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#16**The IRS Has Not Studied or Addressed the Impact  
of the Large Volume of Undelivered Mail on Taxpayers****RESPONSIBLE OFFICIALS**

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**DEFINITION OF PROBLEM**

The proper delivery of refunds, notices, and other official correspondence is essential for effective tax administration. The IRS mails over 200 million pieces of correspondence to taxpayers each year, yet it does not track how much of this mail is annually returned as “undeliverable as addressed” (UAA).<sup>1</sup> A recent Treasury Inspector General for Tax Administration (TIGTA) audit estimated that during fiscal year (FY) 2009, approximately 19.3 million pieces of mail, or almost ten percent of all correspondence for the year, were returned to the IRS at an estimated cost of \$57.9 million.<sup>2</sup> TIGTA reported that 37 percent of the UAA mail could not be delivered due to bad addresses.<sup>3</sup> Additionally, IRS internal studies have shown that 65 percent of all international mail is classified as UAA and may be returned if not corrected.<sup>4</sup>

When mail does not reach taxpayers, a host of problems can ensue. For example, if mail is undeliverable, a levy, lien, or other enforcement action may be the taxpayer’s first notice of an IRS problem. Despite the impact on taxpayers of not receiving IRS correspondence, the IRS does not routinely notate a taxpayer’s account when mail is returned as undeliverable, nor does it effectively use available tools to determine a better address for a taxpayer.

<sup>1</sup> IRS, Wage and Investment (W&I) Division, CARE/M&P Mail Management Project Office, Distribution Media and Publications; *Correspondence Production Services (CPS) Volume History*; and National Print Site Data (National Print Sites) Warehouse, available at [http://nps.web.irs.gov/print%20warehouse/CPS%20FY-09-Site-Summ%20\(2\).xls](http://nps.web.irs.gov/print%20warehouse/CPS%20FY-09-Site-Summ%20(2).xls) (last visited July 6, 2010). In FY 2009, 201,254,976 notices and letters were printed and mailed at the two National Print sites (NPS). According to the IRS’s W&I CARE/M&P: Mail Management Project office, an additional 45 million tax forms, publications, and other information items were mailed by Media and Publications.

<sup>2</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 2* (May 14, 2010).

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

<sup>4</sup> IRS, W&I, CARE/M&P: Mail Management Project Office, *International Mail Impact Analysis Final Report* (July 2007). “It is estimated that more than 7 million Americans reside outside of the United States (not including military personnel).” IRS, *Reaching Out to Americans Abroad*; International Tax Gap Series, available at [www.irs.gov/businesses/article/0,,id=205889,00.html](http://www.irs.gov/businesses/article/0,,id=205889,00.html) (last visited Mar. 31, 2010).

## ANALYSIS OF PROBLEM

### Background

#### *IRS Mails Correspondence to the Last Known Address*

When corresponding with a taxpayer, the IRS uses the “address of record,” which is generally the address given on the taxpayer’s last return.<sup>5</sup> IRS policy requires the taxpayer to provide “clear and concise” notice of any change of address.<sup>6</sup> When the IRS sends a notice or document to a taxpayer’s “last known address,” it is legally effective even if the taxpayer never receives it.<sup>7</sup> Although many provisions of the Internal Revenue Code (IRC) require the IRS to mail notices to the taxpayer’s “last known address,” there is no statutory definition of this term.<sup>8</sup>

Despite the lack of a definition of last known address, the U.S. Tax Court has addressed the standards needed to notify the IRS of a new address as well as the IRS’s obligations in determining the correct address for the taxpayer. In *Pyo v. Commissioner*, the Tax Court stated that the IRS must exercise reasonable care and diligence in mailing a notice of deficiency to the correct address once it becomes aware of a change of address.<sup>9</sup> Whether or not the taxpayer has provided clear and concise notification of a new address, and the IRS has then exercised reasonable care and diligence, is a facts and circumstances interpretation. The Tax Court has commented extensively on cases involving both situations. In *Hunter v. Commissioner*, the court stated the IRS is charged with knowing information it has readily available when it sends notices, and technological advances have left the IRS with a minimal burden in searching its own computer systems.<sup>10</sup> The IRS Office of Chief Counsel concluded that the IRS must use the information available in its own files when it sends notices, and document that the search for the address is correct based on information the IRS possesses.<sup>11</sup>

#### *A Transient Taxpayer Population Can Lead to Mismatches Between IRS and USPS Address Records.*

In FY 2009, the U.S. Postal Service (USPS) reported that 46 million people moved and over a million new addresses were identified in the United States.<sup>12</sup> In 2001, the IRS began using the USPS NCOA system, which provides weekly domestic changes of address, to

<sup>5</sup> Taxpayers can also change their “addresses of record” with “clear and concise” instructions during telephone calls with the IRS, in correspondence submitted to the IRS, or through a change of address filed with the U.S. Postal Service (USPS) and transmitted to the IRS via the National Change of Address (NCOA) system. Treas. Reg. § 301.6212-2; Rev. Proc. 2010-16, 2010-1 C.B. 664.

<sup>6</sup> Treas. Reg. § 301.6212-2; Rev. Proc. 2010-16, 2010-1 C.B. 664.

<sup>7</sup> *Id.*

<sup>8</sup> See, e.g., IRC §§ 6212, 6303, 6320, and 6330.

<sup>9</sup> *Pyo v. Comm’r*, 83 T.C. 626, 633.

<sup>10</sup> *Hunter v. Comm’r*, T.C. Memo. 2004-81.

<sup>11</sup> Chief Counsel Memorandum, *Addressing Issues* (Jan. 9, 2008).

<sup>12</sup> USPS/Pitney Bowes Webinar: Address Validation (2010), *How Government Agencies Use Address Quality; America Is on the Move and Growing* 3.

ease taxpayer burden and maintain accurate address records. In 2007 alone, the USPS electronically sent the IRS records of up to 800,000 address changes per week.<sup>13</sup>

The IRS requires an exact match between NCOA and its Integrated Data Retrieval System (IDRS) to change the Master File address record for a taxpayer. Thus, many taxpayer records cannot be matched and the existing “bad” address remains on the taxpayer’s account.<sup>14</sup> A “no match” may occur when a taxpayer uses a nickname instead of his or her formal first or given name on one record but not the other. If the taxpayer used “William” on a tax return but “Billy” appeared on the NCOA database, it would not be an exact match.<sup>15</sup> If a taxpayer-furnished NCOA change of address does not *exactly* match IRS records, the IRS does nothing further to identify a changed address for any future notices and letters.

#### *New Postal Standards Create Barriers for IRS Correspondence Delivery*

Until 2008, mail that contained a correct city, state, and ZIP code was given to the local mail carrier, who was familiar with the people and addresses on his or her route and could potentially deliver mail with misspelled or incomplete street addresses. However, in 2008, the USPS standards for a deliverable address changed and now include the requirement for a “perfect” street address in addition to the traditional city, state, and ZIP code perfection guidelines.<sup>16</sup> These requirements were added to streamline postal delivery operations, qualify customers for reduced postal rates, and accommodate 911 emergency responses.<sup>17</sup> At the same time, the USPS increased its use of address perfection software to identify UAA mail at its distribution centers. This process requires a “perfect” or deliverable address before it is sent on to the local postal carriers, resulting in increased UAA mail.<sup>18</sup>

#### *The IRS Does Not Use Address Perfection Software to Validate Addresses of Record Placed on Taxpayer Accounts.*

Although taxpayer error in reporting new addresses may account for a large portion of undelivered mail, NCOA mismatches and IRS data input errors are also contributing factors.<sup>19</sup> IRS “key punch” mistakes can easily place an undeliverable address on an account without the taxpayer’s knowledge. These internal mistakes, such as street, city, or state misspellings, often go undetected by IRS employees or systems. Addresses on paper returns receive a cursory review to ensure that the city, state, and ZIP code are present and agree, but the IRS

<sup>13</sup> IRS, W&I, CARE/M&P: Mail Management Project Office, *International Mail Impact Analysis Final Report 2* (July 2007).

<sup>14</sup> Treas. Reg. § 301.6212-2(b)(2) states that the IRS will update taxpayer addresses maintained in IRS records by referring to data accumulated and maintained in the NCOA database, and if that taxpayer’s name and last known address in IRS records match the taxpayer’s name and old mailing address contained in the NCOA database, the new address in the NCOA database is the taxpayer’s last known address, unless the IRS is given clear and concise notification of a different address.

<sup>15</sup> National Office Program Manager Technical, PMTA-1634 (Jan. 9, 2008), available at [http://www.irs.gov/pub/lanoa/pmta01634\\_7415.pdf](http://www.irs.gov/pub/lanoa/pmta01634_7415.pdf).

<sup>16</sup> USPS, Pub. 28, *Postal Addressing Standards* (July 2008), available at <http://www.usps.com/ncsc/addressservices/addressqualityservices/lacsystm.htm>.

<sup>17</sup> *Id.*

<sup>18</sup> TAS was unable to determine differences between undelivered mail in FY 2007 (just prior to USPS address standard changes) and FY 2009 (after the changes) because the IRS did not track data on undelivered mail during that time. IRS response to TAS request for UD/UAA mail (May 28, 2010).

<sup>19</sup> IRS, W&I, CARE/M&P: Mail Management Project Office, *International Mail Impact Analysis Final Report 5* (July 2007).

does not validate the street address. Electronically filed returns receive *no* address review, even though they account for approximately two of every three individual tax returns filed.<sup>20</sup> The address information on an e-filed return will overwrite an existing deliverable address on the Master File with anything the taxpayer places on the e-filed return, including an e-mail or website address.

IRS systems also pose significant problems for international accounts. The layout and space provided on IRS databases do not accommodate most foreign addresses.<sup>21</sup> The absence of international address perfection software to detect and correct address problems is especially problematic since receiving countries require over 200 different address standards.<sup>22</sup> IRS studies show that international mail is classified as UAA 65 percent of the time, primarily due to improper addresses and formatting.<sup>23</sup> The IRS could greatly reduce the volume of undelivered overseas mail by using USPS-approved software that can perfect the address to the receiving countries' standards.<sup>24</sup>

#### **The IRS Does Not Measure the Impact of Undeliverable Mail on Taxpayers.**

The IRS does not adequately track the amount of correspondence returned as “undelivered as addressed.”<sup>25</sup> TAS performed an independent review of undelivered mail returned to two IRS campuses and found the IRS could perfect 38 percent or more of the UAA mail reviewed *prior* to printing and mailing notices and letters, but fails to do so.<sup>26</sup> TIGTA found 37 percent of the correspondence it reviewed could not be delivered due to bad addresses.<sup>27</sup>

#### ***The IRS Does Not Have an Enterprise-Wide Strategy to Resolve Undeliverable Mail Issues.***

All IRS operating divisions and functions, including TAS, issue correspondence to taxpayers almost daily. Although the Wage and Investment division is primarily responsible for processing outgoing and incoming mail, printing and mailing notices and letters, the overall maintenance of addresses, and processing undelivered mail, no one organization

<sup>20</sup> IRS, Statistics of Income; see *Internal Revenue Service Data Book, 2009*, available at <http://www.irs.gov/pub/irs-soi/09databk.pdf>.

<sup>21</sup> IRS, W&I, CARE/M&P: Mail Management Project Office, *International Mail Impact Analysis Final Report* (July 2007).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail* (May 14, 2010).

<sup>26</sup> Independent TAS review, *Review and Compilation of Available Undelivered Mail (UD & UAA) Data* (Nov. 2009). The findings in this review result from a limited sample of 1,000 undelivered notices from the Kansas City and Fresno campuses. An in-depth review of 135 of these notices showed that using USPS-approved address perfection software would provide a “deliverable” address for 38 to 54 percent of the sample. Also, the use of other third-party software identified new or “better” addresses in 32 to 48 percent of the sample but would require taxpayer verification before the addresses could be used.

<sup>27</sup> TIGTA, Ref. No. 2009-40-044, *Current Practices Are Preventing a Reduction in Undeliverable Mail* (May 14, 2010).

within the IRS is responsible for overseeing agency-wide mail operations.<sup>28</sup> No single IRS unit is tasked with:

- Overall accountability and responsibility for collecting and analyzing all mail data, including undelivered mail;
- Monitoring all of the print and mail systems and fixing problems timely;
- Identifying funding and programming needs to update print and mail systems; and
- Identifying and incorporating organizational efficiencies, such as reducing undelivered mail, into print and mail systems.

Undelivered mail affects the efficiency of every IRS operation. However, the rules for processing undelivered mail are left up to the individual operating divisions. A recent search of seven major Internal Revenue Manual (IRM) sections produced many different undelivered mail processing references,<sup>29</sup> most of which discussed processing for specific notices while others spoke to the general processing of undelivered mail. The guidelines often conflict with each other on how to process changes of address. Several refer to the practice of destroying selected notice types upon return, some require an “undelivered” notation in the taxpayer’s account while others do not, and several of the references allow only written authorization from the taxpayer to change an address.<sup>30</sup> Undelivered mail, and information from the USPS, are processed in many different ways. The IRS needs to have one servicewide operation responsible for mail activities to maintain consistency for such an important function of tax administration.

***The IRS Does Not Notate All Taxpayer Accounts When Undeliverable Mail Is Returned.***

Although the IRS routinely notates its Master File when sending certain letters and notices to a taxpayer, it does not update its records when the USPS returns this correspondence as undeliverable. If an initial notice is sent back, the IRS continues to send future notices to this “bad” address.<sup>31</sup> Most non-certified undelivered mail and certified unclaimed or

<sup>28</sup> For a more detailed discussion of the National Taxpayer Advocate’s concerns with the functions placed in the IRS’s W&I operating division, see Most Serious Problem: *The Wage & Investment Division is Tasked with Supporting Multiple Agency-Wide Operations, Impeding its Ability to Serve its Core Base of Individual Taxpayers Effectively*, *supra*.

<sup>29</sup> The search covered major IRM sections in the Servicewide Electronic Research Program (SERP), including IRM 1 (Organization, Finance, & Management); IRM 2 (Information Technology); IRM 3 (Submission Processing); IRM 4 (Examining Process); IRM 5 (Collecting Process); IRM 21 (Customer Account Services); and IRM 25 (Special Topics).

<sup>30</sup> IRM 3.13.62-56 (Jan. 1, 2010). Approximately 200 notice types are listed for destruction upon receipt. These notices include: CP 05, *We Have Received Your Income Tax Return and Are Holding Your Refund*; CP 85, *Exam EIC “Soft” Notice*; CP 75, *Exam Initial Contact Letter – EIC – Refund Frozen*; CP 21E, *Examination Adjustment Notice*; CP 33, *Error Delay for Return and Refund Processing*; and Refused or Unclaimed CP 504, *Final Notice - Balance Due, Intent to Levy*.

<sup>31</sup> This practice can particularly harm taxpayers in the collection notice stream. If the IRS’s initial collection notice is returned undelivered, the IRS continues to send remaining notices, including the Final Notice and Collection Due Process (CDP) notice, to the invalid address. Not only does the taxpayer lose remedies available to resolve the issue, but the IRS can cite the taxpayers’ “unresponsiveness” as justification for lien and levy action.

refused mail (including Collection Due Process notices)<sup>32</sup> that is returned to the IRS is destroyed upon receipt at the various campuses, with no attempt to perfect or locate a new address. This procedure overlooks the IRS's requirement to "...exercise due diligence based on information the Service knew or should have known in order to ascertain a taxpayer's last known address."<sup>33</sup> Moreover, since the IRS does not generally notate undelivered mail in a taxpayer's account, a levy, lien, or other enforcement action may be the taxpayer's first notice of a problem with the account.<sup>34</sup>

### *The IRS Is Not Effectively Using Available Research Tools to Obtain "Better" Addresses.*

The IRS maintains a research tool, the Address Research (ADR) system, to attempt to perfect or locate a "good" or "better" address.<sup>35</sup> However, only 24 notices are processed through the ADR system when mail is returned as UAA.<sup>36</sup> Most of these are collection-related notices such as balance due, return delinquency, intent to levy, or installment agreement default notices.<sup>37</sup> When it identifies potential addresses, the IRS issues Letter 2797, commonly referred to as the "Are You There" letter. This letter is generated and mailed to all potential taxpayer addresses, asking the taxpayer to confirm the address and sign and return the letter.<sup>38</sup> However, this process can take 100 days or more.<sup>39</sup>

### *The IRS Is Taking Some Steps to Improve Mail Delivery.*

The National Taxpayer Advocate acknowledges that the IRS is attempting to address undeliverable mail concerns, including a recent request for funding of additional address perfection software and programming changes to integrate domestic and international

<sup>32</sup> IRM 3.13.62-56 (Jan. 1, 2010). Approximately 200 notice types are listed for destruction upon receipt. Notices listed under the "Destroy" column with the notation ADR/DESTROY are destroyed if the returned mail has "Refused" or "Unclaimed" notations from the USPS. Independent TAS review, *Review and Compilation of Available Undelivered Mail (UD & UAA) Data* (Nov. 2009). Research has shown that refused and unclaimed designations may actually be UAA mail.

<sup>33</sup> National Office Program Manager Technical, PMTA-1634 (Jan. 9, 2008), available at [http://www.irs.gov/pub/iranoa/pmta01634\\_7415.pdf](http://www.irs.gov/pub/iranoa/pmta01634_7415.pdf).

<sup>34</sup> Historically, when TAS has raised concerns about the IRS's failure to take additional measures to contact taxpayers, the IRS has cited resource constraints. See 2004 National Taxpayer Advocate Annual Report to Congress 243 (Most Serious Problem: *IRS Collection Strategy*) ("Although early personal contact would be ideal for identifying the reasons for the delinquency at hand and going beyond that to foster future compliance, we must use our limited resources to address the most egregious cases, which are usually those who do not respond to the early phone calls.").

<sup>35</sup> IRM 5.19.7.5 (Jan. 16, 2009). ADR is an IRS system that uses internal databases and Accurint to search for potential new taxpayer addresses. When potential addresses are secured, IRS letter 2797 is generated and mailed to all potential taxpayer addresses, requesting that the taxpayer confirm the address, sign and return the letter. This process can take 100 days or more. IRM 3.13.62-56 (Jan. 1, 2010).

<sup>36</sup> IRM 5.19.7.5 (Jan. 16, 2009). Count only includes notices (excludes letters run through ADR).

<sup>37</sup> Undelivered CP 504, *Final Notice; Notice of Intent to Levy*, is included in ADR address research while CDP notices such as the LT11 Final Notice, *Notice of Intent to Levy and Your Notice of a Right to a Hearing*, are not processed through ADR. IRM 3.14.1-28 (Jan. 1, 2010). These two notices are confusing as the both indicate they are the "Final Notice" with "Intent to Levy." The CP 504 does not provide taxpayer appeals rights, whereas the LT11 and other CDP notices do provide appeal rights associated with the intent to levy. Confusion exists over which notice or letter is actually the final notice with an intent to levy. When the CP504 is returned "Undeliverable as Addressed" and processed through ADR, since no notation is appended to the account, the CDP notice will probably be sent to the same undeliverable address. This is particularly true when mail is returned as "Unclaimed" or "Refused" since such mail is destroyed upon receipt with no research for a "good" or "better" address. Some notices are refused or unclaimed by the current occupant because the taxpayer moved, not because the taxpayer refused or did not claim the mail. Since these are "Final" notices and carry with them an "intent to levy" and taxpayer appeal rights, then even the unclaimed and refused mail should be processed through ADR to try and obtain a "deliverable" address.

<sup>38</sup> IRM 5.19.7.5 (Jan. 16, 2009).

<sup>39</sup> *Id.* ADR is an IRS system that uses internal databases and Accurint (a contracted service that supplies "potential current" address information for taxpayers, upon request from the IRS) to search for potential new taxpayer addresses.

CODE1+ software into many IRS systems that process Master File address changes.<sup>40</sup> These enhancements will allow the IRS to conduct final address checks before printing and mailing notices, and we applaud these initiatives.

The IRS is also reviewing the use of a full-service intelligent bar code on most outgoing mail, which would allow the IRS to electronically exchange mail status information (*e.g.*, notice and mail tracking data) with the USPS. Undelivered mail can be notated in the electronic file and the IRS could quickly process this information to detect addressing errors or to find a new or “better” address and request taxpayer verification. Address change information from the USPS would confirm a “direct match” with NCOA database information and the new address provided by the USPS could be used to update the address of record on the taxpayer’s account. Additionally, information contained in a full-service bar code can be used to quickly route return correspondence to the proper IRS organization.<sup>41</sup>

#### *The IRS Can Take Further Action to Address Undelivered Mail Concerns.*

Notwithstanding these improvement efforts, there is much more the IRS can do. To ensure that taxpayers actually receive important correspondence, the National Taxpayer Advocate previously recommended that Congress amend IRC § 7701 to add a definition of “last known address” that incorporates case law and current regulations. She also recommended that the IRS:

1. Develop procedures for checking third-party databases for credible alternate addresses prior to sending notices that establish legal rights and obligations (*e.g.*, Statutory Notices of Deficiency, CDP notices, and notices of federal tax lien filing); and
2. When the taxpayer has a credible alternate address, require the IRS to mail the notice simultaneously to the last known address and the credible alternate address (as defined by the Secretary).<sup>42</sup>

The IRS can take some of these actions without legislation. As the Office of Chief Counsel noted, the IRS can use third-party software to obtain a potential new address for a taxpayer and send a letter to that address requesting that the taxpayer update his or her account.<sup>43</sup>

## CONCLUSION

Communication with taxpayers is a basic and essential function of tax administration. It helps taxpayers comply voluntarily with the increasingly complex tax laws. Thus, when IRS correspondence does not properly or timely reach a taxpayer, unnecessary problems can

<sup>40</sup> Information from IRS work requests (request numbers WSP1011240TH and WSP9078300TH) to provide programming for implementation of address perfection software. Code 1+ software is a USPS-approved program that identifies an address that is “undeliverable as addressed” and provides alternative addresses for users to choose from.

<sup>41</sup> For a more detailed discussion of IRS internal mail routing problems, see Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely, infra*.

<sup>42</sup> National Taxpayer Advocate 2008 Annual Report to Congress 449-451.

<sup>43</sup> Chief Counsel Memorandum, *Addressing Issues* (Jan. 9, 2008).

ensure for taxpayers and the IRS alike. The IRS needs to take a comprehensive approach to resolving domestic and foreign undelivered mail problems to allow more taxpayers to receive notices and correspondence and provide earlier opportunities to resolve problems. The IRS has opportunities to reduce the volume of undeliverable mail through procedural updates and system enhancements. If properly addressed as an enterprise-wide problem, improved service to taxpayers and an increase in overall organizational efficiency will be the result.

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

1. Study undelivered mail and address perfection problems, including the establishment of baseline data and periodic data reporting to measure the impact of future software integration and programming;
2. Designate one enterprise-level organization to provide policy, procedures, protection, and maintenance of taxpayer addresses, including one-stop processing of undelivered mail;
3. Use full-service intelligent bar coding on all outgoing mail to allow mail tracking and electronic file exchange between the USPS and IRS; and
4. Apply the existing address research system (ADR) to all undelivered mail returned to the IRS.

## IRS COMMENTS

The IRS appreciates the National Taxpayer Advocate's review of the impact of undelivered mail on taxpayers, as well as the acknowledgement of steps that the IRS is taking to improve mail delivery.

The law requires that certain notices and other documents be sent to the taxpayer at his or her "last known address."<sup>44</sup> The legislative history of the predecessor to § 6212(b) indicates *the intended purpose of the "last known address" standard was to relieve the IRS of the obviously impossible task of keeping an up-to-date record of taxpayers' addresses* (emphasis added).<sup>45</sup>

Treasury Regulations (Treas. Reg.) interpret and give directions on complying with the law and generally have the force and effect of law once adopted. Treas. Reg. 301.6212-2(a) defines a taxpayer's "last known address" as the address provided by the taxpayer on the most recently filed and properly processed federal tax return. This regulation also provides that if a taxpayer no longer wishes the address of record to be the one shown on the most recently filed return (for example, because the taxpayer moved after the return was filed), "clear and concise notification" should be provided to the IRS.

<sup>44</sup> IRC § 6212(b).

<sup>45</sup> H.R. Rep. No. 2, 70th Cong., 1st Sess. 22 (1927), 1939-1 (Part 2) C.B. 384, 399; see also Program Manager Technical Advice (PMTA)-1634 (Jan. 9, 2008).



Revenue Procedures (Rev. Proc.) are official statements regarding procedure that affects the rights or duties of taxpayers or other members of the public under the law and regulations that should be a matter of public knowledge. What constitutes “clear and concise notification” of a taxpayer change of address is very specifically set forth in Rev. Proc. 2010-16 (effective June 1, 2010). This Rev. Proc. advises taxpayers that they should be aware of the need to update their address with the IRS in order to receive refunds of tax as well as other notices and provides that:

- Clear and concise written notification is a written statement signed by the taxpayer and mailed to an appropriate IRS address informing the IRS that the taxpayer wishes the address of record changed to a new address. And, any such notification must be specific as to a change of address. Thus, a new address reflected in the letterhead of taxpayer correspondence will not, by itself, serve to change a taxpayer’s address of record. However, correspondence sent by the IRS that solicits a response by the taxpayer that is returned to the IRS with corrections marked on the taxpayer’s address information will constitute clear and concise written notification of a change of address. Additionally, Form 8822, *Change of Address*, can be used by taxpayers to provide clear and concise written notification of a change of address.
- Clear and concise electronic notification is new address information submitted by the taxpayer through one of the secure applications found on the IRS website, located at [www.irs.gov](http://www.irs.gov). A “secure application” is one that requires the taxpayer to verify the taxpayer’s identity before accessing the application. Other forms of electronic notification, such as electronic mail sent to an IRS e-mail address do not meet this definition.
- Clear and concise oral notification is a statement made by a taxpayer in person or directly via telephone to an IRS employee who has access to the IRS Master File, informing the IRS employee of the address change.

In addition, the IRS will automatically update a taxpayer’s address of record based on a new address that the taxpayer provides to the USPS and that the USPS retains in its NCOA database.<sup>46</sup>

Under Treas. Reg. 301.6212-2, the IRS may not use any other change of address information to update a taxpayer’s last known address, even commercially available or other government agency databases.<sup>47</sup>

The IRS must operate in accordance with the law and these implementing regulations and procedures. Undelivered mail is also a complex problem with no easy solutions, since the IRS must carefully weigh any benefits from changing a taxpayer’s address to improve the chances of mail delivery against the potential for unauthorized disclosure of confidential tax information whenever such mail is delivered to the wrong address. Further, as

<sup>46</sup> Treas. Reg. 301.6212-2(b)(2).

<sup>47</sup> IRS, *PMTA-1634* (Jan. 9, 2008).

acknowledged by TIGTA, a significant portion of the mail returned to the IRS as undelivered cannot be eliminated because the causes are external or beyond IRS control.<sup>48</sup>

Nevertheless, the IRS recognizes the importance of enhancing systems and practices as they relate to address updates and has made or is planning a substantial number of improvements to ensure, to the extent possible, that mail is properly delivered. For example, Rev. Proc. 2010-16, cited above, was recently issued to supersede Rev. Proc. 2001-18 in order to allow our IRS toll-free telephone assistors to make an address change when speaking with a taxpayer. This Rev. Proc. was also changed to authorize the IRS to update taxpayer addresses when a taxpayer responds to correspondence received directly from the IRS and provides a new address.

Further, the IRS has been using address hygiene software on its Master File of taxpayer accounts for approximately 28 years. The IRS Master File is the central database that IRS uses to manage taxpayer returns and accounts, which is in the process of being replaced by the modernized Customer Account Data Engine (CADE). Address hygiene software identifies bad addresses. For instance, it will identify when a house number is not included with the street or when a city and state do not match. In some cases, this software can also be programmed to make corrections when such errors are identified.

While many of IRS' modernized systems, including CADE, Accounts Management Services, Modernized Internet Employer Identification Number, and On-Line Payment Agreement have been designed to include initial address checks using address hygiene software, many other applications and independent computer systems remain to be updated. To this end, the IRS obtained an IRS-wide licensing agreement on March 31, 2010, and is in the process of integrating and sequencing implementation of address hygiene software into these systems.

In addition:

- We are adding an indicator that will post to taxpayer accounts whenever addresses are known to be bad or do not produce the required exact match with the USPS NCOA database. Establishment of this indicator will allow the various functions to suppress generation of notices, when appropriate.
- We revised applicable IRMs to require our employees to perform research before overlaying or updating taxpayers' addresses when an address is not provided by the taxpayer on a return.
- We are redesigning IRS notices to include a contact stub that provides space for taxpayers to communicate new address information to the IRS when they respond.
- We are working to expand address fields in our systems to adequately hold foreign addresses.

<sup>48</sup> TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undeliverable Mail* (May 14, 2010).

- We conducted a study to assess whether the IRS could benefit from using the Intelligent Mail barcode (IMBC).
- We are exploring the potential to automatically identify accounts when mail is undeliverable and populating an indicator by leveraging the capabilities of the USPS' electronic mail tracking system through the IMBC.
- We are conducting a study to determine the feasibility of developing standardized procedures for processing undeliverable mail for all IRS functional offices.

With regard to the National Taxpayer Advocate's preliminary recommendations, we offer the following comments:

**Study undelivered mail and address perfection problems, including the establishment of baseline data and periodic data reporting to measure the impact of future software integration and programming.**

As shown by our work in this area, the IRS acknowledges that undelivered mail and address perfection are issues that warrant attention. We have taken many steps and studies as outlined above. We will continue to measure the results of these changes to systems and procedures as we move forward.

**Designate one enterprise-level organization to provide policy, procedures, protection, and maintenance of taxpayer addresses, including one-stop processing of undelivered mail.**

The W&I Division of the IRS is primarily responsible for the processing of mail and the overall maintenance of addresses. As outlined above, we are implementing procedural changes and have requested substantial programming changes that will reduce the incidence of undelivered mail within our corporate systems. We are also conducting a study to determine the feasibility of developing standardized procedures for processing undeliverable mail for all IRS functional offices.

**Use full-service intelligent bar coding on all outgoing mail to allow mail tracking and electronic file exchange between the USPS and IRS.**

As outlined above, IRS is already studying, in consultation with the Taxpayer Advocate Service, the benefits of using IMBC. That study is in its final stages. In addition, the use of IMBC on outgoing mail is only a first step towards leveraging the full capabilities of the USPS' electronic mail tracking system. The IRS is exploring the potential to electronically update accounts with undelivered mail, feed address research systems, and update our files with USPS address corrections. If feasible, this would significantly enhance our address correction capabilities, as well as eliminate the need for the IRS to wait for the return of undelivered mail by the USPS or the handling of this mail in our campuses.

The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers

MSP #16

**Apply the existing address research system (ADR) to all undelivered mail returned to the IRS.**

The IRS currently screens a select number of notice types for ADR research based on their purpose and impact on taxpayers. It would be cost prohibitive to screen all undelivered mail in this manner. Further, when the system enhancements already planned or under study as outlined above are fully implemented, we expect them to achieve similar results.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes that undelivered mail creates problems for both the IRS and taxpayers. The National Taxpayer Advocate applauds the significant efforts the IRS has made in response to the problems, in particular the commitment to add an indicator to taxpayer accounts when an address is known to be bad. However, we continue to have concerns in specific areas.

As a threshold matter, we note that the IRS cited legislative history from 1927 in its response as a partial reason for the current state of mail operations.<sup>49</sup> The world has changed greatly since the last-known-address statute was enacted in 1927 and resources that could not have been imagined at the time for locating more accurate taxpayer addresses now exist. IRS Chief Counsel has acknowledged that the IRS may locate a better address for a taxpayer using, for example, third party software, and send an “Are You There” letter to that address.<sup>50</sup>

### *Centralize Mail Operations*

The IRS should consider moving mail operations to an agency-level organization. Undelivered mail is a servicewide problem. All operating divisions (ODs) send mail and thus have some rate of return on undelivered mail as well as an interest in ensuring that they send mail to the best available taxpayer addresses. However, while each OD handles undelivered mail in its own way, W&I is primarily responsible for processing mail and maintaining addresses. Placing mail operations primarily in one division, instead of at the agency level, leaves these operations secondary to the main mission of that OD. It does not provide the IRS with a centralized unit to focus on and maintain the agency’s overall mail functions, including analyzing undelivered mail, monitoring all mail systems, and identifying necessary system-wide changes.

### *Conduct a Complete Study of Undelivered Mail Issues*

While the IRS has taken important steps to study the problem of undelivered mail, it lacks even a basic knowledge of how much of its mail is returned as undelivered. When asked for figures on the scope of the problem, the IRS could not provide data for total undelivered mail, let alone the types of mail that go undelivered. Proper delivery of mail to taxpayers is an essential component of effective tax administration. If a taxpayer fails to receive a piece of IRS correspondence, a levy or lien may be the taxpayer’s first indication that he or she has a tax problem. In these situations, the burden on the taxpayer is substantial and could have been relieved had the taxpayer timely received correspondence. The IRS needs to complete, at minimum, a baseline study that identifies the scope as well as the

<sup>49</sup> H.R. Rep. No. 2, 70th Cong., 1st Sess. 22 (1927), 1939-1 (Part 2) C.B. 384, 399

<sup>50</sup> See Chief Counsel Memorandum, *Addressing Issues* (Jan. 9, 2008); IRM 5.19.7.5 (Jan. 16, 2009).

types of undelivered mail so that it can judge whether any changes are effective in reducing undelivered mail.

### *Begin Using the Full Service IMBC*

The National Taxpayer Advocate is pleased that the IRS is studying the use of the IMBC and urges its swift adoption, which would relieve many undelivered mail problems. The full-service IMBC would allow the IRS to process all mail in the current ADR system, perfect addresses, and provide for a complete information exchange between the USPS and the IRS.

## Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Study undelivered mail and address perfection problems, including the establishment of baseline data and periodic data reporting to measure the impact of future software integration and programming;
2. Designate one enterprise-level organization to provide policy, procedures, protection, and maintenance of taxpayer addresses, including one-stop processing of undelivered mail;
3. Use full-service intelligent bar coding on all outgoing mail to allow mail tracking and electronic file exchanges between the USPS and IRS; and
4. Apply the existing address research system (ADR) to all undelivered mail returned to the IRS, once the full-service IMBC is applied to outgoing mail.

**MSP  
#17****The IRS Does Not Process Vital Taxpayer Responses Timely****RESPONSIBLE OFFICIALS**

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

**DEFINITION OF PROBLEM**

The IRS does not measure the accuracy or timeliness with which it handles taxpayer correspondence, despite the critical importance of this task in tax administration. The IRS lacks any comprehensive, reliable data that would allow it to understand the sources or causes of misrouted mail.<sup>1</sup>

The IRS receives over 11 million pieces of taxpayer correspondence each year.<sup>2</sup> IRS data indicate that over 75 percent of mail at two Compliance Services Collection Operation (CSCO) sites took longer than the 14-day goal to process.<sup>3</sup> Moreover, nearly 40 percent of collection correspondence at these sites was assigned more than 30 days from the IRS-received date.<sup>4</sup> For all Correspondence Imaging System (CIS) correspondence cases closed in fiscal year (FY) 2009, the average time to assign the correspondence was between 15 and 30 days.<sup>5</sup>

Delayed or inaccurate mail processing can result in premature and incorrect tax assessments and unnecessary collection actions, which harm taxpayers and create rework for the IRS. Incorrect mail processing can also delay refunds, not only increasing the economic burden on taxpayers but also creating additional workloads, resource costs, and refund interest costs for the government. Thus, improper handling of taxpayer correspondence can cause real harm to the taxpayer and real burden to the IRS.

<sup>1</sup> IRS response to TAS research request (Sep. 23, 2010).

<sup>2</sup> IRS responses to TAS research requests (June 18, 2010 and June 23, 2010). These data include 11,439,851 pieces of mail processed between January and September 2009 by the Receipt and Control functions in six campuses: Atlanta, Austin, Cincinnati, Fresno, Kansas City, and Ogden.

<sup>3</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009. For a full explanation of the methods used to analyze the date, see *infra*. The CCA 4243 report is an automated listing, compiled weekly, showing all cases assigned on the Integrated Data Retrieval System (IDRS) system on the day the report generates. IRS procedures require the CSCO and Accounts Management to control incoming correspondence on the Integrated Data Retrieval System (IDRS) within 14 days of the IRS received date. Internal Revenue Manual (IRM) 5.19.1.1 (May 10, 2010); IRM 21.5.4.1.2.2 (Aug. 31, 2010).

<sup>4</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009.

<sup>5</sup> Wage and Investment division (W&I) response to TAS request (June 23, 2010). These statistics are not limited to the Memphis and Brookhaven campuses and include all CIS cases closed in fiscal year (FY) 2009.

## ANALYSIS OF PROBLEM

### Background

The IRS has approximately 1,000 different letters and notices, and sends over 200 million pieces of correspondence to taxpayers each year.<sup>6</sup> Because many of these documents require taxpayers to respond in writing, the IRS receives annually over 11 million taxpayer replies in its mailrooms.<sup>7</sup> The W&I operating division is responsible for the initial processing of incoming mail at IRS campuses.<sup>8</sup> Two IRS functions – Receipt and Control and Campus Support – receive the mail and stamp it with the received date.<sup>9</sup> Mail is then sorted and delivered throughout each campus, going to W&I and Small Business/Self-Employed (SB/SE) functions such as Accounts Management, Examination, Automated Underreporter (AUR), CSCO, Automated Collection System (ACS) Support, and Appeals.<sup>10</sup> Employees of these and other IRS organizations process the mail and update automated systems to show that it has been received.<sup>11</sup>

Because the IRS does not track how much correspondence the various functions receive, it is impossible to calculate the total volume of mail the IRS receives. However, the campuses and ACS together received over 11 million written taxpayer responses in the first nine months of 2009.<sup>12</sup> Timely and accurate routing of these replies to the correct function is critical to helping taxpayers resolve their tax issues and receive any refunds due.

### Mail Processing Delays Negatively Impact Taxpayers

Misrouting and delays in processing mail within the IRS can have deleterious effects on taxpayers. The information is not timely associated with the taxpayer's account, so the IRS does not have a record of the correspondence in its automated systems, and examination and collection actions continue. In an effort to understand how the IRS processes mail and how it affects taxpayers' accounts, TAS analyzed balance due correspondence data for the Memphis and Brookhaven campuses.<sup>13</sup>

IRS procedures require the Compliance Services Collection Operation and Accounts Management to control incoming correspondence on the IDRS within 14 days of the IRS

<sup>6</sup> IRS, Office of Taxpayer Correspondence website at <http://win.web.irs.gov/TPC/Background.htm> (last visited July 5, 2010).

<sup>7</sup> Information based on data from January through September 2009. IRS responses to TAS research requests (June 18, 2010 and June 23, 2010). These data include 11,439,851 pieces of mail processed between January and September 2009 by the Receipt and Control functions in six campuses: Atlanta, Austin, Cincinnati, Fresno, Kansas City, and Ogden.

<sup>8</sup> IRM 3.10 (Jan. 1, 2010); IRM 21.1.7.5 (Oct. 10, 2007).

<sup>9</sup> Receipt and Control functions are located in the Atlanta, Austin, Fresno, Cincinnati, Kansas City, and Ogden campuses. Campus Support functions are located in Andover, Brookhaven, Memphis, and Philadelphia.

<sup>10</sup> IRM 3.10.72 (July 2, 2010); IRM 21.1.7 (June 21, 2010).

<sup>11</sup> IRM 3.10.72 (July 2, 2010); IRM 21.1.7 (June 21, 2010); IRM 21.2.1.9 (Aug. 14, 2009); IRM 4.19.4.3 (Apr. 1, 2010); IRM 4.19.20 (Jan. 1, 2010).

<sup>12</sup> Receipt and Control Operations received 11,439,851 pieces of mail from January through September 2009 while the ACS Support function received 283,463 pieces in FY 2009. The IRS was unable to provide the total volume of mail received by the campus Examination, Compliance Services Collection, or AUR operations in FY 2009. IRS responses to TAS research requests (June 18, 2010, and June 23, 2010).

<sup>13</sup> TAS used these data because information for all types of taxpayer correspondence was not available.



received date.<sup>14</sup> As part of the mail processes, IRS employees are also required to input computer codes at the time the mail is assigned to a function to stop subsequent notices or collection actions, including levies.

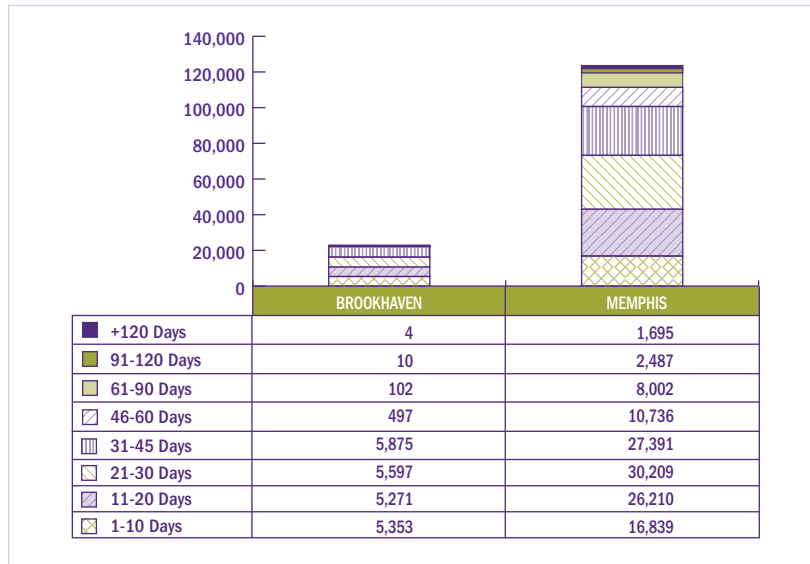
Data from more than 146,000 pieces of taxpayer correspondence received in FY 2009 showed that less than 25 percent of the correspondence was assigned to an IRS work unit within two weeks of receipt. Conversely, it took 15 days or more to assign 75 percent of balance due correspondence.<sup>15</sup> CSCO employees are instructed to resolve tax due correspondence issues within 30 days of the IRS received date or contact the taxpayer if additional time is needed.<sup>16</sup> However, it took more than 30 days from the IRS received date to assign nearly 40 percent of the correspondence received in CSCO. Chart 1.17.1 below breaks down the time between the first receipt of collection correspondence and when it was assigned to the function. While the TAS analysis was limited to two campuses' collection correspondence pertaining to balance due accounts, it indicates that problems exist with current mail routing processes and timelines.

<sup>14</sup> Additionally, once the mail is assigned on IDRS, CSCO employees are instructed to resolve tax due correspondence issues within 30 days of the IRS received date. If the correspondence issues cannot be resolved within 30 days, employees are instructed to issue an interim letter to notify the taxpayer that additional time is needed to resolve the issue and to continue to suspend collection action until the issues are resolved. IRM 5.19.1.1 (May 10, 2010); IRM 21.5.1.4.2.2 (Aug. 31, 2010). See also National Taxpayer Advocate 2006 Annual Report to Congress 222 (Most Serious Problem: *Correspondence Delays*).

<sup>15</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009. TAS research analyzed data (146,532) from the CSCO FY 2009 CCA 4243 reports for Memphis and Brookhaven campuses. Data include only balance due correspondence from these two campuses and are not representative of all correspondence or campuses. Correspondence never assigned on IDRS will not show in this report and was not part of this analysis. Upon receipt in CSCO, correspondence is routed through First Read (CFRP). Per the IRM, correspondence worked in CFRP includes correspondence that can be closed within five (5) minutes following appropriate balance due procedures. Some types of work completed in CFRP are address changes, telephone number input, streamlined installment agreements, and rerouting of correspondence. Cases closed in First Read (CSRFP) and streamlined installment agreements (requests are worked through an automated process in Brookhaven) are excluded from this data set. SB/SE response to TAS request (October 18, 2010). SB/SE provided data showing that in 2009, Brookhaven CSCO resolved 40,644 pieces of correspondence in CFRP and Memphis CSCO resolved 88,492. Brookhaven CSCO resolved 50,920 streamlined installment agreement requests using automated processes. Correspondence assigned to an operation after the last weekly report generated, but closed before the next report was compiled, would not be included in any weekly CCA report. Overall, Brookhaven closed 179,639 total balance due correspondence cases and Memphis closed 232,043 balance due correspondence cases during FY 2009.

<sup>16</sup> IRM 5.19.1.1 (May 10, 2010).

**FIGURE 1.17.1, Number of Days from when IRS Collection Correspondence Received until Assigned<sup>17</sup>**



In a similar effort, W&I analysts used Customer Account Services (CAS) reports to calculate the average time it takes to process correspondence through the Correspondence Imaging System, including preparing, scanning, and cataloging documents.<sup>18</sup> Times are calculated from the original IRS received date to the date cases were assigned to Accounts Management. For all CIS correspondence cases closed in FY 2009, the average time to assign correspondence was between 15 and 30 days.<sup>19</sup> These findings suggest it takes two weeks or more to process correspondence through imaging, which is similar to the results of the TAS analysis.

The delay in initial mail processing not only prevents the IRS from meeting its own timelines, but also keeps employees from timely completing follow-up actions, including suspending collection activity. Therefore, some taxpayers may remain subject to collection actions, despite having timely provided information that could resolve the balance due.

<sup>17</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009. TAS analyzed 146,532 records from which 254 items were excluded because the assigned date was earlier or equal to the IRS received date.

<sup>18</sup> CIS is a system for scanning all Accounts Management correspondence receipts into digital images. An electronic workflow delivers the cases to IRS employees who work the cases from those images.

<sup>19</sup> W&I response to TAS request (June 23, 2010). W&I used data from CIS Time in Motion weekly reports to provide an average processing time of all of the cases closed during each specific week, along with the average time taken for document preparation, scanning, and Customer Service Representative (CSR) processing time. Combining Customer Account Services data for the CIS, and available National Quality Review System (NQRS) data, W&I determined the average days to assign cases was less than 30 days in 2009, with 38 percent assigned in more than 15 days. The NQRS data is not statistically valid to the correspondence level; consequently, this data is only representative for the data reviewed. It cannot be generalized to all correspondence.

### Timely Mail Processing Enables Taxpayers to Resolve Tax Issues Promptly and Prevents Rework for the IRS.

The IRS uses automated processes to generate tax notices and assessments. Examples of these systems include:

- Correspondence Examination;
- Automated Underreporter (AUR);
- Automated Substitute for Return (ASFR);
- Automated Internal Revenue Code (IRC) § 6020(b) program; and
- Combined Annual Wage Reporting (CAWR) program.

These systems move a potential tax assessment through various stages of the process until either the IRS assesses the tax or the taxpayer responds.<sup>20</sup> The IRS builds designated response times into its systems. When the IRS receives taxpayer correspondence, the system is updated to reflect the response and stop additional automated processing until the IRS reviews the correspondence. Any subsequent actions are based on the information the taxpayer provided.

If the taxpayer does not reply or the system is not updated to reflect a response by the designated time, the IRS will issue the next notice automatically or move an account to the next step of the assessment or collection process. Thus, it is critical that the IRS process taxpayer correspondence timely.

### The IRS Does Not Monitor Timeliness of Correspondence Processing, Resulting in Taxpayer Burden.

Despite the negative consequences of failing to timely process taxpayer correspondence, W&I and SB/SE acknowledge they cannot measure the volume of correspondence the IRS receives.<sup>21</sup> More importantly, the IRS does not generally measure processing time (*i.e.*, the period from when the IRS first receives correspondence to the date the correct function receives it and associates it with the taxpayer's account).<sup>22</sup>

Quantifying processing time is crucial for correcting potential delays and building adequate response time into the IRS's systems. Failure to build in enough time can result in inappropriate assessments and collection actions. As discussed earlier, nearly 40 percent of the collections correspondence in the Memphis and Brookhaven campuses was received after the 30-day timeframe for taking follow-up action.<sup>23</sup> This means if the taxpayer responded

<sup>20</sup> IRM 4.19.2.5.41 (Sep. 1, 2009); IRM 4.19.22 (Dec. 14, 2009); IRM 1.4.19.6.14.1 (Dec.1, 2009); IRM 5.8.2 (Jan. 1, 2008).

<sup>21</sup> IRS responses to TAS research requests (June 18, 2010 and June 23, 2010).

<sup>22</sup> *Id.*

<sup>23</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009. TAS research analyzed data (146,532 records) from the CSCO FY 2009 CCA 4243 reports for Memphis and Brookhaven campuses.

timely, but in the later part of the time given to respond, correspondence would likely not be assigned in time to stop subsequent collection actions.

This issue is not limited to collection correspondence. A recent Treasury Inspector General for Tax Administration (TIGTA) study found that mail-processing delays, including misrouted and rerouted work, contributed to delays in resolving audit reconsiderations.<sup>24</sup> A 2008 review of W&I's correspondence examination program and subsequent audit reconsiderations found that in 89 percent of the cases, it took more than 30 days to work and close the reconsideration once it was stamped with the received date.<sup>25</sup> More than half the cases that exceeded the 30 days actually took more than 120 days from receipt until closure.<sup>26</sup> The study attributes this delay, in part, to "misrouted or rerouted mail."<sup>27</sup>

Misrouted and mishandled mail not only delays taxpayers' audit reconsiderations, but also creates additional burden because many taxpayers have to provide the same information to the IRS multiple times.<sup>28</sup> In a review of 78 audit reconsideration cases, TIGTA found evidence that in six cases, the taxpayers or their representatives complained of having to provide the same documentation more than once. In three instances, the case files contained multiple copies of the same document, each with a different IRS date stamp.<sup>29</sup>

The results of the TIGTA audit support what the Taxpayer Advocate Service is hearing from tax professionals. Practitioners at Nationwide Tax Forum focus groups have expressed frustration with having to send documentation to the IRS multiple times.<sup>30</sup> TAS has also received submissions through the Systemic Advocacy Management System (SAMS) about mail processing delays and problems resulting from having to send in the same information several times.<sup>31</sup> In one example, a practitioner had a certified mail receipt showing an IRS campus had timely received his request for a Collection Due Process hearing, but no hearing was scheduled. His client's next contact with the IRS was an enforced collection action.<sup>32</sup>

<sup>24</sup> TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 8-14 (Aug. 6, 2009). An Audit Reconsideration is the process the IRS uses to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed. If the taxpayer disagrees with the original determination, he or she must provide information not previously considered during the original examination. The IRS also uses reconsideration when a taxpayer contests a Substitute for Return determination by filing an original delinquent return.

<sup>25</sup> The correspondence examination program (otherwise known as the Discretionary Examination Program) conducts audits by requesting that taxpayers submit documentation to support disputed items on their tax returns. The review was performed by W&I and later reviewed by TIGTA. TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* (Aug. 6, 2009).

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

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* (Aug. 6, 2009).

<sup>30</sup> 2006 IRS Tax Forum Focus Groups, *Most Serious Problems Facing Taxpayers*, Taxpayer Advocate Service, Feb. 2007, available at [http://tasnew.web.irs.gov/Files/ResearchStudies/OtherStudies/MSPFocusGrpR&A\\_Feb2007.pdf](http://tasnew.web.irs.gov/Files/ResearchStudies/OtherStudies/MSPFocusGrpR&A_Feb2007.pdf).

<sup>31</sup> SAMS is a database of issues submitted to the TAS Office of Systemic Advocacy. Individual and business taxpayers, practitioners, research and professional organizations can submit issues via the TAS website at <http://www.irs.gov/advocate>.

<sup>32</sup> SAMS submission 10001143. Enforced collection actions include issuance of a levy or filing of a notice of federal tax lien.

One result of the IRS's inability to timely process taxpayer responses and associate documents with a taxpayer's case is that taxpayers and their practitioners receive unnecessary statutory notices of deficiency (also known as 90-day letters).<sup>33</sup> In recent years, taxpayer representatives expressed concern that the Examination function was issuing notices of deficiency without first considering taxpayer replies to earlier notices.<sup>34</sup>

### Improved Processing of Taxpayer Correspondence Minimizes Downstream Consequences.

Notice operations cost the IRS nearly half a billion dollars annually. Historically, 60 percent of these costs result from the downstream consequences of issued notices, including subsequent contacts between the IRS and taxpayers via phone calls, office visits, and correspondence.<sup>35</sup> The IRS has recently initiated actions to improve notice processes, including a notice clarity project.<sup>36</sup> Recognizing the significant problem with the correct routing of incoming correspondence, SB/SE and W&I formed a team to improve the accuracy and timeliness of mail routing.<sup>37</sup> The team is developing a model mail process capable of updating the taxpayer's account on the automated system within five days of Examination's receipt of correspondence.<sup>38</sup> In addition, SB/SE is testing new "first read" procedures for the campus CSCO function designed to allow certain employees to close simple correspondence upon receipt and correct routing errors.

Another potential improvement is the use of a full-service intelligent mail barcode (IMb) on most outgoing mail, which would allow the IRS to electronically exchange mail status information (*e.g.*, notice and mail tracking data) with the U.S. Postal Service (USPS). Mail labels with IMb technology could also be included with notices sent to taxpayers for use on their replies. The IRS could use this bar code information to quickly route return correspondence to the proper function for review and action.<sup>39</sup> The postal system can also provide the IRS with two to three day notice of taxpayer correspondence on its way

<sup>33</sup> The notice of deficiency gives the taxpayer 90 days (150 days if the notice is mailed to a person outside of the United States) to file a petition with the U.S. Tax Court for a redetermination of the deficiency. If no petition is filed within 90 days, the IRS will assess the tax.

<sup>34</sup> National Association of Enrolled Agents, Letter Regarding Concern over Recent Enforcement Actions by IRS (Nov. 28, 2007), available at [http://www.naea.org/MemberPortal/Advocacy/Comments/letter\\_nov\\_28\\_2007.htm](http://www.naea.org/MemberPortal/Advocacy/Comments/letter_nov_28_2007.htm). See also National Taxpayer Advocate 2008 Annual Report to Congress 316 (Most Serious Problem: *The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures and Assessments*).

<sup>35</sup> IRS, *Notice Modernization Team Phase I Summary: Baseline of Current Operations & Vision for Future* 6 (Feb. 1, 2001).

<sup>36</sup> The IRS has taken significant steps to improve the clarity of notices it sends to taxpayers. IRS, *TACT: Taxpayer Communication Taskgroup Report*, available at [http://win.web.irs.gov/TPC/TPC\\_docs/Historical/TACT%20Presentation\\_NAEA\\_August%202009.pdf](http://win.web.irs.gov/TPC/TPC_docs/Historical/TACT%20Presentation_NAEA_August%202009.pdf) (last visited July 4, 2010). In July 2008, the IRS created the Taxpayer Communications Taskgroup (TACT) to increase the clarity, accuracy, and effectiveness IRS letters and notices. In January 2010, the TACT became the Office of Taxpayer Correspondence within W&I. Under this effort, IRS notices were rewritten in plain language to help taxpayers understand and respond to them quickly. However, these efforts have not addressed procedures for processing taxpayer replies and reducing downstream consequences. IRS, *Taxpayer Communication Taskgroup (TACT) Charter*, available at <http://win.web.irs.gov/TPC/TACT.htm> (last visited July 4, 2010).

<sup>37</sup> The Misrouted Mail Team's work will be a six-month process, focusing on gathering data in the first month. The team will visit all the W&I and SB/SE programs (Exam, CSCO, etc.) and Campus Support and Receipt and Control. The team is mapping out the process from when the mail comes into a site to when it reaches an IRS function. IRS response to TAS research request (Sep. 23, 2010). Some initial results show that mail clerks in the functions are using their memory or an outdated mail routing list instead of using the updated electronic version. SB/SE response to TAS inquiry (Aug. 3, 2010).

<sup>38</sup> IRS responses to TAS research requests (June 18, 2010, and June 23, 2010).

<sup>39</sup> For a more detailed discussion of the intelligent bar code, see Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*, *supra*.

to the IRS if the taxpayer uses the IMb label or voucher provided by the IRS in outgoing correspondence. This technology could allow the IRS to update accounts to reflect that the taxpayer provided a written reply as soon as the USPS processes the reply. This would prevent premature enforcement actions and invalid tax assessments, while protecting taxpayer rights and reducing rework.<sup>40</sup>

### **The IRS Needs to Reexamine Time Allowed for Taxpayer Response.**

IRS computer systems are not updated to reflect the receipt of correspondence until after the mail has been routed from the incoming mail receipt unit to a function like Examination or Collection. Because the IRS does not measure the time between first receipt of correspondence and its receipt by the correct function, the taxpayer response timeframes built into automated processes may not be sufficient.

For example, the automated examination program allows 105 days for receipt of a response to a statutory notice of deficiency.<sup>41</sup> The notice instructs the taxpayer to respond within 90 days from the date of the notice. If the taxpayer mails a response on the 85th day and the IRS mailroom receives it on the 87th day, a mail processing time of 20 days would mean that Examination would not receive the response until the 107th day. The automated system would assess the proposed tax after 105 days, even though the taxpayer had responded timely.

While the IRS can correct erroneous assessments,<sup>42</sup> correcting the assessment after the fact creates burden and distress for the taxpayer and unnecessary rework for the IRS. The National Taxpayer Advocate previously reported that the correspondence examination process did not provide sufficient time to process taxpayer replies to audit notices.<sup>43</sup> The IRS should gather reliable data on its mail processing systems and use it to adjust automated timeframes to take into account the delay in handling taxpayer correspondence.

## **CONCLUSION**

Despite acknowledging that misrouted mail is a problem, the IRS still lacks the data it needs to understand the source of the problem and implement solutions. While the IRS is taking some steps towards improvement, the impact of misrouted mail on taxpayers and the IRS demands that the IRS give this matter its full attention.

<sup>40</sup> See IRS, *IMB Briefing: A Summary of the USPS Intelligent Mail Barcode®: Full Services "How to", and Best Practices that the IRS Can Apply* (July 29, 2010).

<sup>41</sup> IRM 1.4.19.6.14 (Dec. 1, 1009).

<sup>42</sup> IRM 4.19.20.1.6.4 (Apr. 16, 2008).

<sup>43</sup> National Taxpayer Advocate 2008 Annual Report to Congress 316 (Most Serious Problem: *The IRS Correspondence Examination Program Promotes Premature Notices, Case Closures and Assessments*).

To improve the timely and accurate processing of correspondence, the National Taxpayer Advocate offers these preliminary recommendations:

1. Track and assess the timeliness and accuracy of mail routing to each campus operation.
2. Revise timeframes for automated assessment processes so they provide sufficient time for the IRS to receive taxpayer responses and update its systems.
3. Test the use of technology such as Intelligent Bar Coding on envelopes to enable easier routing of incoming mail.

### IRS COMMENTS

The issues involved in mail routing are complex and are an area of continued focus for the IRS. The National Taxpayer Advocate correctly points out that the IRS uses a thousand different letters and notices and sends over 200 million pieces of correspondence to taxpayers each year, many of which require a response. As a result, the IRS receives and acts upon at least 11 million pieces of taxpayer mail annually, as well as approximately 37-40 million pieces of mail containing paper tax returns.

Taxpayer mail received in IRS campuses deals with a multitude of tax issues. It is intended for and must be routed to multiple IRS functions responsible for the various tax issues involved. Such mail includes account-related taxpayer inquiries that are worked in the Accounts Management (AM) function. Also included are responses to notices and other IRS communications involving ongoing collection actions and audits handled by the CSCO, ACS Support, Automated Underreporter, and Correspondence Examination functions. Measures, such as timeliness and days to close are in place to monitor and manage the health of this correspondence inventory within each of the responsible IRS functional areas. In addition, inventory management tools, such as the CIS and the Automated Management System (AMS), have been implemented to automate and expedite the handling of much of this mail.

Accounts Management uses CIS Time in Motion reports to measure correspondence timeliness from the IRS-received date to the date of imaging and, ultimately, to the date of closing. Similarly, CSCO measures the age of correspondence using AMS reports that track cases from the IRS-received date to closure of a case. ACS Support and CSCO also measure timeliness utilizing various tools, such as Case Control Activity listings, AMS reports, and data from the National Quality Review System and the Embedded Quality Review System. Correspondence Examination also tracks the age of its correspondence using Audit Information Management System data but, as noted in more detail below, is currently in the process of implementing improved correspondence monitoring metrics.

Specifically with regard to the timeliness of routing mail to the appropriate function, Accounts Management has a requirement (IRM 21.5.1.4.2.3) that all cases must be prepped and scanned into the CIS within five calendar days of receipt by its Image Control Team,

or within 14 calendar days of the IRS-received date. During FY 2010, AM met the 14-day timeframe 89 percent of the time. Misrouted mail received by AM from other functions typically accounts for cases scanned beyond the 14-day input timeframe. Nevertheless, CIS has built-in procedures that will systemically input a hold on a taxpayer's account (STAUP) when appropriate and issue an interim letter whenever AM has not closed a case within 30 days, which will also stop any subsequent IRS notices. Such automated interim letters are also generated by other IRS systems.

Similarly, CSCO has a 14-day requirement for mail to be controlled and assigned (IRM 5.19.1.1) and AMS generates reports weekly on the timeliness of correspondence processing. Additionally, CSCO quality review evaluates correspondence timeliness. While the National Taxpayer Advocate reports that much of CSCO mail is not controlled within the 14-day target timeframe, the figures reported for Memphis and Brookhaven are not representative of all correspondence or campuses. Nor do these figures include cases closed in First Read (within five minutes), which CSCO estimates to be as much as 25 percent of all balance due mail. Finally, once the mail is controlled on AMS, a letter is automatically generated to inform taxpayers that IRS is in receipt of their correspondence if the case is not closed within 23 days of the IRS received date.

Correspondence Examination requires taxpayer accounts to be updated to indicate correspondence has been received within five days of its receipt in the Correspondence Examination function. Program reviews reflect that this timeframe is being met. Further, by systemically populating suspense dates within the Report Generation Software/ Correspondence Examination Automation Support (RGS/CEAS) system, it prevents premature issuance of subsequent notices. Moreover, procedures are in place to allow taxpayers every opportunity to resolve cases at the lowest level, such that Correspondence Examination continues to accept and consider taxpayer responses even after issuance of statutory notices of deficiency.

IRS balance due and examination notice processes have taxpayer response times built in which reduces the chances for premature issuance of subsequent notices. In this regard, the National Taxpayer Advocate cites a November 28, 2007, letter from the NAEA as an example of a situation where the IRS was issuing statutory notices of deficiency without first considering taxpayer replies to earlier notices. In its response to a 2008 Most Serious Problem<sup>44</sup> where the National Taxpayer Advocate cited this same 2007 NAEA letter, the IRS noted that it works with the NAEA and others in the practitioner community to solicit this kind of feedback in order to identify improvement opportunities. In this particular instance, the IRS promptly reviewed and adjusted the suspense dates for printing these notices, which served to address the NAEA's concerns.

<sup>44</sup> National Taxpayer Advocate 2008 Annual Report to Congress 253.



Nonetheless, the IRS agrees there is a need to improve internal mail routing and control practices. To this end, multiple process improvement efforts are already underway. These include:

- In W&I Correspondence Examination, a Lean Six Sigma process for streamlining and rationalizing the handling of incoming mail was developed and successfully piloted at the Austin campus. The process resulted in a 70 percent reduction in the time to update examination cases to reply status after correspondence is received during peak processing. The procedures for this process, including a new centralized and standardized mail processing workstation, have been finalized. A rollout to all W&I Correspondence Examination campuses (except Andover, which is moving) will be completed before the end of FY 2011. Small Business/Self-Employed (SB/SE) is piloting the process in Cincinnati with a tentative rollout to other SB/SE campuses also planned for 2011. In addition, requirements for an Exam Mail Tool (EMT) that will automate and reduce the time needed for many aspects of the correspondence update process have been finalized. Included in this EMT tool are enhanced reports that will track the time correspondence was received by the IRS, received in Examination, as well as updated to a mail status on the Audit Information Management System to better monitor the timeliness of taxpayer correspondence. The tool is also scheduled for testing and initial rollout during 2011.
- In SB/SE, two Lean Six Sigma projects currently underway focus on improving the identification and handling of misrouted mail in SB/SE and W&I. These two projects are collectively known as the Misrouted Mail Initiative. Project sponsorship and teams have been developed to include all major operational representation from both SB/SE and W&I compliance organizations, including IMF and BMF sites, as well as related mail handling operations such as Submission Processing, Receipt & Control, and Campus Support. The expected outcomes are to understand and identify lessons learned from current mail routing operations and to identify tools available to accurately direct mail to the proper function.
- In AM, team members assigned to work with the SB/SE Misrouted Mail Initiative described above are currently visiting Submission Processing campuses and Campus Support in AM to identify improvement opportunities. These efforts specifically include evaluating use of a consolidated, enterprise-wide Mail Routing Guide as a replacement for the locally developed, non-standard guides currently used by the campuses to direct tax forms and correspondence to the appropriate functions.

With regard to the National Taxpayer Advocate's preliminary recommendations, we offer the following comments:

- 1) Track and assess the timeliness and accuracy of mail routing to each campus operation.
 

As previously discussed, each IRS function currently has correspondence timeliness measures in place. In addition, multiple efforts are already underway to improve internal mail routing.

- 2) Revise timeframes for automated assessment processes so they provide sufficient time for the IRS to receive taxpayer responses and update its systems.

IRS Collection and Examination systems already have built in uniform and sufficient notice suspense timeframes for the IRS to receive and consider taxpayer responses. For example, in Correspondence Examination RGS/CEAS automatically populates the suspense period whenever a case is updated into a new letter status. Also in this regard, IRS works closely with the tax practitioner community, such as the NAEA, to identify and implement specific improvement opportunities. Based on such feedback, IRS systems have been modified to generate letters to acknowledge receipt of taxpayer correspondence, as well as to adjust notice suspense timeframes. In addition, once mail is received and entered into IRS systems, the taxpayer's account is updated, which prevents the case from automatically moving to the next processing step and ensures IRS considers the taxpayer's response prior to sending the next notice. Further, SB/SE Research recently conducted a study for Examination regarding suspense timeframes and found that of those taxpayers who reply, between 68 percent and 77 percent do so by the due date of the suspense period. This research also found that a change in the suspense period would not materially affect these response rates.

- 3) Test the use of technology such as Intelligent Bar Coding on envelopes to enable easier routing of incoming mail.

The IRS is already studying the benefits of using intelligent mail bar coding (IMBC). We believe utilization of IMBC will provide the greatest initial use and benefit for outgoing IRS mail that is undeliverable. While we agree that IMBC also has the potential to improve the routing of incoming mail, any effort to test the viability of IMBC for this purpose will be a longer term effort that depends on the outcome of the current IMBC study, available funding and programming resources, as well as the results of other mail-related efforts outlined above.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS agrees there is a need to improve internal mail routing and control practices, and believes the process improvement efforts already underway are a good first step. One effort includes evaluating use of a consolidated, enterprise-wide Mail Routing Guide as a replacement for the locally developed, non-standard guides now used by the campuses to direct tax forms and correspondence to the appropriate functions. The National Taxpayer Advocate applauds this effort. She also commends the IRS for studying the benefits of using IMBC to perfect outgoing mail and urges the IRS to continue analyzing the potential to improve the routing of incoming mail. However, with all due respect, the National Taxpayer Advocate does not consider the IRS correspondence timeliness measures to be adequate, and believes the IRS needs service-wide measures to track the timeliness and accuracy of correspondence processing.

The IRS states that measures such as timeliness and days to close are in place to monitor and manage correspondence inventory in each of the responsible IRS functions. However, these measures do not capture the timeliness of all correspondence but only the correspondence assigned to the specific function and controlled on one of the automated systems. Further, many existing IRS measures do not consider timeliness from the taxpayers' perspective. For example, CSCO measures overage status and days in inventory from the CSCO-received date, not from the IRS-received date. The Embedded Quality Timeliness measures use attributes that measure the timeliness and effectiveness of employee actions and adherence to IRS timeframes, which is important and commendable, but do not measure whether those actions were timely for the taxpayer.<sup>45</sup> To a taxpayer awaiting a reply, even the established timeframe of 14 days may seem excessive simply to move a letter from the mailroom to the correct function within a campus, particularly when there is no immediate acknowledgement of receipt.<sup>46</sup>

In response to TAS requests for information on the amount of time it takes to receive correspondence into the computer system, the IRS replied that the information was not available. In its response for this Most Serious Problem, however, the IRS states that 89 percent of AM correspondence was loaded within the 14 days. The IRS provided no data source or other citation for that statement. The IRS previously indicated that for all FY 2009 AM correspondence cases, the average time from the original IRS-received date to the date cases were scanned and assigned to AM was between 15 and 30 days. Even if we accept the IRS's assertion that AM controls 89 percent of its correspondence timely, the remaining 11 percent amounts to over 260,000 pieces of untimely processed correspondence. By not

<sup>45</sup> EQRS User Guide, Chapter 5, June 15, 2010, [http://sbse.web.irs.gov/eq/SysCorner/EQRS\\_UserGuide/docs/Chapter5.doc](http://sbse.web.irs.gov/eq/SysCorner/EQRS_UserGuide/docs/Chapter5.doc) - 2010-06-15; Student Guide Effective Inventory Monitoring and Control Training 25977-102 (2-2008) Catalog Number 20146R, available at <http://core.publish.no.irs.gov/trngpubs/pdf/20146b08.pdf> (last visited Dec. 17, 2010).

<sup>46</sup> IRM 5.19.1.1 (May 10, 2010); IRM 21.5.4.1.2.2 (Aug. 31, 2010). Most functions require that correspondence be loaded to automated systems, such as CIS, AMS, or RGS/CEAS, within five days of the functional received date or 14 days of the IRS received date. Generally, correspondence is not acknowledged upon receipt by the IRS except for mail sent Certified Return Receipt Requested.

processing correspondence timely, the IRS delays resolving taxpayers' account issues, creating additional burden for taxpayers and work for the IRS.

Accounts Management is just one function that receives taxpayer correspondence. IRS data show that over 75 percent of mail at two Compliance Services Collection Operation sites took longer than 14 days to process, and nearly 40 percent of collection correspondence took more than 30 days.<sup>47</sup> While TAS acknowledges that this data reflects only the CSCO work at two campuses, it illustrates the need for additional, servicewide measures to monitor the accuracy and timeliness of correspondence processing.

The IRS indicates that misrouting is the usual reason that correspondence is not controlled within 14 days. Yet the IRS does not measure or track the volume of misrouted or unassigned correspondence. Misrouted correspondence is sent to the wrong function, which then forwards it to a different function or incorrectly loads it into its own inventory. For example, a letter from a taxpayer attempting to resolve a correspondence examination case may be incorrectly sent to AM and placed in its inventory. This could have serious consequences, because the function awaiting the correspondence would assume the taxpayer failed to reply, would not update its automated systems, and instead would proceed to the next step, issuing additional notices, assessing taxes, and taking collection action. Even if the function receiving the case inputs computer codes to suspend further action, it may not stop additional actions on the taxpayer's accounts because many IRS systems do not communicate with each other.

The IRS states that AM, Collection, and Examination systems already have built-in uniform and sufficient notice suspense timeframes to receive and consider taxpayer responses. However, in response to a TAS inquiry the IRS replied that AUR, Examination, ACS, ACS Support, Document Matching, and CSCO do not track the number of days from the IRS-received date to the functional received and control dates.<sup>48</sup> This data is critical to the overall time allowed for processing correspondence. The IRS references a recent study by SB/SE Research regarding Examination suspense timeframes. However, this study cited focused solely on taxpayers' responses to the IRS correspondence examination *report*. It did not consider any other correspondence submitted by taxpayers, and cannot be generalized to all taxpayer correspondence related to correspondence examinations.<sup>49</sup>

The National Taxpayer Advocate suggests that the IRS perform additional studies to verify that the timeframes in automated processes provide adequate time for taxpayer correspondence to be received and processed. Because timely, accurate handling of incoming correspondence directly affects taxpayers and the efficiency of IRS functions, the IRS needs

<sup>47</sup> CCA 4243 Reports for Memphis and Brookhaven, October 1, 2008 – September 30, 2009. For a full explanation of the methods used to analyze the date, see *supra* note 15.

<sup>48</sup> IRS responses to TAS research requests (June 18, 2010, and June 23, 2010).

<sup>49</sup> SB/SE Research, Detroit/Milwaukee, Project DET0088, *Timeliness of Taxpayer Responses to Correspondence Examination Reports* (March 2010). Clarification obtained from a telephone conversation with author on December 16, 2010.

to have one servicewide operation responsible for mail activities to maintain consistency for such an important function of tax administration.<sup>50</sup>

## Recommendations

The National Taxpayer Advocate makes the following recommendations:

1. The IRS should establish one servicewide operation responsible for mail activities to provide consistent guidance for such an important function of tax administration, and to track and assess the timeliness and accuracy of mail routing servicewide.
2. The IRS should further evaluate and revise timeframes for automated assessment processes to provide sufficient time for the IRS to receive taxpayer responses and update systems so that taxpayers who reply to the IRS timely are not adversely affected.
3. The IRS should continue to pursue the use of technology such as Intelligent Bar Coding on notices and envelopes to make it easier to route incoming mail.

<sup>50</sup> For more discussion of the need to centralize oversight of mail responsibilities, see Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*, *supra*.

## MSP #18

## The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of its Enforcement Activities and Service Initiatives

### RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division  
 Richard E. Byrd Jr., Commissioner, Wage & Investment Division  
 Pamela J. LaRue, Chief Financial Officer

### DEFINITION OF PROBLEM

The IRS is required by law to properly record and account for the money it receives in order to prepare reliable financial and statistical reports to the President, Congress, and the American public,<sup>1</sup> and to measure tax enforcement results.<sup>2</sup> IRS procedures generally require employees to code the source of balance due tax payments to determine the revenue effectiveness of specific activities.<sup>3</sup> However, the IRS failed to record the payment code indicator on payment vouchers in over 81 percent of all tax payments received in calendar year (CY) 2009.<sup>4</sup> The National Taxpayer Advocate has identified several additional problems with IRS payment coding processes and procedures, which contribute to the widespread practice of coding payments as miscellaneous or not coding them at all, including:

- A lack of meaningful transaction codes to identify payments received;
- Deficient Internal Revenue Manual (IRM) guidance; and
- Insufficient training and oversight of IRS employees and vendors involved in coding received payments.

As a result, despite its declared commitment to a data-driven approach, the IRS's failure to accurately code and track the source of payments defeats the purpose of having a coding system.<sup>5</sup> It precludes the IRS from drawing meaningful conclusions about the

<sup>1</sup> See generally 31 U.S.C.A. §§ 3512, 3513; 31 U.S.C.A. § 3302(e).

<sup>2</sup> See The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), §§ 1201 and 1204, Pub. L. No. 105-106, 112 Stat. 685, 715-716, 722 (providing rules for establishment of a balanced performance measurement system by the IRS); 31 U.S.C.A. § 3515; IRS Statement of Procedural Rules, Internal Revenue Practice, Balanced System for Measuring Organizational and Employee Performance Within the Internal Revenue Service, 26 C.F.R. §§ 801.1 - 801.6; IRM 5.1.2.8.1.3 (July 13, 2010). See also The National Defense Authorization Act for Fiscal Year 1996 (The Clinger-Cohen Act of 1996), Pub. L. No. 104-106, 110 Stat. 186, 679; The Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285; The Chief Financial Officers Act of 1990, Pub. L. No. 101-576, 108 Stat. 2838.

<sup>3</sup> See, e.g., IRM 5.1.2.8.1 (July 13, 2010); IRM 3.11.10.5.10 (July 2, 2010); IRM 4.4.24.4(5) (Oct. 30, 2007); IRM 21.3.4.7.1.3 (Oct. 1, 2009). These two-digit numeric codes are called Designated Payment Codes (DPCs). The IRS uses DPCs to help identify payments, indicate application of payment to a specific liability, and identify the event that resulted in a payment.

<sup>4</sup> IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction History Table, Transaction Codes 600-899, Transaction File Cycle 201032, Transaction Dates from Jan. 1 to Dec. 31, 2009.

<sup>5</sup> IRS Strategic Plan 2009-2013, Goal 2, Objective 4, 19, 22, available at <http://www.irs.gov/pub/irs-pdf/p3744.pdf> (last visited Aug. 26, 2010). See also Department of Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* (July 8, 2009), Component 2: Make a Multiyear Commitment to Research, 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).

effectiveness of its activities, and making data-driven policy decisions about service, enforcement, and resource allocation.<sup>6</sup>

## ANALYSIS OF PROBLEM

### Background

The IRS receives payments from a variety of sources and methods. Some payments are voluntary while others result from compliance activities or payment alternatives.<sup>7</sup> Various statutory and regulatory provisions require the IRS to measure the results of its operations, and prepare reliable financial and statistical reports to the President, Congress, and the public.<sup>8</sup> To fulfill these requirements, the IRS has established a balanced performance measurement system, composed of three elements: customer satisfaction, employee satisfaction, and business results.<sup>9</sup> Business results consist of both qualitative and quantitative measures of tax enforcement results.<sup>10</sup> The IRS uses data, statistics, compilations of information or “other numerical or quantitative recordations” of tax enforcement results for forecasting, financial planning, resource management, and formulation and development of methodologies and algorithms for its policies and procedures.<sup>11</sup>

The IRS has established two-digit Designated Payment Codes (DPCs) for taxpayer payments received after a tax has been assessed.<sup>12</sup> The IRS assigns a DPC to each subsequent, post-assessment payment it receives to identify the source (*e.g.*, a manually monitored installment agreement (MMIA), offer in compromise (OIC), levy, or seizure and sale of an asset).<sup>13</sup> A DPC serves a three-fold purpose. The code:

- Facilitates identification of payments designated to trust fund or non-trust fund employment taxes;
- Indicates application to a specific liability when a civil penalty includes a Trust Fund Recovery Penalty (TFRP) and other penalties; and

<sup>6</sup> The IRS Oversight Board asserted that “[m]aking more data-driven decisions across the full range of IRS activities, from service to enforcement, will enable the IRS to better serve taxpayers who want to comply and more effectively enforce the law with those who do not.” IRS Oversight Board, *Annual Report to Congress 2009* 6 (Apr. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20Annual%20Report%202009.pdf>.

<sup>7</sup> For example, IRM 5.1.2.4 (July 13, 2010) requires that a Form 795/795A, *Daily Report of Collection Activity*, be prepared each day that payments or returns are secured, or as soon as possible, not later than the next business day.

<sup>8</sup> See RRA 98, 715-716, 722 (providing rules for establishment of a balanced performance measurement system by the IRS); 31 U.S.C.A. § 3515; Treas. Reg. §§ 801.1 – 801.6; IRM 5.1.2.8.1.3 (July 13, 2010). See also The Clinger-Cohen Act of 1996, 679; The Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285; The Chief Financial Officers Act of 1990, Pub. L. No. 101-576, 108 Stat. 2838.

<sup>9</sup> Treas. Reg. §§ 801.1, 801.2.

<sup>10</sup> Treas. Reg. § 801.6. Examples of tax enforcement results include a lien filed, a levy served, a seizure executed, the amount assessed, the amount collected, and a fraud referral. Treas. Reg. § 801.6(d)(1).

<sup>11</sup> Treas. Reg. § 801.6(d)(2). Records of tax enforcement results are data, statistics, and compilations of information or other numerical or quantitative recordations of the tax enforcement results reached in one or more cases.

<sup>12</sup> These are generally balance due payments. Other payments, such as Estimated Tax Payments, Federal Tax Deposits, and payments with filed returns are designated by the nature of the payment, whether received in paper or electronic form.

<sup>13</sup> See IRM 5.1.2.8.1 (July 13, 2010). See also IRM 3.11.10.5.10 (July 2, 2010); IRM 4.4.24.4(5) (Oct. 30, 2007); IRM 21.3.4.7.1.3 (Oct. 1, 2009).

- Identifies the event that resulted in payment.<sup>14</sup>

Although IRS procedures require employees to code the sources of payments received when certain transaction codes (TCs) apply, DPCs are not mandatory in all other situations.<sup>15</sup>

**The National Taxpayer Advocate addressed the IRS's inability to accurately track sources of tax payments in the 2009 Annual Report to Congress.**

In her 2009 Annual Report, the National Taxpayer Advocate raised concerns about the IRS's inability to accurately track the source of tax payments received on past due accounts.<sup>16</sup> TAS reported on a research study that, in part, attempted to assess whether the IRS is filing liens effectively to collect revenue. This analysis of IRS payment data revealed that, in approximately 67 percent of all payment transactions attributable to a statistically representative sample of taxpayers,<sup>17</sup> the IRS coded the payments as "Miscellaneous" or did not code them at all.<sup>18</sup> This means the IRS cannot determine whether any particular collection action (or none at all) was effective in generating tax payments for the liabilities incurred.

The National Taxpayer Advocate recommended that the IRS immediately implement a quality review of payment coding.<sup>19</sup> The IRS later agreed to this recommendation, with anticipated completion date of October 15, 2011.<sup>20</sup>

<sup>14</sup> IRM 5.1.2.8.1.3 (July 13, 2010).

<sup>15</sup> IRM 5.1.2.8 (July 13, 2010); IRM 3.11.10.5.10 (July 2, 2010); IRM 4.4.24.4(5) (Oct. 30, 2007); IRM 21.3.4.7.1.3 (Oct. 1, 2009). The use of a DPC on all posting documents/vouchers is mandatory when the following Transaction Codes (TC) are involved: "640" Advance Payment of Determined Deficiency or Underreporter Proposal; "670" Subsequent Payment; "680" Designated Payment of Interest; "690" Designated Payment of Penalty; "694" Designated Payment of Fees and Collection costs; and "700" Credit Applied. For other TCs (e.g., "610" Remittance with Return; "611" Dishonored Remittance with Return; "612" Correction of TC 610 Processed in Error; "641" Dishonored Advance Payment), DPCs are not required. Transaction codes are numeric codes for all system actions on the IRS Integrated Data Retrieval System (IDRS). IRS Document 6209, *IRS Processing Codes and Information* (2010), 8-1 - 8-42.

<sup>16</sup> National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*).

<sup>17</sup> TAS reviewed 1,886,683 transactions from 270,399 individual taxpayers who first incurred new balance due liabilities during tax year 2002 (and who had no previous unpaid balances due at that time), and against whom Notices of Federal Tax Lien (NFTLs) were filed in subsequent years. For a more detailed discussion and description of this lien analysis and methodology, including payment allocation, see National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*).

<sup>18</sup> IRS, CDW, IMF Transaction File Cycle 200913. Of the 1,886,683 total payment transactions, only 629,158 transactions had the DPC code assigned. 1,257,525 transactions or about 67 percent were designated "miscellaneous" or "DPC indicator not present." Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. The IRS does not conduct a quality review of the payment information by DPC. IRS response to TAS research request (Oct. 6, 2009).

<sup>19</sup> National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*, Recommendation No. 1).

<sup>20</sup> Department of Treasury Joint Audit Management Enterprise System (JAMES) tracking system (last visited Oct. 1, 2010).

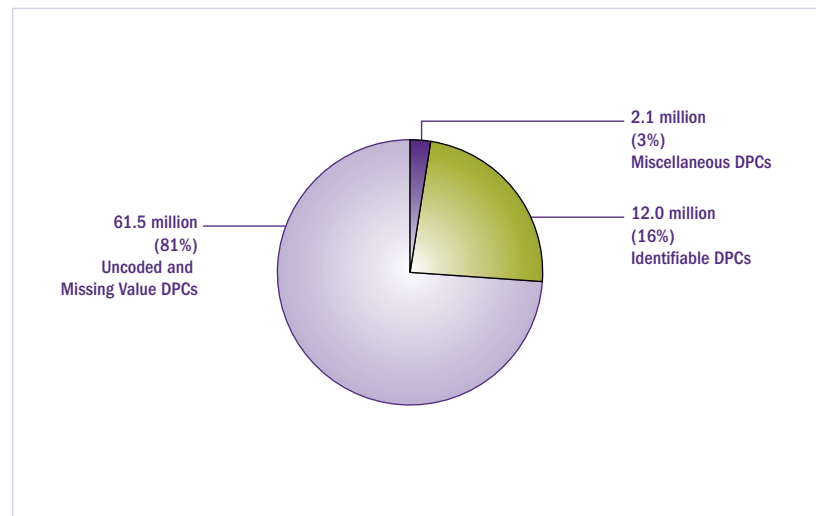


**The IRS has no way to accurately track the effectiveness of its enforcement activities and measure the benefits of its service initiatives.**

The IRS Oversight Board has called for the IRS to make more data-driven decisions across the full range of its activities, from service to enforcement.<sup>21</sup> The IRS Strategic Plan also states the agency's commitment to use data and research servicewide to make informed decisions and allocate compliance resources.<sup>22</sup>

However, TAS's analysis of IRS payment source data revealed the payment code indicators were missing on payment vouchers in over four of five (or about 81 percent) tax payments received in CY 2009.<sup>23</sup> As shown on Chart 1.18.1 below, while about three percent of payments were coded as miscellaneous, only about 16 percent of all payments were identifiable by a DPC.

**FIGURE 1.18.1, CY 2009 Number of Payments with Designated Payment Codes for Major Transaction Codes<sup>24</sup>**



<sup>21</sup> IRS Oversight Board Annual Report to Congress 2009 6 (Apr. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20Annual%20Report%202009.pdf>.

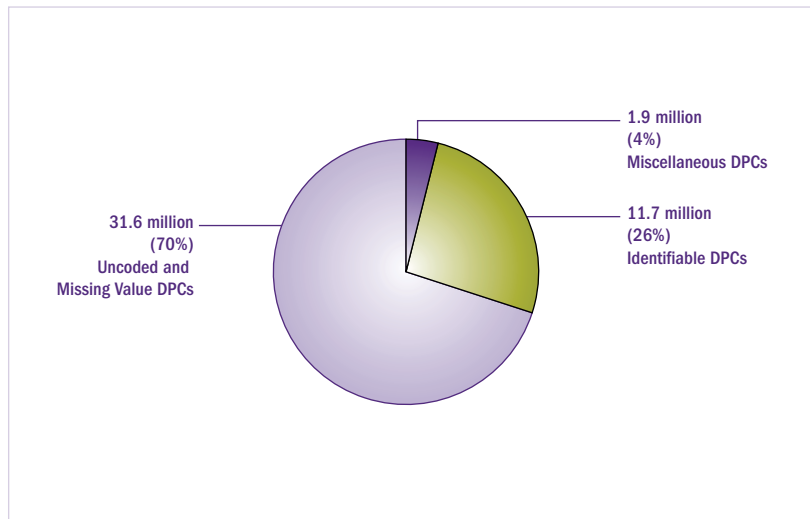
<sup>22</sup> IRS Strategic Plan 2009-2013, Strategic Foundations, Objective 4, 30, available at <http://www.irs.gov/pub/irs-pdf/p3744.pdf> (last visited Aug. 26, 2010).

<sup>23</sup> IRS, CDW, IMF Transaction History Table, Transaction Codes 600-899, Transaction Dates from Jan. 1 to Dec. 31, 2009. The IRS received a total of 298.8 million payments on balance due accounts in CY 2009. TAS Research analyzed a subsegment of 75.6 million of the total 298.8 million (or approximately 25 percent) of those payments. These 75.6 million payments represented subsequent or balance due payments for major Transaction Codes that both require and do not require a DPC.

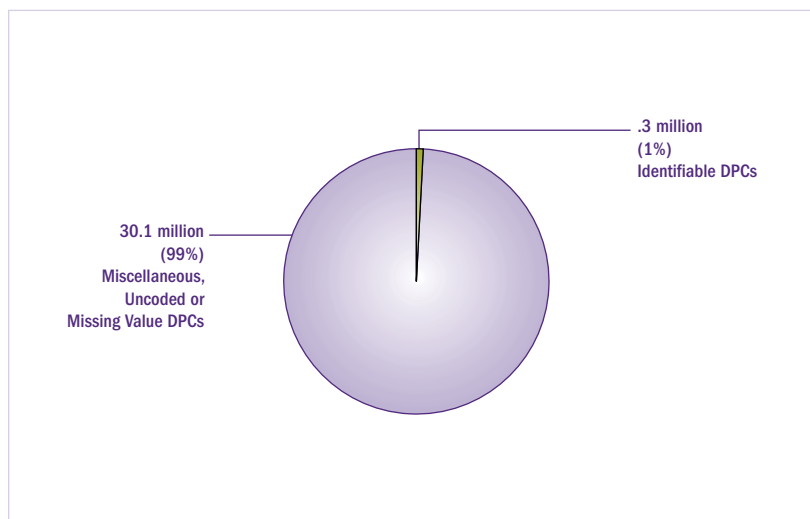
<sup>24</sup> TAS research used a combination of major transaction codes that both require and do not require a DPC. IRS, CDW, IMF Transaction File Cycle 201032. DPC Code "99" indicates a miscellaneous payment. DPC Code "00" indicates a designated payment indicator is not present on posting voucher. Identifiable codes are DPCs with a value other than "00," "99," or missing.

While about 26 percent of CY 2009 payments had identifiable sources where the use of DPCs was mandatory, less than one percent of payments not requiring a DPC had identifiable sources, as shown on Charts 1.18.2 and 1.18.3 below.<sup>25</sup>

**FIGURE 1.18.2, CY 2009 Number of Payments with Transaction Codes Where Use of a DPC Is Required<sup>26</sup>**



**FIGURE 1.18.3, CY 2009 Number of Payments with Transaction Codes Where Use of a DPC Is Not Required<sup>27</sup>**



<sup>25</sup> IRS, CDW, IMF Transaction File Cycle 201032.

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

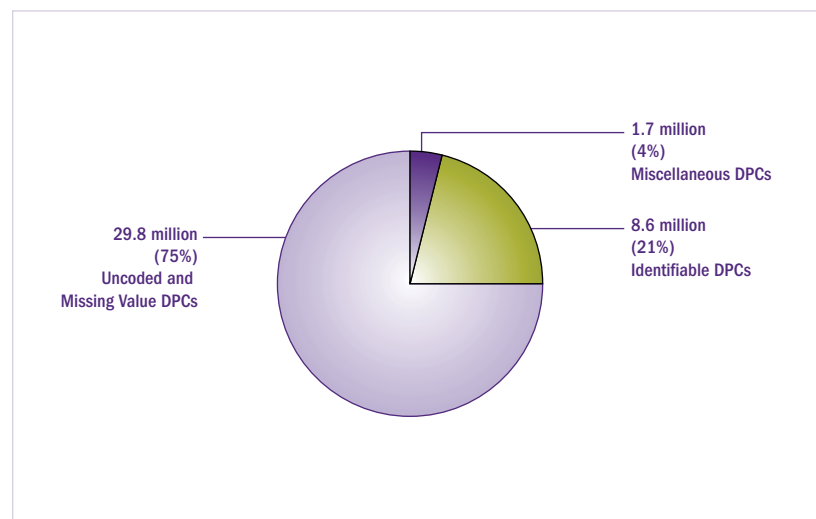
<sup>27</sup> IRS, CDW, IMF Transaction File Cycle 201032. DPCs are not required for all other transaction codes. TAS Research analyzed the total of 30.4 million payments for non-mandatory DPCs.

Although statutory and regulatory provisions require the IRS to measure the costs and benefits of its various collection and enforcement efforts, the IRS does not use DPCs to formulate its collection policy or to evaluate the effectiveness of enforcement and taxpayer service activities.<sup>28</sup> The IRS's failure to accurately code and track the source of payments prevents the IRS from drawing meaningful conclusions about its own activities, and may mislead the American public, including policymakers, academia, researchers, and taxpayers.<sup>29</sup>

### The IRS lacks meaningful transaction codes to identify payments received.

Even with transaction codes that require DPCs, the IRS is still unable to accurately assess the effectiveness of activities resulting in post-assessment or subsequent payments. The TC with the highest volume of posting documents was TC 670 "Subsequent Payment" (a mandatory TC) which accounted for 89 percent (40.1 million of 45.2 million) of all postings in CY 2009 and 94.5 percent of revenue (\$80.3 billion of \$85 billion) collected. This TC does not allow the IRS to distinguish what action caused the payment (*e.g.*, an enforcement action, a response to an IRS notice, or a voluntary payment). The DPC is critical in identifying the action that initiated the TC 670. As shown on Chart 1.18.4 below, about 74 percent (29.8 million of 40.1 million) of all TC 670s had no DPC and defaulted to a DPC of "00" that indicates "undesignated payment." This equates to about 93 percent of subsequent payments collected (\$75 billion of \$80.3 billion) in CY 2009.<sup>30</sup> Thus, in most cases the IRS does not know what event or action has resulted in a subsequent payment on a past due account.

**FIGURE 1.18.4, CY 2009 Coding of DPCs for TC 670 "Subsequent Payment"**



<sup>28</sup> See Treas. Reg. §§ 801.1(a)(2); 801.6(d)(2). W&I, SB/SE, and CFO do not use DPC data or assess program effectiveness based on the use of the DPC data. IRS response to TAS research request (Sept. 20, 2010). TAS is also concerned that actions related to "service initiatives" are not generally represented in DPCs.

<sup>29</sup> The performance measures that comprise the balanced measurement system will, to the maximum extent possible, be stated in *objective, quantifiable, and measurable* terms and will be used to measure the overall performance of various operational units within the IRS. Treas. Reg. § 801.2 (emphasis added).

<sup>30</sup> IRS, CDW, IMF Transaction File Cycle 201032.

The significance of this finding cannot be overstated. *Neither the IRS nor policymakers know the true impact of IRS collection activities on delinquent accounts in the absence of a meaningful DPC or TC.* As a result, they may implement policies that unnecessarily harm taxpayers, and most importantly, adversely affect future compliance.<sup>31</sup> Therefore, the IRS should require its employees to use a meaningful DPC that indicates the source of payment.

**Deficient IRM guidance and insufficient training and oversight of employees and vendors contribute to the IRS coding payments as miscellaneous or not coding them at all.**

Taxpayers generally remit payments to lockbox depositories operated by outside vendors.<sup>32</sup> These vendors process remittances and send tapes containing remittance data, all vouchers, documents, and correspondence to the IRS for additional handling and input to databases.<sup>33</sup> Thus, the IRS can review the coding entered by the vendor and verify that each payment has the proper DPC.<sup>34</sup> However, the IRS generally allows the use of “00” (undesignated payment) and “99” (miscellaneous) DPCs for all TCs.<sup>35</sup> The IRMs for the Collection, Examination, and Accounts Management functions provide the same basic references regarding DPC entry and no further guidance.<sup>36</sup> Although the IRS Submission Processing function is ultimately responsible for coding received payments, the overall process lacks quality review of the accuracy of payment coding.<sup>37</sup>

We applaud recent IRS efforts to improve payment coding accuracy. The IRS revised the Customer Account Services (CAS) IRM to require CAS employees to research the payment source using all available data sources before entering a “00” or “not coded” DPC.<sup>38</sup> However, this IRM change does not apply to all IRS functions and outside vendors, and

<sup>31</sup> See Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance*, *infra*. See also National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*).

<sup>32</sup> IRM 3.0.230 (Apr. 8, 2010); IRM 3.0.230.2.1 (Jan. 1, 2010); IRM 3.0.273 (Jan. 1, 2010). The Secretary of the Treasury under 12 U.S.C. §§ 90 and 265 permits certain financial institutions to act as a fiduciary of Treasury to process federal tax payments on behalf of IRS. The IRS lockbox network is comprised of three financial agents (Bank of America, US Bank, and JPMorgan Chase) with eight individual lockbox locations that process more than \$400 billion annually (or about 17 percent of gross collections in FY 2009) and perform sorting, handling, and shipping of tax returns and other tax correspondence. IRS Data Book, 2009; IRS response to TAS research request (Sept. 20, 2010). About 75 percent of all payments processed by the lockbox network are either estimated tax payments or payments with filed returns. These payments are voluntary and are designated by the nature of the payment. IRS response to TAS (Nov. 1, 2010).

<sup>33</sup> IRM 3.0.273.14 (Jan. 1, 2010).

<sup>34</sup> For example, implementation of a Full Service Intelligent Bar Code for return mail or voucher/return mail labels can substantially improve payment coding. A meaningful DPC could easily be programmed into the bar code. See also Most Serious Problem: *Existing Mail Procedures Fail to Deliver Vital Taxpayer Responses Timely*; Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*, *supra*.

<sup>35</sup> See, e.g., IRM 3.11.10.5.10 (July 2, 2010).

<sup>36</sup> IRM 3.11.10 (Jan. 1, 2010); IRM 3.8.44, IRM 4.4.24 (Jan. 1, 2010); IRM 3.24.133.2 (Jan. 1, 2010); IRM 4.4.24 (Oct. 1, 2007); IRM 5.1.2.8 (July 13, 2010), IRM 21.1.7.9 (Oct. 1, 2010); IRM 21.1.1.4 (Oct. 1, 2007); IRM 21.3.4.7.1.2 (Mar. 22, 2010); IRM 21.3.4.7.1.3 (Oct. 1, 2009).

<sup>37</sup> IRS response to TAS research request (Sept. 20, 2010). Submission Processing Campuses conduct quality reviews in the Receipt & Control Operation before the payments are posted. Quality Reviewers follow instructions in IRM 3.30.28. However, quality reviews standards do not include the accuracy of DPC coding and quality reports are not currently generated.

<sup>38</sup> Acting on National Taxpayer Advocate’s recommendation, the IRS revised IRM 21.3.4.7.12.3(5) (June 17, 2010). Paragraph 5 now reads: “If you are inputting a payment and the Designated Payment Code (DPC) is not present on the 809 receipt, research the payment source using all available data sources and if no information is available use DPC 00.” SEPR Alert 100953 (June 17, 2010).

does not eliminate the use of the “00” DPC, which accounts for over 81 percent of all payments.<sup>39</sup> The IRS should take a servicewide approach to revising and consolidating DPC-related IRM guidance. This effort should involve the IRS operating divisions’ embedded research functions, as well as TAS Research and Analysis, in developing better codes, because these codes can ultimately be used to evaluate the effectiveness of enforcement actions and service initiatives. The IRS also should immediately implement quality reviews of the accuracy of payment coding, generate periodic quality review reports, and annually train all IRS and vendor employees involved in entering DPCs on payments.

## CONCLUSION

The IRS Oversight Board recently stated that one of the most serious challenges for the IRS is the more effective use of data, noting that the IRS “must increase its ability to use data more effectively in making service, enforcement, and resource allocation decisions.”<sup>40</sup> Without accurately coding all the payments it receives, the IRS cannot fully meet its statutory and regulatory requirements to measure its business results.<sup>41</sup> It also cannot meet its strategic objective of developing a data-driven approach to allocating resources and making effective service, enforcement, and resource allocation decisions.<sup>42</sup> Finally, internal and external stakeholders are unable to accurately assess the effectiveness of IRS enforcement activities and service initiatives, and make reasonable, data-driven policy decisions.

The National Taxpayer Advocate offers these preliminary recommendations:

1. Revise IRM guidance and Lockbox Processing Guidelines for lockbox facilities to require the entry of specific designated payment codes on all received payments and require Submission Processing employees to verify the presence of an appropriate DPC on those payments.
2. Provide clear and specific guidance under what limited circumstances a miscellaneous DPC may be used.<sup>43</sup>
3. In consultation with TAS and IRS Research function, review and revise current DPCs and TCs to link each payment to specific IRS enforcement activities and service initiatives.

<sup>39</sup> IRS, CDW, IMF Transaction File Cycle 201032. See also Figure 1.18.1, *CY 2009 Number of Payments with DPCs for Major Transaction Codes*, *supra*.

<sup>40</sup> IRS Oversight Board, *Annual Report to Congress 2009 31* (Apr. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20Annual%20Report%202009.pdf>. See also IRS Oversight Board, *FY 2011 IRS Budget Recommendation Special Report 10* (Mar. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20FY11%20BUDGET%20REPORT.pdf> (“The IRS needs to evolve into a more data-driven organization. Such a transformation is essential for the IRS for two reasons: it offers the potential to create major efficiency gains in IRS business processes while simultaneously reducing taxpayer burden.”).

<sup>41</sup> See, e.g., Treas. Reg. § 801.6(d)(1).

<sup>42</sup> IRS Strategic Plan 2009-2013, Goal 2, Objective 4, 19, 22, available at <http://www.irs.gov/pub/irs-pdf/p3744.pdf> (last visited Aug. 26, 2010). See also U.S. Department of Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance* (July 8, 2009), Component 2: Make a Multiyear Commitment to Research, 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>43</sup> Eliminate use of DPC 00 “undesignated payment” and limit use of DPC 99 “miscellaneous” to situations where after a thorough inquiry no information is available to code the payment.

4. Implement a quality review of payment coding and provide for disciplinary action against employees who do not follow the procedures.

## IRS COMMENTS

### Background

Designated Payment Codes are intended to identify payments received from specific collection activity on accounts in Taxpayer Delinquent Account status. The purpose of DPCs is not to identify the source of all payments the IRS receives, nor are they intended to track taxpayer behavior subsequent to IRS enforcement actions or other service initiatives. They serve a useful purpose in enabling IRS to better understand the motivational factors that cause taxpayers to make a payment on a delinquent tax account and are useful in assessing the cost/benefit and effectiveness of certain collection work streams. In this regard, IRS agrees that the potential exists to improve the accuracy of the coding on subsequent payments and has already initiated a study of this issue.

However, it is important to understand that DPCs have nothing to do with the IRS's ability to account for the revenue, allocate payments to the proper taxpayers' accounts, or prepare reliable financial statements as required by United States Code (USC) Title 31. Nor are DPCs required, or even used, in the IRS's system of balanced measures as required by the IRS Restructuring and Reform Act of 1998 (RRA 98).

IRS procedures require employees to use DPCs to code the sources of payments received only when one of six Transaction Codes apply. Transaction Codes are numeric codes used for all systemic actions on the Integrated Data Retrieval System used by IRS employees to access and update taxpayer accounts. Examples include manually monitored installment agreements, offers in compromise, levy, or seizure and sale of an asset (IRM 5.1.2.8.1 (July 13, 2010)). DPCs are not mandatory in any other situations (IRM 5.1.2.8 (July 13, 2010); IRM 3.11.10.5.10 (July 2, 2010); IRM 4.4.24.4(5) (Oct. 30, 2007), and IRM 21.3.4.7.1.3 (Oct. 1, 2009)).<sup>44</sup>

Payments received with a filed tax return or estimated tax payments are not subsequent payments and are not subject to DPC coding. Furthermore, the IRS estimates that less than one percent of the payments submitted by individuals that are processed by the lockbox network require DPCs. Thus, it is not surprising for the National Taxpayer Advocate to report that "IRS failed to record the payment code indicator on payment vouchers in over 81 percent of all tax payments received in CY 2009."

The IRS strongly disagrees with the allegation that it is unable to properly record and account for the money it receives in order to prepare reliable financial and statistical reports to the President, Congress, and the American public as required by Title 31, or measure tax

<sup>44</sup> The use of a DPC on all posting documents/vouchers is mandatory only when the following Transaction Codes (TC) are involved: "640" Advance Payment of Determined Deficiency or Underreporter Proposal; "670" Subsequent Payment; "680" Designated Payment of Interest; "690" Designated Payment of Penalty; "694" Designated Payment of Fees and Collection costs; and "700" Credit Applied.

enforcement results as required by RRA 98. The IRS also believes it is incorrect that “(t)he IRS’s failure to accurately code and track the source of payments prevents the IRS from drawing meaningful conclusions about its own activities, and may mislead the American public, including policymakers, academia, researchers, and taxpayers.”

### Regulatory and Legal Requirements – Balanced Measures

The National Taxpayer Advocate cites Treasury Regulations that require the IRS to evaluate the effectiveness of its operations as the basis for implying that DPCs are essential to meeting the balanced measures requirements of RRA 98.<sup>45</sup> As part of its implementation of RRA 98, a framework was developed by the IRS requiring a balanced system for measuring organizational and individual performance. The IRS sets performance goals for organizational units and measures the results achieved by those units with respect to those goals. The balanced performance measurement system is composed of three elements: Customer Satisfaction Measures; Employee Satisfaction Measures; and Business Results Measures. For example, for our Collection function, the IRS fulfills the requirements under RRA 98 by monitoring various collection measures such as dollars collected, closures, cycle time, age of inventory, enforcement activity, employee satisfaction, taxpayer satisfaction, and quality.

The IRS supplements the balanced measures it has established in accordance with RRA 98 and the implementing Treasury Regulations with past and current statistically valid research projects. DPCs were not created for and generally are not used for this purpose. In fact, the IRS usually already knows the reasons for taxpayer payments.<sup>46</sup> In only a small number, approximately seven percent, the IRS has not properly coded the payment and is unable to determine the reason for payment based on the Masterfile status of the account.<sup>47</sup>

Simply measuring and reporting on trends in collection activity and dollars collected through DPCs would fail to account for other variables critical to analyzing the effectiveness of collection actions. For example, changes to economic conditions, the inventory mix, and collection business practices and structure all can influence dollars collected through the various enforcement work streams. To credit the influence of collection actions only to those payments with transactions directly resulting from use of collection tools (*i.e.*, lien, levy, and seizure) does not provide a complete picture. Taxpayer actions, such as paying the liability in full, making installment payments, or filing an offer in compromise, may be motivated by the anticipation of, as well as the utilization of, IRS collection tools. Given these limitations, relying solely on DPC data to study or report externally on collection actions would provide an unrealistic and unreliable estimate of the amount collected as a result of various IRS collection actions.

<sup>45</sup> Treas. Reg. §§ 801.1(a)(2); 801.6(d)(2).

<sup>46</sup> In FY 2009, approximately 58 percent from notices; 18 percent related to installment agreements; and 16 percent in TDA status that contain DPCs. See IRS, Collection Activity Report NO-5000-07; IRS, Collection Activity Report NO-5000-08.

<sup>47</sup> IRS, Collection Activity Report 5000-07; IRS, Collection Activity Report 5000-09.

Further, IRS performance goals and measures, as well as its compliance with RRA 98, have been the subject of numerous reviews by the IRS Oversight Board, the Treasury Inspector General for Tax Administration, the Government Accountability Office (GAO), and the Congress, among others. In its Annual Report for 2007, the IRS Oversight Board stated: “It is now almost a decade since the enactment of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) and the IRS Oversight Board is pleased to report that the *IRS has made steady progress in meeting the letter and spirit of that landmark legislation* (emphasis added).<sup>48</sup> None of these external oversight functions have reported the IRS to be in violation of the balanced measures requirements of RRA 98.

Nothing in RRA 98 and the implementing regulations, or the external oversight reviews referenced above, requires the use of DPCs, or even mentions them as a part of the IRS’s balanced measures process. As a result, the IRS does not agree with the statement in this report that “(w)ithout accurately coding all the payments it receives, the IRS cannot meet its statutory and regulatory requirements to measure its business results.”

### Regulatory and Legal Requirements – Financial Management

The report also takes the position that a DPC is essential to IRS financial management and implies that the IRS is not in compliance with the law (USC Title 31). The IRS disagrees. In fact, the IRS accurately records information on the revenue it collects in its financial systems and in the Enforcement Revenue Information System (ERIS), built to report on IRS enforcement activities.

Each year the IRS also prepares audited financial statements in compliance with the Statement of Federal Financial Accounting Standard No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting.<sup>49</sup> The GAO has issued an unqualified opinion on the IRS financial statements for eleven consecutive years, stating that the financial statements are presented fairly, in conformity with Generally Accepted Accounting Principles and the principles and standards required by 31 USC § 3513.

In its annual financial statements, the IRS reports the tax revenues it collects including supplemental information showing the tax class and tax year of the collection in accordance with federal accounting standards. The IRS also provides GAO evidence that the revenue can be traced between the taxpayer accounts, sub-ledger and general ledger through Trace ID numbers. Reporting on DPCs is neither required nor useful for this purpose and the IRS is unaware of any external requirements to report on collected revenue by DPC.

<sup>48</sup> See also Hearing on Status of IRS Efforts to Implement the IRS Restructuring and Reform Act of 1998, Senate Committee on Finance (Feb. 2, 2000); GAO, GGD-007-71R, (Feb. 28, 2000); TIGTA, Ref. No. 2007-10-140, *The Development of Specific Long-Term Measures and Targets Improved the Internal Revenue Service’s Strategic Plan (2005-2009)* (Aug. 23, 2007); TIGTA, Ref. No. 2010-IE-R007, *The Internal Revenue Service Restructuring and Reform Act of 1998 Was Substantially Implemented but Challenges Remain* (Mar. 1, 2010).

<sup>49</sup> The CFO Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (Nov. 15, 1990) and codified in relevant part, as amended, at Title 31 USC § 3521(g) and under the authority of 31 USC § 3515.



### Measuring Enforcement Results

This report states that the absence or inaccuracy of DPCs “precludes the IRS from drawing meaningful conclusions about the effectiveness of its activities, and making data-driven policy decisions about service, enforcement, and resource allocation.” The IRS believes that this statement is inaccurate. As noted above, DPCs are used strictly to code subsequent payments resulting from certain collection actions and do not measure the effectiveness of IRS services. More importantly, ERIS tracks and analyzes enforcement activities across all the enforcement functions from the day a case starts to the day it closes. ERIS reports enforcement revenue collected by the function that made the assessment or by where in the collection stream a case was when the dollars were collected. By using additional data elements captured in ERIS, such as the assessing function (*e.g.*, Examination, Substitute for Return, Information Return Program, etc.), the system can report on the effectiveness of IRS enforcement programs at the program level and has been used to make decisions in the past.

The IRS also maintains a cost module in the Integrated Financial System (IFS) that contains five years of cost information available to business units to determine the costs of its programs. The IRS managerial cost accounting system consists of IFS, ERIS, and multiple business-unit workload and production management systems. Since 2008, the IRS has completed numerous cost/benefit studies on enforcement programs where the IRS was able to match IFS cost information to the tax revenue data from ERIS and workload and production data from various business unit management systems to measure and report on the cost of IRS products and services. For example, studies in the following were provided to both the Business Operating Divisions and GAO in the past three years: AUR, EITC Exam/EITC AUR, Field Exam, Correspondence Exam, ACS, Field Collection, and ASFR. In fact, in FY 2009, GAO agreed the IRS has demonstrated it has the ability to effectively cost its programs, although it remains a management challenge.<sup>50</sup>

As referenced above, the IRS does agree that if the entry of DPC information were improved it would assist IRS in performing additional analyses and breakouts below the summary program levels. However, the absence of this information does not preclude the IRS from meeting its regulatory and statutory requirements for reporting on tax revenues collected or making data-driven policy decisions about its enforcement programs and resource allocations.

### Ongoing Study of Potential DPC Coding Improvements

The National Taxpayer Advocate raised the issue of DPC coding in the 2009 Annual Report to Congress.<sup>51</sup> In response the IRS agreed to conduct a review of its payment coding process. IRS is currently in the process of conducting that review and will be exploring a range of potential improvement opportunities. This review is scheduled for completion by October 15, 2011.

<sup>50</sup> GAO, GAO-10-176, *IRS's Fiscal Years 2009 and 2008 Financial Statements* (Nov. 2009).

<sup>51</sup> National Taxpayer Advocate 2009 Annual Report to Congress (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*).

### Response to Preliminary Recommendations

With regard to the National Taxpayer Advocate's recommendation to revise IRM guidance and lockbox processing guidelines, these instructions already correctly specify when DPCs are required and provide the appropriate codes to be used when coding designated payments. However, as noted above, IRS is already conducting a review of the DPC coding process to identify potential improvement opportunities. As part of that process, IRS will study the need for improving IRM or lockbox payment processing procedures.

With regard to the National Taxpayer Advocate's recommendation to improve guidance on when the "miscellaneous" DPC may be used, this will be considered as part of the currently ongoing DPC process review.

For the reasons outlined above, including the fact that DPCs are not required for every payment received by the IRS, we do not agree with the recommendation to review and revise current DPCs to link each payment to specific IRS enforcement activities and service initiatives.

The National Taxpayer Advocate also recommends that IRS implement a quality review of payment coding and provide for disciplinary action against employees who do not follow the procedures.

With regard to the quality review recommendation, this recommendation was also included in the National Taxpayer Advocate's annual report for 2009. In response, the IRS stated that it recognizes the need to ensure the consistent and appropriate use of DPCs by employees and agreed to review IRM guidance on this subject for clarity to ensure employees understand the need to properly code payments received and to conduct a review to assess appropriate use of these codes. That study is ongoing. The IRS has not agreed to implement a DPC quality review process at this point but is considering the need for such a system as part of its ongoing study.

With regard to the National Taxpayer Advocate's recommendation to provide disciplinary action against employees who do not follow the procedures, the IRS does not agree there is a need for any such punitive measures. The IRS does not believe that DPC coding issues are a result of employee malfeasance or misconduct. Rather, IRS believes existing employee performance management tools are more than adequate to address employee conformance with IRM requirements. However, as previously stated, the clarity and adequacy of these IRM requirements, as well as the need for a dedicated quality review process, will be assessed as part of the DPC process review currently underway and scheduled for completion in October 2011.

## Taxpayer Advocate Service Comments

For the second consecutive year, the National Taxpayer Advocate raises concerns about the IRS's inability to accurately track the source of *subsequent, post-assessment* tax payments received on past due accounts.<sup>52</sup> The IRS, however, seems to have missed the point of our concerns. The IRS response discusses financial accounting and accurate posting of tax payments to proper taxpayer accounts. The National Taxpayer Advocate, on the other hand, identifies the material weaknesses in the IRS's measurement of the revenue effectiveness of its various activities. She is not implying that the IRS does not substantially comply with the statutory and regulatory requirements. She instead provides actionable recommendations to improve "the balanced performance measurement system" in terms of revenue generated by a particular enforcement activity or service initiative targeting past due accounts.

The Federal Managers' Financial Integrity Act of 1982 codified under Title 31 U.S.C. § 3512(c) requires that "revenues and expenditures applicable to agency operations [be] recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared..."<sup>53</sup> The IRS Restructuring and Reform Act of 1998 and implementing regulations requires the IRS to establish a balanced system for measuring organizational and individual performance.<sup>54</sup> The IRS has substantially complied with these requirements by establishing a "balanced performance measurement system."<sup>55</sup> The regulations further contemplate that "the balanced measurement system will, to the maximum extent possible, be stated in *objective, quantifiable, and measurable* terms."<sup>56</sup> The IRS may use the records of tax enforcement results, for example "a lien filed, a levy served, a seizure executed, the amount assessed, the amount collected, and a fraud referral,"<sup>57</sup> "for purposes such as forecasting, financial planning, resource management, ...the formulation of case selection criteria, ...[and] to develop methodologies and algorithms for use in selecting tax returns to audit."<sup>58</sup>

While the law does not specifically require the use of DPCs, the Treasury Regulations provide that the IRS use "data, statistics, compilations of information or other numerical or quantitative recordations of the tax enforcement results" in measuring its performance.<sup>59</sup>

<sup>52</sup> Most pre-filing, voluntary payments are already identifiable from their source, e.g., payments with return (TC 610); federal tax deposits (TC 650); estimated tax payments (TC 660), etc.

<sup>53</sup> 31 U.S.C. § 3512(c)(1)(C).

<sup>54</sup> RRA 98, § 1201(a)(2)(A) (requiring "establishing goals or objectives for individual, group, or organizational performance (or any combination thereof)...). See also Treas. Regs. §§ 801.1; 801.6.

<sup>55</sup> Treas. Reg. § 801.1(a)(2). The balanced performance measurements system is composed of three elements: Customer Satisfaction Measures; Employee Satisfaction Measures; and Business Results Measures. *Id.* Business results measures consist of the quality and quantity measures, including "records of tax enforcement results." Treas. Reg. § 801.6(d)(2).

<sup>56</sup> Treas. Reg. § 801.2 (emphasis added).

<sup>57</sup> Treas. Reg. § 801.6(d)(1).

<sup>58</sup> Treas. Reg. § 801.6(d)(2).

<sup>59</sup> *Id.*

The IRS's own internal guidance interprets that DPCs are "*congressionally mandated* and will be accumulated on a national basis to *determine the revenue effectiveness of specific collection activities*."<sup>60</sup>

DPCs are designed to provide the IRS and outside stakeholders with meaningful information regarding the revenue outcomes of IRS compliance activities. DPCs are also very important for gauging the IRS's performance in *objective, quantifiable, and measurable* terms. The IRS's use of the DPCs, however, does not provide good data for use in this manner. A TAS analysis of IRS payment source data has found that the DPC is not present on payment vouchers in 81 percent of all post-assessment tax payments received in 2009. Even with transaction codes that require DPCs, about 75 percent of all entries either had no DPC or defaulted to DPCs of "00" (undesignated payment) or "99" (miscellaneous). Thus, in most cases, the IRS does not know and cannot determine what event or action prompted the subsequent payment on a past due account. Accordingly, the IRS lacks critical data that would improve its ability to make meaningful policy decisions, assess programs, and effectively allocate resources.

The National Taxpayer Advocate respectfully disagrees that the Integrated Financial System, Enforcement Revenue Information System, and multiple business-unit workload and production management systems provide adequate cost-outcome and revenue effectiveness measurements of enforcement activities. The IRS's use of balanced measures tend to evaluate the performance of "organizational units," rather the IRS as a whole, or even key compliance activities such as liens, levies, and seizures, without analyzing the revenue impact of those actions.<sup>61</sup> The IRS acknowledges that "[e]xisting data structures in ERIS and CDW make it difficult to easily extract data needed to assess the effectiveness of collection programs, and only the few power users who understand the systems and data can extract critical information."<sup>62</sup> Several GAO reports dating back to 2002 have cited the need for "outcome-oriented performance measures."<sup>63</sup> The IRS continuously experiences challenges with respect to "developing and routinely using cost-based (and, where appropriate, enforcement revenue-based) performance metrics to measure the results of its efforts

<sup>60</sup> IRM 5.1.2.8.1.3, *Identify the Event That Resulted in a Payment* (Aug. 15, 2008) (emphasis added).

<sup>61</sup> The IRS acknowledges that existing reports do not track assessment dollars as they enter various collection streams to determine process effectiveness. Often, data are not captured or are counted inconsistently among systems, and there are no reports showing assessments, collections, and abatements in one report. The data are scattered and must be manually extracted from different systems, including ERIS, Collection Activity Reports (CAR), and CDW. IRS, PowerPoint presentation, *Improving the Collection Process* (May 5, 2010) (on file with the National Taxpayer Advocate).

<sup>62</sup> IRS, PowerPoint presentation, *Improving the Collection Process* (May 5, 2010) (on file with the National Taxpayer Advocate).

<sup>63</sup> See, e.g., GAO, GAO-09-119, *Financial Audit of IRS's Fiscal Years 2008 and 2007 Financial Statements* (Nov. 2008); GAO, GAO-10-176, *Financial Audit of IRS's Fiscal Years 2009 and 2008 Financial Statements* (Nov. 2009); GAO, GAO-11-142, *Financial Audit of IRS's Fiscal Years 2010 and 2009 Financial Statements* (Nov. 2010).

and assist in allocating resources.”<sup>64</sup> The GAO further commented that the IRS had to rely on “a resource-intensive statistical sampling process” to compensate for these deficiencies and estimate these amounts.<sup>65</sup> The GAO believes that “[t]hese issues also lead to increased taxpayer burden.”<sup>66</sup>

The National Taxpayer Advocate also disagrees that DPCs are not designed to track taxpayer behavior and future compliance. To the degree that taxpayer behavior is represented by payments, the DPCs are intended to track that behavior. The DPC is not the be-all or end-all measurement, but is another useful tool to track the impact of IRS actions taken to motivate post-assessment, balance due payments, as well as the cost effectiveness of these actions.<sup>67</sup> And right now, because of the manner in which it is being applied, this tool is completely ineffective.

The National Taxpayer Advocate is pleased that the IRS is already reviewing the DPC coding process to identify potential improvement opportunities and has committed to study the payment coding process. However, she is disappointed that the IRS disagrees with the recommendation to review and revise current DPCs to link each payment to specific enforcement activities and service initiatives. The IRS also declines to implement a DPC quality review process, citing the need for additional study.

The National Taxpayer Advocate is baffled by the IRS’s inflexible approach to payment coding and its resistance to changes that would improve its “balanced measurement system.” It is clear that measuring specific enforcement activities and service initiatives, by using meaningful DPCs and TCs, would enable the IRS to give stakeholders a more accurate and complete picture of activities that cause the taxpayer to pay on balance due accounts and the costs associated with those activities.<sup>68</sup> The use of meaningful DPCs would also

<sup>64</sup> GAO-09-119 at 24-25 (Nov. 2008) (stating “[the] IRS has limited ability to develop performance measures or related goals and to compare the relative effectiveness of its programs or activities....In addition, developing and tracking performance goals against actual performance would assist the IRS in evaluating the effectiveness of its various programs and activities in achieving IRS’s mission.”). See also GAO-11-142 at 6 (Nov. 2010) (pointing out a “material weakness in [IRS’s] internal control over unpaid tax assessments.... [as a result of] ....a continuing deficiency in IRS’s ability...to trace amounts reported in its financial statements and required supplementary information through its general ledger back to underlying source documents on a transaction-by-transaction basis” (emphasis added)).

<sup>65</sup> GAO-11-142 at 6 (Nov. 2010).

<sup>66</sup> GAO, GAO-11-142, *Financial Audit of IRS’s Fiscal Years 2010 and 2009 Financial Statements* 6 (Nov. 2010).

<sup>67</sup> See Status Update: *The IRS Has Been Slow to Address the Adverse Impact Its Lien Filing Policies Have on Taxpayers and Future Tax Compliance*, *infra*. While the IRS increased NFTL filings by about 550 percent from 1999 to 2010, the collected revenue (in 2010 dollars) has essentially remained flat. The IRS estimates that a lien filing costs between \$25 and \$100 plus labor costs. IRS Collection Process Study (CPS) 122 (Sept. 30, 2010). The IRS spends up to \$109 million in lien filing costs annually, not including labor costs, based on 1,096,376 NFTLs filed in FY 2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at [http://www.irs.gov/pub/irs-utl/2010\\_enforcement\\_results.pdf](http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf).

<sup>68</sup> One important example of nebulous “data, statistics, compilations of information” is the Statistics of Income (SOI) reports between 2007 and 2008, where the IRS had “lost” about \$32 billion in collection revenue for FYs 2005, 2006, and 2007. Since 2008 the IRS revised the SOI data with minimal explanation. IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 2005-2008*. The IRS originally reported revenue yield for FY 2005-2007 as (in thousands, respectively): \$37,113,036, \$40,813,309, and \$43,318,830, but corrected these figures in the 2008 IRS Data Book and subsequent reports (in thousands, respectively) to \$27,615,348, \$29,172,915, and \$31,952,399. See also National Taxpayer Advocate 2009 Annual Report to Congress viii-ix.

yield better “data-driven” decisions like those anticipated by the IRS Oversight Board.<sup>69</sup> The National Taxpayer Advocate believes the IRS should not delay the implementation of meaningful payment coding of all subsequent payments and link each payment to specific IRS enforcement activities and service initiatives, and should include TAS in the “ongoing study” of payment coding.

Finally, the National Taxpayer Advocate agrees that miscoding of subsequent payments does not stem from employee misconduct. Rather, it results from a lack of training and from IRS procedures that allow coding subsequent payments as “miscellaneous” or not coding them at all. Therefore, she would not recommend disciplinary action against employees not following procedures at this time. Instead, she insists that the IRS provide clear and specific guidance about the limited circumstances under which employees can use a miscellaneous DPC and implement a quality review of payment coding.

## Recommendations

That National Taxpayer Advocate offers the following recommendations:

1. Revise IRM guidance and guidelines for lockbox facilities to require the entry of specific designated payment codes on all balance due payments, and require Submission Processing employees to verify the presence of an appropriate DPC on those payments.
2. Provide clear and specific guidance about the limited circumstances under which employees can use a miscellaneous DPC.
3. Implement a quality review of payment coding.
4. In consultation with TAS and IRS Research functions, review and revise current DPCs and TCs to link each subsequent payment to specific IRS enforcement activities and service initiatives.

<sup>69</sup> IRS Oversight Board, *Annual Report to Congress 2009 31* (Apr. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20Annual%20Report%202009.pdf>. See also IRS Oversight Board, *FY 2011 IRS Budget Recommendation Special Report 10* (Mar. 2010), available at <http://www.treas.gov/irsob/reports/2010/IRSOB%20FY11%20BUDGET%20REPORT.pdf>.

The IRS Has Been Reluctant to Implement Alternative Service Methods that Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance

MSP #19

**MSP  
#19**

## The IRS Has Been Reluctant to Implement Alternative Service Methods that Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance

### RESPONSIBLE OFFICIAL

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

### DEFINITION OF PROBLEM

Taxpayer Assistance Centers (TACs) are the IRS's main vehicle for providing face-to-face customer service available to taxpayers from the IRS. Although the IRS maintains 401 TACs, more than 30 percent of taxpayers do not live within a 30-minute drive of any of them.<sup>1</sup> Thus, tens of millions of taxpayers cannot easily obtain face-to-face service from the IRS. Additionally, TACs remain out of reach for many rural taxpayers, as most TACs are located in more populous areas<sup>2</sup> and only 55 percent are open 36 to 40 hours per week.<sup>3</sup> In 2008, the IRS convened the Geographic Coverage Initiative (GCI) to examine the placement of TACs and determine if the current TACs met the needs of the public. The GCI worked with a computer model to map the location of TACs in relation to the taxpaying population in general, as well as with regard to certain segments of the population, such as low income taxpayers or those who speak English as a second language. Using this model, the IRS should make more effective use of its limited resources to reach a greater percentage of the taxpaying population with alternative face-to-face service options. The IRS could achieve additional geographic coverage with solutions such as mobile vans or telepresence.<sup>4</sup>

### ANALYSIS OF PROBLEM

#### Background

Some segments of the taxpaying population need or prefer to receive services face-to-face from the IRS.<sup>5</sup> The National Taxpayer Advocate has addressed the coverage and services provided by TACs in several Annual Reports to Congress, recommending that the IRS

<sup>1</sup> IRS, *Taxpayer Assistance Blueprint (TAB): Phase 2*, 116, 194 (Apr. 17, 2007). The *Taxpayer Assistance Blueprint* reported a coverage rate of 60 percent of taxpayers within a 30-minute drive time of TACs. In response to a research request from TAS, the IRS provided the "*Field Assistance Geographic Coverage Initiative Executive Briefing January 2010*" and reported a 68.2 percent face-to-face coverage rate within a 30-minute drive of TACs. The coverage gains are due to changes in the underlying assumptions on travel time and are less conservative than the TAB estimates. Regardless of which assumptions are accepted as accurate, the IRS reports that at a minimum, nearly one-third of taxpayers (31.8 percent) do not have ready access to face-to-face services.

<sup>2</sup> See <http://www.irs.gov/localcontacts/index.html> (last visited Oct. 5, 2010).

<sup>3</sup> IRS, *Contact My Local Office, Face-to-face Tax Help*, available at <http://www.irs.gov/localcontacts/index.html> (last visited Oct. 5, 2010).

<sup>4</sup> Cindy Waxer, *Telepresence: Current and Future*, VOIP-News, Making VoIP Connections, available at <http://www.voip-news.com/feature/telepresence-current-futureapps-051507/> (May 15, 2007).

<sup>5</sup> See IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (*Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services*).

increase face-to-face service through increased TAC hours, the ability to make appointments at the TACs, vans, telepresence, and sharing space with local and state agencies.<sup>6</sup>

### *Brick and Mortar TACs May Not Reach the Right Populations.*

The low income taxpayer population tends to be more transitory than other taxpayer groups, with more than 26 percent of the low income population moving in 2009 compared with approximately 15 percent of the general public.<sup>7</sup> This population may shift to areas where migratory work is available or may move more rapidly as the economy of an area changes, placing the taxpayers in and out of range of a TAC. The low income population is also less likely to have access to online assistance and may therefore be more in need of face-to-face service than other population segments.<sup>8</sup> Currently, the IRS reports approximately 67 percent coverage for taxpayers with incomes below \$39,000.<sup>9</sup> The remaining 33 percent of taxpayers below this threshold cannot access reasonable face-to-face service and may be better served by alternatives to brick and mortar TACs.

### *Increase Face-to-Face Service Using Innovative Solutions*

Brick and mortar TACs are not the only way to bring face-to-face service to taxpayers. The IRS should pilot a program using mobile vans to reach taxpayers in underserved areas. A van is a particularly good solution in states such as Montana, where towns and cities are very spread out. Employees based in one location could easily drive 50 to 75 miles from their home base each day and serve ten different locations in a two-week period. A 75-mile trip would not only provide service to taxpayers in that particular location, but to all those within a 30-minute drive of the location.

For example, in Montana, six brick and mortar TACs provide coverage within a 30-minute drive time to 59 percent of the taxpayers.<sup>10</sup> Placing a mobile TAC in various additional locations in the state could significantly increase face-to-face coverage to taxpayers. For example, if the IRS had a mobile van in Ramsay, Montana, one day a week an additional five percent of Montana taxpayers would have access to face-to-face coverage, while a day

<sup>6</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 95-113 (Most Serious Problem: *Taxpayer Service: Bringing Service to the Taxpayer*); National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: *Service at Taxpayer Assistance Centers*); National Taxpayer Advocate 2004 Annual Report to Congress 8-25 (Most Serious Problem: *Taxpayer Access – Face-to-Face Interaction*).

<sup>7</sup> U.S. Census Bureau, *American FactFinder, 2009 American Community Survey 1-Year Estimates, Table, B07012*, available at [http://factfinder.census.gov/servlet/DTTable?\\_bm=y&-geo\\_id=01000US&-ds\\_name=ACS\\_2009\\_1YR\\_G00\\_-&-lang=en&-redoLog=true&-mt\\_name=ACS\\_2009\\_1YR\\_G2000\\_B07012&-format=&-CONTEXT=](http://factfinder.census.gov/servlet/DTTable?_bm=y&-geo_id=01000US&-ds_name=ACS_2009_1YR_G00_-&-lang=en&-redoLog=true&-mt_name=ACS_2009_1YR_G2000_B07012&-format=&-CONTEXT=) (last visited Oct. 25, 2010).

<sup>8</sup> PEW Internet & American Life Project, *Internet, Broadband, and Cell Phone Statistics* (Jan. 5, 2010) available at <http://www.pewinternet.org/Reports/2010/Internet-broadband-and-cell-phone-statistics/Report.aspx>. Only 60 percent of Americans with incomes below \$30,000 a year use the Internet, compared with 94 percent of Americans with incomes over \$75,000. Broadband Internet, providing faster access and making online tasks easier to complete, is adopted at even lower rates by those with lower incomes. Only 42 percent of American Internet users with incomes below \$30,000 have access to broadband, compared to 84 percent of households with incomes of \$75,000 or more.

<sup>9</sup> IRS, Field Assistance Geographic Coverage Executive Briefing (July 2010).

<sup>10</sup> IRS response to TAS research request (Nov. 3, 2010).



in Corvallis, Montana would cover another three percent.<sup>11</sup> By using mobile vans as an alternative solution to provide face-to-face service, the IRS could increase face-to-face service in Montana significantly.

In West Virginia, seven TACs provide face-to-face coverage for 62 percent of the state's taxpayers.<sup>12</sup> The IRS could work with the West Virginia government to identify walk-in state government office sites where the IRS could offer service one day per week. If the IRS rotated through state offices in the five to ten cities in West Virginia with no TACs, face-to-face service coverage would again increase significantly. For example, placing an account resolution employee in a state office one day a week in Newburg or in Independence, West Virginia would each cover an additional six percent of West Virginia taxpayers.<sup>13</sup>

Vans also have the advantage of being able to respond quickly to population changes and disasters. In states where a transient low income population follows seasonal work, such as California, a van provides the flexibility necessary to keep up with the migratory needs of this population, which a brick and mortar TAC cannot do. When a disaster strikes, such as the recent Gulf Coast oil spill, the vans could be sent immediately to the area where taxpayers need help without the IRS having to find temporary work space. Having mobile vans on site at disaster areas would allow taxpayers to quickly obtain the information they need, such as tax transcripts, to apply for benefits.

Because many TACs are in populous areas and are inaccessible to taxpayers in more remote towns,<sup>14</sup> the IRS needs a strategy to assist those who cannot easily reach a walk-in site. Previously, the National Taxpayer Advocate recommended the use of telepresence sites to provide service to remote areas of the country.<sup>15</sup> In the United States, doctors have used videoconferencing and telemedicine capabilities to remotely interact with patients who otherwise could not consult a medical professional in a timely manner.<sup>16</sup> The IRS could use similar technology to provide an interactive face-to-face experience for taxpayers. Taxpayers could bring documents and show them through the video screen to the assistor and receive all the benefits of a TAC, including tax preparation, tax law assistance, and account services.

<sup>11</sup> IRS response to TAS research request (Nov. 3, 2010). The five most populous cities not currently covered by TACs are Ramsay, Warm Springs, Butte, Corvallis, and Hamilton. However, the populations of several of these locations overlap, so the IRS would need to determine which non-overlapping areas would provide the greatest overall coverage increase to test a mobile van program.

<sup>12</sup> IRS response to TAS research request (Nov. 4, 2010).

<sup>13</sup> *Id.*

<sup>14</sup> See <http://www.irs.gov/localcontacts/> (last visited Oct. 5, 2010).

<sup>15</sup> National Taxpayer Advocate 2008 Annual Report to Congress 95-113 (Most Serious Problem: *Taxpayer Service: Bringing Service to the Taxpayer*).

<sup>16</sup> Linda Lou, *Dr. Robot Is on Call, Interactive Tool Can Make Rounds*, The San Diego Union Tribune, Aug. 15, 2008, available at <http://www.signonsandiego.com/news/northcounty/20080815-9999-1m15robodoc.html>.

*The IRS Made Efforts to Expand Face-to-Face Service in Fiscal Year 2010.*

The National Taxpayer Advocate commends the IRS's efforts to provide more face-to-face service options to taxpayers. In fiscal year (FY) 2010, the IRS continued to test a program to locate IRS employees at Volunteer Income Tax Assistance (VITA) sites to help taxpayers who may need more than just tax preparation. The IRS tested this program at 27 sites and served over 5,300 taxpayers during the filing season.<sup>17</sup> Plans to continue this program in FY 2011 include expansion to a total of 30 VITA sites.<sup>18</sup> The IRS also continued to provide assistance at one VITA site in Minnesota through the end of September, 2010.<sup>19</sup>

In FY 2010, the IRS also tested a series of "Saturday Service" days where TACs across the country opened from 9:00 am to 2:00 pm.<sup>20</sup> The Taxpayer Advocate Service (TAS) participated in the Saturday events by providing telephone assistors to take in cases that met TAS criteria and sending Local Taxpayer Advocates to assist at several of the open TACs. The IRS opened 200 TACs at two Saturday events and 99 at a third event, serving over 35,000 taxpayers.<sup>21</sup> Additionally, the IRS offered Saturday Earned Income Tax Credit (EITC) assistance at 170 TACs and offered help on Saturday, July 17 at seven Gulf Coast TACs for taxpayers impacted by the oil spill.<sup>22</sup>

The IRS also made efforts to extend service hours at TACs, expanding hours on weekdays and Saturdays at 16 TACs during the 2010 filing season.<sup>23</sup> The IRS provided Saturday service at seven TACs throughout the filing season, with the exception of April 3.<sup>24</sup> Due to taxpayer response, the IRS plans to offer expanded service during filing season 2011 as well.<sup>25</sup>

*Minimal Barriers Exist to Implementing Pilot Programs.*

While some costs exist in implementing pilot programs, these costs should be minimal. Leasing or purchasing a van to test a mobile TAC program would be inexpensive and could serve to increase face-to-face coverage significantly. Partnering with state tax agencies to provide additional services to the citizens of those states will not involve costly or long-term investment in real estate for the IRS. The IRS would only need to negotiate the use of minimal space to provide TAC services to taxpayers one day a week. The largest cost would be associated with setting up a pilot telepresence program, which would require the IRS to invest in technology and space.

<sup>17</sup> IRS response to TAS research request (Oct. 13, 2010).

<sup>18</sup> *Id.*

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

<sup>20</sup> See <http://www.irs.gov/localcontacts/article/0,,id=220631,00.html> (last visited Oct. 1, 2010).

<sup>21</sup> IRS response to TAS research request (Oct. 13, 2010).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

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

***Maintaining the Status Quo of Face-to-Face Service Is Not an Option.***

While the IRS made efforts to add face-to-face services in FY 2010, these solutions are not permanent. Additionally, most VITA sites only operate during filing season, while taxpayers need face-to-face service year-round. Saturday Service days are not held often enough or scheduled at optimal locations.

Unless the IRS tries new solutions, over 30 percent of taxpayers will not have ready access to face-to-face service, the same rate since the IRS completed opening its 401 TACs.<sup>26</sup> Those who need this service most include low income taxpayers, the elderly, and the disabled.<sup>27</sup> Studies have shown that these taxpayers have less access to the Internet and prefer to receive service face-to-face.<sup>28</sup>

**CONCLUSION**

Face-to-face assistance is essential to effective tax administration. Certain segments of the taxpaying population will always require face-to-face assistance.<sup>29</sup> The IRS could significantly increase the reach of face-to-face services through mobile vans, collaborating with state and local agencies, telepresence, and other innovative solutions. In addition to maintaining brick and mortar TACs where there are stable populations of taxpayers with face-to-face requirements, the IRS should also become flexible in providing face-to-face service to other fluctuating populations and areas with varying needs.

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

1. Test a program using mobile vans to increase face-to-face service;
2. Pilot a program to work with state and local agencies to increase the IRS's face-to-face presence; and
3. Test telepresence in remote areas.

**IRS COMMENTS**

We appreciate the National Taxpayer Advocate's review of the IRS's customer service to taxpayers, as well as the acknowledgement of the Geographic Coverage Initiative that examines the placement of TACs and determines if the current TACs meet the needs of taxpayers.

The IRS recognizes the continual need to provide taxpayers with increased face-to-face services. Since the creation of the GCI in 2008, the IRS has taken several steps to increase its

<sup>26</sup> IRS, *Taxpayer Assistance Blueprint: Phase 2*, 116, 194 (Apr. 17, 2007). Or a slightly higher 68.2 percent using estimates that assume taxpayers are able to travel more quickly than those used in the TAB study. IRS response to TAS research request (Oct. 13, 2010).

<sup>27</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (*Study of Taxpayer Needs and Preferences*).

<sup>28</sup> See IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (*Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services*).

<sup>29</sup> National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (*Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services*).

partnerships with volunteer sites and other IRS organizations and expand the TAC hours of service to meet the face-to-face needs of taxpayers.

In 2009, IRS employees worked at nine VITA locations assisting taxpayers with account issues, transcripts, Individual Taxpayer Identification Numbers (ITIN), and answering tax law questions. Over 1,300 taxpayers received service. During 2010, the IRS provided assistance at 27 volunteer locations and assisted over 5,300 taxpayers. The IRS plans to staff approximately 30 volunteer locations in 2011.

Also during 2010, the IRS held two EITC Awareness Saturday events to bring awareness of EITC and prepare returns for those who qualify. These EITC events were held in 170 TACs where the IRS assisted over 9,500 taxpayers and prepared over 4,000 tax returns.

The IRS sponsored nationwide Open House events in 2010, in at least one TAC in each state.<sup>30</sup> The Open House events convened various IRS organizations, including TAS, Small Business/Self-Employed; Large Business and International; Chief Counsel; Tax Exempt and Government Entities; Governmental Liaison; Stakeholder, Partnerships, Education and Communication; Automated Collection System; and outside partners who worked together to resolve taxpayer issues. Although the events provided assistance to all taxpayers who came to the TAC, some of the events had special themes and reached out to specific taxpayers, such as small businesses, the disabled, veterans, and taxpayers who were struggling due to the economic downturn. These events were very successful and well attended, over 35,000 taxpayers were assisted and 8,600 tax returns were prepared.

For 2011, the IRS will continue to offer EITC Saturday service and Open House events in partnership with many of the IRS organizations mentioned above. Four Open House events are planned during the filing season at nearly 100 TACs and two after the filing season at approximately 50 TACs. The IRS will continue to partner with community organizations to increase our services for taxpayers and looks forward to continuing its partnership with TAS during these events.

The IRS also provided expanded service hours during 2010. Sixteen TACs across the country opened before 8:30 a.m. and after 4:30 p.m. on weekdays and Saturdays. The expanded service hours resulted in 6,272 walk-in taxpayers through the week of April 15, 2010. As a part of this initiative, the IRS analyzed data and solicited feedback from both taxpayers and employees to evaluate the success of the expanded hours of operations at select TACs. Based on this feedback, the IRS is planning to offer similar expanded hours of service during the 2011 filing season in select TACs where existing staff can effectively accommodate taxpayers.

The IRS recognized the potential need for taxpayers impacted by the Gulf of Mexico oil spill and initiated the Gulf Coast Assistance Day at seven TACs located throughout the Gulf

<sup>30</sup> Those events were conducted on February 20th, March 27th, May 15th, June 5th, and September 25th.

Coast area on Saturday, July 17. A total of 168 taxpayers received assistance to resolve a variety of federal tax-related issues.

#### **PRELIMINARY RECOMMENDATIONS:**

##### **Test a program using mobile vans to increase face-to-face service.**

The IRS has tested this option in the past and received low taxpayer interest and turnout. For example, the IRS conducted a mobile Tax Tour in North Dakota using alternative locations. Despite efforts to promote the IRS's availability in the mobile locations through radio announcements, newspaper ads, and local flyers, the number of taxpayers served was 76 in 2008, 12 in 2009, and 13 in 2010. Based on these tests, we have observed that taxpayers do not come to sites that are not established and staffed on a regular basis.

##### **Pilot a program to work with state and local agencies to increase the IRS's face-to-face presence.**

The IRS currently partners with state and local agencies to increase IRS's ability to directly provide service to taxpayers. We currently prepare returns for 27 states through 263 TACs across the country. Eight additional states (Kentucky, Michigan, Minnesota, Nebraska, New Jersey, Ohio, Pennsylvania, and Virginia) will be brought online in 2011 and six additional six states, plus the District of Columbia, will be considered in subsequent years.

In addition, we have co-located with state tax agencies, such as the State of Utah, to offer a full range of TAC-related services including return filing, resolution of account issues, transcripts, and tax law assistance. During 2010, the TAC in Charleston, West Virginia partnered with the State of West Virginia to provide IRS staffing at the state's office on selected days to assist taxpayers with heavy vehicle use taxes. The IRS is interested in pursuing other opportunities to collaborate with state tax agencies on an as needed basis. However, there are resource challenges as some states are requesting monetary assistance.

The IRS is utilizing the GCI Model to increase the coverage rate by exploring the use of alternative locations and increasing partnerships by establishing an increased IRS presence at the volunteer sites during the filing season. By staffing volunteer sites with IRS employees from offices within the commuting area, IRS is able to provide additional service and enhance coverage. IRS employees provide services not currently offered at these volunteer sites such as accounts, transcripts, and tax law questions.

##### **Test telepresence in remote areas.**

The IRS agrees with the National Taxpayer Advocate's recommendation that a telepresence in remote areas may be a potential option. We are currently working on technical and bandwidth issues at existing TAC locations to optimize computer applications that are used to access taxpayers' accounts. Once these issues have been resolved, the IRS will consider the telepresence option.

The Facilitated Self Assistance (FSA) kiosks, which are another form of virtual presence, were used at 49 TACs for the 2010 filing season. FSA allows the IRS to expand its service and outreach to taxpayers by providing assistance through computer workstations that taxpayers can use to connect to IRS.gov and conduct their tax-related business and share feedback about their experience. Approximately 9,700 taxpayers used FSA to file their tax returns electronically, apply for an Employer Identification Number, print current and prior year forms and publications, and enroll in Electronic Federal Tax Payment System (EFTPS). Dated equipment and structure has delayed further deployment of FSA. However, IRS Field Assistance is working on a viable solution for kiosks in the TACs and will continue to provide FSA in 2011.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS acknowledges the potential of telepresence as a method of serving taxpayers in areas where TACs are not in reasonable driving distance. The National Taxpayer Advocate continues to encourage the IRS to explore this option and implement a pilot program to test its effectiveness. In fact, the Taxpayer Advocate Service will be testing this approach by establishing a telepresence site for taxpayers seeking TAS assistance in at least two states. We will share our progress and results with the IRS. We also commend the IRS's efforts to expand service in current TAC locations by offering weekend service and longer hours on weekdays.

However, the focus of this issue is the large number of taxpayers with no access to face-to-face service. While offering additional services at existing TACs is also critical, the National Taxpayer Advocate is concerned that the IRS is not expanding service to underserved areas. Open houses and EITC Awareness Days are very important, but take place at current TAC locations. Neither these events nor increasing hours can deliver face-to-face coverage to taxpayers who live beyond a reasonable driving distance of a TAC.

The National Taxpayer Advocate is surprised by the IRS response to the recommendation that the IRS test a program of using mobile vans to expand face-to-face service to taxpayers. Twice, the IRS replied to TAS requests for information by saying it does not own mobile vans.<sup>31</sup> The IRS did not respond at all to the National Taxpayer Advocate's recommendation in her 2008 Annual Report that it test a van program.<sup>32</sup> However, in its response for this year's report, the IRS states that it has been testing a Mobile Tax Tour in North Dakota since 2008. Despite requests for information about how the IRS has expanded face-to-face service to taxpayers, the IRS has not previously mentioned this program.<sup>33</sup> Thus, we have had no opportunity to explore the parameters of the Mobile Tax Tour. For example, the IRS provided no information about the dates or locations of the tour in North Dakota, the hours the vans were available or how frequently they went to sites, or the methods of publicizing and promoting the service. The National Taxpayer Advocate is unable to evaluate from the IRS response whether this program meets the recommendation of testing a mobile TAC program. The National Taxpayer Advocate encourages the IRS to share more information regarding this program with TAS.

In its response to a TAS research request, the IRS also failed to mention partnering with state tax agencies,<sup>34</sup> yet in the response to this Most Serious Problem the IRS states it collaborated with the tax agencies in Utah and West Virginia to provide, respectively, a full range of TAC services and services related to heavy vehicle use taxes. The National

<sup>31</sup> IRS response to TAS research requests (Oct. 21, 2010, and Nov. 3, 2010).

<sup>32</sup> See 2008 National Taxpayer Advocate Annual Report to Congress 95-113.

<sup>33</sup> IRS response to TAS research request (Oct. 21, 2010).

<sup>34</sup> *Id.*

Taxpayer Advocate is pleased that the IRS is working with state agencies, but again cannot evaluate this program based on the information provided. The National Taxpayer Advocate encourages the IRS to share further information regarding this program with TAS.

Successful pilots of van and co-location programs must contain several key elements. The programs must be consistent; that is, taxpayers must be able to expect that certain services will be available on certain days in certain locations. Haphazardly advertising a mobile van program through print and advertising, holding the program for one day, and then declaring it was unsuccessful because only a few taxpayers availed themselves of the service does not reflect a well-structured pilot program. It will take time for taxpayers to realize and trust that a mobile TAC will be in their area every other Thursday offering full-scale IRS services. A one-day trial, even with advertising, will not give the IRS useful information about the extent to which taxpayers use the program. Programs must also be advertised to taxpayers most likely to need face-to-face services, through channels they are likely to use. Simply informing the public of an event via the IRS website will not reach those segments of the population that are most likely to need face-to-face service, as those taxpayers are less likely to use the Internet.<sup>35</sup>

Tax agencies in other countries have had significant success with mobile van units, and even use them to supplement brick-and-mortar assistance centers in populous areas as well as more remote or rural ones. In November, 2010, the National Taxpayer Advocate visited with Chilean Servicio de Impuestos Internos (SII – the tax agency or “IRS”) officials and observed both stationary and mobile assistance centers. There are four such centers in Santiago, the most populous city in Chile. Notwithstanding these four centers, the tax agency utilizes vans to visit various communities in Santiago. The Chilean SII believes that having a presence among taxpayers and making it easier to obtain assistance increases voluntary tax compliance.<sup>36</sup>

The National Taxpayer Advocate suggests that the IRS work with TAS to evaluate the programs referenced in its response, to determine if they are effective tests of mobile TACs and co-locations and to develop a strategy for a successful van program. Additionally, the National Taxpayer Advocate recommends that the IRS focus on expanding face-to-face service to underserved taxpayers in addition to expanding services at current TACs. Maintaining the status quo of brick and mortar TACs as the main vehicle for face-to-face service leaves more than 30 percent of taxpayers without reasonable access to this service. The IRS needs to explore further options to reach these taxpayers.

<sup>35</sup> See IRS Oversight Board, *Taxpayer Customer Service and Channel Preference Survey Special Report* (Nov. 2006); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (*Study of Taxpayers Needs, Preferences, and Willingness to Use IRS Services*).

<sup>36</sup> Conversations between the National Taxpayer Advocate and Chilean SII officials, November 22 – 24, 2010.



## Recommendations

The National Taxpayer Advocate recommends that the IRS work with the Taxpayer Advocate Service to design and:

1. Test a program that uses mobile vans to increase face-to-face service;
2. Pilot a program to work with state and local agencies to increase the IRS's face-to-face presence; and
3. Test telepresence in remote areas

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## The S Corporation Election Process Unduly Burdens Small Businesses

### RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division  
William J. Wilkins, Chief Counsel

### DEFINITION OF PROBLEM

Subchapter S corporations are the most common corporate entity in the tax system.<sup>1</sup> S corporation status is highly desirable because in addition to traditional corporate attributes such as limited liability and transferable ownership, these corporations “pass-through” profits or losses to shareholders who report the income and receive the tax benefit of any losses on their individual returns.<sup>2</sup>

While the IRS rarely denies S corporation status for failure to meet the election criteria, many S corporation returns remain unprocessed for years because of missing or late elections, internal IRS errors in recognizing or processing a valid election, and an absence of effective relief procedures. In processing year (PY) 2009 alone, about 24 percent of all new S corporation returns could not be processed as filed.<sup>3</sup> The IRS does not provide examples of scenarios that meet the criteria for reasonable cause relief in its published guidance, nor does the IRS always fully inform taxpayers of their options for relief under five available Revenue Procedures.<sup>4</sup> These shortcomings impose undue burdens on small business taxpayers and may create significant re-work for the IRS. The National Taxpayer Advocate has identified the following challenges in the S election process:

- Despite increased IRS outreach, some taxpayers still overlook the requirement to file an S election;
- Administrative relief procedures for a late S corporation election are complex and burdensome for taxpayers;
- Retroactive relief via a Private Letter Ruling (PLR) is lengthy, complicated, and cost-prohibitive for many small businesses;

<sup>1</sup> In FY 2009, 4.5 million S corporation returns were filed, accounting for about 64 percent of all corporate returns. IRS, *Data Book 2009*, Table 2, 4.

<sup>2</sup> Internal Revenue Code (IRC) § 1361(a)(1) defines an “S corporation” as a small business corporation for which an election under §1362(a) is in effect for such year. A small business corporation must make an election to be an S corporation by filing a completed Form 2553, *Election by a Small Business Corporation*. Treas. Reg. § 1.1362-6(a)(2).

<sup>3</sup> IRS, Compliance Data Warehouse (CDW) for PY 2009 (June 2010). In PY 2008 and 2009, nearly 17 percent and nearly 24 percent, respectively, of all new S corporation filings were unpostable. If there is no election on file, the information cannot “post” to the IRS Master File; hence the return becomes “unpostable.”

<sup>4</sup> A taxpayer may obtain relief for certain late S corporation and late corporate classification elections by following the procedures in Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-49, 2004-2 C.B. 210; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; or Rev. Proc. 97-48, 1997-2 C.B. 521.

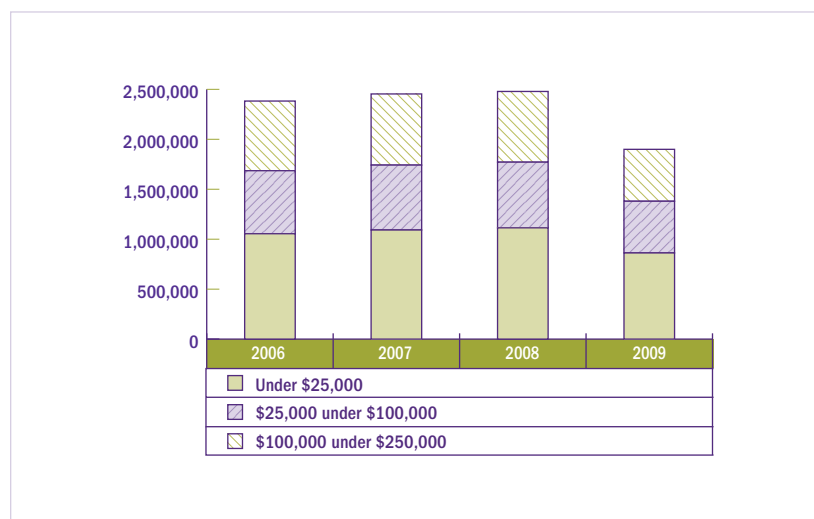
- The IRS's inability to verify the receipt of S corporation election applications increases taxpayer burden; and
- The conversion of S corporation returns to regular, taxable corporate returns imposes downstream burdens on S corporation shareholders and may have violated the law in the past.

## ANALYSIS OF PROBLEM

### Background

In tax year (TY) 2009, S corporations accounted for about 64 percent of all corporate returns, with 45 percent of S corporation returns reporting gross receipts under \$100,000 and 63 percent reporting gross receipts under \$250,000.<sup>5</sup> As Chart 1.20.1 illustrates, returns with gross receipts of under \$250,000 comprised about 60 percent of all S corporation returns from TY 2006 to TY 2008. In TY 2009, approximately 419,000 small business taxpayers elected to be treated as S corporations.<sup>6</sup>

**CHART 1.20.1, S Corporation Filings Stratified by Gross Receipts, TY 2006 – TY 2009**



For a business to be treated as an S corporation, the entity must file Form 2553, *Election by a Small Business Corporation*, on or before the 15th day of the third month of the tax

<sup>5</sup> IRS, CDW, Business Returns Transaction File (Tax Year 2009).

<sup>6</sup> Business Master File (BMF) Extract for TYs 2006-2009 for Transaction Codes 090-095 (Sept. 2010). TY 2009 figures reflect partial year data through Sept. 2010.

year for which the election is to be in effect.<sup>7</sup> The IRS rarely denies S corporation elections for failure to meet the election criteria.<sup>8</sup> In PY 2009, only 615 of approximately 419,000 elections were denied on this basis.<sup>9</sup> It is not rare, however, for S corporation returns to remain unprocessed for several years because of missing or late elections or IRS errors in recognizing or processing a valid election. In PYs 2008 and 2009, there were 81,431 and 97,823 unprocessable S corporation returns – or nearly 17 and nearly 24 percent, respectively, of all new S corporation filings.<sup>10</sup> Prior IRS research reports revealed approximately 20 percent of these returns remain unprocessable for multiple years.<sup>11</sup>

**Despite increased IRS outreach, some taxpayers still overlook the requirement to file an S election.**

The IRS cannot process Form 1120S, *U.S. Income Tax Return for an S Corporation*, until it approves the S corporation election and determines an effective date of the S corporation status. It is this two-step, two-form, filing process in the first year that businesses often overlook. Even though the IRS uses several methods to educate taxpayers, many corporations only become aware of this pre-filing requirement after they attempt to file their first tax returns.<sup>12</sup>

The IRS could and should do more to help small business owners identify the requirement to file Form 2553. Typing the phrase “starting a new corporation” into the search box on [www.irs.gov](http://www.irs.gov) provides a link to Publication 583, *Starting a New Business and Keeping Records*. While this publication mentions S corporations as a form of business, describes the value of an S corporation, and directs the reader to Form 2553 (and the related instructions) for further information, it never explains that a business **must** file Form 2553 to become an S corporation. Form 2553 is conspicuously missing from the “Which Forms Must I File?” section and filing Form 2553 did not make the list as one of the “Top Six Tips for Taxpayers Starting a New Business.” While the SB/SE Examination function maintains an excellent website that explains applicable S corporation laws and procedures, this site is not referenced in any IRS publications.<sup>13</sup>

<sup>7</sup> The S corporation election must be made at any time during the preceding taxable year, or at any time during the taxable year on or before the 15th day of the third month of the taxable year. IRC § 1362(b)(1); Treas. Reg. § 1.1362-6(a)(2). When an S corporation election is made after the 15th day of the third month of the taxable year and on or before the 15th day of the third month of the following taxable year, the election is treated as made for the following taxable year. IRC § 1362(b)(3). When Congress created the S corporation in 1958, the election was made by simply sending the request in writing to the IRS. The first official Form 2553, *Election by Small Business Corporation*, was issued in October 1968.

<sup>8</sup> The election criteria are short and straightforward. Under IRC § 1362, in order to be considered an S corporation, a business must meet the criteria of a “small business corporation” as defined in IRC § 1361(b)(1) (a domestic corporation which is not an ineligible corporation and which does not 1) have more than 100 shareholders, 2) have as a shareholder a person who is not an individual, 3) have a nonresident alien as a shareholder, and 4) have more than one class of stock). See also Treas. Reg. § 1.1361-1(2)(b).

<sup>9</sup> BMF Extract for Tax Years 2006-2009 for Transaction Codes 090-095 (Sept. 2010).

<sup>10</sup> BMF from the CDW for PYs 2007-2009 (June 2010). If there is no election on file, the return information cannot “post” to the IRS Master File, and the return becomes “unprocessable.”

<sup>11</sup> IRS, SB/SE Research report, Profile Taxpayers with Unprocessable Initial 1120S Returns (May 2007).

<sup>12</sup> For example, the IRS provides information about the need to file Form 2553 to elect S corporation status on its website, when applying for an employer identification number (EIN), and even on the face of the Form 1120S.

<sup>13</sup> See <http://www.irs.gov/businesses/small/article/0,,id=98263,00.html> (last visited June 3, 2010).

**Administrative relief procedures for a late S corporation election are complex and burdensome for taxpayers.**

When an S corporation return cannot be processed because an S election is not on file, the IRS sends a letter requesting evidence of a valid election. If the taxpayer has no evidence or simply did not make a timely election, the IRS has the authority to treat the S election as timely for the taxable year if there was reasonable cause for the failure to make the election.<sup>14</sup> The IRS only provides reasonable cause relief for a late S corporation election under one of five Revenue Procedures, or through a letter ruling request discussed below.<sup>15</sup> The IRS does not provide examples of acceptable scenarios that meet criteria for reasonable cause relief in its published guidance,<sup>16</sup> nor does the IRS always inform taxpayers of all their options under the Revenue Procedures.<sup>17</sup> Moreover, the IRS does not provide routine reasonable cause relief through its campus employees and has no administrative appeal process to address S corporation election denials.

The current Form 2553 includes space for an explanation of reasonable cause based on the latest retroactive relief provision in Revenue Procedure 2007-62. Under this procedure, a company that fails to timely file Form 2553 can request relief by filing Form 2553 with its first Form 1120S as long as the return is filed within six months of the original due date (excluding extensions).<sup>18</sup> The hope expressed in the National Taxpayer Advocate's 2007 Annual Report to Congress – that Revenue Procedure 2007-62 would reduce the number of unpostable returns and ease taxpayer burden – has not been fully realized. After an initial dip in the number of unpostables in processing year 2008, unpostable returns continue to rise, even though the total number of S corporation elections has decreased about 23

<sup>14</sup> IRC § 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)) after the date prescribed by § 1362(b) for making the election for the taxable year or no election is made for any taxable year, and (B) the IRS determines that there was reasonable cause for the failure to timely make the election, the IRS may treat the election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

<sup>15</sup> A taxpayer may obtain relief for certain late S corporation and late corporate classification elections by following the procedures in Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-49, 2004-2 C.B. 210; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; or Rev. Proc. 97-48, 1997-2 C.B. 521. For letter ruling procedures, see Treas. Reg. § 301.9100-1; Rev. Proc. 2010-1, 2010-1 I.R.B. 1.

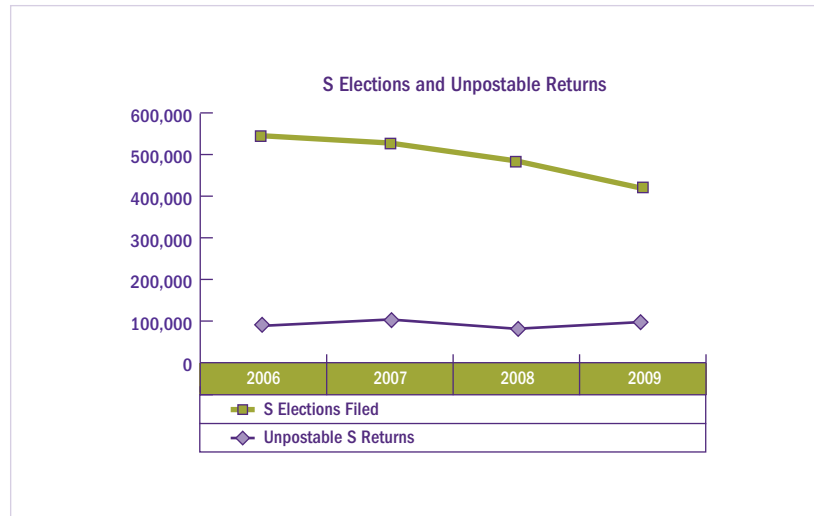
<sup>16</sup> There is, however, a listing of common reasonable cause criteria in Internal Revenue Manual (IRM) 3.13.2.22.5 related to the application of Rev. Proc. 2003-43.

<sup>17</sup> The IRS letter requesting evidence of a valid and timely S corporation election is generated by the IRS Correspondex system, which allows the IRS to insert various explanatory paragraphs. Depending on the employee processing the election, a taxpayer may not be informed of Revenue Procedures specific to its situation.

<sup>18</sup> Revenue Procedure 2007-62 provides that an entity may request relief for a late S corporation election if all of the following requirements are met: 1) The entity fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to file a timely Form 2553 with the applicable campus; 2) The entity has reasonable cause for its failure to file a timely Form 2553; 3) The entity seeking to make the S corporation election has not filed a tax return for the first taxable year in which the election was intended; 4) The application for relief is filed under this revenue procedure no later than six months after the due date of the tax return (including extensions) of the entity seeking to make the election for the first taxable year in which the election was intended; and 5) No taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election on any affected return for the year the S corporation election was intended.

percent between PY 2006 and PY 2009, from nearly 545,000 elections to nearly 419,000, as shown in Chart 1.20.2 below.<sup>19</sup>

**CHART 1.20.2, Comparison of S Corporation Filings and Unpostable Returns, PY 2006 - PY 2009**



The IRS could simplify administrative relief procedures for late S corporation elections and avoid confusion by consolidating the five revenue procedures into one, and by including a simple guide to the relief process in letters to taxpayers who did not make a timely election.

**Retroactive relief via the Private Letter Ruling process is lengthy, complicated, and may be cost-prohibitive for many small businesses.**

A small business entity that does not meet the requirements for relief, or is denied relief under a revenue procedure, is taxed as a C corporation for at least one year and may face the challenge of requesting relief by means of a PLR.<sup>20</sup> The IRS charges a user fee for a PLR ranging from \$625 to \$14,000 per request.<sup>21</sup>

According to a recent report by the Treasury Inspector General for Tax Administration, the IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under

<sup>19</sup> IRS, SB/SE Research report, *Profile Taxpayers with Unpostable Initial 1120S Returns* (May 2007) for PY 2006, and CDW BMF for PYs 2007-2009 (June 2010). With the exception of a dip in unpostable returns in 2008, unpostable returns continue to rise. The total number of unpostable Forms 1120S from PY 2006 to PY 2009 was as follows: PY 2006 – 88,672, PY 2007 – 103,762, PY 2008 – 81,431, PY 2009 – 97,823, IRS Master File Transaction Code (TC) data for Form 1120S. The total number of S elections filed from PY 2006 through 2009 was as follows: PY 2006 – 544,917, PY 2007 – 527,644, PY 2008 – 484,595, PY 2009 – 418,567. See BMF Extract for TYs 2006-2009 for Transaction Codes 090, 093, and 094 (Aug. 2010).

<sup>20</sup> For a discussion of the PLR process specific to S corporation rulings, see National Taxpayer Advocate 2004 Annual Report to Congress 392. See also Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010).

<sup>21</sup> A PLR may cost up to \$14,000 per ruling request. Treas. Reg. § 301.9100-1; Rev. Proc. 2010-1, 2010-1 I.R.B. 1. However, a reduced user fee of \$625 is available to taxpayers with gross income of less than \$250,000 and \$2,100 to taxpayers with gross income of less than \$1,000,000. See Rev. Proc. 2010-1, Appendix A, (A)(3) – (4) and (B)(1).

IRC § 1362 from fiscal year (FY) 2007 to FY 2009.<sup>22</sup> Although the Office of Chief Counsel is aware of the need for guidance in the S corporation election area and issued numerous Revenue Procedures of which five are still active,<sup>23</sup> this guidance did not eliminate or reduce the need for letter rulings in connection with S corporation elections.<sup>24</sup>

The National Taxpayer Advocate is concerned about the increasing burden imposed on small business taxpayers by the need to seek relief via a lengthy, complicated, and often cost-prohibitive PLR process when the taxpayer is ineligible for relief under the existing revenue procedures.<sup>25</sup> Small business taxpayers need easy-to-follow published guidance providing retroactive relief for the failure to make a timely S corporation election.<sup>26</sup>

**The IRS's inability to verify the receipt of election applications and acceptance of S corporation returns increases taxpayer burden.**

In addition to reasonable cause, most of the relief procedures also require proof of timely and consistent filing of the S corporation and shareholder returns. In the past, it has been difficult to prove the existence of timely filed S corporation returns because the IRS filed unprocessable returns without cross-referencing them to the Employer Identification Number of the entity.<sup>27</sup> Unless a taxpayer had correspondence from the IRS with a Document Locator Number (DLN), it was nearly impossible to locate these unprocessable returns and prove timely filing. Since PY 2009, these returns have been transcribed to the Master File. We are pleased to report that the IRS can now verify proof of timely and consistent filing from its Master File, and has updated IRM procedures to require employees to research this readily available information before denying relief. While these enhancements will be very helpful from now on, they do not help resolve old, unpostable accounts.

<sup>22</sup> TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* 7 (Figure 2, Issue Code 1362.01-03) (Sept. 10, 2010). See also IRS, *IRS Written Determinations*, at <http://www.irs.gov/app/picklist/list/writtenDeterminations.html> (last visited Sept. 30, 2010). IRS Written Determinations are documents the IRS is required to make "...open to public inspection..." pursuant to the provisions of IRC § 6110.

<sup>23</sup> Rev. Proc. 2007-62, 2007 -2 C.B. 786; Rev. Proc. 2004-49, 2004-2 C.B. 210; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 97-48, 1997-2 C.B. 521.

<sup>24</sup> In response to a TIGTA recommendation, the Office of Chief Counsel agreed that it "should identify common issues in letter ruling requests, and, when possible and beneficial, issue published guidance that eliminates or reduces the need for taxpayers to request letter rulings in connection with these identified issues." TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010).

<sup>25</sup> For letter ruling procedures, see Treas. Reg. § 301.9100-1; Rev. Proc. 2010-1, 2010-1 I.R.B. 1. See also TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010). TIGTA determined that Chief Counsel personnel did not always make the initial contact with taxpayers to discuss the taxpayers' issues within 21 calendar days after case assignment, and did not always meet Counsel's internal target date of 120 calendar days to issue a PLR.

<sup>26</sup> The IRS Office of Chief Counsel plans to issue guidance under IRC § 1362. Department of the Treasury, 2009-2010 Priority Guidance Plan (Nov. 24, 2009) and First Periodic Update of the 2009-2010 Priority Guidance Plan (Mar. 16, 2010), at <http://www.irs.gov/newsroom/article/0,,id=215792,00.html>.

<sup>27</sup> In 2002, TIGTA reported that first-time filers of Form 1120S encountered a cumbersome, ineffective verification process for unpostable returns. TIGTA, Ref. No. 2002-30-186, *The Internal Revenue Service Needs to Simplify Filing Requirement and Clarify Processing Procedures for Small Business Corporate Returns* 1-3 (Sept. 2002).

Some S corporation elections are filed timely, but are not properly received, controlled, and processed by the IRS.<sup>28</sup> The IRS acknowledged these problems in 2002 and promised to improve electronic filing for corporate returns.<sup>29</sup> These changes have not been fully implemented. The IRS still does not allow Forms 2553 to be filed electronically as a stand-alone form or record any information about faxed or mailed Forms 2553 upon receipt, and therefore cannot verify the receipt of filed elections.<sup>30</sup> While taxpayers should and do bear the burden of showing that their elections are timely filed, the IRS could and should ease that burden by tracking the receipt of S elections, regardless of the filing method. Doing so will reduce the burden to both taxpayers and the IRS.

**The conversion of S corporation returns to regular, taxable corporate returns imposes downstream burdens on S corporation shareholders and may have violated the law in the past.**

The IRS converts S corporation returns without proof of a valid, timely election to Form 1120, *U.S. Income Tax Return for a Corporation*, where income is taxed at the corporate level. This conversion is reflected on the IRS Master File system. However, often the IRS does not assess any tax at the corporate level, and therefore does not issue a Statutory Notice of Deficiency (SNOD), leaving taxpayers with the incorrect assumption that the IRS accepted their 1120S returns as filed.<sup>31</sup> S corporation shareholders may then report the Form 1120S income or loss on their Forms 1040, or claim other expenses or credits attributable to the corporation. Years later, these shareholders may find themselves in an audit situation with large proposed assessments.

In some instances prior to 2004, the IRS converted S corporation returns to C corporation taxable returns and assessed the tax liability without issuing a SNOD. A TIGTA audit in 2002 identified about 3,700 instances where unclear IRS procedures may have violated taxpayer rights, as the IRS assessed taxes on an estimated \$6.7 million in taxable income without sending the taxpayers a SNOD.<sup>32</sup> Although Chief Counsel determined in 1999 that the IRS “may not assess tax liability without following deficiency procedures specified under IRC §§ 6212 and 6213,” the IRS continued this practice through tax year 2003.<sup>33</sup> TAS continues to resolve old cases where the IRS’s Submission Processing, Accounts

<sup>28</sup> BMF Extract for Tax Years 2006-2009 for Transaction Code 093 (Sept. 2010). There were 12,372 timely filed but unprocessed and unresolved elections in TY 2006, 8,768 in TY 2007, 6,848 in TY 2008, and 6,275 in TY 2009.

<sup>29</sup> TIGTA, Ref. No. 2002-30-186, *The Internal Revenue Service Needs to Simplify Filing Requirement and Clarify Processing Procedures for Small Business Corporate Returns* 4 (Sept. 2002).

<sup>30</sup> The IRS tracks S elections by inputting certain transaction codes on IDRS. IRS Document 6209, *IRS Processing Codes and Information* (2010). However, Transaction Code 093, *Application for Small Business Election*, only goes on the module 30 days after receipt.

<sup>31</sup> Memorandum from Assistant Chief Counsel (Field Service) to District Counsel, Pennsylvania District, Ref. No. 199929036 (May 20, 1999). In a nonprecedential opinion, the IRS Office of Chief Counsel concluded that the IRS may process unpostable Form 1120S returns by transferring line item information to other forms that are postable (i.e., Forms 1120). However, these postable forms do not constitute the taxpayers’ returns but are merely a processing mechanism.

<sup>32</sup> TIGTA, Ref. No. 2002-30-186, *The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns* (Sept. 23, 2002).

<sup>33</sup> Memorandum from Assistant Chief Counsel (Field Service) to District Counsel, Pennsylvania District, Ref. No. 199929036 (May 20, 1999).



Management, and Examination support and processing functions assessed tax at the corporate level without issuing notices of deficiency.<sup>34</sup>

## CONCLUSION

The cumbersome S corporation election procedures unduly burden small businesses and waste valuable IRS resources in resolving unpostable S corporation accounts where the income has most likely already been reported on the shareholders' individual returns. The IRS should refocus its efforts and assist small business owners who are trying to elect S corporation status by simplifying the late election relief process and updating publications and the IRS website with the simplified procedures.

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

1. Consolidate the five revenue procedures providing relief for late S corporation elections into one.
2. Include a simple guide to the relief process in letters to taxpayers that did not make a timely election.
3. Publish guidance providing retroactive relief where reasonable cause exists for the failure to make a timely S corporation election at any time without the need to request a letter ruling and delegate authority to provide reasonable cause relief. The guidance should provide examples of what constitutes reasonable cause.
4. Enhance systems to allow electronic filing of Form 2553 at any time during the tax year, up to and including with the first S corporation return filing.
5. Update publications, forms, correspondence, and the IRS website with instructions for making the S election and how to seek relief to correct late elections.
6. Develop an administrative appeal process for taxpayers whose elections are denied.
7. Identify and correct old conversion cases where the IRS assessed tax without issuing a statutory notice of deficiency or denied effective elections because of lost returns or other errors.

## IRS COMMENTS

As part of Congress' enactment of Subchapter S in 1958, qualified businesses are allowed the option of electing tax treatment as an S corporation. The benefits allowed to S corporations include avoidance of double taxation, as can be the case with C corporations, while preserving the limited liability features that can be lost in the case of some partnerships.

<sup>34</sup> A review of 318 of 2,332 TAS cases involving S corporation election issues uncovered 32 (approximately ten percent) accounts where tax was assessed without a statutory notice of deficiency for tax years prior to 2003. Cases were selected from the Taxpayer Advocate Management Information System (TAMIS) using issue code 440 for the period June 1, 2006, through September 30, 2010. Cases were selected for review based on a convenience sample.

The IRS continues to attempt to ease taxpayer burden and appreciates the National Taxpayer Advocate's analysis of the S corporation election process, its impact on small business taxpayers, and recognition of the valuable IRS resources dedicated to resolving related discrepancies.

Chief Counsel Passthroughs and Special Industries (CC:PSI) has included an item in their 2009-2010 Priority Guidance Plan entitled "Guidance under § 1362" which will carry over to the 2010-2011 Priority Guidance Plan. This project will look at superseding most or all of the existing relief revenue procedures and combining them into a single source which will facilitate taxpayer understanding.

As noted in the National Taxpayer Advocate's report, the IRS has taken several steps to educate taxpayers regarding the S corporation election process. For example:

- When taxpayers apply for an EIN and indicate the new entity is a corporation or S corporation, they receive an EIN confirmation notice<sup>35</sup> which includes text entitled "Important Information for S Corporation Election."
- When taxpayers apply for EINs for S corporations using the Modernized Internet EIN application, they are presented with several pages of instructions concerning the requirements for making an S Corporation election.
- Instructions for Form 2553, *Election by a Small Business Corporation*, page 2, includes guidance on the late election relief provisions.
- Letter 3853 is issued to taxpayers who file an S corporation with no election in effect to notify the taxpayers of late election relief provisions.
- Using the search term "S corporation" on [www.irs.gov](http://www.irs.gov) results in a top link to "S corporations." This leads to the website which defines S corporations, explains the requirements to elect S corporation status, and states the requirement to submit Form 2553 signed by all the shareholders.
- Since tax year 2007, the Form 1120S warns taxpayers not to file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation. It also reiterates this requirement on a line G by asking for the Form 2553 to be attached if this is the first year of S corporation status, if it was not already filed.
- From 1993 through 2006, Form 1120S stated not to file this form unless the corporation has filed Form 2553 to elect to be an S corporation.
- The Form 1120S Instructions discuss the need to have an accepted election in effect and references Form 2553 and related instructions.

The National Taxpayer Advocate's report indicates that in the past, it has been difficult to prove the existence of timely filed S corporation returns. As the report recognizes, the IRS processes have improved as we now have the ability to capture rejected returns in Master File.

<sup>35</sup> CP 575A.

The IRS campus provides relief for late S elections when taxpayers file requests for relief pursuant to one of the current safe harbor revenue procedures and the procedural requirements of the revenue procedure are satisfied. The procedures that previously converted S corporation returns to taxable C corporation returns were discontinued prior to 2004. Currently, when an S corporation return is filed which rejects in processing, the IRS provides the corporation Letter 3853C which informs the taxpayer that no election, Form 2553, has been accepted. The letter requests a completed Form 2553 and explains late election relief provisions. It also advises the taxpayer the correct form to be filed and that the shareholder(s) should be advised of the tax consequences. If no response is received from the taxpayer, the S corporation is processed as a C corporation. The conversion process does not result in tax assessment. Although the taxpayer will not receive a Statutory Notice of Deficiency, the taxpayer is appropriately notified they do not have a valid S election.

The National Taxpayer Advocate makes seven preliminary recommendations to improve the S corporation election process. The IRS is taking or has taken the following actions with respect to these recommendations.

The IRS agrees with the merits of the National Taxpayer Advocate's preliminary recommendation to consolidate the five relief revenue procedures. As previously noted, Chief Counsel Passthroughs and Special Industries (CC:PSI) has a project on the 2009-2010 Priority Guidance Plan entitled "Guidance under § 1362" which will be carried over onto the 2010-2011 Plan. This project is currently in progress and was expanded earlier this year to supersede most or all of the existing relief revenue procedures, offering a single source for this relief, consistent with the National Taxpayer Advocate's recommendation.

The National Taxpayer Advocate's report indicates that IRS misses opportunities to educate taxpayers and preliminarily recommends that the IRS provide a simple guide to the relief process in letters to taxpayers that did not make a timely election. The IRS understands the importance of providing taxpayer education and outreach. IRS will continue to review and update instructions, correspondence, and other communications in order to educate the taxpayer. We note that we may be able to better educate taxpayers as to the relief process after the issuance of the combined late election relief revenue procedure.

The National Taxpayer Advocate recommends the IRS publish guidance, with examples, providing retroactive relief where reasonable cause exists for the failure to make a timely S corporation election at any time without the need to request a letter ruling and delegate authority to provide reasonable cause relief. The determination of "reasonable cause" is factual and must be applied to the facts and circumstances of a particular case. It would be difficult to provide specific examples of what constitutes reasonable cause "at any time." For example, it could necessarily implicate years in which the statute of limitations is closed for the corporation or its shareholders. As previously discussed, if taxpayers file requests for relief for late S elections pursuant to one of the current safe harbor revenue

procedures, and the procedural requirements of the revenue procedure are satisfied, the Campus routinely provides relief for late S elections.

The National Taxpayer Advocate preliminarily recommends that IRS enhance systems to allow electronic filing of Form 2553 at any time during the tax year, up to and including with the first S corporation return filing. The IRS currently allows for the Form 2553 to be filed as an attachment to an electronically filed Form 1120S. The IRS has no plans at this time to expand the use of electronic filing to allow Form 2553 to be processed as a stand-alone form. The due date for the Form 2553 cannot be extended under current law. IRC § 1362(b) provides that an election for a given taxable year may be made at any time during the preceding taxable year or at any time during the taxable year and on or before the 15<sup>th</sup> day of the 3<sup>rd</sup> month of the taxable year. Therefore, the Form 2553, whether paper or electronic, cannot allow elections to be effective up to and including the return filing date without a statutory change. There have been legislative proposals in the past which would permit taxpayers to make the S corporation election with the first S corporation return.

The National Taxpayer Advocate's report also suggests the IRS update publications, forms, correspondence, and the IRS website with instructions for making the S elections and how to seek relief to correct late elections. As stated previously, the IRS already has many communication vehicles alerting taxpayers of the rules for S elections. The IRS will continue to review and update instructions, correspondence, and other communications in order to educate taxpayers. We note that it may be easier to communicate the relief process to taxpayers after the issuance of the combined late election relief revenue procedure.

The National Taxpayer Advocate's report proposes that the IRS develop an administrative appeal process for taxpayers whose initial elections are denied. Taxpayers currently have several processes available when their initial elections are denied. Late S election relief is presently available under the safe harbor revenue procedures. Taxpayers denied relief under the safe harbor revenue procedures may request late S election relief through the Private Letter Ruling process. If Chief Counsel reaches a tentatively adverse determination to the PLR, taxpayers have the right to a conference and to submit additional information supporting their request.

The National Taxpayer Advocate's report indicates the IRS converted S corporation returns to C corporation taxable returns and assessed the tax liability without issuing a Statutory Notice of Deficiency. Although the report recognized that the IRS changed this procedure prior to 2004, the report recommends that the IRS identify and correct old conversion cases where tax was assessed without issuing a SNOD or denied effective elections because of lost returns or other errors. While the IRS does not disagree with the value of the recommendation, the IRS lacks the systemic ability to isolate the assessments made to these converted returns. Identifying such cases would be an extremely high resource-intensive undertaking. It should be noted that previous assessments were often abated (either at the corporate or shareholder level) after taxpayers contacted the campus to resolve their late election issue.

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased the IRS considers updated guidance under IRC §1362 a priority, and is encouraged to know this guidance will supersede most or all of the existing revenue procedures, and therefore offer a single source for late S corporation election relief. With thousands of S corporation returns remaining unpostable year after year, many taxpayers continue to experience unnecessary burdens and downstream consequences of the conversion of S corporation returns to regular, taxable corporate returns. The National Taxpayer Advocate encourages the IRS to expedite the release of the new, consolidated late election relief revenue procedure. The guidance should provide easy-to-follow examples of what constitutes reasonable cause, which can be applied fairly and consistently by IRS processing units. The National Taxpayer Advocate looks forward to consulting with Chief Counsel in developing this guidance and examples.

The National Taxpayer Advocate commends the IRS for improving systems to document rejected returns and increasing outreach to new S corporation filers. However, the National Taxpayer Advocate remains concerned that these efforts are not providing the desired result, as evident from the increasing number of unpostable returns. Although we agree with the IRS that “it may be easier to communicate the relief process to taxpayers after the issuance of the combined late election relief revenue procedure,” we also believe the IRS should not delay improvements in its outreach, especially for taxpayers whose returns are not accepted and converted into taxable entity returns. IRS correspondence to taxpayers, including Letter 3853C, should include a simple, complete guide to the relief process.<sup>36</sup> In addition, the IRS website should be a one-stop resource for taxpayers making the S election and seeking relief to correct late elections.

The National Taxpayer Advocate agrees that allowing a small business corporation to elect S corporation status at the time it timely files its first S corporation return requires a legislative change. She recommended such action in the past and reiterates her proposal in this report.<sup>37</sup> Nonetheless, the electronic filing of an S corporation election as a stand-alone form, or at a minimum scanning the document into the Correspondence Imaging System, would allow the IRS to instantly verify the receipt of filed elections. Most importantly, it would reduce the burden to both taxpayers and the IRS.

The National Taxpayer Advocate also believes that creating an administrative appeal process for taxpayers whose elections were denied will alleviate taxpayer burden and ensure that IRS errors in reasonable cause determinations are addressed. When the IRS directs taxpayers to amend prior-year unpostable returns, and they do not qualify for relief

<sup>36</sup> For example, none of the explanatory paragraphs available for Notice 3853C include information pertaining to the most recent Revenue Procedure 2007-62.

<sup>37</sup> See Legislative Recommendation: *Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections*, *infra*. See also National Taxpayer Advocate 2004 Annual Report to Congress 390; National Taxpayer Advocate 2002 Annual Report to Congress 246.

under one of the revenue procedures, their only option is to seek late election relief through a PLR, which may cost up to \$14,000. If the business cannot afford the PLR user fee, it will not be treated as an S corporation until the following taxable year. The business also may be subject to certain special corporate-level taxes,<sup>38</sup> and carry on certain C corporation attributes such as retained earnings that may be taxable to shareholders as a dividend upon distribution, or be limited in the use of any net operating losses arising during the period it was a C corporation.<sup>39</sup> Given these significant consequences, it is effective tax administration to develop an administrative appeal process for late elections. This process will serve two purposes – (1) ensure that IRS errors in reasonable cause determinations will be addressed with minimal taxpayer burden, and (2) free up the Office of Chief Counsel resources for other, more substantive PLR requests.

Finally, the National Taxpayer Advocate rejects the IRS's rationale for not correcting illegal corporate assessments because "identifying such cases would be an extremely high resource-intensive undertaking." These assessments, made in violation of the deficiency procedures under IRC §§ 6212 and 6213, abridge a taxpayer's right to due process and should be systemically identified and abated. TAS offers its assistance in identifying and correcting these cases.

## Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. In consultation with TAS, expedite the issuance of a consolidated revenue procedure for late S corporation elections to supersede existing revenue procedures and offer a single source for relief. The guidance should contain easy-to-follow examples of what constitutes reasonable cause under each aspect of the procedure.
2. Immediately identify and correct old conversion cases where the IRS assessed tax without issuing a statutory notice of deficiency or denied effective elections because of lost returns or other errors.
3. Update IRS publications, forms, correspondence, and websites to include a simple and complete guide to the late election relief process.
4. Develop an administrative appeal process for taxpayers whose elections are denied.
5. Allow electronic filing of Form 2553 as a stand-alone form with an instant verification of filing provided to taxpayers.

<sup>38</sup> See generally IRC §§ 1374 and 1375.

<sup>39</sup> IRC §§ 1368(c); 1374(a) and (b)(2). IRC § 1374(b)(2) generally provides an exception, allowing certain carryover losses to be used against the built-in gains tax of IRC § 1374(a). If the business has C corporation retained earnings and receives too much of its income in future taxable years from certain passive investment activities, its S corporation election may terminate under IRC § 1362(d)(3).

**MSP  
#21****The Combined Annual Wage Reporting Program Continues  
to Impose a Substantial Burden on Employers****RESPONSIBLE OFFICIAL**

Chris Wagner, Commissioner, Small Business/Self-Employed Division

**DEFINITION OF PROBLEM**

The purpose of the Combined Annual Wage Reporting (CAWR) program is to ensure that employers pay and withhold the proper amount of tax. The program accomplishes this task by comparing the data on wage and information reporting forms submitted to the Social Security Administration (SSA) with the amounts reported on IRS employment tax forms.<sup>1</sup> This process enables the IRS and SSA to identify potentially missing or incorrect tax and wage data. The IRS then contacts employers to resolve any discrepancies.

The National Taxpayer Advocate has raised concerns about the CAWR program in prior Annual Reports to Congress.<sup>2</sup> Although the IRS has improved the program in some respects, the National Taxpayer Advocate remains concerned that it still does not respond to employers' correspondence in the timeframes the IRS has set. In May 2010, almost 87 percent of correspondence was not worked within the established period of 45 days from receipt.<sup>3</sup> The IRS has since reduced that percentage to 44.7 percent, which is a marked improvement, but it remains the case that nearly half of all CAWR correspondence was not worked within the established timeframe.<sup>4</sup> Failure to timely resolve correspondence increases taxpayer burden.

The IRS recently issued more restrictive guidance on abatement of the Failure to Timely File Information Returns penalty and the Intentional Disregard penalty.<sup>5</sup> As a result, taxpayers are now far less likely to have such penalties abated. In fact, the Failure to Timely File Information Returns penalty dollars abated fell from 82 percent in fiscal year (FY) 2008 to 71 percent in FY 2010. The Intentional Disregard penalty dollars abated dropped even more drastically, from 85 percent in FY 2008 to 61 percent in FY 2010.<sup>6</sup> The IRS's reluctance to abate penalties in CAWR cases may impose an unnecessary financial burden

<sup>1</sup> Wage and information reporting forms include Forms W-2, W-3, W-2C, W-3C, 1099-R, and W-2G. Employment tax forms include Forms 941, 943, 944, 945, and Schedule H filed with 1040/1040X.

<sup>2</sup> National Taxpayer Advocate 2008 Annual Report to Congress 316 (Most Serious Problem: *Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources*); National Taxpayer Advocate 2003 Annual Report to Congress 220 (Most Serious Problem: *Combined Annual Wage Reporting (CAWR) Reconciliation*).

<sup>3</sup> Small Business/Self-Employed Division (SB/SE) response to TAS information request (June 21, 2010).

<sup>4</sup> SB/SE response to TAS information request (Oct. 22, 2010).

<sup>5</sup> Internal Revenue Manual (IRM) 4.19.4.6.1 (Sept. 28, 2008).

<sup>6</sup> IRS, Business Master File Transaction History from Compliance Data Warehouse (Oct. 2010). Percentage of tax periods receiving a full or partial abatement divided by the number of tax periods where abatement was requested.

on businesses without addressing the underlying account problem or achieving increased voluntary compliance, which is the purpose of civil penalties.<sup>7</sup>

IRS systems limitations may cause taxpayers to provide late responses, thereby incurring the penalty. The IRS's Business Master File (BMF) system, which is the repository for name and address information for all business entities in the United States, can record only one address per entity. This limitation contributes to misrouted IRS mail, potentially leading to penalties and collection action.<sup>8</sup> This is a significant problem for large entities with multiple divisions, which may have different addresses and pay different taxes, such as corporate income tax or employment taxes. Every time one of these divisions files a return, the address on the BMF is changed.<sup>9</sup> This may cause notices to go to an inappropriate division (*e.g.*, an employment tax notice is sent to the corporate tax division), causing the corporation to miss the due date for responding to the employment tax notice.

## ANALYSIS OF PROBLEM

### Background

Since the National Taxpayer Advocate last reported on this issue, the Small Business/Self-Employed Division has made systemic and procedural improvements to the CAWR program.<sup>10</sup> The National Taxpayer Advocate acknowledges SB/SE's efforts to improve service in resolving wage and tax reporting discrepancies. However, CAWR still ranks as the number one issue in TAS cases involving large and mid-size businesses, tax-exempt organizations, and government entities.<sup>11</sup> CAWR also remains one of the top ten issues in TAS receipts from small business and self-employed taxpayers.<sup>12</sup>

<sup>7</sup> See National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (A Framework for Reforming the Penalty Regime).

<sup>8</sup> Information Reporting Program Advisory Committee Report, Burden Reduction Subgroup (June 11, 2010). This report identified the BMF's inability to record more than one address for a corporation that has different divisions and the problems this inability causes for corporations, such as misrouted mail. The report recommended that the BMF be modified so it can record multiple addresses for one corporation.

<sup>9</sup> The IRS will send correspondence to the taxpayer's last known address, which is defined as the address on the most recently filed and properly processed return. Treas. Reg. § 301.6212-2(a). For a discussion on last known address issues, see Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers, infra/supra*.

<sup>10</sup> Such improvements include: (1) In 2008, the Late Reply inventory was added to the CAWR Automated Program (CAP) database along with the existing inventory. This provides better tracking and control of employers requesting reconsideration of their CAWR tax assessments. (2) In March 2010, SB/SE improved automated screening of potential CAWR cases, providing greater consistency in identifying cases where the IRS had internal information that resolved the potential discrepancy. (3) In 2010, SB/SE enabled the CAWR program to automatically send copies of the pre-assessment letters to the employers' representatives, including reporting agents. (4) SB/SE revised its procedures, implemented a tracking mechanism, and established designated points of contact to improve coordination with the Large Corporation Technical Unit (LCTU), which allows CAWR to resolve more large corporate case discrepancies without issuing notices. (5) The IRS provided new written guidance to assist clerical teams, managers, and coordinators conducting CAWR and FUTA (Federal Unemployment Tax) operations. This guidance explains the different types of reports and provides direction on their use. (6) The IRS worked with SSA to increase IRS employee access to an SSA database with information needed to resolve older cases. (7) The IRS reviewed and updated mail routing references for accuracy in an effort to decrease misdirected CAWR mail, and created a guide to assist mailrooms and other clerical functions in routing penalty notices. See SB/SE response to TAS information request (June 21, 2010).

<sup>11</sup> See TAS, *Business Performance Review* (4th Quarter FY 2010).

<sup>12</sup> *Id.*



**The IRS Does Not Timely Resolve Correspondence from Employers.**

A taxpayer attempting to resolve a case can be frustrated and confused when the CAWR program has delayed response to correspondence. When the IRS identifies potentially missing or incorrect tax and wage data, it issues a notice asking the taxpayer to provide information to resolve the discrepancy within 45 days.<sup>13</sup> If the taxpayer provides the information or verifies data, the IRS has 45 days to resolve the case.<sup>14</sup> However, according to SB/SE data, the IRS does not meet this timeframe in the vast majority of cases. For example, in May 2010, 87 percent of correspondence was not worked within 45 days, an increase of 19 percent over the same period in FY 2009.<sup>15</sup> When the IRS cannot resolve the correspondence within the 45 days, it should issue an interim letter to let the taxpayer know that it needs more time. However, IRS reviews in 2009 identified instances where each of the three CAWR sites was unable to locate requested cases, controlled cases incorrectly, or had not issued interim letters.<sup>16</sup> These defects adversely affect taxpayers. The IRS should evaluate its CAWR staffing level, which appears inadequate to handle its inventory.

**IRS Policy Changes Have Caused a Substantial Decline in CAWR Penalty Abatements.***Overview of CAWR Penalties*

The IRS can penalize employers when they fail to file information returns or file them after the due date.<sup>17</sup> Such penalties can be significant, with the amount varying according to when, if it all, the correct information is filed. The purpose of these penalties is to encourage employers to timely provide employees with the information necessary to comply with their tax obligations.<sup>18</sup>

The IRS may impose a harsher penalty if a taxpayer's failure to file an information return or provide a correct return is due to intentional disregard of the filing requirements.<sup>19</sup> Internal Revenue Code (IRC) § 6721(3) provides an uncapped penalty based on intentional disregard when the taxpayer knowingly or willfully failed to timely file the information returns.<sup>20</sup> For example, the intentional disregard penalty for late filing Form 1099 information returns is five percent of the aggregate amount of the items that must be reported.<sup>21</sup>

<sup>13</sup> IRM 4.19.4.3.1(3)a (Apr. 1, 2010).

<sup>14</sup> SB/SE defines unresolved correspondence in inventory of more than 45 days as aged work. SB/SE response to TAS information request (June 21, 2010).

<sup>15</sup> SB/SE response to TAS information request (June 21, 2010).

<sup>16</sup> *Id.*

<sup>17</sup> Internal Revenue Code (IRC) § 6721(a).

<sup>18</sup> Report of the Committee on the Budget, HR Rep. No. 247, 101st Cong., 1st Sess. 1383 (1989), reprinted in 1989 USCCAN 1906, 2853.

<sup>19</sup> See IRC § 6721(e).

<sup>20</sup> Treas. Reg. § 301.6721-1(f)(2).

<sup>21</sup> See IRC § 6721(e)(2)(B).

Whether a taxpayer knowingly or willfully fails to timely file an information return is “determined on the basis of all the facts and circumstances in the particular case.”<sup>22</sup> Some of the factors in the determination are stated in Treas. Reg. § 301.6721-1(f)(3) and include:

- Whether the failure to file timely is part of a pattern;
- Whether the taxpayer promptly made a correction upon discovery of the failure;
- Whether the taxpayer corrects the failure to file within 30 days of a written request from the IRS; and
- Whether the failure to timely file penalty is less than the cost of timely filing.

Recently, the IRS seems to have changed its approach to the abatement of penalties on CAWR cases. Previous guidance stated, “If the employer establishes a reasonable cause or due diligence, abate the penalty ...”<sup>23</sup> In guidance issued in September 2008, SB/SE instructed employees to use “caution” when considering abatement requests for the Failure to Timely File Information Returns penalty and the Intentional Disregard penalty.<sup>24</sup> The revised guidance states:

Prior to abating a CAWR penalty (Late Filing and/or Intentional Disregard), be aware of the numerous attempts made by both the Service and SSA to solicit the correct information from the employer. Failure to secure and properly credit the missing Forms W-2 will impact an individual’s SSA earnings record and ultimately that individual’s retirement benefits. Given the history of correspondence sent to the taxpayer by SSA and the CAWR unit, caution should be used in abating the penalty.<sup>25</sup>

This guidance shifts the focus from reasonable cause and willful neglect, a statutory standard set forth by IRC § 6724(a), to a standard that urges caution. The IRS now instructs its employees to focus on the number of attempts the IRS or SSA has made to contact the employer, rather than consider whether there is reasonable cause for the unresponsiveness or whether IRS processes and communications contributed to the lack of response. Since the IRS issued this revised instruction, the number of Failure to Timely File Information Returns and Intentional Disregard penalties abated has decreased significantly.

The tables below shows the percentages of tax periods assessed that were later abated in CAWR penalty cases.<sup>26</sup>

<sup>22</sup> Treas. Reg. § 301.6721-1(f)(2).

<sup>23</sup> IRM 4.19.4.6.1 (May 1, 2006).

<sup>24</sup> IRM 4.19.4.6.1 (Sept. 28, 2008). This IRM was updated April 16, 2009, but this instruction was left unchanged.

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

<sup>26</sup> IRS, Business Master File Transaction History from Compliance Data Warehouse (Oct. 2010). Percentage of tax periods receiving a full or partial abatement divided by the number of tax periods where abatement was requested.

The Combined Annual Wage Reporting Program Continues to Impose a Substantial Burden on Employers

MSP #21

**TABLE 1.21.1, Failure To File Penalty Abatement Rates**

FY of Abatement	Number of Abatements Requested	Number of Abatements	Percent of Tax Periods Abated
2006	45	41	91.11
2007	39	30	76.92
2008	84	69	82.14
2009	1,375	1,091	79.35
2010	1,677	1,187	70.78

**TABLE 1.21.2, Intentional Disregard Penalty Abatement Rates**

FY of Abatement	Number of Abatements Requested	Number of Abatements	Percent of Tax Periods Abated
2006	52,586	40,115	76.28
2007	48,876	39,477	80.77
2008	17,328	14,699	84.83
2009	46,078	27,871	60.49
2010	51,868	31,568	60.86

***The IRS Should Expand Its First-Time Abatement Policy to Include Late Filing and Intentional Disregard Penalties.***

The IRS has a policy of abating certain penalties for first-time offenders regardless of whether reasonable cause exists. This so-called “First-Time Abatement” policy is set forth in IRM 20.1.3.5.1, which states that this option will be available only for Failure to Deposit (FTD), Failure to File (FTF), and Failure to Pay (FTP) penalties, not for the Failure to Timely File Information Returns Penalty and the Intentional Disregard Penalty. The IRM provides that in cases where an FTD, FTF, or FTP penalty has been assessed, the First-Time Abatement relief option can be applied if a taxpayer has not been required to file a return previously or has not been assessed penalties in the past three years (with the exception of estimated tax penalties).<sup>27</sup> First-Time Abatement relief is a policy decision that the IRS has made, and is not governed by statute. As such, there is nothing in the law preventing the IRS from revising the IRM to extend this administrative relief to the Failure to Timely File Information Returns and the Intentional Disregard penalties.<sup>28</sup> Abating these penalties in certain situations would promote voluntary compliance.

**IRS Systems Limitations Result in Penalties Being Assessed Unnecessarily.**

The IRS may be able to reduce unnecessary penalty assessments by modifying its systems to ensure that taxpayers timely receive notices about employment tax issues. Because the BMF can record only one address per entity, IRS correspondence may be misrouted, particularly

<sup>27</sup> IRM 20.1.1.3.6.1 (Dec. 11, 2009).

<sup>28</sup> The IRS Office of Chief Counsel, in a recent memorandum, approved the revised guidance. This memorandum points out that no statute or regulation addresses the First Time Abatement penalty relief option. In other words, the IRS’s application of this relief is entirely a policy decision. See IRS Chief Counsel, Chief Counsel Memorandum on First-Time Abatement Penalty Relief Option, POSTN-143178-09 (Dec. 7, 2009).

for large entities that have different divisions with separate addresses. Each division may have responsibility for paying just one type of tax, but every time a division submits a tax filing (*e.g.*, income tax, payroll, or information reporting), the last known address for that entity changes to the individual division's address on the BMF.<sup>29</sup> This makes it very difficult for businesses to know what address the IRS is using at any given time. Further, correspondence regarding employment taxes may be sent to a division that manages other tax filings, such as the corporate income tax division. This means the employment tax division may not find out about the notice until there is very little time left to respond, or even until after the deadline. By then, the IRS may have already assessed penalties, requiring the firm to attempt to convince the IRS to abate the penalty, which as noted above, has become increasingly difficult.<sup>30</sup> Businesses that cannot obtain abatements may be subject to liens or levies.

The Information Reporting Program Advisory Committee (IRPAC) raised this issue and recommended that the IRS immediately update its guidance on last known addresses related to business addresses.<sup>31</sup> Specifically, IRPAC recommended that Revenue Procedure 2010-16 be updated to separate last known address processes between businesses and individuals, and that the IRS accelerate development of a system that allows multiple addresses and contacts. However, the IRS's 2010-2011 Guidance Priority Plan did not include these recommendations.

## CONCLUSION

The IRS has made some positive changes in the CAWR program, but it needs further analysis and improvement. The National Taxpayer Advocate is concerned that the IRS's delayed responses to taxpayer correspondence causes taxpayer confusion and frustration. These delays may result from inadequate staffing levels. Timely communication with taxpayers is an essential component of an effective program. Additionally, the National Taxpayer Advocate is concerned about the impact on businesses of the recent change in the IRS's guidance regarding abatement of penalties, particularly when IRS processes may contribute to late responses. For example, the IRS's inability to record different mailing addresses for corporate entities can result in late responses, unnecessary penalties, and possible collection action.

<sup>29</sup> IRM 3.13.36.27 (July 1, 2010). The IRS will send correspondence to the taxpayer's last known address, which is defined as the address on the most recently filed and properly processed return. Treas. Reg. § 301.6212-2(a).

<sup>30</sup> IRM 4.19.4.2.1.1 (Feb. 1, 2008); IRM 4.19.4.3.36(1) (Apr. 1, 2010); IRM 4.19.4.4(7) (Apr. 1, 2010); IRM 21.7.1.4.11 (Oct. 3, 2007); IRM 21.7.1.4.10 (Jan. 1, 2007). The IRS has a Large Corporate Technical Unit (LCTU) that serves the needs of large entities, and each corporation has a dedicated representative/technician. Prior to any assessment of penalties, the CAWR unit is supposed to communicate with the LCTU technician so he or she can contact the corporation and attempt to resolve the issue. However, this process only applies to cases with a Large Corporation indicator or tax and penalties of \$1 million or higher and relies heavily on communication between three different groups, increasing the risk of some taxpayers falling through the cracks. The process also attempts to address the problem after it happens, whereas modifying the BMF to record multiple addresses would prevent the problem from occurring (*i.e.*, the IRS will send notices to the correct corporate division).

<sup>31</sup> IRPAC Report, Burden Reduction Subgroup (June 11, 2010). Revenue Procedure 2010-16 provides an explanation of how IRS is informed of a change of address.

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

1. The IRS should evaluate CAWR staffing to determine if existing levels are adequate to handle its correspondence.
2. The IRS should expand the First-Time Abatement policy to include late filing and intentional disregard penalties.
3. The IRS should upgrade its systems to allow for multiple corporate addresses based on the type of tax.

### IRS COMMENTS

The IRS agrees that timely communication with taxpayers is an essential function of tax administration and assists with voluntary compliance. The IRS continually strives to perfect the CAWR program to address overage and the quality of service through improved inventory management controls, inventory selection, and the use of various automated tools.

The IRS acknowledges that overage correspondence remains problematic due to continual increases in workloads and correspondence levels as stated in the Office of the National Taxpayer Advocate's report. As part of the FY 2011 work planning process, the IRS evaluated CAWR staffing and workload levels and adjusted the CAWR workload to better align with our resources.

Resolving taxpayer correspondence timely remains a top priority. Throughout FY 2010, IRS took action to allocate additional resources to the CAWR operations to reduce aged inventories. These efforts resulted in a significant improvement going from 87 percent overage to 45 percent from May 2010 to September 2010.<sup>32</sup>

Improving CAWR program effectiveness remains a priority and the CAWR staff continues to collaborate with the Modernization & Information Technology Services (MITS) organization to secure programming changes to provide improved inventory management functionality and promote program efficiency. Recent enhancements include auto-generation of Interim Letters<sup>33</sup> on cases with correspondence aged 25 days or more from the IRS received date, auto-generation of IRS CAWR notices, and providing copies of CAWR notices to authorized third parties.

In addition, forthcoming improvements for fiscal year (FY) 2011 include:

- Systemic uploads of assessment data, letters, and case updates from CAWR to Masterfile/IDRS;
- New status codes to define and track case results;
- Storage and tracking of case data to improve case selection and reduce burden; and

<sup>32</sup> September 2010 COBR.

<sup>33</sup> Letter 2645C or Letter 2644C is generated informing taxpayers that the IRS needs additional time to review their correspondence and they can expect a response within 60 days.

- New reports to improve inventory management.

Combined, these changes will reduce resources expended on manual processes and enable campuses to manage CAWR staffing and inventory levels more effectively.

Furthermore, a completely redesigned CAWR Automated Program (CAP) that will offer capabilities similar to the current Automated Underreporter (AUR) system is scheduled for deployment in FY 2014 as part of the Information Reporting Document Matching (IRDM) effort. The new system is expected to provide world class automation and technology upgrades to support data driven CAWR case creation and selection, TIN-level case management, embedded interest calculation capabilities, and various other inventory tracking and report generation functionality.

In her report, the National Taxpayer Advocate cites declines in CAWR penalty abatements between FY 2008 and FY 2010. The IRS does not dispute the decline in penalty abatements. The National Taxpayer Advocate states the reason for the decline in penalty abatements is due to an IRS change in its approach to the abatement of penalties on CAWR cases citing language from an update made to IRM 4.19.4.6.1, *Late Replies Addressing SSA-CAWR Penalties*, in September 2008 which encourages caution when abating the penalty. This language was taken directly from IRM 20.1, *Penalty Handbook*, which has been in place since at least 1998.<sup>34</sup> The September 2008 update to IRM 4.19.4 was made to include CAWR penalty guidance previously contained in the Penalty Handbook. No changes to intent or wording was made as part of this update as the language used in the update matches instructions previously contained in the Penalty Handbook.<sup>35</sup> Therefore, the IRS does not believe this guidance shifts the focus from reasonable cause and willful neglect to a standard that urges caution. Instead, the IRS believes this decrease is reflective of the actions IRS took to address prior National Taxpayer Advocate concerns contained in the 2008 Annual Report to Congress regarding inconsistent administration of CAWR penalties.<sup>36</sup> In response to the 2008 report, the IRS clarified IRM penalty application and abatement procedures and delivered additional penalty related training to campus technicians. In addition, the IRS took actions to improve outreach and education services to taxpayers by posting CAWR related communiqués on the www.irs.gov website and partnering with the payer agent liaison to stress the importance of timely addressing issues raised on CAWR notices with the practitioner community.

The IRS believes it exercises reasonable care and diligence when issuing CAWR notices to businesses. The IRS sends notices to the taxpayer's last known address, provides a copy of the notice to authorized third parties, allows recipients 45 days to respond (compared to 30

<sup>34</sup> Refer to IRM 20.1.7.3.4.4(7)b and (8). The guidance shown has been in place since at least 1998.

<sup>35</sup> As the National Taxpayer Advocate states, the 2008 CAWR IRM 4.19.4.6.1(1) was updated. The update incorporated language directly from the Penalty Handbook. IRM 20.1.7.3.4.4(7)b and (8) language was removed on Nov. 16, 2007. IRM 20.1.7.3.4 (4) and (5) now refers technicians to CAWR IRM 4.19.4 for guidance.

<sup>36</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 319 (Most Serious Problem: *Inefficiencies in the Administration of the Combined Annual Wage Reporting (CAWR) Program Impose Substantial Burden on Employers and Waste IRS Resources, Improper Assessment of Penalties Leads to Subsequent Abatement*).

days for individuals), and does not take subsequent actions on CAWR cases until at least 81 days after the initial notice has been issued. The National Taxpayer Advocate indicates that the CAWR program contacts the Large Corporate Technical Unit (LCTU) on cases that contain a large corporation indicator or penalties of \$1 million and that some taxpayers still fall through the cracks.<sup>37</sup> Prior to assessment of penalties, CAWR technicians are instructed to contact the LCTU on any case with a Large Corporation indicator or tax and/or penalty assessment of \$1 million dollars or more.<sup>38</sup> This coordination ensures penalty assertion on Large Corporation cases is appropriate and case processing is accurate. In an effort to further improve the process, a Large Corporation Tracking sheet has been instituted for the CAWR Program as well as the LCTU.

The National Taxpayer Advocate makes three preliminary recommendations to improve the CAWR Program. The IRS is taking, or has taken, the following actions with respect to these recommendations:

The IRS has made great strides in reducing overage CAWR inventory over the last few months in FY 2010. Due to this steady decline in overage, coupled with the additional program enhancements already planned, the IRS does not believe further evaluation in CAWR staffing needs to be performed beyond what is regularly performed in our program areas as we make routine resource decisions.

The late filing and intentional disregard penalties discussed in the National Taxpayer Advocate's report pertain to information return documents and are assessed against the payer, not the wage earner. This protects the individual taxpayer by encouraging employers to timely provide the taxpayer necessary information to comply with the taxpayer's tax obligations. Due to the nature of these penalties, and after careful consideration and input from Chief Counsel, the Office of Servicewide Penalties, and the 1998 Penalty Task Group findings, the IRS does not believe it is appropriate to apply the First-Time Abatement Penalty relief option for these late filing and intentional disregard penalties. However, if a taxpayer can demonstrate reasonable cause, abatement of these penalties will be fully considered.

Through our current procedures, the IRS believes it exercises reasonable care and diligence when issuing CAWR notices to businesses. Issuing notices to multiple corporate addresses increases the risk of unauthorized disclosure, increases burden as multiple recipients will receive and spend time responding to the same notice, and campus correspondence and overage volumes would increase exponentially. For these reasons, the IRS does not agree it would be prudent to allow input into the Business Masterfile (BMF) for multiple corporate addresses.

<sup>37</sup> IRM 4.19.4.2.1(4) (Feb. 1, 2008); IRM 21.7.1.4.11 (Oct. 3, 2007); IRM 21.7.1.4.10 (Jan. 1, 2007).

<sup>38</sup> IRM 4.19.4.3.36(1) and 4.19.4.4(7).

## Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for evaluating staffing and workload to better align CAWR resources for FY 2011 and for initiating additional programming enhancements to improve inventory management over the next two years. Due to this steady decline in aged correspondence and the enhancements already planned, the IRS states that no further evaluation in CAWR staffing is needed. However, even after significant improvement, almost half of the aged CAWR correspondence still could not be resolved within the established timeframes as of September 2010. The National Taxpayer Advocate urges the IRS to address this issue quickly by increasing staffing or adjusting workload.

The IRS recognizes the decline in penalty abatements but does not believe the decrease was related to the revised guidance issued in 2008. Although the National Taxpayer Advocate acknowledges that the revised guidance may not have been a change in policy, the revisions to the IRM, procedural guidance, and training materials did shift the focus of penalty administration to increased assessment of the Failure to Timely File Information Returns penalty and the Intentional Disregard penalty.<sup>39</sup> Regardless of the cause, the National Taxpayer Advocate remains concerned by the significant decline in Failure to Timely File Information Returns penalty dollars abated (from 82 percent in FY 2008 to 71 percent in FY 2010), for which the IRS has offered no explanation other than the IRM change. Even with respect to the Intentional Disregard penalty, a first-time waiver can be a corrective, educational opportunity.

The IRS states the penalty assessments protect individual taxpayers by encouraging employers to timely provide the taxpayers with the information they need to comply with tax obligations. However, the IRS has no data to verify that assertion of the penalties improves compliance. In 2008 the National Taxpayer Advocate urged the IRS to regularly collect and analyze more detailed penalty data, and conduct an empirical study to quantify the effect of each penalty on voluntary compliance.<sup>40</sup> Despite the lack of research on how penalties impact voluntary compliance, the IRS refuses to apply the First-Time Abatement Penalty relief option for these late filing and intentional disregard penalties. Thus, the IRS is potentially imposing unnecessary financial burdens on businesses without even knowing if the policy is achieving the desired result.

The IRS appears to have misunderstood the National Taxpayer Advocate's recommendations to modify its systems to record more than one address per BMF entity and did not address problems that large entities face (*i.e.*, they have different divisions that constantly deal with IRS correspondence that has been mailed to the wrong address). Both IRPAC and the National Taxpayer Advocate recommend that the IRS modify its systems so that notices relating to a specific type of tax (*e.g.*, employment taxes) are sent to the corporate office

<sup>39</sup> IRM 4.19.4.6.1 (Sept. 28, 2008). This IRM was updated April 16, 2009, but this instruction was left unchanged.

<sup>40</sup> National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 2 (*A Framework for Reforming the Penalty Regime*).



that handles that tax. We are not suggesting that the IRS send multiple copies of notice to multiple corporate addresses. Under this approach, there should not be an increased risk of unauthorized disclosure and no increase in the number of notices issued by IRS campus correspondence units. To the contrary, the use of more accurate addresses should reduce penalty assessments, the need for abatements, and reopened cases.

## Recommendations

The National Taxpayer Advocate offers these recommendations:

1. The IRS should conduct research to determine whether assessment of the Failure to Timely File Information Returns penalty and the Intentional Disregard penalty increases compliance with filing requirements.
2. The IRS should conduct a pilot to determine whether expansion of the First-Time Abatement policy to late filing and intentional disregard penalties undermines compliance with filing requirements.
3. The IRS should upgrade its systems to allow for multiple corporate addresses based on the type of tax.