effective marketing strategy for the product; and
6. Take a more proactive role in the oversight of the commercial refund delivery products, including amending Circular 230 to require preparers to inform taxpayers about the costs and accurate timeframes associated with each refund delivery option, with associated sanctions for failure to do so, and developing an information sheet for use by preparers.

### IRS COMMENTS

The IRS is committed to providing taxpayers with sufficient information to make informed decisions on their filing, payment, and refund delivery options including electronic alternatives that speed up the delivery of refunds. Each filing season, the IRS delivers extensive communications and conducts outreach to explain the various options available to taxpayers. Key messages for the 2012 filing season include the following.

- Due to technology improvements, the IRS will issue refunds to more taxpayers in as few as ten days this year. In tax year 2010, IRS issued refunds to 98 percent of electronic filers by direct deposit within 14 days and issued refunds to 98 percent of all taxpayers in 21 days or less.<sup>39</sup>
- The IRS posts the refund cycle chart on IRS.gov in English and Spanish, providing very specific information about when a refund should be issued based on when the tax return is filed, whether it was filed electronically or on paper, and whether the refund is delivered by direct deposit or paper check. This information is shared with the tax professional and e-file industry.
- Even though the vast majority of returns are processed without delay, our communications will include reminders regarding the following:
  - How to submit a complete and accurate return,
  - What to expect if a return is selected for review, and
  - That taxpayers should be aware that many variables can affect the speed of a tax refund including the need to protect revenue and to ensure that claims are valid.

Communications will also provide information on filing, payment and refund options; how the refund process works; and the speed of refunds.

The IRS developed the “Where’s My Refund” application to provide an automated method for taxpayers to check the status of their refund. The application has the ability to provide information on many situations that impact the amount or timing of a refund including adjustments due to mathematical errors. The “Where’s My Refund” application does not

<sup>39</sup> Refund Cycle Times for E-filed and Paper Returns by Refund Type, Tax Year 2010 Through Cycle 30.

provide the debt indicator to taxpayers. It will provide a notice to taxpayers who owe a non-tax debt through the Financial Management Service's Treasury Offset Program (TOP) to let them know all or part of their refund may be offset prior to refund release. Once a TOP offset occurs and the offset record is received by the IRS, "Where's My Refund" provides the amount of the offset, as well as the amount of refund the taxpayer can expect to receive. In a small number of situations where the application cannot provide the taxpayer's specific refund information, taxpayers are able to call and speak to a live assistor about their account and refund status.

In 2009, IRS initiated a formal effort to collaborate with banks and Volunteer Income Tax Assistance sites to encourage taxpayers not requesting direct-deposit refunds to opt for a prepaid card sponsored by financial institutions. During the 2011 filing season a total of 4,746 sites (excluding AARP and military sites) offered prepaid cards. The IRS partnered with two different banks to offer prepaid cards at certain VITA sites, which allowed these sites the ability to offer multiple prepaid cards. All VITA sites had the prepaid card option available through the tax preparation software TaxWise. The IRS offers this commercial off-the-shelf tax preparation software to electronically prepare and transmit taxpayer returns. At the time the IRS entered into the software contract with TaxWise, it did not include this debit card feature. Although it is available to all VITA/TCE sites, the particular debit card offered through the software is not required and many sites do not offer this exclusive debit card option. We will continue to evaluate options for the future related to this issue.

With regard to Refund Anticipation Loans, the IRS shares the National Taxpayer Advocate's interest in ensuring consumers are fully informed of their choices. The IRS believes the best approach to combat potential problems is to give taxpayers all the information they need to make decisions with regard to their refunds. For this reason, the IRS conducts extensive communications before and during the filing season to ensure taxpayers are aware of the alternatives — including the low-cost electronic options the IRS itself makes available through its partners.

The National Taxpayer Advocate makes six recommendations in the report.

The IRS will explore the possibility of establishing a Compliance indicator that can be passed to "Where's My Refund," which if implemented would result in a message telling impacted taxpayers their refund is being delayed due to Compliance issues. While the IRS continually improves the features of this application, the cost and complexity of providing more specific information for all circumstances that may impact the amount and/or timing of a refund must be examined.

The IRS agrees that taxpayers should be well informed about their refund options and the expected time it takes the IRS to issue a refund. The IRS's education and outreach program is extensive. Refund issuance and promoting the "Where's My Refund" web and phone look-up tools are key messages built into filing season and new media communications

each year starting with the filing season kick off and continuing throughout filing season including tax tips, news releases, YouTube videos, widgets, external and internal articles, satellite media tours, etc. In preparation for the 2012 filing season a cross functional team developed and will implement updated, consistent internal and external refund messaging across communication channels and vehicles — especially the “Where’s My Refund” landing page, IRS.gov, the *IRS2Go* phone app, the IRS Refund Cycle Chart, and filing season media products. We will work with IRS relationship managers and our partners in the tax and banking industries to promote a consistent refund message and, when necessary, explain delays to taxpayers.

The IRS agrees that providing taxpayers the ability to receive a refund electronically in lieu of a paper check is advantageous for both the government and the taxpayer. In 2015, when we renegotiate the software contract for VITA/TCE electronic preparation and transmission of taxpayer returns, we will consider adding debit card options.

The National Taxpayer Advocate recommends the IRS pursue the ability to assign a portion of refunds to preparer bank accounts. As noted in the National Taxpayer Advocate’s own draft report, the Anti-Assignment Act prohibits the IRS from issuing a check or payment to an account not owned by the taxpayer. In addition, according to regulations contained in Circular 230 and a subsequent Counsel memorandum, there is a clear prohibition on the negotiation of a taxpayer’s check (or electronic refunds) received with respect to a tax liability. Further, our experience with the current split refund program indicates this would increase the risk of fraud that could not be easily controlled by the IRS and would place additional burden on the agency to oversee, regulate, investigate, and review millions of additional transactions.

Due to the low participation rate, Treasury made a decision to terminate the 2011 Treasury-sponsored debit card pilot for tax refunds and will not offer the cards during the 2012 filing season. If Treasury considers sponsoring a debit card for tax refunds in future tax years, the IRS would work with it to explore the feasibility and options.

Finally, the IRS will consider the recommendation relating to Circular 230, but we question whether amending Circular 230 would be effective policy and whether such change is necessary at this time. Circular 230’s section on fees contains language prohibiting “unconscionable fees.” To the extent that consumer protections in the refund products area are needed, the IRS already has due diligence requirements that compel preparers to disclose costs to their clients. In order to impose discipline using Circular 230, IRS has to show by clear and convincing evidence that a practitioner voluntarily and intentionally violated a known legal duty. Any expectations regarding how refund delivery options are disclosed and explained may be more in the realm of the new Federal Consumer Protection agency.

## Taxpayer Advocate Service Comments

We commend the IRS for its continued commitment to educate taxpayers, both before and during the filing season, about refund options. As the IRS rolls out CADE 2 in 2012, it is more important than ever to educate taxpayers about the quick turnaround times associated with government-sponsored options. By providing clear and complete information, including both the range and average refund times associated with these refund choices, the IRS can help taxpayers make informed decisions. We also encourage the IRS to pursue the enhancement of “Where’s My Refund” to include compliance information. In fact, the IRS should consider examining this issue as part of its Real Time Tax System Initiative, which officially began during a public meeting on December 8, 2011.

The National Taxpayer Advocate believes the incorporation of Western Union’s MoneyWise prepaid card in the TaxWise software provides an unfair advantage to the Western Union product and is essentially an indirect endorsement of the product by the IRS. In its response, the IRS states that the debit card feature was not incorporated into the software at the time the IRS entered into the contract with CCH. If the product was added to the software without IRS approval, the IRS should have the authority under the existing contract to demand that it is eliminated immediately. Conversely, if the product was added with IRS approval, it is an improper endorsement. Thus, the IRS should review the terms of the current contract to pursue the immediate elimination of all references by TaxWise to the debit card product in software packages and marketing materials distributed to volunteer sites. It is highly inappropriate to allow the existing arrangement to continue for three more years to the detriment of taxpayers. Once the product is removed, it can be offered externally along with other debit card products. Further, when the IRS renegotiates the contract with CCH for VITA/TCE electronic preparation and transmission of returns, we urge the IRS to address debit cards as well as other commercial refund products. The IRS has the authority to review the terms of all commercial products offered on the software, and the vendor should be required to seek IRS approval before marketing any such product on software for volunteer organizations. Moreover, the IRS should make it clear to the VITA/TCE partners and their customers that it does not endorse any commercial refund products incorporated into existing vendor software.

In its response, the IRS lists several obstacles to the development of a program allowing taxpayers to pay preparation fees through split refund arrangements. The National Taxpayer understands the need for legislative action before the IRS can undertake this initiative. We also believe the IRS must comprehensively evaluate the safeguards necessary to prevent fraud. However, if the IRS successfully proposes legislative changes and can minimize the risk of fraud, it would provide a valuable service by enabling taxpayers to pay preparation fees without incurring the high costs associated with some commercial products.

We are disappointed that Treasury discontinued the debit card pilot after just one filing season. We realize that participation was lower than expected, perhaps because direct mailing did not work well with this population. However, the IRS and Treasury may be able to reach these taxpayers through other means, such as registration at a post office.<sup>40</sup> We encourage the IRS and Treasury to review the findings of the program to determine how to increase participation in a future pilot. The IRS's response displays remarkable passivity in the face of taxpayer need; we encourage the IRS to evaluate the data from the pilot and develop a more successful product and marketing strategy.

Finally, we believe Circular 230 is the appropriate body of law to include standards of behavior and practice expected of tax return preparers. We are aware of the cost disclosure requirements for electronic return originators (EROs) in Revenue Procedure 2007-40 and IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.<sup>41</sup> However, these ERO requirements do not necessarily cover the same preparers covered by Circular 230, and the sanctions are different. In addition, we disagree with the IRS when it suggests that the Federal Consumer Protection agency may be better suited to oversee how preparers disclose and explain refund delivery options. The IRS already regulates the practices of preparers pursuant to the provisions of Circular 230. There is no reason to delegate part of this responsibility to another agency.

## Recommendations

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

1. Enhance "Where's My Refund" to include more detail about delays due to compliance initiatives.
2. Undertake an aggressive public awareness campaign to educate taxpayers about the reduced return processing time as well as its impact on refund turnaround times for government-sponsored refund options. This campaign should also inform taxpayers about the questions they should ask before purchasing a commercial refund product, such as a debit card.
3. Immediately require that CCH remove all references to the Western Union debit card product from the standard TaxWise software the IRS requires VITA/TCE sites to use, or negotiate terms for debit card services as part of its contracting for VITA/TCE tax preparation software.
4. Evaluate the possibility of providing taxpayers with the ability to assign a portion of refunds to preparer bank accounts as long as the IRS modifies Form 8888 to require

<sup>40</sup> In Australia, individuals can obtain a Load&Go card at the post office. This product is a reloadable Visa prepaid debit card. For more information, see <http://auspost.com.au/personal/what-is-loadandgo-card.html> (last visited Dec. 15, 2011).

<sup>41</sup> Rev. Proc. 2007-40, 2007-26 I.R.B. 1488 (June 25, 2007).

the preparer to enter the PTIN and adds a checkbox indicating the taxpayer's awareness of the refund splitting arrangement.

5. Partner with Treasury and the financial sector to offer a Treasury-sponsored debit card for tax refunds, and use the results of the Treasury debit card pilot to design a more desirable product and a more effective marketing strategy.
6. Take a more proactive role in oversight of commercial refund delivery products, including amending Circular 230 to require preparers to inform taxpayers about the costs and accurate timeframes associated with each refund delivery option, with associated sanctions for failure to do so, and developing an information sheet for use by preparers.

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

### RESPONSIBLE OFFICIAL

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

### DEFINITION OF PROBLEM

When a taxpayer's paper refund check is stolen, the IRS asks the Treasury's Financial Management Service (FMS) to issue a replacement check. However, despite the growth of electronic banking and its own efforts to get taxpayers to e-file returns, the IRS has insufficient procedures for replacing stolen direct deposit refunds. In recent years, refund theft has evolved from stealing refund checks from the mail to directing the deposits of tax refunds to thieves' bank accounts. To do so, a thief may alter a tax return intercepted from the mail or an unscrupulous return preparer may alter the direct deposit account number on a return.

The IRS has detailed procedures for replacing stolen paper refund checks, but it has limited procedures for replacing stolen electronic refunds. The taxpayer's ultimate recourse is to pursue legal action against the thief, with no help from the IRS. This lack of procedures causes disparate treatment of taxpayers who elect to receive their refunds electronically compared to those who choose to receive paper checks. Even as the IRS promotes electronic filing and payments, the risk of stolen direct deposits creates a disincentive for taxpayers to e-file.<sup>1</sup>

### ANALYSIS OF PROBLEM

#### Background

*The IRS has procedures for processing a claim for a lost or stolen paper refund check.*

The IRS has established procedures to address theft of a paper refund. The taxpayer completes a Form 3911, *Taxpayer Statement Regarding Refund*, and the IRS contacts FMS. In turn, FMS verifies that no person negotiated the check, cancels it, and returns the credit to the IRS, which sends a new refund record to FMS, which then issues a new check to the taxpayer.<sup>2</sup> If FMS identifies that the paper check has been negotiated, it sends a copy of the check (front and back) to the taxpayer, along with an FMS Form 1133, *Claim Against the United States for the Proceeds of a Government Check*. The form asks a series of questions about the negotiation of the check, which the taxpayer must answer. The taxpayer must

<sup>1</sup> See Internal Revenue Manual (IRM) 21.4.2 (Aug. 26, 2011) (discussing Form 3911). By March 1, 2013, the government will pay all non-tax government payments and benefit payments electronically, either by direct deposit or with a pre-paid debit card. See Department of the Treasury website <http://www.godirect.org>.

<sup>2</sup> The negotiation of a check is the process of conversion into cash or the equivalent value. <http://www.merriam-webster.com/dictionary/negotiate>.

also sign the form three times, and FMS compares these signatures with the check endorsement to determine if the check is forged.

FMS's Check Claims Branch (CCB) decides whether a Form 1133 is valid. If the CCB determines (from examination of the evidence, an opinion from the Questioned Documents Branch, a Secret Service investigation, or a bank protest) that a payee was not involved in the negotiation of the check,<sup>3</sup> FMS issues a settlement check to the payee and charges the Check Forgery Insurance Fund (CFIF).<sup>4</sup> The CFIF is a revolving fund established by statute to settle claims of non-receipt where a third party fraudulently negotiated the original check and to make sure that innocent payees receive timely settlement checks.<sup>5</sup>

***The IRS has limited procedures for correcting direct deposit errors.***

The IRS has limited procedures to correct an IRS error that results in depositing a refund into the wrong bank account.<sup>6</sup> The IRS asks the bank to return the funds, but if the bank does not cooperate, the IRS issues a refund to the taxpayer.<sup>7</sup>

In situations where the taxpayer or return preparer made an error that results in a misdirected direct deposit (DD) refund, the IRS asks the bank to return the funds, but the IRS does not pay reimbursement.<sup>8</sup> The IRS may make the same request if it believes a party intentionally misdirected a refund for purposes of theft, even though the IRS does not have the authority to *require* the return of funds that the bank deposited into the account indicated in the Automated Clearinghouse (ACH) record.<sup>9</sup>

TAS has previously discussed in depth the problems taxpayers encounter when the IRS electronically deposits a refund into a third-party bank account.<sup>10</sup> Insufficient procedures for stolen or misdirected DD refunds can leave taxpayers worse off than if they had requested paper checks. This contradicts the improvements in technology that make it easier for both the taxpayer and the government to issue a DD tax refund.

***The IRS has limited procedures for a claim for a lost or stolen direct deposit.***

If a taxpayer inquires about a missing DD, the IRS refers the claim to FMS, which processes refund trace records following guidelines in the Green Book, *A Guide to Federal Government*

<sup>3</sup> The payee is one to whom money is or is to be paid. <http://www.merriam-webster.com/dictionary/payee?show=0&t=1311771315>.

<sup>4</sup> A settlement check is a replacement check based on the Form 1133 claim issued by FMS to replace the original check. Internal Revenue Manual (IRM) 21.4.2.4.13 (Dec. 20, 2010).

<sup>5</sup> See 31 U.S.C. § 3343.

<sup>6</sup> IRM 21.4.5.10.1 (May 2, 2011).

<sup>7</sup> IRM 21.4.5.10.1(3)a (May 2, 2011). IRS reimbursement under this provision is distinct from FMS reimbursement out of the CFIF.

<sup>8</sup> A misdirected refund is a result of a return with the wrong account number. "The IRS is not responsible for misdirected direct deposits that are a result of bank error or the taxpayer providing the wrong Routing Transit Number (RTN) or bank account number." IRM 21.4.5.10(2) (Jan. 7, 2011).

<sup>9</sup> IRM 21.4.1.4.7.5(4) (Oct. 1, 2011). The Automated Clearing House (ACH) transfers refunds or funds electronically for participating depository financial institutions. IRM 3.17.79.1.1 (Jan. 1, 2011).

<sup>10</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 315-325 (Most Serious Problem: *Direct Deposit of Income Tax Refunds*).

*ACH Payments and Collections.*<sup>11</sup> FMS asks the receiving financial institution to verify receipt of the funds and provide information on their disposition, but does not request any personally identifiable information about the owner of the bank account where the IRS deposited the funds.<sup>12</sup> The institution completes a form verifying deposit of the funds in the given account, supplying copies to the payee account owner and FMS, which in turn forwards a copy to the IRS.<sup>13</sup>

FMS guidelines state in part, “If the taxpayer or the taxpayer’s agent gave incorrect account information, neither FMS nor IRS will assist the taxpayer with recovering the funds, and the taxpayer is free to pursue civil actions.”<sup>14</sup> The IRS interprets this guideline as relief from further obligation as long as the account is the one listed on the return.<sup>15</sup> However, an unauthorized third party who wrongfully inserts an inaccurate bank account number on a return is not “the taxpayer’s agent,” so payment to the listed account would not relieve the IRS of the obligation to pay the taxpayer.<sup>16</sup> The IRS’s narrow and incorrect interpretation of FMS guidelines leaves taxpayers with little recourse to recover their stolen DD tax refunds.

With no revolving fund like the CFIF to settle claims for stolen or misdirected DD refunds, FMS may not reimburse payees for these refunds. As discussed above, the CFIF was created by a statute (before the computer age) that specifically refers to a “check,” with long-standing rules and regulations that do not contemplate electronic payments.<sup>17</sup>

***The IRS continues to promote direct deposit as a means to receive a quicker tax refund check, yet has insufficient procedures to resolve instances where a direct deposit refund is stolen.***

Despite the IRS’s insufficient procedures for handling stolen electronic tax refunds, the IRS continues to promote DD as the faster, more efficient way to receive a refund.<sup>18</sup> However, the IRS and tax preparers fail to inform taxpayers that there is no easy way to replace a stolen or misdirected DD refund. Because the IRS is unwilling to help victims of tax refund theft, some taxpayers have contacted TAS for assistance in recovering DD refunds they did not receive.

<sup>11</sup> FMS defines the *Green Book* as a comprehensive guide for financial institutions that receive ACH payments from and send payments (*i.e.*, collections) to the federal government. The ACH is a fund transfer system governed by the National Automated Clearing House Association, a non-governmental organization, which provides for the interbank clearing of electronic entries for participating financial institutions. *Green Book*, Glossary 9-1, available at <http://www.fms.treas.gov/greenbook/intro/index.html> (last visited Aug. 15, 2011).

<sup>12</sup> *Green Book, Federal Government Participation in the Automated Clearing House* 3-8.

<sup>13</sup> IRM 21.4.2-2 (Nov. 2, 2011); IRM 21.4.2-5 (Oct. 20, 2009).

<sup>14</sup> *Green Book, Federal Government Participation in the Automated Clearing House* 1-9.

<sup>15</sup> *Cf.* IRM 21.4.1.4.7.5 (Oct. 1, 2011).

<sup>16</sup> TAS consultation with FMS Office of Chief Counsel (Apr. 25, 2011).

<sup>17</sup> Congress established the CFIF by law in 1941, before the advent of electronic checks. Pub. L. No. 77-310, 55 Stat. 777 (Nov. 21, 1941). While unrelated regulations provide for electronic checks, the CFIF regulations and rules contemplate forgery of signatures on paper. *Compare* 31 C.F.R. § 240.3 (relating to electronic Treasury checks) with §§ 235.1 *ff.* (governing CFIF); see also *Treas. Fin. Man.* vol. 1, pt. 4, § 7055.

<sup>18</sup> See, e.g., IRS, *Get your refund faster – Tell IRS to Direct Deposit Your Refund to One, Two or Three Accounts*, revised Dec. 29, 2010, <http://www.irs.gov/individuals/article/0,,id=163764,00.html> (last visited Sept. 12, 2011).

### Existing Rules Allow the IRS to Implement Procedures.

The IRS should establish a process for a taxpayer to show that whoever wrongfully altered the bank account number on a return was not an authorized agent. Upon confirmation of the facts, the IRS should pay the refund to the taxpayer.<sup>19</sup> In case of a stolen DD, the IRS Office of Chief Counsel previously has advised that “the Service is legally permitted to reissue the refund to the taxpayer.”<sup>20</sup>

In the case of a return fraudulently altered by a preparer, the IRS should have even more reason to assist the taxpayer. While an unauthorized third party who alters a return may be a mere thief, an errant preparer is abusing a recognized role in the tax system. Citing recommendations by the National Taxpayer Advocate and others, the IRS has taken a widely-publicized position asserting authority to regulate preparers. Not long ago, an IRS report stated, “that tax return preparers and the associated industry play a pivotal role in our system of tax administration and they must be a part of any strategy to strengthen the integrity of the tax system.”<sup>21</sup> Consequently, regulations recommended by that report “will increase tax compliance and allow taxpayers to be confident that the tax return preparers to whom they turn for assistance are knowledgeable, skilled, and ethical.”<sup>22</sup> If the IRS has regulatory authority over preparer ethics, then it should have authority over preparer fraud.

Accordingly, the proposed process to show alteration of the bank account number by an unauthorized person would encompass an errant preparer. Certain cases have held that a return wrongfully altered by a preparer is not valid.<sup>23</sup> Similarly, the IRS should not treat an account number wrongfully altered by a preparer as valid.

### CONCLUSION

The IRS currently reimburses taxpayers in case of IRS error and has legal authority to do so in case of a stolen DD refund. Moreover, the IRS may be obligated to pay reimbursement if someone other than “the taxpayer’s agent” caused the error. To provide relief to victims of DD refund fraud, the National Taxpayer Advocate offers these preliminary recommendations:

1. Establish procedures that make no distinction between paper and electronic refund theft or loss, setting forth standards of evidence upon which the IRS will reimburse the taxpayer.

<sup>19</sup> As indicated above, it is unclear whether the CFIF could reimburse these payments since the applicable statute refers to “forged endorsement” of paper checks. 31 U.S.C. § 3343.

<sup>20</sup> FSA 2000-38-005 (June 6, 2000) (stating advice confirmed in TAS consultation with IRS Office of Chief Counsel, Sept. 14, 2011); see also 31 C.F.R. § 210.4(a)(1) (indicating that an agency that accepts an ACH authorization shall verify “the validity of the recipient’s signature”).

<sup>21</sup> IRS Pub. 4832, *Return Preparer Review* (Dec. 2009) 32.

<sup>22</sup> 75 Fed. Reg. 14,539 (Mar. 26, 2010).

<sup>23</sup> See IRS Office of Chief Counsel Memo. to Special Counsel (National Taxpayer Advocate), June 27, 2011; Chief Counsel Memo. re: Horse’s Tax Service (May 12, 2003) at <http://www.irs.gov/pub/lanoa/pmta-2011-013.pdf>; see also *Beard v. Comm’r*, 82 T.C. 766 (1984) *aff’d per curiam* 793 F.2d 139 (6th Cir. 1986); Chief Counsel Memo. re: Refunds Improperly Directed to a Preparer (Dec. 17, 2008).

2. Train IRS employees involved in refund processing how to recognize and correct accounts where fraud is an issue.
3. Seek additional amounts if the fund that currently reimburses taxpayers in case of IRS error proves insufficient for the proposed purpose.

### IRS COMMENTS

The IRS is committed to providing relief to victims of direct deposit refund fraud. The IRS recognizes that the process for addressing stolen or misdirected refund claims differs between paper check and direct deposit refunds and we are working to make improvements in this area.

When a taxpayer's refund appears to be stolen or misdirected, the IRS initiates a refund trace through FMS regardless of whether the refund was issued by paper check or direct deposit. The IRS relies on FMS to make a determination on the replacement of IRS paper check refunds. The FMS Check Claims Branch determines whether a stolen or misdirected paper check claim is valid and a replacement check issued. Determinations are based on an examination of the evidence, an opinion from the Questioned Documents Branch, a Secret Service investigation, or a bank protest. Once the CCB makes a determination that a payee was not involved in the negotiation of the check, FMS issues a settlement check without any intervention or additional input from the IRS. The Check Forgery Insurance Fund funds the replacement check.

The procedures for tracing and replacing a direct deposit refund in cases of IRS error are comprehensive. FMS performs the requested trace and notifies IRS of the results. When the IRS determines it made an error and misdirected a direct deposit refund, the impacted taxpayer receives a replacement refund. The IRS requests the bank return the misdirected funds, but regardless of whether sufficient funds are available for the bank to return, the IRS reimburses the taxpayer for the full refund amount. In these cases, since the error occurred due to IRS processing, the liability for replacing the misdirected funds lies with the IRS. In such cases, the erroneous refunds are transferred to the general ledger 1540 account. This account represents erroneous refund receivables rather than an account to be funded.<sup>24</sup>

When the IRS determines a direct deposit refund was stolen or the taxpayer or return preparer made an error that resulted in a misdirected direct deposit, the IRS is only able to issue a replacement when the bank returns the funds. The IRS requests the bank return the funds, but it does not have the authority to direct a bank to return funds that are not available if the bank applied the funds as directed by IRS in the Automated Clearinghouse

<sup>24</sup> IRM 3.17.64.17.2.3(1) (Sept. 1, 2011).

record.<sup>25</sup> The CFIF is not available to fund the replacement of the refunds and there is no similar fund to cover replaced direct deposits.

The IRS is working with FMS to improve the process of tracing direct deposit refunds and recouping misdirected funds from financial institutions. For example, IRS and FMS personnel are collaborating to improve the current paper-based direct deposit refund trace process of mailing FMS Forms 150.1 or 150.2 to banks. In order to achieve parity with the paper check process, however, legislative changes may be needed to allow settlement for direct deposit refunds out of the CFIF or to establish a similar, but separate, fund for reimbursing taxpayers for stolen or misdirected direct deposit refunds.

The IRS agrees that providing employees with the appropriate training is important for the IRS to meet its goal of providing a high degree of accuracy to every taxpayer. To accomplish its goals of providing quality service, each year IRS functions conduct a thorough review of the training provided to employees to make sure they have the tools necessary to respond to taxpayers in an appropriate manner. In the return processing centers, all employees are provided with annual fraud awareness training. This training helps employees to improve the identification of questionable refund returns.

With respect to the recommendation to seek additional amounts for the fund that currently reimburses taxpayers in case of IRS error, please note that currently there is no fund for this purpose. The CFIF is currently available only to fund reimbursements to taxpayers for stolen or misdirected paper check refunds. There is no similar fund for direct deposit refunds. Reimbursements due to IRS error are currently written off. Legislative changes may be needed to establish an account similar to the CFIF to reimburse misdirected or stolen direct deposit refunds.

<sup>25</sup> IRM 21.4.1.4.7.5(4) (Oct. 1, 2011). The ACH transfers refunds or funds electronically for participating depository financial institutions. IRM 3.17.79.1.1 (Jan. 1, 2011).

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the disparity in reimbursement of stolen or lost direct deposits and paper checks. As cited in the response, the IRM refers to missing direct deposit cases in which “the taxpayer alleges preparer fraud,” but these IRM provisions lack standards to prove that allegation. On the other hand, paper check forgery is subject to stipulated evidentiary standards as detailed in the response. In addition, the National Taxpayer Advocate is pleased that the IRS agrees with the importance of training employees how to deal with refund fraud.

We agree that neither the CFIF nor any similar fund covers replacement of stolen or lost direct deposits; indeed, that is the reason for the recommendation to identify appropriate funds. As the response acknowledges, the IRS replaces direct deposits when it believes liability lies with the IRS due to processing error. However, it is unclear if the IRS escapes liability merely by delivery to a designated account when that account number has been wrongfully altered.

On August 16, 2011, the National Taxpayer Advocate issued four Taxpayer Assistance Orders to the Deputy Commissioner, Services and Enforcement, to adjust the accounts of taxpayers who were victims of return preparer fraud. The IRS complied with these Taxpayer Assistance Orders and is moving the diverted portions of the refunds from the taxpayers’ accounts to an internal account.

As the response indicates, the IRS has the authority to designate funds to cover its liabilities. While legislation could create a specific fund for the proposed purpose, this existing authority calls into question whether legislation would be necessary. Rather, the IRS should exercise this authority to designate funds for reimbursement of stolen or lost direct deposits and should seek budgetary supplements if needed.

## Recommendations

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

1. Set forth standards of evidence upon which to reimburse a taxpayer who proves elements of direct deposit theft.
2. Draw on IRS funds to reimburse proven victims of direct deposit theft, seeking additional amounts as necessary.

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

### RESPONSIBLE OFFICIAL

David R. Williams, Director, Return Preparer Office

### DEFINITION OF PROBLEM

In 2011, the IRS made tremendous strides in creating and implementing a system to regulate tax return preparers. Most significantly, preparers must now obtain Preparer Tax Identification Numbers (PTINs) before preparing all or substantially all of a tax return for compensation. Through September 2011, over 735,000 preparers acquired PTINs.<sup>1</sup> The IRS is also developing a Form 1040-based examination, a continuing education program, and a compliance strategy.

While the National Taxpayer Advocate commends the IRS for its accomplishments, she has two main concerns as the IRS continues to develop the program:

- **Development of Business Examinations.** In its Return Preparer Review, the IRS committed to develop two types of examinations.<sup>2</sup> The National Taxpayer Advocate understands that the IRS needed to focus initially on the 1040-based exam. However, the IRS should develop two more examinations for business returns as soon as feasible, with the first exam devoted to payroll tax issues and the second covering corporate, partnership, and complex Schedule C topics. The IRS's National Research Program (NRP) data show a high level of underreporting noncompliance with employment taxes, business income reported on individual returns, and corporate income tax.<sup>3</sup> Requiring preparers of these returns (other than attorneys, certified public accountants, and enrolled agents) to pass a minimum competency test will reduce noncompliance in these areas.
- **Consumer Protection Campaign.** As the IRS continues to educate return preparers about the new requirements, it can also protect taxpayers by conducting a comprehensive public awareness campaign to educate taxpayers about the rules. Most importantly, the message should convey to taxpayers that their preparers need to sign the return, enter a PTIN, and give the taxpayer a copy of the return. This campaign will

<sup>1</sup> Information provided by the Return Preparer Office (Oct. 20, 2011).

<sup>2</sup> The IRS published the Return Preparer Review in January 2010. It included the results of a six-month study of the return preparer industry as well as several recommendations which formed the basis for the current IRS initiative to register, test, and require continuing education requirements for preparers. IRS Publication 4832, *Return Preparer Review* (Dec. 2009); IRS, IR-2010-1, *IRS Proposes New Registration, Testing and Continuing Education Requirements for Tax Return Preparers Not Already Subject to Oversight* (Jan. 4, 2010).

<sup>3</sup> The gross federal tax gap attributable to employment tax is estimated at \$54 billion. The portion attributable to underreported corporation income is \$30 billion and underreported business income for individual income tax is \$109 billion. IRS, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance 4* (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf) (last visited Nov. 4, 2011).

arm taxpayers with the knowledge they need to avoid falling victim to negligent or unscrupulous preparers.<sup>4</sup>

## ANALYSIS OF PROBLEM

### Background

The National Taxpayer Advocate has advocated for the regulation of return preparers since 2002. Specifically, she proposed a program to register, test, and certify return preparers as well as to increase penalties and improve due diligence requirements. Moreover, she recommended that the IRS mount a comprehensive advertising campaign to educate taxpayers about paid preparer requirements to sign and provide a copy of the return to the taxpayer, and how to choose a competent preparer.<sup>5</sup>

In January 2010, the IRS published a report on its study of federal return preparers and related issues, which in most important aspects reflected the proposals made by the National Taxpayer Advocate.<sup>6</sup> The IRS has since implemented the following requirements:

**PTIN Requirement.** In September 2010, Treasury issued regulations requiring preparers who are compensated for preparing or assisting in the preparation of all or substantially all of any U.S. federal tax return, claim for refund, or other tax form submitted to the IRS (with the exception of certain enumerated tax forms) to obtain a Preparer Tax Identification Number. PTIN registration began in the fall of 2010 and the program has issued over 735,000 PTINs as of September 2011.<sup>7</sup> Approximately 62 percent of these PTIN holders are not attorneys, certified public accountants (CPAs), or enrolled agents.<sup>8</sup> Preparers are required to renew their PTINs every (calendar) year.<sup>9</sup>

**Testing Requirement.** Attorneys, CPAs, enrolled agents, certain supervised preparers, and individuals who do not prepare Form 1040 series returns are not required to take the competency test. All other paid preparers must pass an examination that covers the ethical responsibilities of federal tax return preparers as set forth in Circular 230, as well as the basic preparation of Form 1040 series along with the basic related schedules and forms. The

<sup>4</sup> In fiscal year (FY) 2011, the IRS Criminal Investigation Division initiated 371 investigations on allegedly abusive return preparers and 233 cases were recommended for prosecution. See IRS, Statistical Data – Abusive Return Preparers (Oct. 11, 2011), available at <http://www.irs.gov/compliance/enforcement/article/0,,id=106776,00.html> (last visited Oct. 20, 2011).

<sup>5</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 41-69; National Taxpayer Advocate 2008 Annual Report to Congress 503-512; National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>6</sup> IRS Publication 4832, *Return Preparer Review* (Dec. 2009).

<sup>7</sup> Information provided by the Return Preparer Office (Oct. 20, 2011).

<sup>8</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 1, 4 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>9</sup> TD 9501 (Sept. 30, 2010); IRS, *Requirements for Tax Return Preparers: Frequently Asked Questions*, available at <http://www.irs.gov/taxpros/article/0,,id=218611,00.html> (last visited Sept. 8, 2011).

IRS expects testing to begin in November 2011. Those who are required to take the test and already have a provisional PTIN will have until December 31, 2013 to pass the test.<sup>10</sup>

**Continuing Education.** Beginning in the 2012 calendar year, all preparers required to take the competency exam must complete 15 hours of continuing education per year, including three hours of federal tax law updates, two hours of ethics, and ten hours of other federal tax law.<sup>11</sup> Preparers subject to this requirement cannot renew their PTINs without meeting the requirement.<sup>12</sup>

**Suitability.** All preparers are subject to tax compliance checks. All of those who are not attorneys, certified public accountants, or enrolled agents must also submit to some form of background checks.<sup>13</sup>

**We Commend the IRS for its Accomplishments in Implementing the Registration System but Believe the IRS Can Better Protect Taxpayers with Two Main Modifications to the Program.**

The National Taxpayer Advocate is pleased with the progress the IRS has made with this important program, which will greatly benefit both taxpayers and tax administration. However, as the IRS further implements the program, the National Taxpayer Advocate has concerns about two issues: (1) the availability of only one competency examination and (2) the lack of a public awareness campaign educating taxpayers about the new preparer requirements.

**The Development of Additional Competency Examinations Covering Business Tax Topics Will Protect Taxpayers and Improve Compliance in the Largest Components of the Tax Gap.**

The IRS committed to develop two examinations for preparers, one covering Form 1040 series returns with wage and nonbusiness income, and the second examination for wage and small business 1040 series returns.<sup>14</sup> However, the IRS decided to first offer only one competency exam covering 1040 series returns, and exempted preparers who do not handle these returns from the requirement.<sup>15</sup> The test specifications released by the IRS in

<sup>10</sup> The IRS has been issuing provisional PTINs to individuals who are not attorneys, CPAs, or enrolled agents to enable them to prepare tax returns prior to meeting competency testing and suitability requirements. Even with the launch of the test in November 2011, the IRS will continue issuing provisional PTINs at least through April 18, 2012 to prevent a disruption in the filing season. Once the IRS stops issuing provisional PTINs, tax return preparers who are required to complete the competency test or suitability requirements must complete these requirements successfully prior to obtaining a PTIN. IRS Notice 2011-80, 2011-43 I.R.B. 591; IRS, IR 2011-96, *IRS Issues Guidance to Further Implement Return Preparer Oversight* (Sept. 21, 2011).

<sup>11</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight 6* (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>12</sup> Circular 230, 31 C.F.R. Part 10, § 10.6(f)(1)(iii), (rev. Aug. 2011).

<sup>13</sup> Circular 230, 31 C.F.R. Part 10, § 10.5(d), (rev. Aug. 2011); see also <http://www.irs.gov/taxpros/article/0,,id=221009,00.html> (last visited Sept. 12, 2011).

<sup>14</sup> IRS Publication 4832, *Return Preparer Review* (Dec. 2009).

<sup>15</sup> The following preparers are exempt from taking the current minimum competency exam: attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, enrolled actuaries, "supervised preparers," and individuals who do not prepare Form 1040 series tax returns. IRS, Notice 2011-6, I.R.B. 2011-3 (Jan. 17, 2011).

September 2011 set the topics that may be covered in the competency exam, which include wage, nonbusiness, and business income Form 1040 series returns.<sup>16</sup> The IRS plans to make the exam available in November 2011, but has not publicly committed to develop any other examinations.<sup>17</sup>

The National Taxpayer Advocate understands that the IRS needed to focus initially on one examination. It is reasonable to start with Form 1040 series returns, due to the size and vulnerability of the individual taxpayer population, especially those with low incomes.<sup>18</sup> However, we are concerned that preparers who prepare other returns will continue to do so without passing a minimum competency test. While it is reasonable to expect preparers to know who is subject to the exam, most taxpayers will not know all the details of the requirements and may believe their preparers have demonstrated competency to the IRS if they have IRS-issued PTINs. Thus, it is vital that the IRS develop examinations covering more complex business tax issues.

We recommend that the IRS develop two business examinations. The first exam should be devoted to payroll tax issues due to the significant impact of noncompliance in this area.<sup>19</sup> The payroll service provider industry prepares employment tax returns for over 1.4 million employers.<sup>20</sup> TAS Research found that for tax years 2008 and 2009, payment noncompliance rates for employment tax businesses hovered at or above 20 percent. For those same years, filing noncompliance rates for employment tax businesses were approximately 15 percent.<sup>21</sup> In addition, IRS National Research Program (NRP) 2001 federal tax gap data estimated the employment tax gap at more than \$54 billion.<sup>22</sup> Further, the National Taxpayer Advocate has raised significant concerns over the years regarding the payroll tax industry, payroll service providers (PSPs) in particular.<sup>23</sup> By requiring all individuals who

<sup>16</sup> IRS, IR-2011-89, *IRS Releases Specifications for Registered Tax Return Preparer Test* (Sept. 6, 2011).

<sup>17</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 1, 4 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>18</sup> Approximately 140 million individual taxpayers file Form 1040 returns and approximately 60 percent use preparers. *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 5 (July 28) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>19</sup> IRS data shows that 26.8 percent of Forms 940, 941, 943, and 944 returns had a paid preparer in tax year 2009. However, the number is likely substantially higher. IRS, Compliance Data Warehouse (CDW), Business Returns Transaction File (BRTF) for tax year 2009 (Oct. 2011).

<sup>20</sup> Payroll service providers that are members of the National Payroll Reporting Consortium represent over 1.4 million employers with a combined total of more than 35 million employees, over one-third of the private-sector workforce. See <http://www.nprc-inc.org/about.html> (last visited Oct. 20, 2011).

<sup>21</sup> IRS, CDW, BRTF for tax years 2008 and 2009 (Apr. 2011). 2001 tax gap data estimate that noncompliance due to underreported FICA and unemployment taxes amounts to \$14 billion per year. IRS, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* 4 (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf).

<sup>22</sup> IRS, Tax Year 2001 Federal Tax Gap, available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf) (last visited Oct. 19, 2011). The tax gap amount for FICA and unemployment taxes amounted to \$14 billion and the self-employment amounted to \$39 billion.

<sup>23</sup> A payroll service provider typically prepares employment tax returns for signature by its common law employer/client and processes the withholding, deposit and payment of the associated employment taxes for its common law employers/clients. When providers go out of business or embezzle their customers' funds, the employers remain liable for the underlying payroll taxes, penalties, and interest, and can experience significant burden. National Taxpayer Advocate 2007 Annual Report to Congress 337-354. Consistent with a 2004 legislative recommendation by the National Taxpayer Advocate, the IRS has issued internal guidance stating that it can assess the Trust Fund Recovery Penalty against third-party payers. See Scott D. Reisher, Director, Collection Policy, *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer* (July 1, 2011); National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

prepare all or substantially all of a Form 941, *Employer's Quarterly Federal Tax Return*, or any other employment tax return, and who are not in an exempt category (*i.e.*, attorney, CPA, or enrolled agent) to take a minimum competency exam, the IRS will help professionalize the industry and ensure that such preparers are minimally competent. The American Payroll Association (APA) currently administers examinations to payroll professionals in connection with providing certification credentials. The IRS could partner with the APA to develop a minimum competency exam to meet the needs of the IRS program.<sup>24</sup> Finally, to address the noncompliance found in payroll taxes, we believe the payroll exam should include a vigorous ethics component.

The second business exam should cover complex Schedule C, corporation, and partnership tax issues. The NRP estimates the 2001 federal tax gap attributable to underreported corporation income at \$30 billion and underreported business income for individual income tax at \$109 billion.<sup>25</sup> IRS data shows that approximately 88.5 percent of business returns were prepared using a paid preparer in tax year 2009.<sup>26</sup> In addition, anecdotal evidence from Local Taxpayer Advocates, the Low Income Taxpayer Clinics, other preparers, and the experience of the National Taxpayer Advocate indicates that return preparer noncompliance is a problem with business tax returns. Thus, requiring preparers of business tax returns to establish minimum competency would help reduce this high level of noncompliance (We anticipate the requirement would apply to the same categories of preparers that are covered by the Form 1040 series examination).<sup>27</sup> At the very least, the IRS should develop studies to validate these concerns.

A commitment by the IRS to develop additional examinations covering business tax topics would send a signal to preparers that the IRS is focused on these returns. Such a commitment might even have an early compliance impact as affected preparers may try to distinguish themselves by showing their competency ahead of time. In the meantime, as the IRS continues to develop policies concerning the Form 1040 series exam, it makes sense to determine the impact of such policies on any future testing requirements.

**A Taxpayer Education Campaign Reminding Taxpayers to Obtain a Copy of Their Returns With Preparer's Signature and PTIN Will Protect Taxpayers Against Fraud, Increase Preparer Compliance, and Help Detect Preparer Noncompliance.**

In the first year of the new program, the IRS focused most communications on making preparers aware of the rules that apply directly to them. We understand why the IRS initially prioritized preparer education over taxpayer communications. During the first year, the

<sup>24</sup> See <http://www.americanpayroll.org/certification/> (last visited Oct. 19, 2011).

<sup>25</sup> IRS, *Tax Year 2011 Federal Tax Gap*, available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf) (last visited Oct. 19, 2011).

<sup>26</sup> Specifically, 88.5 percent of Forms 1120, 1120S and 1065 were prepared using a paid preparer for tax year 2009. IRS, CDW, BRTF for tax year 2009 (Oct. 2011).

<sup>27</sup> The Government Accountability Office (GAO) analyzed IRS data from the National Research Program study on S corporation compliance and found that 81 percent of S corporations used a paid preparer and 71 percent of those that did were noncompliant. GAO, GAO-10-195, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules* 15 (Dec. 2009).

IRS needed to cast a wide net and persuade as many preparers as possible to register (*i.e.*, bringing preparers into the system before telling taxpayers how to find them). However, since the National Taxpayer Advocate first proposed a system to regulate preparers in 2003, we have taken the position that a taxpayer education campaign is a key component of the program's success.<sup>28</sup> Thus as the program progresses, the IRS needs to devote more resources to informing taxpayers about the rules. Specifically, the message should remind taxpayers that if they paid for tax preparation, their preparer is required to enter the PTIN, sign the return, and provide a copy to the taxpayer.

Taxpayers can protect themselves from unscrupulous or underground preparers if they can identify those who refuse to comply with the basic rules to register and obtain PTINs. While the IRS cannot guarantee the competency of any registered preparers, especially before they are subject to suitability checks and competency examinations, taxpayers should be able to form their own opinions about a preparer who refuses or neglects to follow the applicable professional rules. Taxpayers may even be able to help police the preparer community if the IRS develops procedures to report noncompliance. Without taxpayer education, the IRS is missing a valuable opportunity to use taxpayers as a compliance mechanism and is unnecessarily putting taxpayers at risk. For example, when the GAO conducted undercover visits to return preparers in 2006, it found that approximately 32 percent of the preparers either did not sign the return or failed to provide an identifying number.<sup>29</sup> If taxpayers are warned to check for these items, they may avoid some of the downstream compliance consequences typically associated with returns prepared by noncompliant or underground preparers. Moreover, if taxpayers know to demand that the preparer put his or her PTIN on the return, the number of "underground" preparers will be minimal.

A taxpayer education campaign could also reduce the number of taxpayers falling victim to fraudulent preparer practices. TAS has received a significant number of cases where a portion of the taxpayer's refund is improperly direct deposited into the preparer's bank account.<sup>30</sup> In many instances, after the taxpayer has left the office, the preparer will change the return to increase the refund and deposit the additional amount into his or her own account. The taxpayer may not realize what happened until the IRS freezes the refund or sends the taxpayer a notice seeking to collect the improper refund. We believe the IRS should warn taxpayers about this significant risk,<sup>31</sup> and stress the importance of obtaining a copy of the return, which would substantiate the taxpayer's case as well as any fraud allegations against the preparer.

<sup>28</sup> See National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

<sup>29</sup> GAO, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 23 (Apr. 4, 2006). In addition, out of the 19 returns prepared, all 19 contained errors and the tax liability was wrong on 17 of the 19 returns.

<sup>30</sup> Through fiscal year 2011, TAS had approximately 140 alleged preparer fraud cases open. Each of these cases may be one of many instances of alleged fraud by the preparer and are often part of a concurrent criminal or civil IRS investigation of a potentially broader scheme. TAS, 2011 Refund Fraud CTA Case Referrals (on file with the Taxpayer Advocate Service).

<sup>31</sup> Instructions to IRS Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*.

The IRS should launch this public awareness campaign in the 2012 filing season. The IRS generally has many low-cost communication platforms, but it should use paid advertising if necessary to reach a widespread and diverse audience.<sup>32</sup>

We also believe a publicly-accessible database of PTIN holders is an important tool for taxpayers so they can make informed decisions when choosing a preparer. The IRS has indicated that it plans to build this type of database in several years.<sup>33</sup> We support this decision and encourage the IRS to indicate the type of preparer and any limitations on the types of returns he or she is qualified to handle.

### **We Encourage the IRS to Develop a Return Preparer Compliance Strategy That Takes a Responsive Regulation Approach.**

We encourage the IRS to take a “responsive regulation” approach, tailored to address different types of noncompliance, in the preparer compliance strategy now under development.<sup>34</sup> That is, the IRS should start with “soft” compliance touches, such as notices and well-targeted education visits, and progressively step up enforcement actions when a preparer’s actions become more egregious. Accordingly, the Taxpayer Advocate Service will closely monitor the development, implementation, and evaluation of this strategy.

## **CONCLUSION**

The National Taxpayer Advocate is pleased with the progress made by the IRS in developing a program to regulate return preparers. This program enables the IRS to effectively track preparers, ensure they are competent to prepare tax returns, and coordinate all preparer-related initiatives to effectively provide services and apply enforcement when necessary. We continue to have concerns regarding the limited availability of competency examinations and the delay in the launch of a taxpayer consumer protection and education campaign.

While the IRS continues to develop the return preparer program, the National Taxpayer Advocate preliminarily recommends that it take the following actions:

1. Develop two examinations on business topics, with the first covering payroll tax issues and the second covering corporations, partnerships and complex Schedule C items, and launch the first exam by 2014 and the second by 2015.

<sup>32</sup> The IRS should also revise the “Tips for Choosing a Tax Preparer” message that the IRS releases at the beginning of each filing season to prominently display these requirements. Currently, the information is included at the end of the message. See <http://www.irs.gov/individuals/article/0,,id=133088,00.html> (last visited Oct. 19, 2011); IRS, Tax Tip 2011-06, *Points to Keep in Mind When Choosing a Tax Preparer* (Jan. 10, 2011).

<sup>33</sup> *Hearing on Return Preparation Program Before the U.S. House Comm. on Ways and Means, Subcommittee on Oversight* 5 (July 28, 2011) (statement of David R. Williams, Director, Return Preparer Office, IRS).

<sup>34</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 74-116 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

2. Mount a public awareness campaign, starting in the 2012 filing season, specifically reminding taxpayers that if they paid for return preparation, they should obtain a copy of the return that shows the preparer's signature and PTIN.
3. Incorporate into filing season communications a warning to taxpayers about preparers who may attempt to direct deposit all or part of the taxpayer's refund into the preparer's bank account.

### IRS COMMENTS

The IRS appreciates that the National Taxpayer Advocate has recognized the significant strides the IRS has made establishing an oversight program for return preparers. We have successfully implemented core program components including PTIN registration, competency testing, and registration of continuing education providers. We continue to work on remaining aspects of the program including establishing suitability requirements, creating and implementing standardized business processes, and finalizing the roles and responsibilities of the newly-created Return Preparer Office (RPO) and its relationship to the Office of Professional Responsibility.

Perhaps most important is our ongoing effort to establish and improve compliance activities that support the ultimate program goal of improving tax administration. The RPO has recently assumed leadership for return preparer compliance activities and is focused on exploring the best methods of identifying problematic preparers and applying the most cost-effective treatments. Building this compliance strategy is an ongoing process but we have already launched a number of trial efforts to help determine what approaches will have the most impact. We look forward to working with the National Taxpayer Advocate and the many organizations representing tax practitioners as our compliance work evolves.

The IRS launched the competency test for individuals seeking to become Registered Tax Return Preparers in November 2011. We anticipate that as many as 400,000 people will take the test by the end of 2013. The test is designed to ensure preparers demonstrate competency with regard to preparation of individual income tax returns. The test is focused on 1040 preparation because these returns account for the largest portion of the tax gap and because the Return Preparer Review concluded this area offers the largest opportunity to improve overall tax administration. The test was developed with the participation of numerous internal and external tax experts in conjunction with an internationally known testing company.

Our goal is to build a data-driven strategy to improve compliance and tax administration more broadly. By requiring all tax preparers to obtain and maintain a single identification number, we now have the ability to analyze preparer-related data in unprecedented detail. We intend to use that data to determine where there are preparer performance issues and identify strategies for improving that performance. In this context, we intend to consider the areas the National Taxpayer Advocate recommends for additional testing, but at this

time, our current efforts are focused on creating and launching the 1040 test. We will also engage with the tax professional community as we determine and implement our strategies to improve preparer compliance.

The Return Preparer Office has crafted a communications strategy that parallels the phased-in nature of the entire return preparer program. During 2010 and 2011, RPO focused its communications on educating return preparers about the new regulations. It is imperative that all preparers understand their responsibilities before preparing returns for compensation. In addition, RPO recognizes the importance of a robust public awareness campaign and we will communicate to consumers about the requirement that tax returns be signed by paid preparers and the mandatory use of a PTIN.

One concern of both the IRS and reputable return preparers is that unscrupulous preparers will continue to prepare returns, but not sign them, in an effort to avoid the regulatory process. If preparers are intentionally noncompliant with the oversight regulations, then there is a likelihood they are also willing to engage in other noncompliant behaviors to benefit themselves or their clients, such as preparing incorrect tax returns. This risk underscores the need to educate consumers about the regulations and to stress the importance of protecting themselves by hiring only preparers who have registered for a PTIN and sign returns.

We share the National Taxpayer Advocate's concern regarding a preparer's misappropriation of a portion of the taxpayer's refund without the taxpayer's consent. We believe it is important to warn taxpayers of this significant risk, in addition to educating them about the new regulations. Therefore, we will make both of these topics part of our future messages to the public.

Within the next few years, the IRS plans to create a publicly-accessible database of PTIN holders. Some time after December 2013, when provisional PTIN holders must have passed the competency test and suitability checks, and after the public database of PTIN holders is available, RPO will launch an extensive marketing campaign to inform taxpayers not only about the signing of returns, but also to use only registered tax return preparers, CPAs, attorneys or enrolled agents for the preparation of individual income tax returns. Our strategy will involve multiple communication tools, including news releases, website updates, YouTube videos, podcasts, and modification to the Form 1040 instructions, to advise taxpayers to use only those return preparers with these credentials who sign returns and use PTINs.

In summary, we appreciate the National Taxpayer Advocate's commendation of the progress with the return preparer program, and we will continue our efforts to make it a successful, effective program.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate supports the continuing commitment of the Return Preparer Office to develop a successful and effective oversight program. We look forward to working with the RPO as the office evolves. We are particularly interested in contributing to the development of the data-driven compliance strategy as well as future public awareness campaigns directed at taxpayers.

In addition, we reiterate the need for the IRS to develop additional exams in areas associated with high levels of noncompliance. The National Research Program data show a high level of underreporting in employment taxes, business income reported on individual returns, and corporate income tax.<sup>35</sup> We urge the IRS to analyze the preparer-related data as soon as it becomes available in order to focus on the areas of high noncompliance specific to preparers. As it develops strategies to address preparer performance in these areas, we encourage the IRS to consider developing a competency examination focusing on these topics. We believe a competency examination for problem areas specific to preparers would protect taxpayers and enable the IRS to redirect its resources to more egregious preparer behavior.

## Recommendations

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

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

<sup>35</sup> *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance 4* (July 8, 2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf) (last visited Nov. 4, 2011).

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

### RESPONSIBLE OFFICIAL

Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities Division

### DEFINITION OF PROBLEM

In 2010, as many as 730,000 exempt organizations (EOs) had annual gross receipts that were normally \$25,000 or less.<sup>1</sup> Prior to 2006, these small EOs did not have annual IRS reporting requirements, and some had never been required to seek initial recognition of their tax-exempt status.<sup>2</sup> Congress passed section 1223 of the Pension Protection Act of 2006 (PPA) to correct the resulting information gaps.<sup>3</sup> The PPA not only imposes an annual filing requirement on small EOs but also provides that the exempt status of any EO failing to file for three consecutive years is automatically revoked. The statute does not specify how EOs are to apply for reinstatement of exempt status following automatic revocation.

In accordance with the PPA, on June 8, 2011, the IRS notified approximately 275,000 EOs, most of which were public charities, that their tax-exempt status had been automatically revoked. On the same day, the IRS issued guidance on how to apply for reinstatement and provided transitional relief for small EOs.<sup>4</sup> The National Taxpayer Advocate commends the IRS for providing meaningful transitional relief to these organizations. However, the IRS makes it unnecessarily burdensome for EOs to obtain reinstatement following automatic revocation by:

- Not allowing administrative challenges to the accuracy of the automatic revocation;
- Requiring EOs to apply for reinstatement by submitting Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, the same form taxpayers file to request *initial recognition* of exempt status, without plans to use the information on the form in a way that justifies the burden on taxpayers;<sup>5</sup>

<sup>1</sup> IRS response to TAS information request (Aug. 17, 2010). The exact number is uncertain because the available data may not reflect current levels of gross receipts for all organizations. The term "exempt organization" encompasses organizations exempt from federal income tax pursuant to Internal Revenue Code (IRC) § 501(a). "Public charity" refers to a type of organization exempt pursuant to IRC § 501(c)(3), and "includes most organizations active in the arts, education, health care, and human services. They are what most people mean when they use the term 'nonprofit organization.'" (More precisely, public charities and private foundations together comprise "charities," generally speaking, a subset of "exempt organizations," in turn a subset of "nonprofit organizations.") Of all exempt organizations registered with the IRS as of 2005, almost 63 percent were public charities. See Amy Blackwood, Kennard T. Wing & Thomas H. Pollak, *The Nonprofit Sector in Brief, Facts and Figures from the Nonprofit Almanac 2008: Public Charities, Giving, and Volunteering*, Urban Institute, available at [http://www.urban.org/UploadedPDF/411664\\_facts\\_and\\_figures.pdf](http://www.urban.org/UploadedPDF/411664_facts_and_figures.pdf).

<sup>2</sup> See IRC § 508(c)(1)(B), with respect to organizations otherwise exempt under IRC § 501(c)(3). Other organizations specified in IRC § 501 are also not required to seek formal recognition of exempt status.

<sup>3</sup> Pension Protection Act of 2006, Pub. L. No. 109-280 § 1223, 120 Stat. 780, 1090 (2006). See S. Rep. No. 109-336 (2006) 41, accompanying S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Tit. III, W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return.

<sup>4</sup> See IRS Identifies Organizations that Have Lost Tax Exempt Status; Announces Special Steps to Help Revoked Organizations (June 8, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=240239,00.html?portlet=7>.

<sup>5</sup> Organizations seeking recognition of exempt status other than under IRC § 501(c)(3) submit Form 1024, *Application for Recognition of Exemption Under Section 501(a)*.

- Not allocating additional resources to handle applications for reinstatement or taking into account the effect on resources of applications for reinstatement; and
- Not notifying EOs when they have failed to file two consecutive required returns, and automatic revocation is imminent.

## ANALYSIS OF PROBLEM

### Background

Under IRC § 501(a) and (c)(3), EOs devoted to charitable, religious, educational, or certain other purposes may be exempt from federal tax, and contributions to these organizations may be tax deductible.<sup>6</sup> These organizations, most of which are public charities, generally must formally apply for recognition of their tax-exempt status and file annual information returns.<sup>7</sup> From 1969 until 2006, Congress excused these EOs with gross receipts of normally not more than \$5,000 from both applying for recognition and filing returns.<sup>8</sup> Over the same period, the IRS increased the threshold for the annual reporting exception to \$25,000.<sup>9</sup>

As a result, an organization that had to apply for initial recognition under IRC § 501(c)(3) (because its gross receipts exceeded \$5,000) was not necessarily required to file annual returns (because the receipts did not exceed \$25,000) and could thus become “invisible” to the IRS. An organization with gross receipts of less than \$5,000 could dispense with the application for initial recognition of exempt status under IRC § 501(c)(3) and remain invisible as long as its gross receipts stayed below the applicable thresholds.<sup>10</sup>

Because of these exceptions to annual reporting requirements, the IRS could not maintain a reliable record of small EOs' continuing existence. The public could not easily obtain basic information about a nonreporting organization, such as its current address, and the IRS did not know when to omit EOs from its published list of organizations to which charitable contributions could be made.<sup>11</sup> To address these concerns, the PPA imposed an annual reporting requirement on the smaller EOs not previously required to file returns, and further

<sup>6</sup> IRC § 170(c).

<sup>7</sup> IRC § 508(a); IRC § 6033 (a)(1). The general obligation to file annual returns applies to all EOs exempt under IRC § 501(a), not only those described in IRC § 501(c)(3).

<sup>8</sup> IRC § 508(c)(1)(B); Treas. Reg. § 1.508-1(a)(3) (excepting such small EOs that are not private foundations from the obligation to apply for recognition of exempt status); IRC § 6033(a)(3)(A)(ii) (excepting such small EOs from filing an annual information return).

<sup>9</sup> IRC § 6033(a)(3)(B) provides discretionary exceptions from filing information returns where such filing is not necessary to the efficient administration of the internal revenue laws. In Rev. Proc. 80-44, 1980-2 C.B. 777, the IRS exempted organizations that are not private foundations and normally have annual gross receipts of not more than \$10,000 from the annual filing requirement; in Rev. Proc. 83-23, 1983-1 C.B. 687, the IRS increased the gross receipts amount to \$25,000. With Rev. Proc. 2011-15, 2011-3 I.R.B. 322, the IRS increased the gross receipts amount to \$50,000, applicable for tax years beginning on or after Jan. 1, 2010.

<sup>10</sup> See, e.g., Treas. Reg. § 1.508-1(a)(3)(ii), defining gross receipts as not normally more than \$5,000 depending on how long the organization has been in existence. Moreover, Form 1024 lists 14 other types of organizations specified in IRC § 501(c) (e.g., civic leagues, business leagues, and social clubs) most of which are not required to obtain formal recognition to be tax-exempt but may obtain formal recognition by submitting Form 1024.

<sup>11</sup> See S. Rep. No. 109-336 (2006) 41, accompanying S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Tit. III, W. Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return.

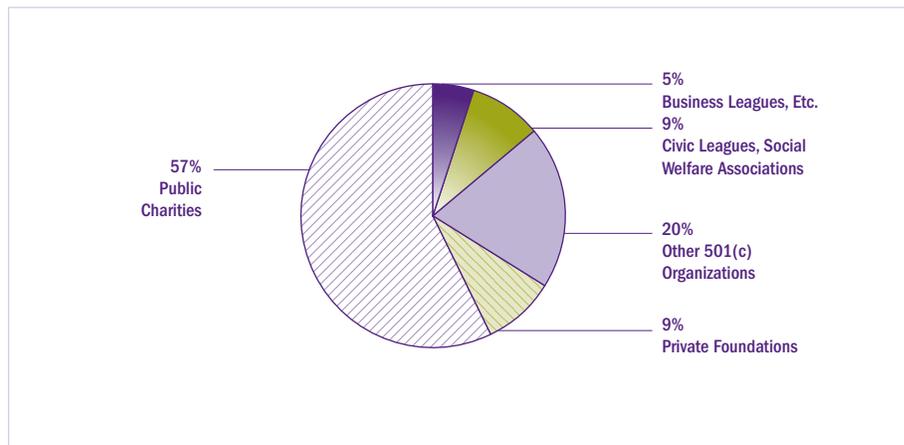
provided for automatic revocation of exempt status of any EO failing to report as required for three consecutive years.<sup>12</sup>

The PPA did not remove the exception for applying for initial recognition of tax-exempt status under IRC § 501(c)(3); EOs with gross receipts that are normally \$5,000 or less are still not required to apply. However, the PPA requires an EO seeking *reinstatement* of exempt status following automatic revocation to submit an application, even if the EO was not required to apply for initial recognition.<sup>13</sup> The statute does not specify how the EO should make the reinstatement application.

### Revoked Organizations Were Primarily Small Public Charities

Information is available for about half of the organizations listed as revoked in June 2011.<sup>14</sup> Of these 144,980 organizations, most were public charities that had last reported revenue of less than \$25,000, as shown in Figures 1.24.1 and 1.24.2, below.

**FIGURE 1.24.1, Revoked Organizations by Type<sup>15</sup>**



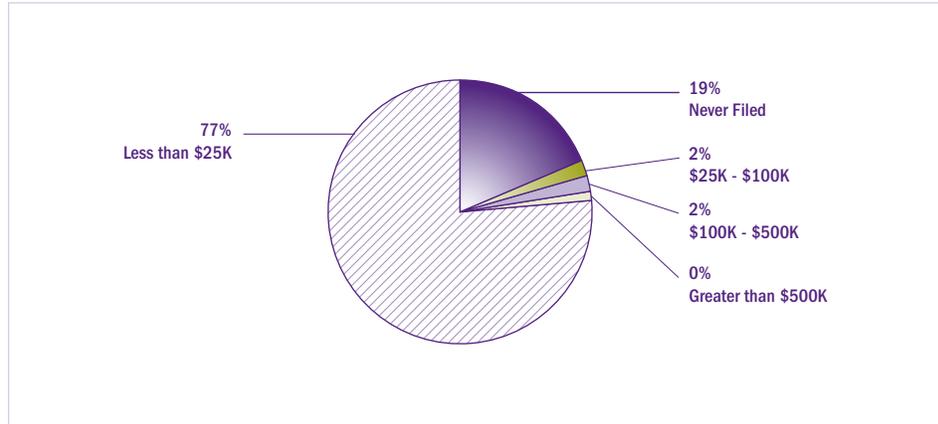
<sup>12</sup> Section 6033(i) now requires small EOs not otherwise required to file an annual return to submit Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*. The obligation to file annual returns applies to all EOs exempt under IRC § 501(a), not only those described in IRC § 501(c)(3). Exceptions to the new reporting requirement include churches, their integrated auxiliaries, and conventions or associations of churches. IRC § 6033(j) provides for automatic revocation for failing to file required returns for three consecutive years.

<sup>13</sup> IRC § 6033(j)(2) ("Any EO the tax-exempt status of which is revoked under paragraph (1) must apply in order to obtain reinstatement of such status regardless of whether such EO was originally required to make such an application.")

<sup>14</sup> According to GuideStar (the registered trademark and operating name of GuideStar USA, Inc., a § 501(c)(3) nonprofit organization that provides information about nonprofits), of the 279,595 nonprofits on the June list of revoked organizations, 134,615 "either never appeared on the IRS list of exempt organizations or have not been on it for some time." See Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/xa/news/articles/2011/for-whom-revocations-tolled.aspx>.

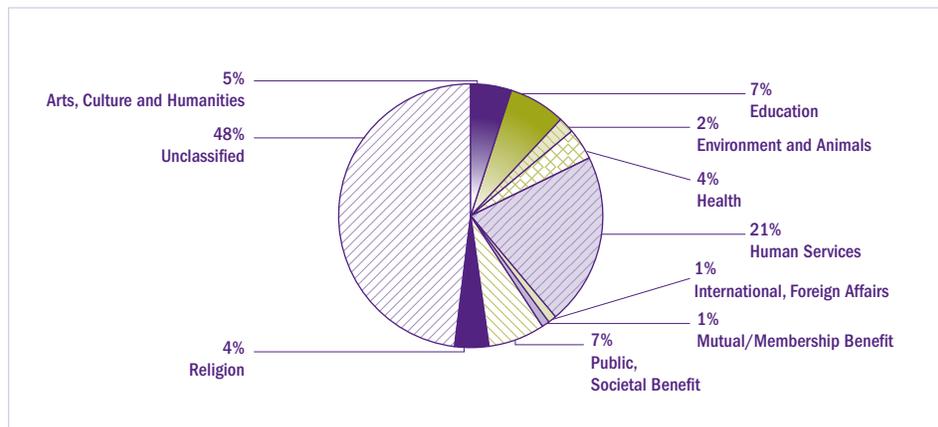
<sup>15</sup> Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/xa/news/articles/2011/for-whom-revocations-tolled.aspx>.

**FIGURE 1.24.2, Revoked Organizations by Last Reported Revenue<sup>16</sup>**



The largest activity sector identified for the revoked organizations was human services, as shown in Figure 1.24.3.

**FIGURE 1.24.3, Revoked Organizations by Sector<sup>17</sup>**



<sup>16</sup> Chuck McLean and Suzanne E. Coffman, *For Whom the Revocations Told: An In-Depth Analysis* (June 2011), GuideStar, available at <http://www2.guidestar.org/rxa/news/articles/2011/for-whom-revocations-told.aspx>.

<sup>17</sup> *Id.* The "Human Services" designation, based on the National Taxonomy of Entities (NTEE) system used by the IRS, encompasses "Crime & Legal-Related, Employment, Food, Agriculture & Nutrition, Housing & Shelter, Public Safety, Disaster Preparedness & Relief, Recreation & Sports, Youth Development and Human Services." See Urban Institute, National Institute for Charitable Statistics, *National Taxonomy of Exempt Entities* (2009), available at <http://nccs.urban.org/classification/NTEE.cfm>. It is not clear whether the IRS will continue to use the NTEE classification system. See IRS Announcement 2011-36 (June 27, 2011), Issues for Public Comment, Activity Codes, available at [http://www.irs.gov/irb/2011-26\\_IRB/ar12.html](http://www.irs.gov/irb/2011-26_IRB/ar12.html).

### Judicial Review of Automatic Revocations Is Not Available, Yet the IRS Does Not Provide an Avenue for Administrative Review.

When an EO's exempt status is revoked, the EO becomes subject to tax on its receipts, and if the organization was exempt under IRC § 501(c)(3), its donors can no longer deduct their contributions, both of which are serious consequences that may prevent the organization from continuing operations. Administrative review rights would normally exist to allow EOs to contest revocation,<sup>18</sup> and the PPA does not preclude administrative appeal. However, the IRS declines to provide administrative appeals of its conclusion that an EO's exempt status was *automatically revoked*, instead advising taxpayers to simply contact the IRS in the event of a dispute.<sup>19</sup> The absence of this basic taxpayer protection is compounded by the fact that judicial review of automatic revocations is not available.<sup>20</sup> The National Taxpayer Advocate recommends that Congress require the IRS to provide for administrative review of automatic revocations.<sup>21</sup>

### Requiring a Full Form 1023 for Reinstatement Burdens Taxpayers and Is Not Justified by the Manner in Which the IRS Intends to Use the Information the Form Provides.

The PPA does not prescribe any particular IRS form to apply for reinstatement as an IRC § 501(c)(3) organization, but the IRS requires a full Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, thereby equating a request for *reinstatement* of exempt status with a request for initial *recognition* of that status. The IRS could have developed – but did not – a less burdensome method of applying for reinstatement other than a full Form 1023, which the IRS estimates takes about two working days to complete.<sup>22</sup> Cyber Assistant, a web-based software program that the IRS is developing to assist in the preparation of Form 1023, is not yet available.<sup>23</sup> The IRS asserts, “We also are seeking other ways to use this information to better focus our outreach and

<sup>18</sup> Rev. Proc. 2011-9, 2011-2 I.R.B. 283, secs. 12 and 7 (Jan. 10, 2011).

<sup>19</sup> For example, the answer to Frequently Asked Question 10, “If an organization on the Auto-Revocation List has documentation that it met its filing requirement for one or more years during the three-year period, what should it do?” is: “An organization possessing documentation (an IRS receipt for a filed return, for example) that shows it has *not* failed to file for three consecutive years should contact Customer Account Services, or send the documentation directly to the Exempt Organizations Account Unit.” The answer to Frequently Asked Question 11, “If an organization on the Auto-Revocation List has a letter from the IRS stating that it does not have an annual filing requirement, what should it do?” is: “An organization with a letter from the IRS stating that it does not have an annual filing requirement should contact Customer Account Services.” See Automatic Exemption Revocation for Non-Filing: Frequently Asked Questions, available at <http://www.irs.gov/charities/article/0,,id=221600,00.html>.

<sup>20</sup> IRC § 7428(b)(4).

<sup>21</sup> See Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant, infra.*

<sup>22</sup> IRS Instructions for Form 1023 at 24. The instructions also indicate that taxpayers should expect to spend over two weeks of recordkeeping for the form. In addition, applicants must complete appropriate schedules and submit various attachments.

<sup>23</sup> Release of Cyber Assistant has been delayed until further notice. Internal Revenue Manual (IRM) 3.45.1.10.6.2 (Mar. 29, 2011), available at <http://serp.enterprise.irs.gov/databases/irm.dr/current/3.dr/3.45.dr/3.45.1.dr/3.45.1.10.6.2.htm>. The IRS's Tax Exempt and Government Entities division (TE/GE) cannot predict when Cyber Assistant will become available. IRS response to TAS information request (Aug. 26, 2011). The National Taxpayer Advocate this year recommends that Congress fund and order the IRS to implement Cyber Assistant. See Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and to the IRS by Implementing “Cyber Assistant,” infra.*

education to small organizations.” However, it remains unclear why information elicited by a Form 1023-EZ would not serve the same purpose equally well.

### **The IRS Does Not Take Increased Volume of Applications Into Account in Planning or in Allocating Resources.**

The large volume of automatic revocations could be expected to trigger an increase in the number of requests for reinstatement the IRS receives, yet the IRS has not increased the staffing for processing exemption applications.<sup>24</sup> TE/GE does not appear to know how long it takes, on average, to make a determination in response to a Form 1023,<sup>25</sup> but it can be a lengthy process, and a significant increase in volume may make it even lengthier.<sup>26</sup> Moreover, because TE/GE does not and has no plans to track the number of calls to the IRS call site that taxpayers are directed to contact regarding automatic revocation, the unit is not positioned to know how much additional staff it will need to handle future requests for reinstatement.<sup>27</sup> TE/GE simply does not take these requests into consideration in its planning.<sup>28</sup>

### **The IRS Provided Transitional Relief for Small EOs.**

The PPA provides that reinstatement, if granted, is effective as of the date of the application. However, if the EO can show reasonable cause for its failure to file, reinstatement may be retroactive to the date of revocation.<sup>29</sup> In June 2011, the IRS provided guidance on how it will administer this aspect of the statute. Generally, to obtain retroactive reinstatement, an organization must explain and substantiate its reasonable cause for failing to file an information return for *each* of the three years that culminated in the automatic revocation.<sup>30</sup> However, the IRS will treat some organizations as having reasonable cause

<sup>24</sup> TE/GE, *Exempt Organizations Annual Report and Fiscal Year 2011 Work Plan* 3, 6 (charting volume of annual determinations of applications for tax exemption and volume of EO on-roll employees over a three-year period, showing 364 Rulings and Agreements employees in FY 2008 and 366 in FYs 2009 and 2010), available at [http://www.irs.gov/pub/irs-tege/fy2011\\_eo\\_workplan.pdf](http://www.irs.gov/pub/irs-tege/fy2011_eo_workplan.pdf). As of Oct. 7, 2011 (*i.e.*, four months after the IRS notified organizations of the revocations), about 5,500 organizations had requested reinstatement following automatic revocation. IRS response to TAS information request (Oct. 12, 2011).

<sup>25</sup> In response to TAS's request for information about processing times, broken down by requests that can be disposed of at a screening stage and those that require further development, TE/GE referred to its Business Performance Review (Aug. 16, 2011) which shows processing time for initial applications on Form 1023 aggregated with processing times for Form 1024 and for other determinations, such as public charity and private foundation status determinations, advance approval of scholarship grant procedures, and group determinations of tax-exempt status. The figures are not broken down between requests that can be developed through screening versus those requiring full development. IRS response to TAS information request (Aug. 26, 2011).

<sup>26</sup> For applications that do not require development, the IRS either issues a determination letter or requests additional information within approximately 90 days. As of Aug. 29, 2011, the IRS was assigning to an agent applications needing development that were received in March 2011. *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html>. However, as a letter to Commissioner Shulman from Rep. Cao indicates, although the IRS's website in 2009 indicated that processing an application for recognition of tax-exempt status would take six to eight weeks, the process, according to Rep. Cao, took six to eight months. Letter from Rep. Cao to Commissioner Shulman (June 17, 2009) (on file with TAS). For a discussion of the delays experienced in obtaining an Exempt EO ruling, see, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 210-221.

<sup>27</sup> IRS response to TAS information request (Aug. 17, 2010).

<sup>28</sup> See Tax Exempt and Government Entities Business Performance Review 15 (Aug. 16, 2011) (stating that “EO expects a potential increase of applications from organizations that were revoked for the non-filing of returns. These potential applications are not factored into our overall projections.”), available at [http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE\\_3rd\\_Qtr\\_BPR\\_FY2011.pdf](http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_3rd_Qtr_BPR_FY2011.pdf).

<sup>29</sup> IRC § 6033(j)(2), (3).

<sup>30</sup> IRS Notice 2011-44, 2011-25 I.R.B. 883 (June 9, 2011). Additional requirements, including a 15-month deadline from the time of revocation, apply.

for the failure to file returns sufficient to obtain reinstatement retroactive to the date of automatic revocation, simply by submitting their application by December 31, 2012. These are organizations that had annual gross receipts of not more than \$50,000 in the most recently completed tax year; were not required to file a Form 990 prior to 2007; and were eligible to file an e-Postcard in 2007, 2008, and 2009.<sup>31</sup> In addition, organizations eligible for this transitional relief may submit their application for a reduced user fee of \$100.<sup>32</sup> The National Taxpayer Advocate commends the IRS for recognizing the unique challenges small EOs face and providing this transitional relief.

TE/GE recently concluded a pilot research study on the communication preferences and educational needs of small EOs.<sup>33</sup> Phase 2 of the study, a telephone survey completed in June 2011, showed that the IRS website and tax professionals are the primary sources of information for small and midsize organizations. The program with the highest awareness, usage, and perceived value to compliance is the IRS website.<sup>34</sup> Accordingly, the IRS delivered information about the transitional relief through the website. It also reached out to practitioner groups, umbrella organizations, and state officials, asking them to share information about revocation, reinstatement, and transitional relief for small organizations.<sup>35</sup>

The National Taxpayer Advocate designated automatic revocations as meeting the TAS Public Policy criterion that qualifies taxpayers for TAS assistance.<sup>36</sup> TAS developed guidance about automatic revocations, including transitional relief, for employees who handle calls on this issue,<sup>37</sup> and Local Taxpayer Advocates included a discussion of transitional relief in their outreach to congressional offices.

### **In the Future, the IRS Needs to Better Communicate with Small EOs Before Exempt Status Is Automatically Revoked.**

In 2009, the IRS began notifying EOs required to submit an e-Postcard that they had not done so, but did not issue a second reminder to file for the same tax year.<sup>38</sup> The IRS is

<sup>31</sup> Notice 2011-43, 2011-25 I.R.B. 882 (June 9, 2011).

<sup>32</sup> Rev. Proc. 2011-36, 2011-25 I.R.B. 915 (June 9, 2011). The user fee for filing Form 1023 is usually \$400 for EOs with gross receipts of \$10,000 or less and \$850 for those with gross receipts in excess of \$10,000. Rev. Proc. 2011-8, 2011-1 I.R.B. 237 (Jan. 3, 2011). Taxpayers who prepare a Form 1023 using Cyber Assistant will pay a lower user fee.

<sup>33</sup> IRS response to National Taxpayer Advocate 2009 Annual Report to Congress, Most Serious Problem: *Targeted Research and Increased Collaboration Are Needed to Meet the Needs of Tax Exempt Organizations* (recorded on the Joint Audit Management Enterprise System (JAMES) database Jan. 2011). The pilot study is named EO Services and Assistance (EOSA).

<sup>34</sup> IRS response to TAS information request (Aug. 26, 2011); Tax Exempt and Government Entities Business Performance Review 15 (Aug. 16, 2011), available at [http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE\\_3rd\\_Qtr\\_BPR\\_FY2011.pdf](http://tege.web.irs.gov/content/PLANMainWindow/LinkedHtmlDocuments/TEGE_3rd_Qtr_BPR_FY2011.pdf).

<sup>35</sup> IRS response to TAS information request (Aug. 26, 2011).

<sup>36</sup> IRM 13.1.7.2.4 (Apr. 26, 2011) provides: "Criteria 9 - The NTA determines compelling public policy warrants assistance to an individual or group of taxpayers. The NTA has the sole authority for determining which issues are included in this criteria and will so designate by memo. Example: The NTA decided any inquiries related to organizations where the IRS automatically revoked their tax-exempt status because the organization did not file an annual return or notice for three consecutive years."

<sup>37</sup> The guidance includes a question and answer document and flowchart, as well as a series of links to the latest information available from the IRS.

<sup>38</sup> In contrast, Form 990 and 990-EZ filers routinely receive two reminders to file for the same tax year. See IRM 21.3.8.10.2.7 (Oct. 1, 2010). Even though e-Postcard filers cannot obtain an extension to file and cannot file for a prior year without using an e-file service provider, a second reminder might avert a second failure to file.

aware that many small EOs are staffed by volunteers who typically do not remain with the organization from one year to the next and may not know of the previous (or subsequent) year's failure to file.<sup>39</sup> Nevertheless, the IRS did not notify EOs that more than one failure to file had already occurred, and automatic revocation was therefore imminent. Especially now that the IRS is gathering better information about EOs, such as their current addresses, these types of reminders may help avert automatic revocations in the future.

## CONCLUSION

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

1. The IRS should allow administrative review of its conclusion that an organization's exempt status was automatically revoked.
2. The IRS should develop a Form 1023-EZ for use by small organizations.
3. The IRS should expedite the development of Cyber Assistant for Form 1023 preparation.
4. The IRS should notify EOs when they have failed to file two consecutive returns or e-Postcards, and automatic revocation is imminent.

## IRS COMMENTS

The IRS is proud of its implementation of Congress' mandate in § 1223 of the Pension Protection Act of 2006, which automatically revokes the exemption of any organization that has failed to file required returns or notices for three consecutive years. The IRS took unprecedented steps in bringing awareness of the provision to the exempt organizations community through targeted as well as general outreach. The IRS also provided small organizations additional time for filing after releasing a preliminary list of organizations for which we had not received a filing. Slightly larger organizations were also given an opportunity to come into compliance without losing their tax-exempt status. In addition, after the revocation list was released, the IRS provided a special transition process for smaller organizations to have their tax-exempt status reinstated. In the years building up the imposition of the automatic revocation, and in this period following revocation, the IRS has continually taken steps to assist EOs, especially those that are smaller.

The IRS disagrees that we have made it unnecessarily burdensome for EOs to obtain reinstatement following automatic revocation. The PPA provides that an organization, revoked by operation of law, must apply in order to obtain reinstatement of such status regardless of whether such organization was originally required to make such an application. In accordance with the statute, automatically revoked organizations must file an application for exemption just like any other organization seeking an IRS determination of tax-exempt status.

<sup>39</sup> Notice 2011-43, 2011-25 I.R.B. 882 (June 9, 2011).

To simplify matters for an organization seeking reinstatement, the IRS provides a wealth of information on automatic revocation and reinstatement through the Charities and Non-profits page of the IRS website. In addition, when an organization is added to the Automatic Revocation List, the IRS sends a letter to the organization's last known address to inform the organization that its tax-exempt status has been revoked. This letter refers the organizations to our web page for further information about revocation, reinstatement and transitional relief. Because we recognize that we may not have valid addresses for some of the revoked organizations, we have also reached out to practitioner groups, umbrella groups and state officials and asked them to share information about revocation, reinstatement and transitional relief for small organizations.

As the report of the National Taxpayer Advocate explains, organizations seeking recognition as public charities—which gives them the dual tax advantages of exemption from income tax and eligibility to receive tax-deductible contributions—must submit Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*. The IRS does not believe that a less comprehensive application satisfies Congress' intent in requiring automatically revoked organizations to apply to the IRS for recognition of exemption. The legislative history of the PPA indicates that Congress understood and intended that revocation (and the associated statutorily required application for reinstatement) to be a significant consequence for those organizations that did not file even one of the three required notices in spite of the fact that those organizations held themselves out as tax-exempt.

As explained in the report of the National Taxpayer Advocate, Congress imposed two new requirements on small EOs when it passed the PPA. The PPA imposed an annual filing requirement on small EOs and also provided that the exempt status of any EO failing to file for three consecutive years is automatically revoked. The legislative history describes Congress' intent in adopting the new annual filing requirement as follows:

Accordingly, the Committee believes that exempt organizations that do not have to file an annual information return by virtue of the amount of their gross receipts should file with the Secretary a simple, short annual notice. The committee *does not intend that the annual filing be burdensome* and does not believe that a monetary penalty is appropriate for a failure to file the notice.<sup>40</sup>

While it is apparent, therefore, that Congress did not want small EOs to file the Form 990 or the Form 990-EZ, there is no such language indicating that Congress also wanted to spare automatically revoked organizations from filing the Form 1023 when applying for reinstatement. Moreover, the committee report indicates that Congress saw revocation,

<sup>40</sup> Report to Accompany S. 1321, the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, Title III, Subtitle W., "Notification Requirement for Exempt Entities Not Currently Required to File an Annual Information Return," S. Rep. No. 109-336, at 41 (2006) (emphasis added). The language to which this report referred was subsequently enacted as part of the Pension Protection Act of 2006. Following Congress' instructions, the IRS developed the Form 990-N.

and the required application for reinstatement, as a suitable penalty for failing to satisfy an intentionally simple notice requirement.

However, if an organization is unable to file a notice with the Secretary for three consecutive years, the Committee believes that revocation of the organization's exempt status *is an appropriate sanction under the circumstances*. In addition, the sanction of loss of exempt status is extended to consecutive failures to file a required information return.<sup>41</sup>

The report of the National Taxpayer Advocate questions why the IRS needs all of the information requested by a Form 1023. The IRS believes that its obligation to decide whether an organization qualifies for exemption, by itself, justifies the extent of information requested on the Form 1023. Automatically revoked organizations are subject to the same requirements for exemption as all other organizations; therefore, the IRS needs the same quality and quantity of information to make an exemption determination.

The Form 1023 also serves an educational purpose because it provides applicants either an introductory or a refresher course on the rules for tax exemption. Finally, the law encourages transparency and accountability to the public by requiring organizations to make their Form 1023 exemption applications and their Form 990-series information returns available to the public.

The report of the National Taxpayer Advocate recommends that the IRS develop a Form 1023-EZ for use by small organizations and expedite the development of Cyber Assistant for Form 1023 preparation. The IRS developed Cyber Assistant, a web-based software program, to help 501(c)(3) applicants file a complete and accurate Form 1023 and improve the quality and consistency of these applications. Software testing revealed problems requiring correction prior to public launch, and the IRS had to delay the release. Because the IRS must balance a number of competing information technology needs, we cannot presently predict when Cyber Assistant will be available. It is important to recognize, however, that Cyber Assistant was designed to accommodate the current Form 1023. Any significant changes in the Form 1023 would more than likely require substantial reprogramming of Cyber Assistant.

The report of the National Taxpayer Advocate has recommended that the IRS should allow "administrative review of its conclusion that an organization's exempt status was automatically revoked." The IRS disagrees as there is not any IRS "conclusion" about automatic revocation to be reviewed; automatic revocation of exemption occurs by operation of law. Revenue Procedure 2011-9 is inapplicable in the case of automatic revocation. It describes administrative review of the conclusion, at the end of an examination, that an organization is no longer organized or operated for exempt purposes. Automatic revocation involves no such conclusion. It occurs, by operation of law, simply because an organization has failed to meet its filing requirements for three consecutive years. There is no IRS conclusion to be administratively reviewed.

<sup>41</sup> S. Rep. No. 109-336, at 41-42 (emphasis added).

The IRS agrees that it is critical that only those organizations that have failed to meet their filing requirements for three consecutive years will be identified by the IRS as having their exemptions automatically revoked. For that reason, many business units of the IRS have worked collaboratively since shortly after the passage of the PPA to ensure that IRS records correctly reflect those organizations that have failed to meet filing requirements for three consecutive years. The IRS relies on automated data processing systems to generate the names of organizations that failed to meet their filing requirements for three consecutive years. The IRS recognizes that in rare cases automated systems can produce mistaken results either because of programming issues or because of faulty data. The IRS has issued public guidance to organizations to notify us about organizations that have been erroneously included on the Automatic Revocation List so the mistake can be corrected. When an organization brings an error to our attention, the organization is removed from the Automatic Revocation List.

The IRS would like to provide some additional perspective on its preparation for the submission of reinstatement applications. The IRS did take the increased volume of applications into account when planning and allocating resources. The IRS engaged in contingency planning on how to use existing staff, based both at EO Determinations in Cincinnati and at the National Office in Washington, D.C., in a variety of functions to meet whatever application processing needs were presented once automatically revoked organizations began to apply for reinstatement.

Based on the number of applications for reinstatement since the first Automatic Revocation List was posted in June 2011, Congress appears to have been correct that the vast majority of automatically revoked organizations are defunct. With the initial list posted in June and with monthly updates since, the number of automatically revoked organizations totaled around 385,000 on October 7, 2011. As of October 14, 2011, the IRS had received about 5,500 reinstatement applications (less than 1.5 percent). The IRS appreciates the importance of processing applications for exemption in a timely manner and we have closed almost half of these to date.

The report of the National Taxpayer Advocate suggests that the IRS needs to better communicate with small EOs at risk of automatic revocation. As support for this proposition, the report notes that the IRS sends only one reminder each year to organizations that fail to file Form 990-N, while it sends two to organizations that fail to file a Form 990 or a Form 990-EZ. The first reminder (Notice CP259E), which is sent to non-filers of Forms 990-N, 990 and 990-EZ, explains that if they fail to file for three consecutive years, they will lose their tax-exempt status. The second notice—the EO Return Delinquency Notice, which is only sent to Form 990 and Form 990-EZ filers—contains information about financial and criminal penalties that do not apply to Form 990-N filers. Accordingly, the IRS does not send it to them. In addition, Form 990 and Form 990-EZ filers are subject to daily penalties that

may accrue up to \$50,000 for each unfiled return,<sup>42</sup> while the Code specifically provides that such penalties do not apply to failures to file Form 990-N.<sup>43</sup> Especially given current budget constraints, the value in sending a second reminder simply repeating the first is unclear.

The IRS agrees that it is important that EOs be informed of their filing requirements and the possibility of automatic revocation. After passage of the PPA, the IRS sent multiple letters to EOs about filing requirements and automatic revocation. As Congress intended by imposing the notice requirement and mandating automatic revocation for those that failed to file for three consecutive years, the IRS now has much more accurate information on addresses of exempt organizations. Failure-to-file notices will be sent to the updated addresses on record and we will continue to monitor whether additional notices are necessary.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS to the extent that it conducted outreach and allowed transitional relief to small charities. There is no dispute that the Pension Protection Act of 2006 provides for automatic revocation of exempt status. As the IRS points out, Congress viewed *revocation* as an appropriate sanction for failing to report as required for three consecutive years. However, nothing in the legislative history of the PPA indicates that Congress also intended the *reinstatement process* to operate as a sanction for failing to report. Just because Congress provided that “revoked” organizations must apply for reinstatement does not mean that it intended the process to be disproportionately burdensome or punitive. Nor, contrary to the IRS’s assertion, is a full Form 1023 necessary order to make a determination about the exempt status of a small EO. For many if not most small EOs, one or two pages of questions that elicit basic information would suffice. Instead, they are confronted with 12 pages of questions that are likely inapplicable,<sup>44</sup> sometimes mind-numbingly so.<sup>45</sup> Small organizations need a Form 1023-EZ, and Form 1023 filers need Cyber Assistant to help complete it.

The IRS refers to “competing information technology needs” to explain why it cannot predict when Cyber Assistant will become available. The National Taxpayer Advocate notes that the IRS has anticipated processing applications prepared using Cyber Assistant at least

<sup>42</sup> IRC § 6652(c)(1)(A).

<sup>43</sup> IRC § 6652(c)(1)(E).

<sup>44</sup> For example, Part V, question 1b is: “List the names, titles, and mailing addresses of each of your five highest compensated employees who receive or will receive compensation of more than \$50,000 per year.” A Form 1023-EZ could simply ask if any employees received more than \$50,000 per year in compensation from the organization. If the answer is “yes”, then the EO could be required to file the full Form 1023.

<sup>45</sup> For example, Part VIII, question 11 is: “Do you or will you accept contributions of: real property; conservation easements; closely held securities; intellectual property such as patents, trademarks, and copyrights; works of music or art; licenses; royalties; automobiles, boats, planes, or other vehicles; or collectibles of any type? If “Yes,” describe each type of contribution, any conditions imposed by the donor on the contribution, and any agreements with the donor regarding the contribution.”

since 2008.<sup>46</sup> The user fee for applications prepared using Cyber Assistant was to be \$200, independent of the size of the organization.<sup>47</sup> An organization presently required to pay \$850 (already a significant cost for many small EOs) could save \$650 and apply that money to its direct program services if Cyber Assistant were available. The software will not replace the paper application form, which the applicant will still print and mail to the IRS, but it will help applicants avoid errors or leave mandatory sections of the form incomplete. The release of software like Cyber Assistant will reduce cost and burden to taxpayers and to the IRS; these criteria should make it a priority for modernization funding.<sup>48</sup>

Lengthy processing times for Form 1023 continue to burden taxpayers. A check of the IRS website “Where is my exemption application?” on December 10, 2011, indicated that the IRS was assigning to reviewers Form 1023 applications that were received in May 2011.<sup>49</sup> This means that any organization that submits an application that is not “plain vanilla” will have to wait at least seven months to be assigned to a reviewer, and many more months to get the exemption ruling letter. As a matter of routine business, these delays are unacceptable and can impede the delivery of important program services. Moreover, these delays could drive exempt organizations to submit “bare-bones” applications so that they can get in the queue early, and use the intervening time to develop supporting documentation to present to the reviewer. TE/GE needs to staff its EO function appropriately for its workload, and Congress should fund the IRS accordingly.

The IRS’s description of its role in the automatic revocation process is that of a disinterested bystander, exercising no judgment and arriving at no conclusions. This is contrary to the facts. Although the IRS cannot control whether taxpayers file required returns, it is the first arbiter of whether returns are required. As the IRS acknowledges, it is the custodian of the returns. The PPA requires the IRS to publish accurate lists of organizations to whom deductible contributions can be made and organizations whose exempt status was automatically revoked. The IRS’s role in the automatic revocation process is therefore central. It cannot escape responsibility by portraying the process as driven solely by automation or operation of law. The IRS asserts that it responds appropriately when an organization demonstrates that the IRS included it on the Automatic Revocation list in error, and we expect that this is indeed the situation when the decision maker for the IRS agrees with the taxpayer that an error occurred. The National Taxpayer Advocate commends the IRS for correcting revocation errors, the existence of which warrant an organized review process. Our concern is that there is no mechanism for review of disputed cases, and the IRS should provide one.

<sup>46</sup> IRM 3.45.1.4.6.2 (Jan. 1, 2008) describes procedures for processing Forms 1023 prepared with Cyber Assistant.

<sup>47</sup> See IRS Notice 1382 (Rev. Sept. 2009) advising taxpayers that Cyber Assistant would become available in 2010 and the user fee for applications prepared using Cyber Assistant would be \$200. Rev. Proc. 2011-8, 2011-1 I.R.B. 237, sec. 2.06 (Jan. 3, 2011) states, “The references...to application fees after Cyber Assistant availability have been removed because the Service does not expect Cyber Assistant...to become available in 2011.”

<sup>48</sup> See Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant*, *infra*.

<sup>49</sup> See *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html>.

As the IRS points out, it is now acquiring more accurate information about exempt organizations. The National Taxpayer Advocate supports the IRS plan to consider whether to provide additional notices, such as a notice explaining that an organization failed to file a required return for two years rather than only one, and that revocation is imminent.

## Recommendations

The National Taxpayer Advocate recommends that the IRS should:

1. Allow administrative review of its conclusion that an organization's exempt status was automatically revoked.
2. Develop a Form 1023-EZ for use by small organizations.
3. Expedite the development of Cyber Assistant for Form 1023 preparation.
4. Notify EOs when they have failed to file two consecutive returns or e-Postcards, and automatic revocation is imminent.

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

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage & Investment Division  
Chris Wagner, Chief, Appeals

### DEFINITION OF PROBLEM

When married taxpayers file a joint tax return, as more than 98 million people did for 2010,<sup>1</sup> they become jointly and severally liable for the tax shown on the return, as well as for any additional tax, penalties, and interest later determined to be owed.<sup>2</sup> “Joint and several liability” means that each spouse is *individually* responsible for the *entire* tax liability stemming from a joint return, even if all of it is attributable to the other spouse, and the joint filers are no longer married.

Internal Revenue Code (IRC) § 6015, known as the “innocent spouse” provision, provides for relief from this joint and several liability.<sup>3</sup> IRC § 6015(f), sometimes referred to as equitable innocent spouse relief, relieves taxpayers from liability when, taking into account all the facts and circumstances, it would be inequitable to hold an individual liable for the tax.<sup>4</sup> Until recently, a Treasury regulation required taxpayers to request equitable relief within two years after the IRS commenced certain collection activity against the taxpayer seeking innocent spouse relief.<sup>5</sup> The National Taxpayer Advocate has long advocated for removal of the two-year rule that prevented taxpayers from obtaining equitable relief,<sup>6</sup> and is very pleased that on July 25, 2011, the IRS announced the rule was no longer in effect.<sup>7</sup>

<sup>1</sup> For tax year 2010, there were 49,235,798 joint returns. Each joint return is filed by two people. Individual Returns Transaction File Data from the Compliance Data Warehouse tax year 2010 extract cycle 201130 (Aug. 24, 2011).

<sup>2</sup> Internal Revenue Code (IRC) § 6013(d)(3); see Treas. Reg. § 1.6013-4(b).

<sup>3</sup> Taxpayers in community property states who do not file joint returns are generally liable for the tax on half of community income, regardless of which spouse generated the income (*Poe v. Seaborn*, 282 U.S. 101 (1930)); IRC § 66 provides for innocent spouse relief from this type of liability.

<sup>4</sup> IRC § 6015(b) and (c), respectively referred to as “traditional” innocent spouse relief and “separation of liability” relief, provide for relief in other circumstances. To obtain relief under § 6015 (f), relief under (b) or (c) must be unavailable.

<sup>5</sup> Treas. Reg. § 1.6015-5(b). The same two-year rule is a statutory requirement for relief under the other innocent spouse provisions. IRC § 6015(b)(1)(E), (c)(3)(B).

<sup>6</sup> National Taxpayer Advocate 2010 Annual Report to Congress 377 (Legislative Recommendation: *Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015 (f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions*); vol. 2, 1-12 (*Unlimit Innocent Spouse Equitable Relief*); National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief under IRC § 6015 or 66*).

<sup>7</sup> Notice 2011-70, 2011-32 I.R.B. 135 (July 25, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>. See *Taxpayer Advocate Commends IRS for Policy Change on Equitable Innocent Spouse Relief*, Tax Notes Today (July 26, 2011), 2011 TNT 143-26.

The IRS removed the two-year rule pursuant to a more general review of procedures in the innocent spouse cases.<sup>8</sup> As of this writing, the review is still in progress. The National Taxpayer Advocate recommends that the IRS:

- Track the number of taxpayers who indicate they are victims of domestic violence or abuse; and
- Require employees to place outbound calls to taxpayers in all innocent spouse cases before making a final determination about whether to grant relief.

## ANALYSIS OF PROBLEM

### Background

Married taxpayers who file a joint return are jointly and severally liable for the tax with respect to the return.<sup>9</sup> Recognizing that this rule sometimes produces unfair results, Congress enacted the first innocent spouse provision in 1971.<sup>10</sup> It revised the rules in 1984 and again as part of the IRS Restructuring and Reform Act of 1998 (RRA 98) to make relief easier to obtain.<sup>11</sup> IRC § 6015 now provides three avenues of relief, under subsections (b),<sup>12</sup> (c),<sup>13</sup> and (f). Subsection (f) is referred to as “equitable” innocent spouse relief because it provides for relief when, “taking into account all of the facts and circumstances, it would be inequitable to hold the individual liable for any unpaid tax or any deficiency.” As opposed to the relief available under IRC § 6015 (b) and (c), IRC § 6015(f) allows relief for underpayments as well as understatements of tax and does not impose any time limit for requesting relief.<sup>14</sup> However, IRS guidance in 2000 and a Treasury regulation in 2002 imposed a two-year deadline parallel to one statutorily prescribed in subsections (b) and (c) on requests for relief under subsection (f).<sup>15</sup>

<sup>8</sup> IR 2011-80, *Two-Year Limit No Longer Applies to Many Innocent Spouse Requests* (July 25, 2011), available at <http://www.irs.gov/newsroom/article/0,,id=242867,00.html>.

<sup>9</sup> IRC § 6013(d)(3).

<sup>10</sup> IRC § 6013(e).

<sup>11</sup> Pub. L. No. 91-679, 84 Stat. 2063 (adding IRC § 6013(e)); Pub. L. No. 98-369 § 424(b)(1), 98 Stat. 494 (expanding the availability of relief under IRC § 6013(e) to encompass any substantial understatement (*i.e.*, over \$500) attributable to a spouse’s grossly erroneous items (including any omission of which the taxpayer did not know or have reason to know.); Pub. L. No. 105-206, § 3201, 112 Stat. 685, 734 (RRA 98) (adding IRC § 6015).

<sup>12</sup> Under IRC § 6015(b), taxpayers may obtain relief only from an understatement of tax – the amount by which the tax reported on the return is less than the tax actually owed. The understatement must be attributable to the other spouse; the spouse requesting relief must demonstrate that he or she did not know, and had no reason to know, of the understatement when the return was signed, and that it would be inequitable to hold him or her liable for the tax; and the request for relief must come within two years of the first collection activity.

<sup>13</sup> Under IRC § 6015(c), taxpayers who are divorced, widowed, legally separated, or living apart from the other spouse for the previous 12 months may obtain relief from an understatement if they request relief within two years of the IRS’s first collection activity. Allocation rules are set forth with the objective of allocating the item that gave rise to the deficiency as it would have been allocated if the spouses had filed separate returns. Relief will generally not be available if the IRS shows that the spouse requesting relief had actual knowledge of the understatement at the time the return was signed.

<sup>14</sup> We use the terms “understatement” and “deficiency” interchangeably to refer to the difference between the amount of tax that had to be shown on the return and the amount that was actually shown. “Underpayment” refers to tax shown on the return but not paid.

<sup>15</sup> See Rev. Proc. 2000-15, 2000-1 C.B. 447, *superseded by* Rev. Proc. 2003-61, 2003-2 C.B. 296; Treas. Reg. § 1.6015-5(b)(1), 67 Fed. Reg. 47,278 (July 18, 2002).

**The IRS Recently Dropped the Two-Year Rule for Requesting Equitable Relief.**

The validity of the two-year rule for equitable innocent spouse claims was questioned in 2009, when the Tax Court, in *Lantz v. Commissioner*,<sup>16</sup> held the regulation imposing the rule invalid. The IRS appealed the Tax Court's decision, as well as other cases with the same issue, and three Courts of Appeal ultimately held that the regulation was valid.<sup>17</sup> Notwithstanding these decisions, in the interest of tax administration, on July 25, 2011, the IRS issued Notice 2011-70, providing that it would no longer require taxpayers to request equitable relief under IRC § 6015(f) within two years of the first collection activity.<sup>18</sup> Pending formal modification of the Treasury regulation, the Notice provides the following transitional rules for IRC § 6015(f) claims.

**Future Requests:** Taxpayers who request relief after July 25, 2011, must do so within the period of limitation on collection or, for any credit or refund of tax, within the statutory period for requesting a refund.<sup>19</sup>

**Pending Requests:** The IRS will now consider requests that were under consideration or in suspense as of July 25, 2011, even if taxpayers submitted them more than two years after the first collection activity, as long as the taxpayers requested relief within the applicable period of limitation on collection or, if applicable, during the statutory period for obtaining a credit or refund.<sup>20</sup> Pursuant to this provision, the IRS sent more than 4,500 letters to taxpayers advising them that it would now consider their claims.<sup>21</sup>

**Requests that were denied solely as untimely and were not litigated:**<sup>22</sup> Taxpayers whose requests were denied as untimely and were not litigated may *reapply* for relief, and the IRS sent nearly 3,000 letters to taxpayers advising them of this opportunity.<sup>23</sup> The IRS will treat the original request for relief as a claim for refund for purposes of the period of

<sup>16</sup> 132 T.C. 131 (2009).

<sup>17</sup> *Lantz v. Comm'r*, 607 F.3d 479 (7th Cir. 2010) *rev'g and remanding* 132 T.C. 131 (2009); *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011) *rev'g and remanding* 132 T.C. 196 (2009); *Jones v. Comm'r*, 642 F.3d 459 (4th Cir. 2011), *rev'g and remanding* T.C. Docket No. 17359-08 (May 28, 2010).

<sup>18</sup> Notice 2011-70, 2011-32 I.R.B. 135 (July 25, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-70.pdf>.

<sup>19</sup> The statutory period of limitation on collection is generally ten years after the date the IRS assesses the tax. IRC § 6502(a). Generally, taxpayers must request a refund within three years from the date their return was filed or two years from the time the tax was paid, whichever occurs later, or, if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). A taxpayer who meets the three-year timeframe can recover payments made during the three-year period that precedes the date of the refund claim, plus the period of any extension of time for filing the return. A taxpayer who does not meet the three-year requirement can recover only payments made during the two-year period preceding the date of the refund claim. IRC § 6511(b)(2).

<sup>20</sup> The IRS revised its procedures to allow taxpayers requesting equitable relief from the IRS under IRC § 6015(f) more than two years after collection activity commenced to suspend their request for relief while the validity of the two-year deadline for IRC § 6015(f) claims was being litigated.

<sup>21</sup> As of July 30, 2011, the IRS had sent 4,559 letters to taxpayers (IRS Letter 4754 or Letter 4771) who had requested suspension of their claims pending the outcome of litigation in the courts, or whose claims were pending in IRS Appeals when Notice 2011-70 was issued, advising them that the IRS would consider their claims. IRS response to TAS information request (Sept. 29, 2011).

<sup>22</sup> As the National Taxpayer noted, "I am pleased the IRS will be providing relief from the two-year rule not merely to taxpayers who file future claims but also to most taxpayers whose claims were rejected in the past." See *Taxpayer Advocate Commends IRS for Policy Change on Equitable Innocent Spouse Relief*, Tax Notes Today (July 26, 2011), 2011 TNT 143-26.

<sup>23</sup> As of July 30, 2011, the IRS had sent 2,963 Letters 4767C explaining that taxpayers could reapply for relief. The IRS contacted these taxpayers directly because their cases were still in IRS inventory; the IRS had not closed them because the time for administrative appeal or for filing a Tax Court petition had not expired. IRS response to TAS information request (Sept. 29, 2011).

limitation on refunds. This means any amount for which a refund was available as of the date the original request was filed, and any amount subsequently collected, may be eligible for refund if warranted by the IRS's reconsideration of the claim for equitable relief. With respect to unpaid liabilities, the taxpayer must reapply within the period of limitation on collection. Before the IRS adopted the procedure of giving taxpayers the option of suspending their claims, it denied claims for relief as untimely on average about 1,500 times each year.<sup>24</sup> As of September 24, 2011, the IRS had received 258 reapplications for relief, 79 of which were in response to the IRS's letter advising them that they could reapply.<sup>25</sup>

**Requests in litigation:** On the same day it announced the end of the two-year rule, the government filed motions to dismiss all the appellate cases affected by the change, and the courts have now dismissed all the appeals.<sup>26</sup> For docketed Tax Court cases, including those docketed before the IRS's change in position, the IRS instructed its Chief Counsel attorneys to, among other things, no longer argue that the two-year deadline applies to claims for equitable relief.<sup>27</sup>

**Requests where litigation is now final:** If the IRS stipulated in the court proceeding that relief would have been available if not for the two-year rule, the IRS will take no further collection activity with respect to that portion of the liability (but no refunds or credits will be available). The IRS has identified five cases belonging to this category.<sup>28</sup>

### **In Conjunction with the Change in Policy as to the Two-Year Rule, the IRS Undertook a Review of Equitable Innocent Spouse Procedures.**

IRC § 6015(f) permits taxpayers to request equitable relief pursuant to procedures set by the Secretary, and those procedures are found in Revenue Procedure 2003-61.<sup>29</sup> In June 2011, the IRS assembled a team to review the existing procedures for obtaining equitable relief under IRC § 6015(f) to see if they could be improved.<sup>30</sup> In addition to any new procedures for analyzing innocent spouse cases, there are two procedural matters that the IRS should address.

<sup>24</sup> The numbers of IRC § 6015(f) disallowed untimely claims in FY 2004-10 were 1,127; 377; 1,175; 1,752; 2,053; 2,396; and 1,555, respectively. Email from IRS Wage & Investment Division Compliance function (Dec. 7, 2010) (on file with TAS).

<sup>25</sup> IRS response to TAS information request (Sept. 29, 2011).

<sup>26</sup> *Hall v. Comm'r*, 135 T.C. 374, *appeal dismissed* (6th Cir. Aug. 2, 2011); *Buckner v. Comm'r*, T.C. Docket No. 12153-09, *appeal dismissed* (6th Cir. July 27, 2011); *Payne v. Comm'r*, T.C. Docket No. 10768-09, *appeal dismissed* (9th Cir. July 25, 2011); *Coulter v. Comm'r*, T.C. Docket No. 1003-09, *appeal dismissed* (2d Cir. Aug. 4, 2011). The IRS had already conceded in all these cases that but for the two-year rule, equitable relief would be appropriate.

<sup>27</sup> CC-Notice 2011-017 (July 25, 2011), providing direction for Chief Counsel attorneys handling cases docketed with the Tax Court that involve the two-year deadline.

<sup>28</sup> IRS response to TAS information request (Sept. 29, 2011).

<sup>29</sup> 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1C.B. 447.

<sup>30</sup> The team consisted of representatives from the Wage & Investment operating division, including analysts in the Cincinnati Centralized Innocent Spouse Unit, Chief Counsel, and TAS.

### Domestic Violence and Abuse<sup>31</sup>

IRS Form 8857, *Request for Innocent Spouse Relief*, solicits information about domestic violence and abuse, and abuse is relevant to determining whether innocent spouse relief is appropriate, but the IRS does not presently track the frequency with which taxpayers indicate they are victims. In a random sample of 290 Forms 8857 submitted in fiscal year 2011, TAS found that 45 taxpayers, or 15.5 percent, indicated they were victims.<sup>32</sup>

### Personal Contact with Taxpayers

The National Taxpayer Advocate has long advocated for more personal IRS contact with taxpayers, in a variety of contexts. For example, over the past seven years, the National Taxpayer Advocate has urged the IRS to adopt collection policies that emphasize personal contact, both by telephone and face-to-face.<sup>33</sup> This year, she reports that an IRS streamlined Centralized Offer in Compromise pilot program that incorporates personal taxpayer contacts has resolved a greater portion of cases in six months or less than the non-streamlined approach, and more often resulted in offer acceptance.<sup>34</sup> As another example, in 2004 the National Taxpayer Advocate reported the findings of a TAS study that explored, among other issues, whether additional contacts and interaction with the taxpayer improved the chances of taxpayers receiving the Earned Income Tax Credit (EITC). The study found that in the context of audit reconsiderations, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC to which he or she was entitled — *i.e.*, of achieving the right result — increased with the number of phone calls made by the TAS employee.<sup>35</sup> Because personal contact may improve timeframes and lead to better decisions, employees who evaluate claims for innocent spouse relief should attempt to contact taxpayers personally before making a final determination.

<sup>31</sup> See Most Serious Problem: *The IRS Does Not Sufficiently Recognize Domestic Violence and Abuse and Its Consequences for Tax Administration*, *supra*.

<sup>32</sup> Just as important as taking abuse into account is the need to better *recognize* that a taxpayer may be a victim and solicit appropriate evidence that might support the claim. The IRS uses training material developed in 2001 to train employees about domestic violence and abuse. The training has been classified as obsolete as of Nov. 2004 and has not been replaced. See IRS Catalog Information, *available at* <http://publish.no.irs.gov/cat12.cgi?request=CAT1&catnum=86924>. The National Taxpayer Advocate this year developed training that is mandatory for all TAS employees and is available to all other IRS employees. *Recognizing and Working with Taxpayers Who Have Experienced Domestic Violence or Abuse*, IRS Enterprise Learning Management System (ELMS) course 41304.

<sup>33</sup> See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*.

<sup>34</sup> Under the standard program, 48.07 percent of cases are resolved within six months. Under the streamlined program, 68.46 percent of cases are resolved within six months. See Most Serious Problem: *The IRS Does Not Emphasize the Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*, *supra*. Prior to the streamlined Centralized Offer in Compromise program, the overall acceptance rate was about 25 percent. IRS, Collection Activity Report No-5000-108 (Oct. 2009). After the streamlined process was implemented the acceptance rate rose to 34 percent. IRS, Collection Activity Report No-5000-108 (Oct. 2011).

<sup>35</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 1-10 (EITC Audit Reconsideration Study).

## CONCLUSION

The National Taxpayer Advocate commends the IRS for removing the two-year rule for equitable innocent spouse claims, and for its willingness to review its procedures. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

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

## IRS COMMENTS

The IRS appreciates the recognition by the National Taxpayer Advocate of the improvements we have made to the Innocent Spouse Program. We believe that the IRS decision to eliminate the two-year rule, as proposed by the National Taxpayer Advocate, will improve administration of the Innocent Spouse Program and provide needed relief to taxpayers.

As noted in the report of the National Taxpayer Advocate, in addition to eliminating the two-year rule, the IRS recently conducted a thorough review of the Innocent Spouse Program. In connection with that review, the IRS is proposing revised rules that apply in innocent spouse determinations. The proposed rules revise the factors that apply for granting equitable relief. The IRS is seeking public comment on these proposed revisions and looks forward to working with the National Taxpayer Advocate and the Low Income Taxpayer Clinics (LITCs), as well as other organizations, in this effort.

Most significantly, the proposed revised rules expand the effect abuse will have in determining whether relief is warranted. As noted in the National Taxpayer Advocate's report, the IRS solicits information about domestic violence and abuse on Form 8857, *Request for Innocent Spouse Relief*, and considers whether that information is relevant to determining whether innocent spouse relief is appropriate. The IRS recognizes that when abuse is present, the requesting spouse may not have been able to challenge the treatment of items on a tax return, question the payment of taxes or challenge the other spouse's assurance regarding the payment of taxes. The new proposed rules recognize that the presence of abuse may mitigate other factors that might otherwise weigh against granting relief. In connection with these changes, the IRS has recently increased its training to innocent spouse unit employees on domestic violence. The IRS takes seriously the effects that domestic violence and abuse may have on taxpayers. We recognize that abusive situations could result in tax consequences to the taxpayer that he or she is sometimes powerless to prevent.

In connection with the changes to the Innocent Spouse Program, the IRS has increased its use of personal taxpayer contact. We are in the process of implementing procedures to

require Innocent Spouse employees to make two attempts at personal contact in all cases where there is insufficient data in the case to make a determination. If an employee is unable to reach a taxpayer after two phone call attempts the employee must issue a letter to the requesting spouse asking for the necessary information.

We will continue to work with the National Taxpayer Advocate and consider recommendations as we finalize improvements to the Innocent Spouse Program.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate welcomes the IRS's interest and willingness to collaborate with TAS in improving procedures in innocent spouse cases, and we look forward to working together on these issues. We appreciate the IRS's inclusion of LITCs and other stakeholders in the process, and we will work with the IRS to ensure their continued participation. The National Taxpayer Advocate is also pleased the IRS is heightening employee awareness of these issues through training on domestic violence.<sup>36</sup> We note that the IRS does not articulate any objection to tracking the incidence of domestic violence and abuse.

The National Taxpayer Advocate supports the IRS's move toward increased personal taxpayer contact in innocent spouse cases, but is concerned that the new procedures do not go far enough. The employee is required to attempt to contact the taxpayer only "where the employee believes there is insufficient data in the case to make a determination." The problem with this approach is that until he or she speaks to the taxpayer, the employee may not realize that the available information is insufficient or incomplete. A conversation with the taxpayer may change the preliminary analysis or confirm what the employee already knows. Either way, if the employee speaks to the taxpayer, that employee is more likely to arrive at the correct tax result, have an opportunity to educate the taxpayer, and resolve the case in a timely manner.

<sup>36</sup> For an in-depth discussion of this issue, see Most Serious Problem: *The IRS Does Not Sufficiently Recognize and Address Domestic Violence and Abuse and its Effects on Tax Administration*, *supra*.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

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

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

### RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division  
 Faris Fink, Commissioner, Small Business/Self-Employed Division  
 Terry Milholland, Chief Technology Officer

### DEFINITION OF PROBLEM

The IRS's miscalculations of interest can lead taxpayers to pay the balances shown on official IRS documents, only to later receive additional bills for accruals of interest, or to pay incorrect amounts without ever knowing the IRS made a mistake. As the National Taxpayer Advocate reported in 2008, the IRS has had particular difficulty with "restricted" interest, which IRS computers cannot calculate automatically.<sup>1</sup> Since the 2008 report, the IRS has significantly improved its processes to avoid restricted interest computation errors.<sup>2</sup> While the IRS reported a restricted interest error rate of more than 30 percent in 2008, the current error rate is only about five percent.<sup>3</sup> The National Taxpayer Advocate commends the IRS for this progress, and looks forward to continued improvement in the accuracy of interest computations with the release of the IRS's Customer Account Data Engine (CADE 2).<sup>4</sup>

However, two problems persist:

- The computation of the underlying failure-to-pay (FTP) penalty may be erroneous, which may in turn cause inaccurate interest calculations. As the National Taxpayer Advocate reported, computer-generated miscalculations of FTP penalties could potentially affect two million taxpayer accounts.<sup>5</sup>

<sup>1</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 307. We use the terms "manual interest," "restricted interest," and "complex interest" interchangeably to refer to interest that requires manual computation because it is limited to specific time periods or rates (or is prohibited altogether) pursuant to various statutory provisions. See Internal Revenue Manual (IRM) 20.2.8.1 (Dec. 4, 2009).

<sup>2</sup> Moreover, because the IRS previously used a flawed method of evaluating the accuracy of restricted interest calculations, the 2008 error rate may have been overstated. Prior to December 2010, the IRS's sampling methods were not statistically valid. Small Business/Self-Employed (SB/SE) Research, Project # PHL0075, *Profile and Sampling Method for Complex Interest Cases*, Final Report (Feb. 2011).

<sup>3</sup> National Taxpayer Advocate 2008 Annual Report to Congress 308; SB/SE Research, Project # PHL0075, *Profile and Sampling Method for Complex Interest Cases*, Final Report (Feb. 2011); IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO 3 (June 2011) (reporting a 95 percent accuracy rate). Some improvements are attributable to better measurement of the quality of restricted interest computations.

<sup>4</sup> CADE 2 is a modern database that will ultimately replace the IRS's more than 50-year-old return and data processing systems. IRS, CADE 2 Overview Briefing 5 (Sept. 2011).

<sup>5</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 306; IRC § 6651.

- Contrary to law, taxpayers whose accounts have restricted interest do not always receive statements showing accumulated interest until several years have passed and the balance has grown to unmanageable proportions.<sup>6</sup>

## ANALYSIS OF PROBLEM

### Background

Under Internal Revenue Code (IRC) § 6601, taxpayers must pay interest on tax that is not paid when due. Under IRC § 6611, the government pays interest on taxpayers' overpayments.<sup>7</sup> In many instances, interest begins to accrue with reference to the due date of the return or the date of the overpayment, and continues to accrue without interruption until the tax or refund is paid. However, various statutory provisions scattered throughout the IRC restrict the accrual of interest to certain periods or suspend it altogether.<sup>8</sup> When IRS computer systems cannot identify and accommodate these situations, IRS employees must compute restricted interest manually.<sup>9</sup>

*Example: IRC § 7508 - Combat Zone*<sup>10</sup>

IRC § 7508 prescribes a period of time to be disregarded when determining the interest accrual and penalties for individuals who serve in a combat zone. The period starts when a taxpayer enters the zone and ends 180 days after he or she leaves it. The IRS also disregards any time spent in a hospital due to injuries sustained in a combat zone when computing an interest liability. The interest due from these taxpayers must be manually computed.

Each year, as required by IRC § 7524, the IRS sends an updated balance due statement, which includes any penalty and interest, to taxpayers whose accounts do not have restricted interest computations, whether or not there have been any payments or credits to the account.<sup>11</sup> However, when the account involves restricted interest, and there is no payment or credit to trigger the necessary manual computation, the taxpayer may not

<sup>6</sup> IRC § 7524 provides "Not less than annually, the Secretary shall send a written notice to each taxpayer who has a delinquent tax account of the amount of the tax delinquency as of the date of the notice." IRS Notice CP 71, *Reminder Notice*, when issued to taxpayers whose accounts have restricted interest, states "penalty and interest are *not* calculated to the date shown above, if a payoff is required, please call the telephone number shown." (Emphasis added.) IRM 3.14.1.7.7.5.11 (Jan. 1, 2011). Only if the taxpayer calls the IRS and requests it will the IRS mail a statement that shows the full amount, including interest, due from the taxpayer.

<sup>7</sup> Interest is imposed with reference to a principal amount, which, pursuant to IRC § 6601(e)(2)(A), may include penalties and additions to tax.

<sup>8</sup> See IRM Exhibit 20.2.8-1 (Dec. 4, 2009) for a table of these statutory provisions.

<sup>9</sup> As the General Accounting Office (GAO, now the Government Accountability Office) initially described the problem, "some interest is calculated manually or on personal computers because the capability to calculate interest in accordance with certain legal requirements has not been programmed into systems at IRS' primary computing center. IRS refers to this interest as restricted interest because the accounts it relates to have been restricted from the automatic interest calculations that most accounts are subject to." GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 27 (Dec. 21, 1993).

<sup>10</sup> IRC § 7508; IRM 20.2.7.7 (Mar. 9, 2010).

<sup>11</sup> See also IRM 21.3.1.4.44 (Oct. 1, 2002). The annual notice is referred to as a "reminder notice."

receive periodic statements of the total amount owed.<sup>12</sup> A restricted interest account with a large tax liability accruing interest over a year (or multiple years) can create an unexpected financial burden for the taxpayer.<sup>13</sup>

### **The General Accounting Office Identified Problems with IRS Interest Computations in 1993.**

In 1993, the General Accounting Office (GAO, now the Government Accountability Office) found that errors in manual interest computations produced inaccurate data that in turn caused unreliable revenue information.<sup>14</sup> In the 2008 Annual Report to Congress, the National Taxpayer Advocate reported the manual interest computation accuracy rate for the first half of fiscal year (FY) 2008 was 67.7 percent.<sup>15</sup> In 2009, the GAO reported the problem had not been fully addressed.<sup>16</sup>

### **A Multifaceted Approach Led to Significant Improvements.**

The IRS's Office of Servicewide Interest (OSI), embedded in the Small Business /Self-Employed division, sets IRS policy and procedures for calculation and application of interest, including restricted interest. In response to the 67.7 percent reported accuracy, OSI created the Complex Interest Quality Management System (CIQMS) unit to sample manual complex interest transactions, review them for accuracy, and report on the weaknesses.<sup>17</sup> OSI monitors the monthly sampling reviews to identify error trends and correct them. For example, OSI sends a letter to any examiner who performed an erroneous computation and to the employee's manager, advising of the error.<sup>18</sup> Other measures the IRS has taken to improve the accuracy of restricted interest computations include onsite and ongoing training and assistance, software upgrades such as Automated Computation Tools, and consistent use of the software by all restricted interest analysts.<sup>19</sup>

<sup>12</sup> See GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 27 (Dec. 21, 1993) ("Further, restricted interest included in reported accounts receivable information is understated, because it is not routinely updated. Instead, individual accounts are updated only as needed, for example, when a payment is made against a taxpayer account").

<sup>13</sup> IRM 5.19.10.5.7 (Sept. 15, 2010). Several examples of Systemic Advocacy Management System (SAMS) complaints relating to this IRS deficiency are on file with TAS.

<sup>14</sup> GAO, GAO/AIMD-94-22, *Important IRS Revenue Information Is Unavailable or Unreliable* 26-29 (Dec. 21, 1993) (noting "IRS has identified its difficulty in properly calculating restricted interest as a problem since 1986 when it was identified as a material weakness in IRS' annual report on internal controls required by the Federal Managers' Financial Integrity Act").

<sup>15</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304-315. See also Memo from IRS Deputy Commissioner, Services and Enforcement, to Deputy Commissioners "Training and Assistance" (July 10, 2008), on file with TAS.

<sup>16</sup> GAO, GAO-09-514, *Status of GAO Financial Audit and Related Financial Management Report Recommendations*, Appendix I (June 2009) ("While IRS has undertaken several actions to strengthen controls over this area, such as updating guidance and providing training related to manual interest calculations, it has yet to develop a sampling methodology to monitor the accuracy of its manual interest computation and assess the effectiveness of its corrective action.").

<sup>17</sup> SB/SE Research Final Report, # PHL0075, *Profile and Sampling Method for Complex Interest Cases* 7 (Feb. 2011).

<sup>18</sup> IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO (June 2011). OSI plans to expand its future sampling to areas identified as having the largest potential for improving manual interest computations.

<sup>19</sup> *Id.* The Decision Modeling, Inc./Automated Computation Tool, also known as DMI/ACT, is software that allows the user to efficiently import taxpayer data from other databases in order to compute restricted interest.

Because a recurring audit issue for the GAO was that the sampling method used to select cases for review was neither statistically valid nor systematic, the OSI asked SB/SE to develop a valid systematic sampling process that the GAO would accept.<sup>20</sup> OSI began using the new sampling method in December 2010 and found that the accuracy rate stood at 95 percent.<sup>21</sup> OSI reported this development to the GAO, which in turn closed the issue as having been effectively addressed.<sup>22</sup> The National Taxpayer Advocate is pleased with the IRS's success in addressing the longstanding concerns surrounding restricted interest accuracy computations.

### FTP Penalty Miscalculations Continue to Cause Problems.

TAS continues to find interest errors attributable to miscalculation of the underlying FTP penalty.<sup>23</sup> A TAS research study published in the 2008 Annual Report to Congress found that computer-generated miscalculations of FTP penalties could potentially affect about two million taxpayer accounts. The statistically valid study found the IRS systemically charged some FTP penalties that exceeded the maximum rate of 25 percent, in direct violation of IRC § 6651, and overcharged taxpayers who were entitled to a reduced FTP penalty rate because they had entered into installment agreements.<sup>24</sup> If a miscalculated penalty is assessed against the taxpayer, the amount of interest owed may also be misstated. The IRS is in the process of correcting penalty miscalculations that trigger interest miscalculations, but some problems remain.<sup>25</sup>

### CADE 2 Is Expected to Resolve Many Computational Problems.

Beginning January 2012, the IRS will roll out an extensive system modernization known as CADE 2, that will permit the Individual Master File (IMF) to accept and post taxpayer account updates every business day. Instead of waiting two weeks for payments to post,

<sup>20</sup> SB/SE Research Final Report, # PHL0075, *Profile and Sampling Method for Complex Interest Cases* (Feb. 2011). The new process called for monthly samples of manual interest transactions from four categories: IMF (open), IMF (closed), BMF (open), and BMF (closed). IMF refers to Individual Master File, the IRS database on which the IRS stores individual taxpayers' data. BMF refers to Business Master File, the database on which the IRS stores business taxpayers' data. "Open" cases are those that will have further interest computations. "Closed" cases are those with a final interest computation.

<sup>21</sup> IRS Financial & Management Controls Executive Steering Committee (FMC-ESC) Briefing to the GAO 3 (June 2011).

<sup>22</sup> GAO, GAO-11-536, *Status of GAO Financial Audit and Related Financial Management Report Recommendations* Appendix I (June 2011) ("IRS has undertaken several actions to strengthen controls over this area, such as updating guidance, implementing standardized software to aid in the computation of manually calculated interest, and providing training related to manual interest calculations. We verified that IRS began testing samples of manual interest transactions in fiscal year 2011, making statistically valid projections of the results, and evaluating the results to gauge the effectiveness of its actions.")

<sup>23</sup> The IRS asserts the FTP penalty when taxpayers fail to fully pay their taxes on or before the due dates of their tax returns. Under IRC § 6651(a), the IRS imposes the penalty rate of 0.5 percent per month, up to a maximum of 25 percent where there is: 1) a failure to pay tax shown on a return, which is calculated from the original due date of the return; or 2) a failure to pay any tax required to be reported on a return that was not reported on the return, and for which the IRS has issued a notice and demand (this penalty does not apply if the amount shown in the notice and demand is paid within 21 calendar days from the date of the notice and demand (or within ten business days if the total balance due is \$100,000 or more). The IRS calculates this penalty from the date that is 21 calendar days, or ten business days, if applicable, after the notice and demand for payment was issued.)

<sup>24</sup> National Taxpayer Advocate 2008 Annual Report to Congress 304, 306.

<sup>25</sup> IRS response to TAS initial draft (Oct. 24, 2011). For example, IRM 20.1.2.2.4 (Apr. 19, 2011) explains how to compute a deficiency under IRC § 6211(b) (4) when a taxpayer claims certain refundable credits in excess of the total tax. The FTP penalty in those cases must be manually computed. IRM 20.1.2.1.5 (3) (Apr. 19, 2011).

it will only take from 48 hours to a week.<sup>26</sup> Ultimately, CADE 2 will replace the more than 50-year-old system the IRS now uses to process tax return data. The new database and its related applications will, over time, replace the IMF and BMF as the IRS system of record for taxpayer accounts and will speed the transition from the multiple systems that now manage taxpayer accounts to one comprehensive system. The OSI anticipates that the January 2012 release of CADE 2 and the availability of real-time data will eliminate some account restricting for interest and certain interest accruals, and will increase timeliness of taxpayer account data.<sup>27</sup> For this reason, it is important that CADE 2 continue to develop, roll out, and operate as planned.

## CONCLUSION

The IRS has an obligation to protect the integrity of taxpayer accounts by accurately calculating interest. While the IRS has significantly improved its restricted interest program, other problems still cause interest miscalculations. Moreover, taxpayers whose accounts have restricted interest do not always receive a notice that states the total amount they owe. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Address inaccurately computed FTP penalties that impact corresponding interest computations in the next CADE 2 release; and
2. Notify taxpayers of updated restricted interest balances at least twice each year.

## IRS COMMENTS

The IRS agrees with the importance of ensuring notices to taxpayers contain accurate penalty and interest computations and has taken several steps over the years to this end. The IRS developed statistically valid monthly samples of manual interest transactions for an ongoing review by the Complex Interest Quality Measurement System function to measure the effectiveness of actions taken to improve interest accuracy. The IRS completed the review of the first statistically valid sample of manual interest transactions reporting a 95 percent accuracy rate for FY 2010.

In 2011, the GAO reviewed the accomplishments of the IRS and the results achieved through the first quarter of FY 2011. With the review process documenting the positive impact of the actions taken to improve the accuracy of Manual Interest computations, GAO acknowledged the IRS has taken several actions to strengthen controls over manual interest

<sup>26</sup> See IRS, *Cade 2 Modernizes IRS System for Taxpayer Accounts* (Aug. 29, 2011), available at <http://irweb.irs.gov/AboutIRS/Nwsctr/Headlines/28279.aspx>.

<sup>27</sup> For example, IRC § 6611(e)(1) prohibits the IRS from paying interest on overpayments if a refund is made within 45 days after the due date the return, or 45 days after the return was filed, if the return was filed after its due date. The more often the IRS can process refund claims within these timeframes, the more often it can avoid paying interest on overpayments.

accuracy.<sup>28</sup> In addition, to ensure our employees have the knowledge and skills to perform accurate manual interest computations, the IRS has:

- Developed, updated, and disseminated guidance in the Internal Revenue Manual.
- Developed and provided Restricted Interest training courses for the computational units throughout the IRS.
- Provided training assistance through our Office of Servicewide Interest to the computational units throughout the IRS.

The IRS also has made programming changes to correct Failure to Pay penalty systemic calculations. In the report, the National Taxpayer Advocate mentions an issue, referencing the 2008 report, where the FTP was systemically charged above the 25 percent maximum rate and, for taxpayers entering into installment agreements, was not systemically computed at the appropriate reduced rate. These issues were both corrected. A programming change was implemented to prevent FTP penalties charges from exceeding the 25 percent maximum rate. A recent review performed by the Office of Servicewide Penalties showed that the accuracy of assessed FTP penalty has consistently been better than 99 percent. Programming changes were also made to ensure qualifying taxpayers received a reduced failure to pay penalty rate if entered into an installment agreement. In fact, in June of 2010, GAO closed its recommendation with regard to ensuring qualified taxpayers received the reduced FTP penalty rate confirming the accuracy of these computations.<sup>29</sup>

In compliance with the Internal Revenue Code,<sup>30</sup> the IRS mails an annual reminder notice of delinquent tax to taxpayers with balances due, including penalties and interest. However, in certain cases the law for restricted interest is so complex that restricted interest must be calculated manually and the interest amount cannot be systemically printed on the notice. For the few cases where a manual interest computation is required, taxpayers are provided a contact number in the notice for obtaining a detailed computation and pay-off amount.<sup>31</sup> We provide this contact number so taxpayers can be informed of the exact amount owed including interest.

The National Taxpayer Advocate makes two preliminary recommendations to improve the accuracy of calculating interest. IRS is taking, or has taken, the following actions with respect to these recommendations.

The IRS agrees to continue devoting resources toward planning and programming for its systems to resolve any remaining penalty and interest computation issues including FTP

<sup>28</sup> GAO, GAO-11-536, *Status of GAO Financial Audit and Related Financial Management Report Recommendations*, Appendix I (June 2011).

<sup>29</sup> GAO, GAO-10-597, *Status of GAO Recommendations from Internal Revenue Service Financial Audits and Related Management Reports*, Issue 09-01, 62.

<sup>30</sup> IRC § 7524, Annual Notice of Tax Delinquency. Not less often than annually, the Secretary shall send a written notice to each taxpayer who has a tax delinquent account of the amount of the tax delinquency as of the date of the notice.

<sup>31</sup> IRM 3.14.1.7.7.5.11 (Jan. 1, 2011).

penalties that impact corresponding interest computations. These efforts include improvements made during a future iteration of CADE 2.

With regard to the National Taxpayer Advocate's recommendation to notify taxpayers of updated restricted interest balances at least twice each year, this would dramatically increase the volume for the print sites that currently send notices annually and would result in inconsistent treatment compared with other taxpayers. Taxpayers without restricted interest only receive an annual notice. At this time, given current resources limitations, we do not anticipate sending semi-annual notices.

### Taxpayer Advocate Service Comments

The National Taxpayer Advocate congratulates the IRS on its progress in addressing interest accuracy and FTP penalty miscomputations. She applauds the IRS's commitment to work toward resolving, in a future CADE 2 release, remaining penalty miscomputations that lead to interest miscalculations. Accordingly, we find our first preliminary recommendation is satisfied. However, the National Taxpayer Advocate is concerned about the IRS's insistence that providing taxpayers with a contact number they can call to obtain pay-off amounts is sufficient to notify taxpayers of the amount they owe.<sup>32</sup> A taxpayer may very well respond to such a notice by paying the dollar amount shown on the notice. If the taxpayer does not realize that dollar amount did not include interest, he or she will be surprised to receive another notice the following year advising that a balance is still outstanding. Even if the taxpayer understands the notice did not include all interest on the liability, he or she may be surprised at the impact interest has on the calculation of the debt.<sup>33</sup> In either situation, an additional year of interest will have accrued on the outstanding balance by the time the taxpayer receives the next reminder notice – which again may not show all the interest owed. Finally, displaying the actual interest accruals in notices may incentivize taxpayers to pay the IRS debt before paying lower-interest debts.

The IRS raises two objections to the preliminary recommendation that the IRS notify taxpayers of updated restricted interest balances at least twice each year. After noting that the cases requiring manual computation are “few,” the first objection is that semi-annual notices would “dramatically” increase the volume for print sites that send the notices. The second objection is that providing semi-annual notices to taxpayers whose accounts have restricted

<sup>32</sup> See, e.g., IRC § 6631, which provides, “The Secretary shall include with each notice to an individual taxpayer which includes an amount of interest required to be paid by such taxpayer under this title information with respect to the section of this title under which the interest is imposed and a computation of the interest.” The provision is based on Congress' belief that “taxpayers should be provided the detail to support the amount of interest charged by the IRS. The computation of interest is a complex calculation, often involving multiple interest rates. The Committee believes that it is appropriate to require the IRS to give notice to the taxpayer that interest is being charged, how it is calculated, and the total amount of the interest.” S. Rep. No. 105-174 (1998) 66, accompanying H.R. 2676, IRS Restructuring and Reform Act of 1998, Tit. III, D. Notice of Interest Charges.

<sup>33</sup> Interest generally accrues on delinquent tax accounts at the federal short-term rate plus three percentage points, is *compounded daily*, and applies to penalties and interest as well as the outstanding tax balance itself. IRC §§ 6621, 6622.

interest would afford them different treatment compared to taxpayers whose accounts do not have restricted interest.

With respect to the second objection, it is already the case that the IRS treats taxpayers whose accounts have restricted interest differently from taxpayers whose accounts do not have restricted interest. The annual notice to taxpayers with restricted interest may not reflect the amount they actually owe, while the notice to taxpayers without restricted interest shows their entire liability. Moreover, taxpayers whose accounts do not have restricted interest can immediately obtain an accurate statement of the balance due, either by calling the IRS or going in person to a Taxpayer Assistance Center, but neither of these options is available to taxpayers whose accounts have restricted interest.<sup>34</sup> Nevertheless, we will accommodate the IRS's inclination to treat taxpayers consistently, and now recommend that taxpayers with restricted interest receive at least *annual* notices showing the entire amount they owe, including restricted interest. This would put taxpayers with restricted interest on the same footing as taxpayers who do not, and would require fewer resources than semi-annual notices would consume.

## Recommendation

Notify taxpayers, in writing, of the entire amount they owe, including restricted interest, at least annually.

<sup>34</sup> An IRS Customer Service Representative must request a qualified analyst to compute the taxpayer's balance. See IRM 20.2.3.5 (2) (Nov. 18, 2008).