

NATIONAL TAXPAYER ADVOCATE

# 2012 ANNUAL REPORT TO CONGRESS

Executive Summary:  
Preface & Highlights



YOUR VOICE AT THE IRS



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*To my dear friend  
Christine Brunswick,  
Whose extraordinary service to the tax system  
As Executive Director  
of the  
American Bar Association Tax Section  
Over 25 years  
Is unparalleled.  
But most importantly,  
She has taught me how to live  
With grace in the face of adversity.*

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**Honorable Members of Congress:**

I respectfully submit for your consideration the National Taxpayer Advocate's 2012 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.

As this report goes to press, it appears an agreement has been reached to patch the Alternative Minimum Tax. For taxpayers and the IRS, that is extremely good news. The IRS systems that process tax returns cannot generally be programmed to accommodate alternative scenarios. As the IRS Commissioner has said, the IRS made a risk-based decision to program its systems on the assumption that an AMT patch would be passed, and if a patch was not enacted, the start of the filing season would have been delayed from January to late March or possibly later for the significant majority of taxpayers. That would have brought about the most chaotic filing season in memory. I am hopeful and relieved that that near-crisis seems to have been averted.

Since the election, the dominant issue before Congress has been the so-called "fiscal cliff." While that term seems to mean different things to different people, it encompasses three critical issues from a tax administration perspective — tax complexity, the Alternative Minimum Tax, and the risk that sequestration or alternative budget cuts will further weaken the IRS's ability to serve taxpayers and collect the revenue upon which the rest of government depends.

Consider the following:

- **Tax Complexity.** An analysis of IRS data by the Office of the Taxpayer Advocate shows it takes U.S. taxpayers (both individuals and businesses) more than 6.1 billion hours to complete filings required by a tax code that contains almost four million words and that, on average, has more than one new provision added to it daily. Indeed, few taxpayers complete their returns without assistance. Nearly 60 percent of taxpayers hire paid preparers and another 30 percent rely on commercial software to prepare their returns. To inspire confidence and trust, the tax laws should be comprehensible and the computations of tax should be transparent and relatively simple, yet few taxpayers today can confidently say they understand the tax code or even that they have correctly computed their tax liabilities.<sup>1</sup> In this report, we identify tax complexity as the #1 most serious problem facing taxpayers, and we recommend (as we have in prior reports) that Congress vastly simplify the tax code to make tax compliance easier. We offer both conceptual and specific suggestions for Congress to consider as it moves forward.
- **Alternative Minimum Tax.** Taxpayers spent about 18 million hours for the 2000 tax year (the most recent year for which we found data) completing and filling out AMT tax forms and determining whether they owed the tax. The AMT was originally enacted to ensure that the wealthiest U.S. taxpayers pay at least some tax each year by adding back into income certain tax benefits known as "tax preferences." Yet in 2008, 87 percent of all tax preferences that

<sup>1</sup> See Most Serious Problem: *The Complexity of the Tax Code*, *infra*.

gave rise to AMT liabilities was attributable to the disallowance of personal exemptions and the deduction for state and local taxes. Only under the unique logic of the AMT are the acts of having a large family and living in a high-tax state viewed as a tax dodge. As we document in this report, the AMT does not seem to achieve its intended purpose. Many middle and upper-middle class taxpayers pay the AMT, while most wealthy taxpayers do not, and thousands of millionaires pay no income tax at all. At the same time, the AMT adds significant complexity to tax computations, requiring millions of taxpayers essentially to compute their tax liabilities twice — once under the regular tax rules and again under the AMT rules — and then to pay the higher of the two tax amounts. Because the AMT largely fails to achieve its objective and because it adds considerable complexity for so many taxpayers, including millions who don't even end up owing it, we identify the AMT as the #2 most serious problem facing taxpayers, and we reiterate our longstanding recommendation that the AMT be repealed.

- **IRS Funding.** In fiscal year (FY) 2012, the IRS received around 125 million calls. The IRS answered only about two out of three calls from taxpayers trying to reach a live person, and those taxpayers had to wait, on average, about 17 minutes to get through. Meanwhile, at fiscal year end, the IRS had a backlog of more than one million pieces of correspondence (up 188 percent from FY 2004), and almost half of that backlog was overage (up 316 percent from FY 2004). Is it any wonder that some taxpayers give up and stop responding to the IRS?<sup>2</sup> At the same time that the IRS is not meeting taxpayer needs, it is struggling to close a “tax gap” estimated at nearly \$400 billion a year. In this report, we designate the significant and persistent underfunding of the IRS as the #3 most serious problem facing taxpayers.

To elaborate on this funding challenge, no business would fail to fund a unit that, on average, brought in \$7 for every dollar spent. Shareholders would rebel and bring lawsuits, or at least oust the management or board of directors.

Yet this is precisely what we are doing with the IRS budget. Last year, the IRS brought in federal revenue of about \$2.52 trillion on a budget of \$11.8 billion, for a return-on-investment (ROI) of 214:1. If we cut IRS funding, the IRS Commissioner recently estimated in a letter to Congress that we can expect lower tax collections in an amount seven times as much as the budget cuts. That means fewer dollars to put toward deficit reduction, fewer dollars for military funding, fewer dollars for our intelligence services and embassy protection, fewer dollars for an economic safety net, fewer dollars for disaster recovery, fewer dollars for infrastructure renewal, fewer dollars for medical research — in short, fewer dollars for all the things we believe as a nation we should provide for our citizens. It means real harm to real people.

Since FY 2010, the IRS budget has been declining each year, and absent congressional action, it is likely to be reduced more in the coming years, perhaps significantly so, by sequestration or other budget cuts that replace the sequestration mechanism. More than 90 percent of the IRS's taxpayer service and enforcement budget goes for personnel costs, so budget cuts mean that fewer employees

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<sup>2</sup> See Most Serious Problem: *The IRS is Significantly Underfunded to Serve Taxpayers and Collect Tax*, *infra*.

will be available to answer phone calls from taxpayers needing assistance.<sup>3</sup> Budget cuts mean that there will be long delays when taxpayers call or write to say there is a mistake on their IRS bill and they don't owe these taxes.<sup>4</sup> Budget cuts mean that victims of identity theft will have to wait longer than six months to get resolution of their cases and receive their refunds.<sup>5</sup> Budget cuts mean that because taxpayers couldn't get the assistance they needed when they needed it, they will do things incorrectly. Budget cuts mean that, because of these avoidable problems, taxpayers will face IRS enforcement actions — liens, levies, seizures, audits — that will be automated and initiated without so much as a phone call to the actual taxpayer.<sup>6</sup> And budget cuts mean that the IRS will not have the trained personnel or technology required to administer the laws properly to close the tax gap.

None of this bodes well for taxpayers. But the harm from budget brinksmanship and last-minute tax law changes goes beyond the immediate impacts I've outlined above. As we report in our Volume Two study, *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, the factors that are most highly correlated with noncompliance among sole proprietors — the single largest component of the tax gap — are distrust of government, distrust of the IRS, and disbelief in the fairness of our tax system. The fiscal cliff drama reinforces taxpayers' belief that government and the tax system are not helping them.

Under our system of government, it may be inevitable that important decisions about tax policy and federal budgeting are sometimes deferred until the last minute. But the extent of the resulting uncertainty about tax rates, people's take-home pay, the AMT, and the prospect of a delay in the delivery of tax refunds resulting from a delay in the start of the filing season produces disappointment, dismay, and cynicism among taxpayers. The IRS budget cuts likely to come about with sequestration (or replacement cuts), and the virtual freeze on hiring and training that has already occurred because of successive years of continuing resolutions and inadequate funding, erode what little taxpayer service remains in IRS operations and all but ensure that IRS technology will remain in the 20<sup>th</sup> century, hampering its ability to effectively collect tax and assist taxpayers who are trying to comply. Meanwhile, the complexity creep of the tax code and the menacing shadow of the AMT confirm taxpayers' suspicions that the tax laws are designed to entrap them and obscure what is and is not being taxed.

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<sup>3</sup> See Most Serious Problem: *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs*, *infra*.

<sup>4</sup> See Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively*, *infra*.

<sup>5</sup> See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*.

<sup>6</sup> See Introduction: *The IRS "Fresh Start" Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes*, *infra*; Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental To The Overall Effectiveness Of IRS Collection Operations*, *infra*; Most Serious Problem: *The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively*, *infra*; Most Serious Problem: *Although the IRS "Fresh Start" Initiative Has Reduced The Number Of Lien Notices Filed, the IRS Has Failed To Determine Whether Its Lien Policies Are Clearly Supported by Either Increased Taxpayer Compliance or Revenue*, *infra*; Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*, *infra*; Study: *Study of Tax Court Cases In Which the IRS Conceded the Taxpayer Was Entitled to the Earned Income Tax Credit (EITC)*, *infra*; and Study: *Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior*, *infra*.

The fiscal cliff also deflects attention from other priority issues in tax administration, including the 20 other most serious problems we identify in this report. At its most basic level, insufficient funding drives the IRS to reduce its meaningful interaction with taxpayers and replace it with automated enforcement mechanisms. This approach can erode fundamental taxpayer rights and protections. We see evidence of this erosion in the IRS's failure to provide adequate assistance to victims of identity theft or return preparer fraud;<sup>7</sup> its insistence on draconian penalties against taxpayers with overseas accounts, irrespective of their benign purpose;<sup>8</sup> its inadequate use of installment agreements and offers in compromise for taxpayers, particularly with respect to business taxpayers and taxpayers experiencing economic hardship;<sup>9</sup> and its abandonment of an education and compliance presence in local communities.<sup>10</sup> All of these are problems for which solutions exist and about which my office has made practical recommendations.

Yet throughout this report, the IRS responses to our analysis and recommendations often seem to miss the basic point or are otherwise unpersuasive. What underlies these responses is the understandable IRS concern that it does not have the resources to make the improvements that are so obviously needed, so it is better to rationalize the *status quo* or commit to only those improvements it can afford currently, rather than try to make the case for more funding or for reallocating current funding. The current budget crisis and recurring continuing resolutions exacerbate this IRS tendency.

This is no way to run a tax system. What the IRS — and its taxpayers — need is a stable funding mechanism for the IRS that allows it to educate its taxpayers about their tax obligations, provide assistance to taxpayers when they need it, work with taxpayers who are trying to comply but aren't in compliance for one reason or another (including economic hardship), enforce the tax laws against those who seek to evade reporting their taxable income or paying their tax liabilities, and generally seek to increase the amount of taxes paid voluntarily.

What the IRS — and its taxpayers — have now is an unstable funding mechanism that treats the IRS like any other government spending program instead of the revenue center or accounts receivable function that it is. The IRS must compete for funding with the rest of the government agencies that rely on IRS collections to accomplish their missions. The plain truth is that the IRS's mission trumps all other agencies' missions — because without an effective revenue collector you can't fund those other agencies. Certainly, Members of Congress may disagree about the appropriate level of taxation. But whatever level is written into law, there can be little disagreement

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<sup>7</sup> See Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*, *infra*; Most Serious Problem: *The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully*, *infra*.

<sup>8</sup> See Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*, *infra*.

<sup>9</sup> See Introduction: *The IRS "Fresh Start" Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes*, *infra*; Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental To The Overall Effectiveness Of IRS Collection Operations*, *infra*; Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*, *infra*.

<sup>10</sup> See Most Serious Problem: *The IRS Is Substantially Reducing Both the Amount and Scope of Its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of Its Remaining Outreach Activities, Thereby Risking Increased Noncompliance*, *infra*.

that taxpayers should receive the assistance they need to comply, and the laws should be enforced so that everyone pays their fair share of tax and we have a level playing field. Without an effective tax collector, honest taxpayers end up paying more to subsidize noncompliance by others, and we don't raise the funds our government requires. And that state of affairs is not sustainable.

In this and previous reports, we have proposed a solution to the problem of IRS funding.<sup>11</sup> It is really very simple in concept: fence off — or “sequester,” if you will — IRS funding from the rest of the federal budget. Determine what level of revenue the IRS needs to collect for the government to do what we want it to do, and then determine what the IRS needs to collect that revenue — in a way that maximizes (voluntary) compliance, protects taxpayer rights, and minimizes taxpayer burden. The return on investment in the IRS should be guaranteed to be greater than 1 to 1. And if we simultaneously set goals for the IRS in terms of taxpayer service, victim assistance, online services, and voluntary compliance while funding research, development, and innovation, we may well exceed our ROI expectations. We might actually end up with the 21<sup>st</sup> century tax administration we deserve rather than the heroically struggling, overwhelmed one that we have.

Looking forward, the year 2013 is shaping up to be an active one from the standpoint of tax policy. As Congress moves forward on these fronts, I urge you to keep in mind the impact of various legislative proposals on the taxpayer and on the IRS's ability to administer the proposals effectively and fairly. As the National Taxpayer Advocate, I hope 2013 brings about fundamental tax simplification, repeal of the Alternative Minimum Tax, and a new approach toward funding the IRS that ensures the agency can do a better job of meeting taxpayer needs and collecting the revenue that funds virtually all other government operations. I also hope the IRS makes progress in addressing the growing problem of tax-related identity theft and particularly improves its performance in providing timely and effective assistance to identity-theft victims and preparer fraud victims as well as taxpayers who are struggling to comply with their tax obligations.

I respectfully submit this report to Congress for your consideration and action, and I stand ready to assist you in any way that I can.

Sincerely,



Nina E. Olson  
National Taxpayer Advocate  
31 December 2012

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<sup>11</sup> See Most Serious Problem: *The IRS Is Significantly Underfunded to Serve Taxpayers and Collect Tax*, *infra*; see also National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

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## The Most Serious Problems Encountered by Taxpayers

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Internal Revenue Code (IRC) § 7803(c)(2)(b)(ii)(III) requires the National Taxpayer Advocate to prepare an Annual Report to Congress which contains a summary of at least 20 of the most serious problems encountered by taxpayers each year. For 2012, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS in resolving 23 such problems. This year's report also includes status updates on six issues previously raised by the National Taxpayer Advocate or addressed in previous Annual Reports.

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

The issues described in the report are as follows:

## THE MOST SIGNIFICANT ISSUES FACING TAXPAYERS AND THE IRS TODAY

### 1. The Complexity of the Tax Code

#### *Problem*

The most serious problem facing taxpayers — and the IRS — is the complexity of the Internal Revenue Code.

#### *Analysis*

A TAS analysis of IRS data shows that taxpayers and businesses spend 6.1 billion hours a year complying with tax-filing requirements. To place this number in context, it would require more than three million full-time employees to work 6.1 billion hours, making “tax compliance” one of the largest industries in the United States.

Tax law complexity imposes monetary costs on taxpayers as well. About 59 percent of individual taxpayers pay practitioners to prepare their returns, and another 30 percent use tax software to assist them, with leading software packages costing \$50 or more.

Perhaps most troubling, tax law complexity leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities.

In 2012, TAS commissioned a statistically representative national survey of over 3,300 taxpayers who operate businesses as sole proprietors. Only 16 percent said they believe the tax laws are fair. Only 12 percent said they believe taxpayers pay their fair share of taxes. The National Taxpayer Advocate finds this extraordinary lack of public trust in the method by which our government is funded profoundly disturbing.

To reduce taxpayer burden and enhance public confidence in the integrity of the tax system, the National Taxpayer Advocate urges Congress to vastly simplify the tax code. In general, this means paring back the number of income exclusions, exemptions, deductions, and credits (generally known as “tax expenditures”). For fiscal year (FY) 2013, the Joint Committee on Taxation has projected that tax expenditures will total about \$1.09 trillion, while individual income tax revenue is projected to be about \$1.36 trillion. For perspective, this suggests that if Congress were to eliminate all tax expenditures, it could cut individual income tax rates by about 44 percent and still generate about the same amount of revenue. (If all tax expenditures were eliminated simultaneously, certain mechanical and interactive effects could cause the revenue shift to be somewhat more or less than 44 percent.)

The perennial challenge in enacting fundamental tax reform is that while most taxpayers support a simpler tax code in concept, many of us are reluctant to give up our existing tax breaks, often believing that tax rates could be cut if “loopholes” were eliminated. The term



“loophole,” however, is typically used to describe tax expenditures that benefit others, while terms like “incentives” or “sound government policy” are used to describe tax expenditures that benefit ourselves. In practice, the largest tax expenditures by dollar benefit the masses and enjoy broad popular support — the exclusion of employer contributions for medical insurance premiums and medical care; the exclusion for retirement plan contributions and earnings; the mortgage interest deduction; the reduced rates of tax on long-term capital gains and qualified dividends; and the deduction for state and local taxes.

When proposals to reduce tax expenditures are made, affected groups and industries often mobilize quickly to try to generate public opposition. To build broad support for tax reform, it is therefore essential to engage the public in a substantive dialogue about the required tradeoffs between tax rates and tax breaks. An uninformed taxpayer who hears he may lose a tax break will instinctively want to keep it to prevent his tax bill from rising. An informed taxpayer who understands that tax rates will be substantially lowered in exchange for losing tax breaks often will have a very different reaction.

The argument regarding tradeoffs is easier to make if tax reform proceeds on a revenue-neutral basis, as it did in 1986. In the current budget environment, we understand that Congress may decide to raise revenue in the course of reforming the tax code. However, if the choice is between raising a given amount of revenue through increasing tax rates or eliminating tax expenditures, the same structural tradeoffs apply. Once Congress sets its revenue targets, it can hit those targets by setting relatively high tax rates that continue to be offset by a bewildering array of exclusions, exemptions, deductions, and credits, or it can hit its targets by enacting relatively low tax rates and minimizing the number of tax breaks it permits. (Our office takes no position regarding the broader economic effects of raising or lowering marginal tax rates.)

### *Recommendations*

The National Taxpayer Advocate recommends that Members of Congress take several steps, including the following: (1) consider holding meetings with constituents to discuss the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that tax reform will require; (2) employ a “zero-based budgeting” approach to comprehensive tax reform that starts out with the assumption that all tax benefits will be eliminated and adds tax benefits back only if Members conclude that the public policy benefits of running the provision or program through the tax code outweigh the complexity burden; and (3) direct the IRS to provide each taxpayer with a “Taxpayer Receipt” in conjunction with the filing of a tax return that shows how the taxpayer’s tax payments will be spent.

## 2. The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process

### *Problem*

The individual Alternative Minimum Tax (AMT) was originally enacted to ensure wealthy persons paid at least some tax. Because the AMT is not indexed for inflation, limited to high income taxpayers, or focused on tax loopholes, however, it increasingly penalizes middle income taxpayers for having children, getting married, or paying state and local taxes while allowing thousands of millionaires to pay no tax at all. The AMT is complicated and burdensome, even for those who are not subject to it. Many taxpayers must fill out the lengthy AMT form only to find they owe little or no AMT after all.

### *Analysis*

The AMT requires taxpayers to compute their taxes twice — once under the regular tax rules and again under the AMT rules. If the “tentative” AMT liability exceeds the regular tax liability, the taxpayer pays the difference as AMT. Thus, the AMT reduces the transparency of the tax system, making it more difficult for nearly everyone one to predict what they will owe. Congress regularly passes so-called AMT “patches” to temporarily protect middle-class taxpayers and popular tax benefits, typically at the last minute or on a retroactive basis. Last-minute patches sometimes delay urgently-needed tax refunds. But, if Congress does not enact a patch for 2012, as expected, the IRS will not be able to process more than half of all returns timely, and many filers will face unexpected estimated tax shortfalls and underpayment penalties.

The AMT is difficult to repeal because it is projected to raise a large amount of revenue. However, AMT patches have always prevented the AMT from raising these projected amounts. In other words, we have a law that grants popular tax benefits (the regular tax code), another law (the AMT) that eliminates the benefits, and then another law that undoes the elimination of benefits (the patches), usually at the last minute — a legislative Rube Goldberg contraption of unnecessary complexity. In addition, the AMT reduces the transparency of the tax reform debate. For example, any revenue estimate for the proposal must be compared to the illusory revenue supposedly generated by expiration of the AMT patch under current law. Thus, the AMT corrodes the both the tax system and the democratic process.

### *Recommendation*

Permanently repeal the AMT.

### 3. The IRS Is Significantly Underfunded to Serve Taxpayers and Collect Tax

#### *Problem*

The significant and chronic underfunding of the IRS poses one of the most significant long-term risks to tax administration today. Because of funding shortages, the IRS is unable to answer millions of taxpayer telephone calls or timely process letters; the tax gap (*i.e.*, the amount of tax due but uncollected) stands at nearly \$400 billion each year; taxpayers believe the tax laws are not being fairly enforced against others; and the federal deficit is unnecessarily large. Some taxpayer problems identified in this report result from poor planning or execution, and it is important that the IRS not use lack of funding as a justification for failing to address those problems. However, the lack of sufficient funding is the sole or significant cause of many taxpayer problems.

#### *Analysis*

The IRS serves as the *de facto* Accounts Receivable Department of the federal government. On a budget of \$11.8 billion, the IRS collected \$2.52 trillion in fiscal year (FY) 2012. That translates to an average return-on-investment (ROI) of 214:1. Yet the appropriations process treats the IRS like any other discretionary spending program, with no explicit recognition that each dollar appropriated for the IRS generates substantially more than one dollar in additional revenue. The IRS's budget was reduced slightly from FY 2010 to FY 2011, it was cut by an additional 2.5 percent from FY 2011 to FY 2012, and it may be facing additional cuts (or small increases that fail to cover its rising costs) for the foreseeable future. It is ironic and counterproductive that concerns about the deficit are leading to cuts in the IRS budget, when those cuts are making the deficit larger.

To improve tax compliance, the IRS requires more funding to strengthen front-end taxpayer services, including outreach and education, as well as its back-end enforcement activities. On a few occasions, Congress has channeled additional funding to the IRS outside the otherwise applicable spending caps by using a mechanism known as a "program integrity cap adjustment." To date, however, funds provided under this cap-adjustment mechanism have been used solely for enforcement activities, skewing the delicate balance that should exist between taxpayer services and enforcement.

#### *Recommendations*

The National Taxpayer Advocate recommends that Congress (1) consider revising the budget rules so that the IRS is "fenced off" from otherwise applicable spending ceilings and is funded at a level designed to maximize tax compliance, particularly voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden; and (2) keep in mind in allocating IRS resources that tax compliance requires an appropriate balance between high quality taxpayer service and effective tax-law enforcement, and funding should be provided in a manner that allows the IRS to maintain such a balance.

## VICTIMS OF IDENTITY THEFT AND OTHER VULNERABLE TAXPAYERS

### 4. The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft

#### *Problem*

Over the last few years, the number of tax-related identity theft incidents has been growing rapidly. Within TAS, identity theft case receipts have increased 650 percent from fiscal year (FY) 2008 to FY 2012. Organized criminal gangs have found ways to steal the Social Security numbers (SSNs) of other taxpayers, file tax returns using those taxpayers' names and SSNs, and obtain tax refunds. Then, when the real taxpayer files a return claiming the refund, that return is rejected and the victim cannot get his or her refund. To compound the problem, because the IRS takes more than six months, on average, to resolve stolen identity cases, many victims are left exposed to identity theft-related problems the following filing season. The IRS reports that it is making progress in blocking fraudulent claims and assisting victims, but as the problem grows, the IRS is falling further and further behind.

#### *Analysis*

The IRS had nearly 650,000 active identity theft cases in its inventory at the end of FY 2012, and it now takes the IRS six months or more to resolve stolen-identity cases and provide refunds or other relief to the victims. The National Taxpayer Advocate finds this unacceptable. To try to improve its effectiveness, the IRS recently decided to create specialized units *within each of 21 individual departments* (or functions) to work on identity theft cases. While acknowledging that a specialized approach can have benefits, TAS knows from its own casework that identity theft cases often involve multiple issues that will require action by multiple units. (TAS worked 55,000 identity theft cases in FY 2012 — fully 25 percent of its total case inventory.) Taxpayers need “one-stop shopping” — a single point of contact they can contact to follow up on all issues in their cases — and the IRS needs a “traffic cop” to make sure that all units complete their actions and that parts of cases do not fall through the cracks. In addition, the National Taxpayer Advocate believes the IRS must develop more effective tools to reduce the time victims spend waiting for their accounts to be resolved. For the 2013 filing season, the IRS will again issue identity protection personal identification numbers (IP PINs) to provide a greater level of security for victims. The National Taxpayer Advocate believes IP PINs should be available to all victims whose identities and addresses have been verified.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS make identity theft victims eligible for IP PINs as soon as it verifies their identities and addresses; retain the existing Identity Protection Specialized Unit (IPSU) as the single point of contact with victims throughout the duration of their cases; move the IPSU out of the Accounts Management function; expand the IPSU's role to include initial and final global account reviews; implement agreements between the IPSU and various other IRS functions to set acceptable

timeframes for completing cases; improve service on the dedicated toll-free line for victims; insert into every IRS agreement with state and local agencies an explicit clause that says that return information of an identity thief may not be redisclosed to third parties; seek modification of the consent judgment requiring the release of personal identifying information of decedents; and include TAS at all levels of identity theft program and procedural planning.

## 5. The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully

### *Problem*

Unscrupulous tax return preparers sometimes change their clients' returns without the clients' knowledge or consent to obtain inflated refunds and divert the extra money into their own bank accounts. Return preparer misconduct ties up IRS resources, drains the public fisc, and harms taxpayers. When a return preparer diverts a taxpayer's refund using an altered bank routing number and obtains the funds using direct deposit, the taxpayer is harmed, yet the IRS will not issue a refund to the taxpayer. Instead, the IRS's position has been that the taxpayer's sole recourse is to seek relief from the return preparer or bank.

### *Analysis*

According to a TAS analysis of preparer fraud cases, the average adjusted gross income (AGI) of the victims was less than \$32,000, and the refund sought by these taxpayers constituted, on average, 28 percent of their AGI. The IRS's delay in acting on these cases and issuing guidance is inexcusable and is inflicting significant harm on taxpayers who are victimized in the course of trying to comply with the income tax laws. Since 2000, the IRS has received the benefit of four separate legal opinions from its Office of Chief Counsel addressing return preparer misconduct (one of which explicitly states that the IRS is able to issue a replacement direct deposit refund to a preparer fraud victim), yet the IRS has declined to develop guidance to its employees on how to issue a replacement refund to victims. Where a taxpayer requests a paper check and is victimized by preparer fraud, the IRS will issue a replacement refund, but where a taxpayer requests a direct deposit refund and is victimized by preparer fraud, the IRS generally will not issue a replacement refund. At a time when the IRS is encouraging taxpayers to file electronically and request their refunds by direct deposit, its refusal to issue replacement refunds to preparer-fraud victims who requested direct deposit payment while agreeing to issue replacement refunds to victims who requested paper checks is illogical and counterproductive. The IRS policy also discourages taxpayers from seeking assistance from return preparers, because if a taxpayer chooses poorly and the preparer absconds with the tax refund, the IRS position is essentially, "you're on your own."

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS develop comprehensive guidance providing full relief to victims of return preparer misconduct, including issuance of their refunds; and conduct direct outreach for taxpayers that particularly targets the most vulnerable segments of the taxpayer population.

**6. Despite Some Improvements, the IRS Continues to Harm Taxpayers by Unreasonably Delaying the Processing of Valid Refund Claims that Happen to Trigger Systemic Filters**

*Problem*

To combat refund fraud, the IRS has expanded its use of automated screens to filter out questionable refund claims. In recent years, the IRS has seen large spikes in the Questionable Refund Program (QRP) inventory, which requires manual review. However, the IRS has not provided the Accounts Management Taxpayer Assurance Program (AMTAP) the resources it needs to complete the reviews on a timely basis. The result is that increasing numbers of legitimate taxpayers are waiting excessive amounts of time for their refunds. The number of legitimate tax returns ensnared in IRS anti-fraud filters has increased by 75 percent over the last three years, from 58,013 in 2010 to 101,678 in 2012.

*Analysis*

In fiscal year 2012, AMTAP selected over 1.4 million information documents to verify reported wages, withholding, and credits. Over the past three years, the number of information documents selected for verification rose by 238 percent while AMTAP staffing grew by just 42 percent, resulting in mounting inventory and excessive delays. As a result, the IRS has routinely applied hard freezes on refund claims when AMTAP cannot complete the wage verification within the allotted 70 days. In other words, AMTAP is using a hard freeze — normally used for accounts in which potentially fraudulent activity has been “verified” — as an inventory management tool. In a 2012 TAS study of a representative sample of pre-refund cases, taxpayers who came to TAS with pre-refund problems ultimately received full relief 71 percent of the time. Fifty-three percent of these taxpayers claimed the Earned Income Tax Credit, with a median refund of \$5,175. These refunds comprised 38 percent of their adjusted gross income.

*Recommendations*

The National Taxpayer Advocate recommends that the IRS provide the AMTAP unit sufficient staff and systems resources to work its inventory timely; adhere to the policy of releasing refunds after 70 days if the IRS cannot determine that the return requires greater scrutiny (and if additional time is needed, program systems to extend the “soft freeze” for 30-day intervals); direct taxpayer calls to employees with access to the most current information about their accounts; institute programming that will allow immediate processing of tax returns re-submitted by legitimate taxpayers caught by the OMM filters; track the number of tax returns “verified bad” by electronic filters; and develop a system of recording cases transferred to Exam.

## 7. The IRS's Compliance Strategy for the Expanded Adoption Credit Has Resulted in Excessive Delays to Taxpayers, Has Increased Costs for the IRS, and Does Not Bode Well for Future Credit Administration

### *Problem*

The adoption tax credit was created in 1996 to encourage adoption and help offset the potentially onerous costs associated with it. The Patient Protection and Affordable Care Act increased the maximum credit amount and made the credit fully refundable for 2010 and 2011. The changes to the credit caused the IRS to alter its compliance strategy to focus almost exclusively on minimizing improper payments and stopping potentially fraudulent claims. During the 2012 filing season, 90 percent of returns claiming the refundable adoption credit were subject to additional review to determine if an examination was necessary. Despite Congress' express intent to target the credit to low and middle income families, the IRS created income-based rules that were responsible for over one-third of all additional reviews in fiscal year 2012. Sixty-nine percent of all adoption credit claims during the 2012 filing season were selected for audit. The median refund amount involved in these audits is over \$15,000 and the median adjusted gross income (AGI) of the taxpayers involved is about 64,000 for tax year (TY) 2011. The average adoption credit correspondence audit currently takes 126 days, causing a lengthy delay for taxpayers waiting for refunds. Of the \$668.1 million in adoption credit claims in TY 2011 as a result of adoption credit audits, the IRS only disallowed \$11 million — or one and one-half percent — in adoption credit claims. However, the IRS has also had to pay out \$2.1 million in interest in TY 2011 to taxpayers whose refunds were held past the 45 days allowed by law.

### *Analysis*

Over 30 percent of all adopted children and nearly half the children adopted from foster care live in households with incomes no higher than twice the poverty threshold. Yet the IRS still chose to create an income-based filter that flags the returns of the exact taxpayers the credit was designed to assist. The large amounts at stake — up to \$13,360 in 2011 — and potential for fraud have resulted in excessive delays and an inefficient use of IRS resources. During the 2012 filing season, 90 percent of returns claiming the *refundable* adoption credit tripped IRS filters that select returns for examination and almost 70 percent of *all* adoption credit claims during the 2012 filing season were selected for audit. Of the completed adoption tax credit audits, over 55 percent ended with no change in the tax owed or refund due in FY 2012. Of the adoption tax credit cases TAS closed in TYs 2010 and 2011, 83 percent of the taxpayers received full relief. The IRS's failure to engage in proactive outreach continued the cycle of problems that plagued taxpayers and the IRS.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS ensure that any examination filters take into account the congressionally-intended demographics of the affected taxpayer population and are continually monitored and updated if data demonstrate that they are



catching more taxpayers than appropriate; provide examples of acceptable adoption credit documentation for taxpayers; allow e-filing of adoption tax credit returns that include substantiation in an electronic format; consider the factors for design of refundable credits laid out by the National Taxpayer Advocate when moving forward with administration of the Premium Tax Credit; and study the administration of the adoption credit to identify lessons learned that can be applied to the administration of other refundable credits, including the Premium Tax Credit.

## PROTECTION OF TAXPAYER RIGHTS IN COMPLIANCE INITIATIVES

### 8. The IRS Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those who Inadvertently Failed to Report Foreign Accounts

#### *Problem*

The Bank Secrecy Act (BSA) requires U.S. citizens and residents to report foreign accounts on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts* (FBAR) so the government can better detect “bad actors” engaged in tax evasion, terrorism, and money laundering. Beginning in 2009, the IRS initiated a series of offshore voluntary disclosure (OVD) programs to settle with taxpayers who had failed to report offshore income and file any related information return such as the FBAR. These programs applied a resource-intensive, burdensome, punitive, one-size-fits-all approach designed for “bad actors” to “benign actors” who inadvertently violated the rules.

Benign actors were required to “opt out” to get a fair result — at the risk of facing draconian penalties. Afraid to opt out, some paid more than they should — extortion in their view. Others declined to address the problem. While an estimated five to seven million U.S. citizens reside abroad, and many more U.S. residents have FBAR filing requirements, the IRS received only 741,249 FBAR filings in 2011, and as of September 29, 2012, it had received fewer than 28,000 OVD submissions. Thus, OVD programs have both infringed taxpayer rights and failed to address significant FBAR compliance problems.

#### *Analysis*

The IRS discouraged taxpayers from voluntarily correcting FBAR violations outside of the OVD programs. Those who opted out could be subject to an examination and FBAR penalties of up to 300 percent of the unreported account balance. The IRS also provided inconsistent guidance about how Canadians with certain retirement plans could participate. In addition, the IRS will soon require duplicative reporting on both an FBAR and Form 8938, *Statement of Specified Foreign Financial Assets*.

The IRS recently identified a few situations in which a taxpayer could opt out without penalty. In addition, on September 1, 2012, it established a Streamlined Nonresident Filing Initiative that allows certain nonresidents to correct errors outside of the OVD programs. However, as the IRS identifies more FBAR noncompliance, it will face the choice of whether to devote more enforcement resources to address it, expand its outreach and self-correction options, or ignore the noncompliance altogether.

#### *Recommendations*

The IRS should expand the self-correction options available to all benign actors (including U.S. residents); send “soft” notices to educate persons with foreign accounts about the reporting requirements; consolidate and simplify conflicting guidance; and revise Forms 8938 and TD F 90–22.1 to reduce duplicative reporting.

## 9. The IRS's Handling of ITIN Applications Imposes an Onerous Burden on ITIN Applicants, Discourages Compliance, and Negatively Affects the IRS's Ability to Detect and Deter Fraud

### *Problem*

Any individual who has a tax return filing obligation but is not eligible to obtain a Social Security number (SSN) must apply to the IRS for an Individual Taxpayer Identification Number (ITIN). For years, the National Taxpayer Advocate has raised concerns about ITIN policies and procedures, including the recurring bottlenecks of ITIN applications during the peak tax season and the associated strain on IRS resources inhibiting the ability to timely detect and deter fraud. The IRS has taken a rather reactive approach to the problems with its ITIN program. On June 22, 2012, in response to a Treasury Inspector for Tax Administration (TIGTA) report, it abruptly began requiring applicants to submit only original documents or documents certified by the issuing agency, and it suspended the certifying acceptance agent (CAA) program. This policy change created an unprecedented burden to ITIN taxpayers without addressing tax compliance concerns.

### *Analysis*

An ITIN does not authorize an alien to work in the United States, grant an immigration status, or qualify for the Earned Income Tax Credit (EITC) and Social Security benefits. While tax return filing is the most common use for ITINs, certain taxpayers must furnish ITINs for other legitimate tax administration purposes, such as to open a bank account, for information reporting, or for withholding on the income of foreign investors. Of 21 million ITINs assigned from the inception of the program in 1996 through August of processing year (PY) 2012, about 19.8 million (or about 94.4 percent) showed up on tax returns or information returns. In PY 2011, an average ITIN filer claimed a refund of \$2,126 (including refundable credits) compared to an average refund of \$2,913 for the general U.S. taxpayer population. The IRS ITIN procedures impose needless burden on distinct groups of ITIN applicants and may irreversibly harm filing compliance.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS permit CAAs, federal and state government agencies, and U.S. financial institutions to certify identity documents for dependent ITIN applicants, similar to current rules for CAA certification of documents for primary and secondary taxpayers; accept copies of documents certified by an Apostille in conformance with the U.S. obligations under the Hague Convention; improve oversight of the CAA program, including periodic trainings to CAAs and an annual competency examination; allow filing of ITIN applications throughout the taxable year with a proof of earned income and a filing need; and modernize the ITIN operation, including an update of the RTS software to include the document number and country of issuance of a foreign document, a process for scanning and barcoding submitted documentation, and electronic verification of documents with federal, state, and foreign government databases.

## 10. The Preservation of Fundamental Taxpayer Rights Is Critical as the IRS Develops a Real-Time Tax System

### *Problem*

In the 2009 and 2011 Annual Reports to Congress, the National Taxpayer Advocate wrote about the benefits of accelerated third-party information reporting to both taxpayers and tax administration. In late 2011 and early 2012, the IRS held two public meetings to solicit suggestions and concerns from external stakeholder regarding a potential real-time tax system (RTTS). As the IRS continues to evaluate the idea of an RTTS, the National Taxpayer Advocate has concerns regarding the type of compliance contact the IRS would make to the taxpayer upon identifying a mismatch in information. We caution against the expansion of math error authority to cover mismatched third-party data. In addition, we believe that the IRS should provide taxpayers with electronic access to the third-party data to assist taxpayers in return preparation and develop a pre-populated return option for taxpayers.

### *Analysis*

There is consensus among the National Taxpayer Advocate, the IRS, and external stakeholders that a real-time tax system with upfront matching would benefit both taxpayers and the IRS. However, many have expressed concern about exactly how the IRS would implement such a program. The National Taxpayer Advocate shares the concerns raised during the public meetings that the expansion of math error authority to any planned initiative could increase the burden on taxpayers, especially low income taxpayers. It is imperative that the IRS have confidence in the high degree of accuracy of the third-party data. In addition, sufficient staffing to handle the anticipated increase in taxpayer contacts is imperative. Any planned action by the IRS will occur during filing season when resources are already stretched. Finally, we believe the IRS could reduce information mismatches by providing taxpayers and their representatives electronic access to third-party data to help prepare returns with an additional option to file a pre-populated return.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS work with the National Taxpayer Advocate to develop a real-time tax system; develop accelerated information reporting procedures that afford taxpayers the same rights that accrue during a traditional examination; allocate sufficient staffing to handle increased taxpayer contacts during the filing season; provide taxpayers and their representatives access to a real-time transcript of third-party information to assist in return preparation; provide taxpayers the ability to download third-party data directly from the IRS into their return preparation software; develop a pre-populated return option for taxpayers; and track corrected information reports, by count, dollar amount, and percentage of total reports by type as well as the rate of abatements for Automatic Underreporter (AUR) assessments.

## 11. Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations

### *Problem*

Over the past 18 months, the IRS notified more than 440,000 organizations that their tax-exempt status had been automatically revoked because they failed to file returns for three consecutive years. More than 18,000 organizations have applied for reinstatement of exempt status, yet the increased workload is being handled by fewer IRS employees. It now takes nine months for the IRS to assign a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, to a reviewer, and the application process is unnecessarily burdensome. Moreover, the IRS erroneously treated thousands of organizations as having had their exempt status revoked, and has no administrative review system that might avert or lessen the impact of these errors.

### *Analysis*

The volume of unresolved cases involving determinations of exempt organizations' status more than doubled from June 2011 to June 2012. The IRS's Tax Exempt and Government Entities division also expects that almost 40 percent of calls to its toll-free phone line will go unanswered, and taxpayers who do get through will have to wait about 20 minutes. The IRS erroneously lists some organizations as no longer exempt. Some donors rely exclusively on IRS records in making contribution decisions, and it may take two months to correct the records after an erroneous revocation. TAS case receipts with these issues increased more than fourfold from fiscal year (FY) 2010 to FY 2012.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS create an "EZ" version of the complicated Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, or, in the alternative, implement the recommendations of the Advisory Committee on Tax Exempt and Government Entities to revise the existing form, make it interactive, and provide education support for filers; augment its automatic revocation databases with a smaller electronic file or "addendum" that can be updated more than once a month; provide for administrative review of an organization's claim that it was, or is about to be, erroneously treated as no longer tax exempt, and seek additional staffing to handle applications for exempt status or reinstatement and for phone assistance.

## TAXPAYER SERVICE IN THE TWENTY-FIRST CENTURY

### **Introduction to Taxpayer Service Problems: The IRS Must Confront Challenges to Delivering High Quality Taxpayer Service in the Twenty-First Century**

#### *Problem*

The IRS has entered the twenty-first century after evolving from an organization of local collection districts into a centralized nationwide processing operation. Information technology has facilitated mass production under tight budgetary constraints, but at a cost of individualized service. This section of the Annual Report surveys taxpayer service through eight Most Serious Problems (MSPs), four of which concern means of communication or service to taxpayers, including telephone, correspondence, electronic technology, face-to-face and video-conferencing. Another four MSPs address the needs of and problems facing various sectors of the taxpayer population, including tax professionals as well as low income, small business, and international taxpayers. Thus, a matrix of technological channels and taxpayer preferences confronts the IRS, which must use limited resources to deliver personal service where necessary. Channels that appear expensive at first may turn out to be the most effective for certain taxpayer groups or issues in the long term.

#### *Analysis*

Merely identifying taxpayer needs and preferences may not mean that the IRS meets them. While resource constraints may be the primary concern, cost-effective innovations could yield improvements in service. For example, at least for the Internet-savvy, a potential solution would be more self-service web tools such as the popular “Where’s My Refund?” application. For low income taxpayers, some needs could be met by a return-free or pre-populated filing system and a free e-filing portal. For international taxpayers, a lack of service could be mitigated by guidance on murky tax law questions. A thoughtful combination of social and technological services could help these taxpayers help themselves.

#### *Most Serious Problems*

The following Most Serious Problems relate to taxpayer service:

- The IRS Telephone and Correspondence Services Have Deteriorated over the Last Decade and Must Improve to Meet Taxpayer Needs
- The IRS Has Failed to Make Free Return Preparation and Free Electronic Filing Available to All Individual Taxpayers
- The IRS Is Striving to Meet Taxpayers’ Increasing Demand for Online Services, Yet More Needs to Be Done
- Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs
- IRS Processing Flaws and Service Delays Continue to Undermine Fundamental Taxpayer Rights to Representation

- The IRS Lacks a Servicewide Strategy that Identifies Effective and Efficient Means of Delivering Face-to-Face Taxpayer Services
- The IRS Is Substantially Reducing both the Amount and Scope of its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of its Remaining Outreach Activities, Thereby Risking Increased Noncompliance
- A Proactive Approach to Developing a Government-Issued Debit Card to Receive Tax Refunds Will Benefit Unbanked Taxpayers

## 12. The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs

### *Problem*

The IRS mission statement — “[p]rovide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all” — reflects the obligation of the agency to provide the means for all taxpayers to meet their tax obligations. When the IRS cannot adequately answer taxpayers’ telephone calls or correspondence, and sets declining expectations for performance, it cannot execute its mission.

### *Analysis*

As the IRS faces budget cuts and places an increased emphasis on enforcement, key performance measures of taxpayer service have declined, including:

- The IRS received over 100 million calls in fiscal year (FY) 2012 and more than 30 percent went unanswered.
- The IRS received about 10.5 million pieces of correspondence, and at the end of the last week of FY 2012, nearly 48 percent was “overage.”
- In FY 2012, the IRS answered almost 68 percent of taxpayer calls and in FY 2013 set a goal of answering only 63 percent, a seven percent decrease.
- Wait time to speak to an IRS representative was nearly 17 minutes in FY 2012, compared with under three minutes in FY 2004, an increase of over 500 percent.
- In FY 2012, the IRS received calls to some lines from over 75,000,000 unique telephone numbers with an average of two calls per phone number.

Phones and correspondence represent taxpayers’ main methods of communication with the IRS. As call volumes continue to rise, answering the phones to provide timely and comprehensive service to taxpayers must remain a priority. To serve taxpayers effectively, conducting rigorous research and analysis to understand what services are best provided through each channel, and using this information to guide the overall service strategy, is crucial. Applying the results of research and analysis to strategic service decisions will help the IRS allocate resources appropriately to meet taxpayer needs.

### *Recommendations*

The IRS should conduct studies (such as the TAS Dependent Taxpayer Identification Number Math Error study) to identify opportunities for using IRS internal data to resolve discrepancies and issues, thereby eliminating unnecessary correspondence and minimizing taxpayer burden and delays; use data the IRS has collected and analyzed to make taxpayer service decisions and resource allocations through an overall service strategy; and commit to using the jointly-developed ranking tool in all decisions about taxpayer service policy, including the taxpayer value measures proposed by TAS; to completing the research



necessary to fully populate the tool's data fields, and to extending the methodology to enable scoring of changes to the way covered services are delivered including increases or decreases in the level of service or available service hours for a service activity.

# Most Serious Problems

### **13. The IRS Has Failed to Make Free Return Preparation and Free Electronic Filing Available to All Individual Taxpayers**

#### *Problem*

The IRS has not developed a comprehensive plan to give *all* individual taxpayers the option to prepare and e-file their returns for free, despite the existing array of return filing options currently available to “eligible” taxpayers. Taxpayer Assistance Centers (TACs) increasingly turn away taxpayers seeking return preparation assistance, directing them to Volunteer Income Tax Assistance (VITA) and Taxpayer Compliance for the Elderly (TCE) sites and online products offered by the Free File Alliance. The IRS relies on VITA for return preparation but continues to give taxpayers inaccurate or incomplete information about site locations. The IRS also provides tax software to volunteer preparers embedded with a costly a commercial debit card product.

#### *Analysis*

The lack of clarity about which return preparation service are offered, where, and when, makes it difficult for many taxpayers to find the free services they need to fulfill their filing obligations. Most eligible taxpayers do not have year-round access to free return preparation assistance at TAC sites, and most VITA and TCE site close at the end of the filing season. In 2012, TAS’s own evaluation revealed that telephone assisters failed to provide information about site accessibility in nearly 90 percent of the calls to the VITA help line, and failed to provide language availability at VITA sites nearly 60 percent of the time. The IRS needs to standardize and control the content of commercial tax products for consistency, to avoid potential conflicts of interest.

#### *Recommendations*

Develop a government-provided electronic version of the Form 1040 with computational capability that allows taxpayers to e-file all 1040 series forms and schedules, with links to forms, instructions, related worksheets, and publications; develop a portal to a government-controlled database from which taxpayers can import third party data; adopt a policy that allows taxpayers to make appointments and accepts walk-in taxpayers for return preparation; accelerate the deployment of facilitated self-assistance terminals to TACs, and encourage more VITA and TCE sites to use them; continually reassess the procedures for maintaining VITA site information, and implement measures to improve accuracy.

#### **14. The IRS Is Striving to Meet Taxpayers' Increasing Demand for Online Services, Yet More Needs To Be Done**

##### *Problem*

Taxpayers increasingly use online services to perform financial transactions (and other tasks) in their daily lives. The IRS is striving to meet this demand by developing more online products. We applaud the IRS and its Office of Online Services (OLS) for developing popular self-assist tools and using a research-based strategy. However, we believe the IRS still has a long way to go, albeit with limited resources, to provide the type of services taxpayers demand and are accustomed to receiving from other sources, such as online account access. While such projects would involve upfront development and implementation costs, the IRS would realize savings in the short term from decreased call volume and in the long term from improved tax compliance and a reduction in costly enforcement contacts for basic issues.

##### *Analysis*

The Office of Online Services is responsible for developing technology for taxpayers, practitioners, and IRS employees across a variety of channels. We applaud OLS for taking a balanced approach to the development of electronic services to meet the needs of both the taxpayers and the IRS business units. However, the IRS's Taxpayer Assistance Blueprint team envisioned an IRS that is an "interactive and fully integrated, online tax administration agency" with the capability "for any exchange or transaction that currently occurs face-to-face, over the phone, or in writing to be completed electronically." Accordingly, we believe the IRS should follow the lead of other countries and develop an online account management system to enable taxpayers to view the status of their accounts as well as interact with the IRS electronically to resolve any compliance issues.

##### *Recommendations*

To reduce taxpayer burden and improve online services, the National Taxpayer Advocate recommends that the IRS develop an online account program to allow taxpayers to view the status of their accounts as well as interact with the IRS by responding to notices, scanning documents, etc.; and review online services offered by foreign and state tax administrations as well as private industry.

## 15. Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs

### *Problem*

In recent years, the IRS has devoted substantial resources to improving international tax administration and responding to the challenges of globalization. However, the IRS continues to focus on stepped-up enforcement without adequate coordination and with no corresponding increase in service to millions of individual international taxpayers. While international taxpayers grapple with compliance challenges and inadequate service, the IRS has been slow in taking specific steps to meet their needs and ease their compliance burdens, saving scarce enforcement resources to address egregious noncompliance. Problems include delays in developing specific recommendations to improve international taxpayer service; the lack of a strategic plan to address persistent compliance challenges; the absence of a timeline to implement recommendations from a 2012 IRS research study; the insufficient use of technology as a more efficient method of delivering services and providing information (including virtual face-to-face (VFTE) assistance and online services); and the lack of simplified filing and self-correction options for international taxpayers.

### *Analysis*

The 2012 IRS research study of international taxpayers shows that this group remains underserved, desires self-service options, and may experience a higher rate of post-filing problems than the general taxpayer population. Among those who file, many do not have an adjusted gross income (AGI) high enough to generate a tax liability. Thus, more than 80 percent of U.S. taxpayers abroad claiming the foreign earned income exclusion (FEIE) and foreign tax credit did not have any U.S. tax liability. Others are afraid to file, being uncertain about filing requirements or intimidated by the complexity of U.S. tax laws. Confusion and frustration about U.S. tax requirements, the risk of heavy penalties, and the corresponding compliance burden may cause some taxpayers to expatriate — *i.e.*, give up their U.S. citizenship. Expatriations increased more than six fold between calendar years 2008 and 2011.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS make its International Individual Taxpayer Assistance team permanent, with a formal charter and a responsibility to provide periodic written reports to executives; develop a structured plan for implementing the research study recommendations and inform the public about the timeline; reinstate mailing of forms and publications to international taxpayers and U.S. embassies and consulates; allow electronic filing of 1040NR (non-resident) series forms and tax identification number applications for nonresident alien taxpayers; develop a method of simplifying and combining tax and information reporting online; establish a voluntary compliance program for international individuals, including simplified filing options and relief from all penalties for taxpayers with no tax liability; and increase the threshold for the Streamlined Nonresident Filing Initiative from \$1,500 of tax due to \$5,000.

## 16. IRS Processing Flaws and Service Delays Continue to Undermine Fundamental Taxpayer Rights to Representation

### *Problem*

Taxpayers generally have a right to representation before the IRS and use Form 2848, *Power of Attorney and Declaration of Representative*, to appoint certified public accountants (CPAs), attorneys, enrolled agents (EAs), or other authorized persons to act on their behalf. The IRS receives the forms by mail, fax, or electronic submission and processes them in various departments or the Centralized Authorization File (CAF) units. However, if the CAF units do not timely process Forms 2848, systems and employees that generate notices to taxpayers cannot send these notices to the right representatives or addresses. IRS employees also may assume the taxpayer is unrepresented and contact him or her directly, or disclose information to an unauthorized representative, both of which violate taxpayers' fundamental rights to representation and privacy. When the IRS fails to process Form 2848 properly, it effectively shuts the door to the right to representation set forth in the Code. .

### *Analysis*

Form 2848 filings increased by 89 percent between fiscal years (FY) 2004 and 2012, but the number of employees dedicated to processing per 100,000 forms decreased by 34 percent. The IRS may have become more efficient in processing Forms 2848 since 2010, yet the IRS increased its Form 2848 processing time up to 233 percent, from three days to ten calendar days (or less) — increasing the risk that taxpayers will not receive the benefit of representation at critical times. The IRS fails to recognize student representatives or provide Low Income Taxpayer Clinics (LITCs) a systemic process to substitute student representatives. Further, the IRS has shut down its CAF unit help lines, moved their staff to processing, and directed practitioners to the Practitioner Priority Service line for Form 2848 issues, even though assistants on this line could answer only 73 percent of their calls in FY 2012. Moreover, the Taxpayer Inspector General for Tax Administration (TIGTA) estimated revenue officers violated the rights of 4,845 taxpayers by contacting them directly, and bypassing their representatives. TIGTA also estimated the IRS may not have properly notified 43,817 representatives of their clients' right to appeal lien filings in FY 2012.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS establish a comprehensive system to record, track, and automatically update the CAF system; timely acknowledge receipt of POAs; encourage practitioners to electronically file Forms 2848; retrain some employees to implement e-Service controls; revise e-Services to allow LITC directors to substitute student representatives; educate IRS employees on the role of student representatives; reinstate the CAF unit help lines; gather and track taxpayer and representative complaints on direct contact violations; provide mandatory annual training for all contact employees on how to avoid bypass violations; and collaborate with TAS to address improper systemic bypasses of taxpayers' representatives, provide remedies for violations, and correct problems that deny taxpayers' fundamental right to representation.

## 17. The IRS Lacks a Servicewide Strategy that Identifies Effective and Efficient Means of Delivering Face-To-Face Taxpayer Services

### *Problem*

Taxpayer Assistance Centers (TACs) provide the main means by which taxpayers interact in person with IRS employees. While technological advances begin to allow taxpayers to interact in a virtual face-to-face platform with the IRS, the IRS knows that a segment of taxpayers will always need to receive IRS services in a face-to-face environment. In addition, access to these advances or an unwillingness to try these service delivery methods ensure that the IRS must maintain in person services through TACs. The taxpayers who are least likely to use these types of services, and to have any Internet access overall, constitute extremely vulnerable groups that most need face-to-face services.

### *Analysis*

The IRS provides face-to-face taxpayer services in 397 TACs or local “walk-in” offices across the country. In the past, by visiting a TAC, taxpayers could pick up forms and publications, seek guidance about tax laws, request transcripts or other account information, seek assistance with IRS notices, make tax payments, and have their returns prepared. TAC Services have declined significantly since 2004.

Although technology may fill some of the gaps, taxpayers who visit the IRS in person are experiencing increased difficulties, including long travel times, insufficient staffing, and a lack of services. By failing to pursue research into the impact of its policy shifts, the IRS continues to make these changes in a vacuum without fully understanding their effect and burden on taxpayers, including re-work for both the taxpayer and the IRS.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS continue to study taxpayer needs and preferences; work with TAS to update the surveys done in coordination with the 2006 Taxpayer Assistance Blueprint by addressing service delivery options through traditional channels and emerging technologies; commit to fully populating and using the jointly developed ranking tool in all taxpayer service policy decisions; partner with TAS to study and rigorously analyze the downstream consequences of taxpayer service policy changes; and reinstate the policy of allowing taxpayers to make appointments at TACs for tax return preparation during filing season and throughout the year.

**18. The IRS Is Substantially Reducing Both the Amount and Scope of its Direct Education and Outreach to Taxpayers and Does Not Measure the Effectiveness of its Remaining Outreach Activities, Thereby Risking Increased Noncompliance**

*Problem*

The IRS's commitment to its outreach and education programs, Stakeholder Partnerships, Education and Communication (SPEC) and Stakeholder Liaison, has eroded since the agency's congressionally-mandated reorganization in 1998. Neither program was ever fully staffed, and neither one has the geographic presence originally envisioned. SPEC devotes most of its resources to return preparation and provides outreach that is not directly related to return filing only if another IRS division agrees to provide the funding. Stakeholder Liaison now has only about 150 field employees, and has no stakeholder liaisons in 12 states. Less than a third of its outreach is targeted directly to small businesses.

*Analysis*

SPEC devotes only about six percent of its outreach and education budget to activities that involve direct, face-to-face, contact with taxpayers. Residents of almost half of the states do not have the opportunity to hear or see a SPEC employee at an EITC outreach event in their state. Stakeholder Liaison delivers its education and outreach through partners, and plans to reduce the number of its in-person meetings with tax practitioners. Neither SPEC nor Stakeholder Liaison has been able to measure whether emphasizing leveraging and return preparation are effective in preventing noncompliance.

*Recommendation*

The National Taxpayer Advocate recommends that SB/SE and W&I collaborate with TAS and Compliance employees (*e.g.*, Revenue Officers and Revenue Agents) to design research initiatives to measure the effect of education and outreach methods on specific taxpayer populations or with respect to specific issues. The IRS should suspend its policies of limiting its outreach and education, and should deploy its reduced education and outreach staff to geographic locations based on the findings from such research.

## 19. A Proactive Approach To Developing a Government Issued Debit Card to Receive Tax Refunds Will Benefit Unbanked Taxpayers

### *Problem*

At least 17 million U.S. adults are unbanked, lacking any type of bank account, while 51 million others are underbanked. The unbanked have no free option to receive their tax refunds electronically. The Treasury Department attempted to address this problem in the 2011 filing season when it launched a debit card pilot program to issue refunds via prepaid cards to more than 800,000 unbanked or underbanked taxpayers. After analyzing preliminary results, Treasury ended the program due to low participation rates. However, the National Taxpayer Advocate believes it is in the best interest of taxpayers and tax administration to make a government-sponsored tax refund debit card available nationwide. The IRS should evaluate the methodology of the pilot, with particular focus on the findings and conclusions in a report by the Urban Institute, to develop a more effective strategy. In addition, the National Taxpayer Advocate raised concerns about the incorporation of the Western Union MoneyWise prepaid card into the TaxWise preparation software used at most volunteer tax preparation sites. In response, the IRS has committed to block the product in the software during the 2013 filing season and prohibit any future incorporation in the 2014 contract with CCH.

### *Analysis*

Unbanked taxpayers have no free option to electronically receive returns of their tax overpayments or other congressionally-authorized benefit transfers. For example, nearly 56 percent of the unbanked population and 18 percent of the underbanked population (amounting to over 19 million individual taxpayers) have a household income of less than \$15,000, and receive an average refund of almost \$1,250. A government-sponsored debit card program would benefit both taxpayers and tax administration in many ways. The National Taxpayer Advocate believes the IRS and Treasury should learn from the important findings of the pilot, as well as the Urban Institute analysis, to design a future nationwide program to provide unbanked and underbanked taxpayers a free electronic means to receive their refunds. This means evaluating the feasibility of incorporating the card application into the tax filing process and using post offices to accept applications and distribute the cards.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS work with the Office of the Taxpayer Advocate and the Department of Treasury to design a more effective debit card program; provide the National Taxpayer Advocate with the agreement with CCH concerning the TaxWise product used in the VITA program and any forthcoming Requests for Proposals pertaining to VITA software procurement, prior to public announcement; explicitly state any debit card requirements in forthcoming Requests for Proposal and separately negotiate terms for debit card services; and undertake an aggressive public awareness campaign to educate taxpayers about the reduced return processing time as well as its impact on refund turnaround times for government-sponsored refund options.



## TAXPAYER SERVICE WITHIN COLLECTION

**Introduction to Collection Issues: The IRS “Fresh Start” Initiative Has Produced Significant Improvements in Some Collection Policies; However, Significantly More Emphasis on Service Delivery Is Necessary to Realize the Full Benefits of These Important Changes**

### *Problem*

In fiscal years (FY) 2011 and 2012, the IRS implemented a series of significant operational policy changes collectively known as the “Fresh Start” initiative. Primarily focused on collection, the “Fresh Start” initiative has produced some of the most significant changes to the IRS Collection program in well over a decade. With the focus on liens and flexible payment options, the National Taxpayer Advocate acknowledges the efforts of the IRS to address collection issues that are highly significant to taxpayers struggling to resolve delinquent tax debts. However, the National Taxpayer Advocate continues to urge the IRS to base lien-filing decisions on a thorough analysis of the facts and circumstances of each case, and not simply rely on an arbitrary dollar figure representing unpaid liabilities. Further, relatively few taxpayers have yet to actually experience the benefits of the “Fresh Start” changes related to flexible payment options, such as installment agreements and offers in compromise.

### *Analysis*

The “Fresh Start” initiative has been a “good start”; however, the IRS needs to place much more emphasis on service-delivery to make the “fresh start” a reality for taxpayers. For example, the IRS has filed fewer liens, but the lack of sound judgment in lien-filing decisions remains a problem. Despite positive changes in IRS policies and procedures, the Offer in Compromise program remains an underutilized payment option for taxpayers who owe back taxes. Although, the “Fresh Start” increased IRS flexibilities in granting installment agreements, the IRS actually granted fewer of them in FY 2012. In particular, small business taxpayers have received little relief through the “Fresh Start” initiative, despite the negative impact of a troubled global economy.

The IRS needs to build a service-oriented Collection climate onto the foundation established by the “Fresh Start” initiative. The IRS needs to expand the scope of the initiative, while removing procedural and cultural barriers that limit taxpayer access to these collection tools. Further, the IRS needs to better promote the “Fresh Start” initiative in its internal Collection training and external communication strategies, as well as allocate adequate resources to its functions to ensure the benefits of the initiative are real and sustainable. It is very important to note that the “Fresh Start” initiative did not “fix” Collection. Rather, it produced a number of meaningful policy changes that can serve as a foundation for further improvements. In this section of the Annual Report, the National Taxpayer Advocate sincerely urges the IRS to build on this foundation by creating an environment that actually embraces service delivery as a critically important component of effective tax collection.

## 20. The Diminishing Role of the Revenue Officer Has Been Detrimental to the Overall Effectiveness of IRS Collection Operations

### *Problem*

An imbalanced focus within the IRS Collection operation on automation, centralization, and enforcement has undermined the service and compliance-oriented components of the field-based Revenue Officer job. The IRS does little to identify segments of the taxpayer population that would benefit from timely, face-to-face contacts with skilled collectors, specifically trained to address their problems in a service-oriented manner. Particularly with tax debts involving small business taxpayers, the Revenue Officer's skill set should be recognized as critical to case resolutions that are in the best interests of the taxpayers and the United States.

### *Analysis*

The IRS has reduced the role of field contacts in resolving most types of collection cases, and adopted a model for Revenue Officers that emphasizes highly technical enforcement actions in cases considered "complex." However, the IRS's simple definition of "case complexity" ignores the characteristics and needs of different types of taxpayers. Small businesses with tax problems represent a particular group of taxpayers with similar needs, which are best met by a local IRS presence. While the Automated Collection System (ACS) has not been successful in servicing this segment of the taxpayer population, the IRS continues to migrate employment tax cases to ACS. Despite the impact of a troubled economy, most Revenue Officers are not authorized to use important collection tools, such as offers in compromise, and lien withdrawals to resolve "complex" cases. Further, the IRS's use of the Collection Queue masks the ineffectiveness of Collection's inventory delivery system, and distorts the perceived delivery of taxpayer service in many Collection cases. In addition, traditional IRS measures are not adequate to assess the benefits of the Collection Field operation, particularly in revenue protection and compliance.

### *Recommendations*

To maximize the benefits of Collection resources in taxpayer service, compliance *and* return on investment, the National Taxpayer Advocate recommends that the IRS directly assign to the field function the cases most likely to be fully resolved in the field environment, with particular emphasis on in-business taxpayers with employment tax delinquencies; reevaluate and redesign the Collection Queue concept; empower all Revenue Officers to work offers in compromise and approve lien withdrawals; and develop and implement Collection measures that accurately represent the outcomes the IRS is trying to achieve.

## 21. The Automated Collection System Must Emphasize Taxpayer Service Initiatives to Resolve Collection Workload More Effectively

### *Problem*

The Automated Collection System (ACS) is a computerized inventory system and group of telephone call centers. It routinely issues levies and files Notices of Federal Tax Lien to generate taxpayer contact, rather than initiating personal contact with taxpayers before taking enforcement action. In fact, ACS spends just two percent of its time on outgoing calls. ACS's success at collecting outstanding tax liabilities is limited. In fiscal year (FY) 2012, ACS collected only seven percent of its \$42.7 billion inventory and closed only 41 percent of its inventory. (This includes full pay accounts, installment agreements accounts, and accounts that have been placed in Currently Not Collectable status.) Further, the ACS transfers more taxpayer accounts to other IRS functions than it resolves. In FY 2012, the ratio of delinquent tax dollars transferred to the Queue, a holding place for cases the IRS is not working, to the amount actually collected by ACS was 4 1/2 to one. That is, ACS collected \$2.8 billion but transferred 1.17 million cases valued at \$12.9 billion to the Queue.

### *Analysis*

ACS's customer service strategy is flawed in several ways. For example, ACS focuses on sending levy notices as a technique for getting taxpayers to call, despite several IRS studies that demonstrate that an outbound call or a letter is more effective and less economically damaging to taxpayers. The ACS cannot fully implement the IRS's "Fresh Start" initiative, which provided taxpayers with more flexible methods of meeting their tax obligations and a more moderate collection enforcement policy, because IRS procedures still focus on obtaining full payment. Taxpayers who call ACS also may have trouble reaching an employee. The waiting time averages 8.3 minutes, one of every five calls goes unanswered, and those who get through eventually may have to speak with several different employees and provide the same information several times. Further, ACS may not be prioritizing its case inventory in a way that will yield the best results. Despite these problems, ACS reported a 90 percent customer satisfaction score for FY 2012, but the survey used fails to ask taxpayers if they are satisfied with their case resolution.

### *Recommendations*

The National Taxpayer Advocate recommends that the ACS place more outgoing calls prior to taking enforcement action; once it has established contact, assign each ACS case to one employee who will work with the taxpayer throughout the process; together with TAS Research, revise its customer satisfaction questions to elicit the taxpayer's perception of how reasonably and fairly ACS handled the case; develop a way to identify and review potentially defaulting installment agreements and contact taxpayers prior to default; and revise the Collection Strategy to send to ACS only cases that the unit can readily resolve and place more emphasis on "initial contact" resolutions in making that determination.

## 22. Although the IRS “Fresh Start” Initiative Has Reduced The Number of Liens Filed, the IRS Has Failed To Determine Whether its Lien-Filing Policies Are Clearly Supported by Increases in Revenue and Taxpayer Compliance

### *Problem*

In 2011, the IRS announced a new effort to help financially struggling taxpayers get a “fresh start,” which included several positive changes in how it files and withdraws NFTLs. While the initiative has had a significant impact on the number of NFTL filings and withdrawals, the IRS still has not evaluated the effectiveness of its lien policies in terms of collected revenue or impact on future compliance. The IRS continues to file most Notices of Federal Tax Liens (NFTLs) based on an arbitrary dollar threshold of the unpaid liability, rather than on a thorough analysis of the taxpayer’s individual circumstances and financial situation. While NFTLs establish the priority of the government’s interest in a taxpayer’s property, they are generating significant downstream costs for the government, often without attaching to any tangible or intangible assets. These policies continue to unnecessarily harm the financial viability of taxpayers, especially those experiencing hardship.

### *Analysis*

Over the past decade, the IRS has filed an increasing number of NFTLs, incurring significant downstream costs, despite its inability to measure NFTL effectiveness in terms of collected revenue or impact on future compliance. The number of NFTLs peaked at 1.1 million in FY 2010. As a result of the IRS “Fresh Start” initiative, the IRS has filed significantly fewer NFTLs in FY 2012, *i.e.*, approximately 708,000 NFTLs, representing a reduction of about 32 percent from the FY 2011 volume. However, the IRS continues to file most NFTLs based on a dollar threshold of liability, without human review of the facts and circumstances of each particular case. For example, the IRS practice of filing a NFTL in a CNC-Hardship situation may actually exacerbate the taxpayer’s economic hardship and harm future compliance.

The results of a 2012 TAS study show that NFTL filings during the study period (calendar years (CYs) 2002-2004) had a negative effect on the payment behavior and liabilities of affected taxpayers. Taxpayers with NFTLs filed against them generally paid less and ended up owing more than non-lien taxpayers:

- Taxpayers with NFTLs paid an average of \$25,845, or about 69 percent of their original liabilities. Non-lien taxpayers paid \$38,477, equivalent to about 111 percent of their original liabilities.
- At the end of the study period (CY 2010), taxpayers with NFTLs owed 21 percent more on average than they owed when the lien was filed (they incurred their original liabilities in 2002). Non-lien taxpayers owed 11 percent more than they owed on their original liabilities.

These findings indicate that the IRS needs to develop new, meaningful lien filing criteria based on quantifiable evidence that filing a NFTL in certain situations clearly results

in increased revenue collections and improved voluntary compliance with the affected taxpayers.

### *Recommendations*

The National Taxpayer Advocate, once again, recommends that the IRS revise its lien-filing criteria in a manner that thoroughly considers the facts and circumstances of each case, rather than relying on an arbitrary dollar figure of unpaid liabilities as the threshold for filing NFTLs. The IRS needs to collaborate with TAS in conducting meaningful, ongoing studies of the utility of NFTLs in the collection process, including a comprehensive study on the added value of filing NFTLs in CNC situations, and the impact of NFTLs on future compliance. The IRS should also include TAS in its review of the accurate use of DPCs, and revise the use of DPCs accordingly. In the interim, the National Taxpayer Advocate recommends that the IRS immediately increase the NFTL filing threshold to \$50,000, both for ACS and ROs, as recommended by the IRS Collection Process Study; revise the current practice of filing NFTLs on CNC-hardship taxpayers with no assets; and require managerial approval for NFTL filing in cases involving CNC (Unable to Pay-Hardship) taxpayers and cases in which no personal contact has been made with the taxpayers. It is also recommended that the IRS expand NFTL withdrawal authority to all ROs and ACS employees who are authorized to file NFTLs.

### **23. Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance**

#### *Problem*

Most payroll service providers (PSPs) are trustworthy and play an important role helping taxpayers comply with their payroll tax responsibilities. Although rare, PSP failures can result in grave financial harm to multiple clients that may be required to pay the amount of their payroll taxes twice, once to the PSPs and again to the IRS with interest and penalties. Some small businesses may not be able to recover from these setbacks and may be forced to cease operations and lay off their employees. The IRS made significant progress in addressing the related issues identified in previous Annual Reports to Congress. Still, serious problems persist, including the absence of early detection and timely intervention in PSP delinquencies, ambiguous policies and procedures that limit the use of Effective Tax Administration (ETA) offers in compromise (OICs) as a viable collection alternative for victims of PSP failures, and ineffective communications and outreach about the risks of outsourcing payroll tax obligations.

#### *Analysis*

According to one study, in 2012 about 85 percent of small businesses sampled paid an external tax practitioner or accountant to handle their tax responsibilities, while about 41 percent hired a PSP to prepare and pay their payroll taxes. Employment tax noncompliance by a PSP may result in a large number of delinquent client accounts. However, the IRS is unable to identify employers affected by a noncompliant PSP because PSPs are filing returns under the client employer identification numbers. Without tracking a PSP-client relationship, the IRS cannot accurately detect PSP failures affecting multiple employers and timely intervene to assist victims and protect tax revenue. In addition, while an IRS study recommended considering ETA OICs as a viable collection alternatives for taxpayers who have been harmed by PSP failures, the IRS has generally underutilized this collection alternative. The number of accepted ETA OICs ranged between 21 and 45 during each of the past five years, with only 28 offers accepted during the last full fiscal year (FY) 2012.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS develop the business case for programming that can systemically link the PTIN of a PSP with EINs of its clients, track the number of employers associated with the PSP, and implement a pilot program to estimate the number of affected employers and impact to the public fisc; develop programming that can systemically select a PSP for a Revenue Officer examination when the number of delinquent employment tax returns of clients of a PSP exceeds an established threshold; develop a competency exam for preparers of employment tax returns with a vigorous ethics component. Establish ascertainable timeframes for beginning the use of dual address change letters alerting employers that a PSP has initiated a change of address, including email or text message notifications to taxpayers who so consent in a special field on

employment tax returns; in consultation with TAS, revise the IRM and training materials to promote the use of ETA OICs as a viable collection alternative for victims of failed PSPs, including compromising the amount of tax in appropriate instances; and as a part of a comprehensive outreach strategy, use modern technology, such as text messaging and email alerts to educate employers about the risks inherent to outsourcing payroll.

## Status Updates

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### 1. **Underfunding of IRS Initiatives to Modernize its Taxpayer Address Systems Undermines Taxpayers' Statutory Rights and Impedes Efficient Resource Allocation**

#### *Problem*

The National Taxpayer Advocate reported in the 2010 Annual Report to Congress that over 19 million pieces of mail each year, or about ten percent of all correspondence the IRS sends to taxpayers, are returned as “undeliverable as addressed.” The problem is even worse for taxpayers with international addresses, because nearly two out of every three mailings do not conform to the receiving country’s address standards. Nevertheless, many important taxpayer rights have time limits that begin to run when the IRS *sends* a notice or letter to the taxpayer, regardless of whether the taxpayer actually *receives* it. Also, taxpayers may not receive timely refunds or make timely payments if correspondence to them is returned as undeliverable, which leaves them liable for interest and penalties that could have been avoided. Undelivered mail is also expensive for the IRS — wasted printing and postage alone cost the IRS \$57.9 million in 2009.

#### *Analysis*

The IRS has begun to address the problem of undelivered mail by funding an initiative to affix full service intelligent mail bar codes on outgoing mail in fiscal year 2013. However, other phases of the modernization initiative remain unfunded. For example, the IRS needs to adjust its systems so they can receive data from the U.S. Postal Service and use it to improve taxpayer service. The IRS also needs an enterprise-level organization to oversee the modernization and maintenance of its mail systems.

#### *Recommendations*

The National Taxpayer Advocate recommends that the IRS fully fund its mail modernization efforts, adjust its databases to accommodate international addresses, and identify an enterprise-level organization to oversee modernization and maintain IRS mail systems.



## 2. Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses

### *Problem*

Domestic partners and same-sex spouses face unique federal tax challenges, while the legal landscape rapidly evolves. The IRS has addressed some pertinent questions the National Taxpayer Advocate raised in her 2010 Annual Report to Congress, but in the meantime, several new issues have emerged. Some questions stem from IRS treatment of community property, such as subjecting a proprietor's same-sex partner who does not work in the business to self-employment tax. Additionally, the IRS has rejected e-filed returns that reflect withholding in excess of that on Form W-2 (Wage & Tax Statement), but has confirmed that domestic partners allocate withholding credit to the partner taxed under community property.

### *Analysis*

Currently, the Defense of Marriage Act (DOMA) prohibits federal recognition of same-sex marriage. At the same time, the IRS has yet to answer questions from corporate taxpayers that have contracts covering same-sex couples as well as from individuals. Nevertheless, the IRS has posted some questions & answers (Q&As) on the IRS.gov website. While the informal guidance solves some problems that have surfaced since the 2010 report, it raises even more questions about others.

### *Recommendation*

While some may perceive any guidance as partisan, taxpayers need clarity, which they may prefer over uncertainty even if the result is unfavorable. External resolution of DOMA would not relieve the need for guidance, as a Supreme Court ruling may not answer various federal tax questions. Therefore, the National Taxpayer Advocate again recommends that the IRS publish clarifying guidance, rules, and regulations when taxpayers need answers.

### 3. The IRS's Reliance on Automated "Enforcement Assessments" Has Declined Significantly, But Concerns Remain

#### *Problem*

The IRS's wholesale use of automated "enforcement assessments" such as the Automated Substitute for Return (ASFR) program leads to artificially-inflated assessments and low collection percentages, which results in wasted IRS resources. In fiscal year (FY) 2012, the IRS's use of ASFR assessments has decreased dramatically from prior years. The number of assessments fell by 50 percent from FY 2011, while dollars assessed declined 54 percent. In this Status Update, we will explore possible reasons for the decrease.

#### *Analysis*

Clearly, the IRS made significant adjustments to the ASFR program in FY 2012. Some of the adjustments were resource-driven — that is, the IRS opened fewer ASFR cases so the available staff could handle the workload in a timely manner. Additionally, the IRS has initiated a new practice that limits the number of ASFR returns assessed at one time on the same taxpayer. Finally, the IRS no longer initiates an ASFR assessment if the taxpayer already has a balance due for another tax year. However, the IRS has not yet made the changes recommended in the 2011 Annual Report, which the National Taxpayer Advocate believes are still necessary.

#### *Recommendations*

The IRS should reinstate the policy of not making automated enforcement assessments without confirming the taxpayer's address of record is valid; revise ASFR processing procedures to emphasize the completion of telephonic, personal contacts with the affected taxpayers in all potentially "unagreed" ASFR cases prior to assessment; allocate adequate resources to the ASFR reconsideration process to ensure adjustments are initiated and completed in a timely manner; and apply a pre-assessment collectibility determination to all potential ASFR assessments.

#### 4. **The IRS Should Expand Virtual Face-To-Face Service to Meet Taxpayer Needs and Improve Compliance**

##### *Problem*

Virtual face-to-face (VFTF) service delivery enables taxpayers to interact directly with IRS employees over videoconferencing equipment. While video will not replace traditional face-to-face service, it can supplement and expand existing service and allow the IRS to reach taxpayers in more remote areas of the country and those with mobility issues. VFTF also will provide face-to-face interaction where the IRS currently offers only automated service or correspondence. However, lack of strategy and congressional directive may affect the IRS's ability to focus on investing in the proper technology in the face of competing priorities, preventing a more robust use of VFTF and limiting the types of services provided.

##### *Analysis*

In fiscal year (FY) 2012, the IRS and TAS began testing VFTF. The pilots served over 12,500 taxpayers, and offered an alternative in offices that had a large volume of customers, were unstaffed or only staffed at certain times of the year, or were based outside IRS buildings. Eighty-six percent of taxpayers surveyed about the service reported they were satisfied or very satisfied, and 91 percent would use it again. The IRS is exploring better technology to allow taxpayers to accomplish routine tasks. VFTF technology will help all taxpayers who are willing and able to use it, especially those who live far from traditional face-to-face locations, have limited mobility, are functionally illiterate, or lack representation. Not offering a full range of services in a virtual environment will hinder taxpayers' ability to accomplish everything they could do in a traditional IRS building.

##### *Recommendation*

The National Taxpayer Advocate recommends that as the IRS expands VFTF service, that it pursue strategic solutions that would allow taxpayers to interface with IRS employees via their home computers or mobile devices; continue to study and propose areas where VFTF delivery options would benefit taxpayers; and that Congress provide a directive and funding to allow the IRS and TAS to expand VFTF service using broadband and mobile technology as a way for citizens to interact with their government.

## 5. The IRS Has Improved Training and Procedures to Account for Collection Statute Expiration Dates

### *Problem*

By statute, the IRS generally has ten years from the assessment of a tax to collect it before the statutory period expires, unless the taxpayer extends the period by waiver or a statute suspends the period. The IRS has improved its training and tools for employees to account for the collection statute expiration dates (CSEDs) provided by law, is developing new methods for calculating CSEDs, and is attempting to resolve accounts with CSED waivers of more than six years, which is the current time limit on extensions. However, the Treasury Inspector General for Tax Administration determined that over 20 percent of accounts subject to IRS collection hearings in fiscal year (FY) 2011 had inaccurate CSEDs.

### *Analysis*

The IRS Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) divisions have worked to address CSED problems. SB/SE and TAS formed a workgroup to investigate and correct CSED extensions longer than six years. TAS has continued to research CSED problems and has found the IRS does not adjust accounts with multiple assessments and CSEDs when the CSED expires for the earlier assessment. However, W&I created a specialized Multiple CSED (MULTICSED) unit to verify CSEDs and correct all account modules having multiple CSEDs from the 1960s forward. The IRS also has developed and tested a CSED calculator, and is implementing the Customer Account Data Engine 2 (CADE 2) in stages to correct the CSED problem permanently. The IRS also has made a step towards acknowledging the CSED problem with new training for employees. The National Taxpayer Advocate commends the IRS for its efforts to address CSED issues, despite its inability to date to create a centralized CSED office to promote consistency in procedures, training, and review across units.

### *Recommendations*

The National Taxpayer Advocate recommends that the IRS coordinate its CSED training and case reviews to reinforce and reward the verification and correction of CSEDs; and organize a centralized CSED office to refine training, create and maintain CSED tools, and oversee programs such as the MULTICSED unit.

## 6. The Combined Annual Wage Reporting Program Continues to Impose a Burden on Employers Despite IRS Improvements

### *Problem*

Under the Combined Annual Wage Reporting (CAWR) program, the IRS and the Social Security Administration (SSA) process and reconcile wage and tax data employers report to both agencies. In prior reports, the National Taxpayer Advocate raised concerns about problems employers encountered with the IRS's reconciliation process. The IRS has since significantly improved the CAWR program, however, problems still exist. The CAWR program continues to experience delays in the IRS responding to employers' correspondence within established timeframes. The IRS continues to see a high "no response" rate from employers to their discrepancy notices. In 2012, the IRS closed 52 percent of CAWR cases because it did not receive responses from the employers. The IRS has not determined if penalty assessments for late filing or non-filing of employment returns have effected compliance.

### *Analysis*

In response to previous National Taxpayer Advocate recommendations, the IRS has significantly improved the CAWR program by adjusting its workload to better align with resources; improving inventory management and case selection; issuing interim letters to taxpayers with updates on their cases; and providing copies of CAWR notices to authorized third parties. As part of the effort to improve the program, in 2012, the IRS completed its consolidation of the program from three to two campuses, however staffing decreased by 28 percent over FY 2010 levels. The IRS plans to launch a redesigned CAWR system in fiscal year 2014, which should strengthen case creation, selection, and management, along with various other inventory tracking and report functions. However, the IRS needs to continue with the study of the impact of penalties in relation to compliance and address outstanding problems with responding to employers' correspondence and the response rates to CAWR notices, particularly the no response problem.

### *Recommendations*

The National Taxpayer Advocate recommends the IRS evaluate the late response and no response cases to determine if the current timeframe for employer response is reasonable and whether response would improve if employers were able to designate a dedicated address for employment tax notices. The IRS should determine reasons for the low employer response to IRS CAWR notices and develop approaches to improve that rate. Additionally, the IRS needs to continue research to determine whether the assessment of Failure to Timely File Information Returns penalty and the Intentional Disregard penalty increase compliance. The IRS needs to establish a toll-free operation dedicated to the CAWR unit. It is imperative that IRS launch a redesigned and improved CAWR Program as part of the IRDM in FY 2014, as planned.

## Legislative Recommendations

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

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

## FAMILY STATUS RECOMMENDATIONS

### 1. Simplify the National Status and Related Requirements for Qualifying Children

#### *Problem*

Confusion arises when similar taxpayers receive different deductions or credits depending on the residence or national status of their children. The dependency deduction, child tax credit (CTC), and Earned Income Tax Credit (EITC), all of which relate to the cost of raising children, have different requirements. Simply put, a child who is not an American (citizen or national):

- May reside in the U.S., Canada, or Mexico for the first provision;
- Must reside in the U.S. for the second; and
- Must reside in the U.S. with a Social Security number (SSN) for the third.

Similarly situated taxpayers may fail to claim the correct benefits due to the inconsistency of these requirements.

#### *Analysis*

The complex requirements reflect alternative principles, one of which is ability to pay. The dependency deduction, supplemented by the CTC, reflects the cost of raising children, reducing the taxpayer's income, or ability to pay tax. Another principle is that of a domestic subsidy. The EITC operates as a wage supplement, which Congress has limited to authorized American workers. To the extent that it enhances earned income, the "additional" CTC is a similar subsidy, limited by law to children who are American citizens, nationals, or residents. A third principle is administrability. The exemption deduction's limitation to a dependent with a Taxpayer Identification Number in the U.S. or a contiguous country facilitates IRS verification. For clarification, legislation should organize these various principles into simplified provisions that taxpayers can use and the IRS can administer.

#### *Recommendations*

Simplify the three-part children's national status requirements in conformity with overall simplification of the family tax benefits as the National Taxpayer Advocate previously proposed:

- Consolidate the dependency deduction and CTC (nonrefundable portion) with head of household filing status into a Family Credit.
- Consolidate and modify the EITC with the additional CTC into a Worker Credit not contingent on qualifying children.
- For the Family Credit, apply the contiguous country rule encompassing the U.S., Canada, and Mexico.
- For the Worker Credit, require an SSN valid for work.

- Repeal as obsolete the residence rule that requires the child to be a citizen, national, or otherwise in the U.S., thus resolving the confusion surrounding the national status of children who qualify for a refundable credit.



**2. Amend IRC § 7703(b) to Remove the Household Maintenance Requirement and to Permit Taxpayers Living Apart on the Last Day of the Tax Year Who Have Legally Binding Separation Agreements to Be Considered “Not Married”**

*Problem*

Married taxpayers must file joint returns in order to claim important tax benefits such as the Earned Income Tax Credit (EITC). Internal Revenue Code (IRC) § 7703(b), the provision that determines marital status of married taxpayers who live apart, has remained essentially unchanged since 1984 and causes some married taxpayers to lose their eligibility for tax benefits. First, the statute retains an outdated “cost of maintaining a household” test that disproportionately affects members of racial and ethnic minorities who work and have children. Second, it requires spouses to have lived apart for the last six months of the year even if they have a written, legally binding separation agreement by year’s end.

*Analysis*

IRC § 7703(b) is a definitional statute that has remained essentially unchanged since 1984 and has indirectly been made a part of other statutes such as EITC by virtue of cross referencing. Working single parents may be “too poor” to divorce, and may also not be able to meet the “cost of maintaining a household” test. IRC § 7703(b)(3) requires married taxpayers who live apart to live in a separate household from their estranged spouses for the last six months of the year, even though the dependency exemption rules do not require physical separation when the spouses have a written separation agreement.

*Recommendation*

Amend IRC § 7703(b) to remove the “cost of maintaining a household” test and permit taxpayers living apart on the last day of the tax year who have legally binding separation agreements to be considered “not married.”

### 3. Amend the Adoption Credit to Acknowledge Jurisdiction of Native American Tribes

#### *Problem*

As of fiscal year (FY) 2011, over 104,000 children were waiting to be adopted in the United States. Of the nearly 50,000 children adopted through public agencies that year, some 84 percent were considered to have special needs. Congress enacted the adoption credit, in part, to defray the costs of adopting these children. A taxpayer who adopts such a child can claim \$10,000 (regardless of expense) in the form of a special needs adoption credit. To show that an adopted child has special needs, a taxpayer must file a paper tax return and attach a letter from the state certifying the child's special needs status. However, a Native American tribe is not considered a state for purposes of the credit and cannot certify a child's special needs. Nor can the state where the tribal nation is located issue this documentation, because the Indian Child Welfare Act (ICWA) grants tribes exclusive jurisdiction over decisions regarding tribal children. Therefore, taxpayers who adopt a Native American special needs child are precluded from claiming the \$10,000 special needs adoption credit.

#### *Analysis*

The adoption credit was enacted to mitigate the financial burden experienced by families adopting children as well as to reduce the number of children waiting for adoption. However, current law prevents parents who adopt a child from a Native American tribe from claiming the credit crafted for adoptions of special needs children. This creates a disparity in the tax law (*i.e.*, taxpayers who adopt a non-tribal special needs child can claim the credit while taxpayers who adopt a special needs child from a Native American tribe cannot) and essentially promotes adoption of one group of children over another. Congress can correct this disparity in the tax law by amending IRC § 7871 (which treats tribes as states for specified purposes) to refer to IRC § 23 (which allows the adoption credit), thereby treating tribes as states for purposes of the special needs adoption credit so that tribal determination letters can be accepted by the IRS. This amendment to IRC § 7871 will make the credit for adopting a special needs child more equitable and will remove a disadvantage currently experienced by children who are members of a Native American tribe and in need of adoption.

#### *Recommendations*

The National Taxpayer Advocate recommends that Congress amend IRC § 7871(a) to include IRC § 23 in the list of Code sections for which a Native American tribal government is treated as a "State." If a Native American tribal government is treated as a State for purposes of IRC § 23, its determination that a child has special needs would enable adoptive parents to claim the special needs adoption credit, provided that the other requirements of the Internal Revenue Code are met.

## TAXPAYER RIGHTS RECOMMENDATIONS

### 4. Amend IRC § 7701 to Provide a Definition of “Last Known Address,” and Require the IRS to Mail Duplicate Notices to Credible Alternate Addresses

#### *Problem*

Taxpayers must claim some important statutory rights within strict time limits that begin to run when the IRS *mails* them a notice or letter, regardless of when they actually receive it. So long as the IRS mails the correspondence to the taxpayer’s “last known address,” a term that is not defined by statute, the document is legally effective when sent. The IRS has the duty to use due diligence to ascertain a taxpayer’s current address, but does not interpret the law as requiring it to look beyond its own databases for a taxpayer’s address, even when it knows that address is incorrect.

#### *Analysis*

The Internal Revenue Code (IRC) does not define “last known address.” The definition in a Treasury regulation does not reflect the requirement, established by case law, that the IRS use due diligence based on information it knew or should have known to ascertain a taxpayer’s last known address. The recommendation would relieve the burden on taxpayers who do not receive notifications of important statutory rights. The clarification it provides would reduce the risk to the government that an ineffective notice of deficiency will later bar it from assessing or collecting tax that would otherwise be due. The recommendation would also avert a potential conflict among the Courts of Appeal and help ensure that similarly situation taxpayers receive the same treatment. Given the availability of technology and the centrality of “last known address” to fundamental rights that preserve the perception (and actuality) of fairness in our tax system, the small burden of requiring reliable database investigation is more than outweighed by taxpayers’ and the government’s interest in procedural fairness.

#### *Recommendation*

Amend IRC § 7701 to include a definition of “last known address” that incorporates and updates key concepts from the applicable Treasury Regulation and reflects case law. In addition, direct the Secretary of the Treasury to develop procedures for checking third-party databases for credible alternate addresses whenever mail is returned to it as undeliverable, and prior to sending notices that establish legal rights and obligations (*i.e.*, Statutory Notices of Deficiency, Collection Due Process notices, notices of Federal tax lien filing, etc.). When the IRS learns that its records do not contain a taxpayer’s correct address, and the taxpayer has a credible alternate address, require the IRS to mail the notice simultaneously to the last known and credible alternate addresses (as defined by the Secretary).

## 5. Amend IRC § 7403 to Provide Taxpayer Protections Before Lien Foreclosure Suits on Principal Residences

### *Problem*

Taxpayer protections before the IRS requests lien foreclosure suits against taxpayers' principal residences are inadequate. After a taxpayer fails to pay any tax, the federal tax lien arises by operation of law. The IRS may generally commence an administrative seizure when it notifies a taxpayer of the opportunity to be heard in a Collection Due Process (CDP) hearing. After the hearing (or the taxpayer's failure to respond), the IRS may seize the taxpayer's property or any property to which the lien attaches to satisfy the tax liability. A taxpayer's principal residence is generally protected from seizure if the taxpayer owns insufficient equity in the property or will suffer and economic hardship from the seizure, a collection alternative is pending, the tax liability is \$5,000 or less, an IRS Area Director does not approve the seizure, or a judge or magistrate finds that, among other things, the taxpayer's other assets subject to collection are sufficient to pay the amount due. Yet after the IRS files a Notice of Federal Tax Lien (NFTL) in the public records and offers a CDP hearing to the taxpayer, the IRS may request that the U.S. Attorney General (AG) direct the filing of a suit to foreclose the tax lien and sell the taxpayer's principal residence, without reference to the significant taxpayer protections applicable to seizures.

### *Analysis*

Taxpayers face similar economic harm whether they lose their homes through seizure or lien foreclosure. Loss of a principal residence whether by seizure or foreclosure may disrupt a taxpayer's livelihood and cause unnecessary harm to his or her family. The IRS increased seizures by 21 percent and foreclosure suit referrals by 26 percent from fiscal year 2010 to 2012. Although the administrative seizure process is generally adequate, IRS procedures suggest that revenue officers (ROs) consider referral to the AG for a lien foreclosure suit where seizure and sale would result in a lower sale price; encumbrances on the property, other than the federal tax lien, make it difficult to determine the relative property interests; the title is contested by a third party; or unpaid federal tax liens are filed against only one of several co-owners and a sale of undivided partial interests is not feasible. Once the AG directs the filing of a foreclosure suit, the courts have limited discretion to order the sale of the taxpayer's residence in cases where another party claims an interest. However, the courts cannot refuse to authorize the sale to protect the interests of the taxpayer.

### *Recommendations*

The National Taxpayer Advocate recommends that Congress amend IRC § 7403 to preclude an IRS employee from requesting that the AG direct the filing of a civil action to foreclose the federal tax lien against a taxpayer's principal residence in U.S. District Court, unless the employee has received executive level approval after determining the taxpayer's other property or rights to property, if sold, are insufficient to pay the amount due; and the foreclosure and sale of the residence will not create an economic hardship due to the financial condition of the taxpayer.

**6. Amend IRC §§ 6320 and 6330 to Provide Collection Due Process Rights to Third Parties (Known As Nominees, Alter Egos, and Transferees) Holding Legal Title to Property Subject to IRS Collection Actions**

*Problem*

While some taxpayers may fraudulently convey their property to friends or relatives to avoid their personal legal obligation to pay taxes, others legitimately divest their property before the IRS assesses tax. The IRS files Notices of Federal Tax Lien (NFTLs) and issues levies against the property of third parties (individuals or entities, known as transferees, nominees, or alter egos) that hold property purportedly belonging to taxpayers subject to collection. However, these third parties are not considered taxpayers for the purposes of Collection Due Process (CDP) rights under Internal Revenue Code (IRC) §§ 6320 and 6330 and therefore are not entitled to CDP rights. The purpose of CDP rights is to give taxpayers a meaningful hearing before the IRS levies their property or immediately after the IRS files a NFTL against the taxpayers' property.

*Analysis*

Without the benefit of the protections afforded by IRC §§ 6320 and 6330, the third party against whom the IRS has taken a collection action has limited remedies, provided only after the collection action has occurred. As a result, the collection process for alleged nominees, alter egos, and transferees perversely denies individuals and entities who may be innocent third parties the right to raise concerns and propose collection alternatives before an action is taken, while giving the taxpayer those very rights. Amending the IRC to provide CDP rights to nominees, alter egos, and transferees would appropriately give the "affected third party" (the language used by the Senate Finance Committee in the initial draft of CDP provisions) at least as much due process protection as the person actually responsible for the tax.

*Recommendations*

The National Taxpayer Advocate recommends that Congress amend IRC §§ 6320 and 6330 to extend Collection Due Process rights to "affected third parties," known as nominees, alter egos, and transferees, who hold legal title to property subject to IRS collection actions.

## 7. Protect Taxpayers and the Public Fisc from Third-Party Misappropriation of Payroll Taxes

### *Problem*

The payroll processing industry provides a valuable service to employers, especially small businesses, by helping them comply with complex federal, state, and local employment tax requirements. The industry has created various contractual arrangements for withholding, reporting, and paying employment taxes with third parties. While most third-party payers (TPPs) are legitimate and trustworthy companies, a few “bad actors” have defrauded their clients and tarnished the image of the industry. When a PSP goes out of business or misappropriates its clients’ funds, the employers remain liable for the unpaid payroll taxes. Each PSP failure can cause grave financial harm to multiple clients that may be required to pay the amount of payroll taxes twice, once to the PSPs and again to the IRS, along with interest and penalties. Some small businesses may be unable to recover from these setbacks and may be forced to cease operations and lay off their employees.

### *Analysis*

The payroll industry has established various types of third-party withholding, reporting, and payment arrangements, which include Payroll Service Providers, aggregate filers (Form 2678 Agents), reporting agents (Form 8655 Agents), and Professional Employer Organizations (PEOs). However, Congress has not amended the Internal Revenue Code (IRC) to reflect the evolution of the industry, nor to authorize the IRS to better regulate the growing use of various TPP arrangements for employment taxes. Between FY 2007 and FY 2012 (to date), as a result of the IRS’s recommendations, the Department of Justice criminally prosecuted at least 24 owners and operators of TPPs who collected but did not pay over about \$300 million in employment taxes. Absent statutory authority to require bonding and to regulate, the IRS cannot keep up with changing contractual arrangements and protect employers and the public fisc from unscrupulous TPPs.

### *Recommendations*

The National Taxpayer Advocate recommends that Congress amend the IRC to require any person who enters into an agreement with an employer to collect, report, and pay any employment taxes to furnish a performance bond that specifically guarantees payment of federal payroll taxes collected, deducted, or withheld by such person from an employer and wages or compensation paid to employees; amend IRC § 3504 to authorize the IRS to impose joint and several liability on any person who collected, deducted, or withheld federal payroll taxes from an employer and wages or compensation paid to employees; amend IRC § 3504 to require aggregate filers to allocate reported and paid employment taxes among their clients using a form prescribed by the IRS and impose a penalty for the failure to file absent reasonable cause; and amend the U.S. Bankruptcy Code to clarify that IRC § 6672 penalties survive bankruptcy even when the debtor is not an individual.

## The Most Litigated Issues

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to include in her Annual Report to Congress the ten tax issues most litigated in the federal courts, classified by the types of taxpayers affected. The cases we reviewed were decided during the 12-month period beginning on June 1, 2011, and ending on May 31, 2012.

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### SIGNIFICANT CASES

At the outset, we describe certain judicial decisions that generally do not involve any of the ten Most Litigated Issues, but nonetheless highlight important issues relevant to tax administration. This year, we discuss nine cases, including two from the United States Supreme Court, one from the United States Tax Court, and six from United States Courts of Appeals.

#### 1. Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Enforcement of summonses generated the greatest number of federal court decisions this year. The IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability. To obtain this information, the IRS may serve a summons directly on the individual who is the subject of the investigation or any third party who may possess relevant information. A person who has a summons served on him or her may contest its legality if the government petitions a court to enforce it. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons. Generally, the taxpayer has a difficult burden to establish the illegality of the summons. We reviewed 153 federal court cases that included issues of IRS summons enforcement. The IRS prevailed in full in 152 cases, with one case resulting in a split decision.

#### 2. Accuracy-Related Penalty Under IRC §§ 6662(b)(1) and (2)

IRC §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold, called a substantial understatement. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties, which we did not analyze because they were litigated less frequently.

Cases with accuracy-related penalty issues increased more than 110 percent this year, from 55 in 2011 to 117 in 2012. The IRS prevailed in full in 77 cases, the taxpayers prevailed in full in 29 cases, and 11 resulted in split decisions.

## The Most Litigated Issues

**3. Appeals from Collection Due Process Hearings Under IRC §§ 6320 and 6330**

Collection Due Process (CDP) hearings provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a Notice of Federal Tax Lien (NFTL) or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing before the IRS issues its first levy or immediately after it files its first lien with respect to a particular tax liability. At the hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability. Taxpayers have the right to judicial review of Appeals' determinations provided they timely petition the Tax Court. CDP has appeared as one of the Most Litigated Issues every year since 2003. This year, we identified 116 cases in which taxpayers petitioned the Tax Court to redetermine IRS decisions in CDP hearings. Taxpayers prevailed in full in eight of these cases and in part in seven others with the IRS prevailing in all other cases.

**4. Trade or Business Expenses Under IRC § 162 and Related Sections**

IRC § 162 allows taxpayers to take deductions for ordinary and necessary trade or business expenses paid or incurred during a taxable year. Some of the most common issues litigated in cases involving trade or business expenses include whether the taxpayer could substantiate the expenses, whether expenses were business or personal, and whether the taxpayer could establish that he or she was carrying on a trade or business. This year we identified 115 cases involving a trade or business expense issue. The courts affirmed the IRS position in the majority (approximately 70 percent) of cases, while taxpayers prevailed about five percent of the time. The remaining cases resulted in split decisions.

**5. Gross Income Under IRC § 61 and Related Sections**

When preparing tax returns, taxpayers must calculate gross income for the taxable year to determine the tax they must pay. The gross income cases analyzed in this report include issues that most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. We reviewed 92 cases, with issues that include:

- Damage awards;
- Discharge of indebtedness;
- Loan Proceeds; and
- Parsonage income.

The IRS prevailed in full in 76 cases of these cases, while the taxpayer prevailed in whole or part in 16.





## The Most Litigated Issues

**9. Relief from Joint and Several Liability Under IRC § 6015**

Married couples may elect to file their federal income tax returns jointly or separately; spouses filing joint returns are jointly and severally liable for any deficiency or tax due. Joint and several liability permits the IRS to collect the entire amount due from either taxpayer. IRC § 6015 provides three avenues for relief from joint and several liability.

1. Section 6015(b) provides “traditional” relief for deficiencies;
2. Section 6015(c) provides special relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between the spouses; and
3. Section 6015(f) provides “equitable” relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c).

We reviewed 40 federal court opinions involving relief under IRC § 6015. The most significant issues are the effect of prior proceedings on the Tax Court’s jurisdiction and whether District Courts have jurisdiction to determine innocent spouse claims raised as a defense in a collection suit. Of the 40 cases we analyzed, the IRS prevailed in 21, the taxpayer prevailed in 11, and eight resulted in split decisions.

**10. Limitations on Assessment Under IRC § 6501**

The general statute of limitations on assessment of tax, governed by IRC § 6501(a), is three years, extended to six years in certain circumstances. This statute of limitations does not apply in other circumstances, such as when a taxpayer files a false or fraudulent return, willfully attempts to defeat or evade tax, or fails to file a return altogether. In these cases, the IRS can assess tax or begin a collection proceeding in court at any time.

This is the first year that limitations on assessment has been analyzed as a Most Litigated Issue in the National Taxpayer Advocate’s Annual Report to Congress. We reviewed 33 federal court opinions issued between June 1, 2011 and May 31, 2012 involving limitations on assessment. The IRS prevailed in full in 19 cases, the taxpayers prevailed in full in 11 cases, and three cases resulted in split decisions.

## Volume 2: TAS Research and Related Studies

### 1. Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results

The Taxpayer Advocate Service (TAS) surveyed sole proprietors (*i.e.*, those filing Form 1040, *U.S. Individual Income Tax Return, Schedule C*) to better understand the factors that may affect their income tax reporting compliance. Identifying how to improve compliance among this segment is particularly important because sole proprietor income is generally not subject to information reporting, is difficult for the IRS to detect, and represents the largest portion of the tax gap — tax that is not timely and voluntarily paid.

Because actual reporting compliance is difficult to measure, TAS used IRS tax compliance estimates to identify sole proprietors most likely to have high or low levels of reporting compliance. Unlike researchers outside the IRS, TAS was uniquely positioned to know these IRS estimates. TAS surveyed a stratified random national sample of each group (the “National Survey”).

As discussed in prior reports, a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent’s actual tax compliance. Thus, the National Survey provides an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates.

Because some of the factors thought to influence compliance could be affected by local conditions and attitudes, TAS also sought to identify geographic communities where a disproportionate number of taxpayers were in the high- or low-compliance group. TAS surveyed taxpayers at random in certain communities (the “Community Survey”) using the same survey questions.

TAS designed survey questions to reveal the effect, if any, on reporting compliance of various factors, such as deterrence, tax morale, compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. TAS contracted with a consulting firm, Russell Research, to refine the questions and conduct the surveys by telephone.

TAS’s preliminary analysis of the National Survey results revealed the following key findings:

- Taxpayers in the high-compliance group expressed more trust in government and the IRS.
- Those in the low-compliance group expressed less trust in preparers. Although most used a preparer, they were less likely to follow the preparer’s advice.

- Taxpayers in the low-compliance group were more likely to participate in local organizations. They were also significantly more likely to report that other participants view the law and the IRS negatively.
- Both groups professed a “moral” obligation to report income accurately.
- Responses do not show that economic deterrence motivates compliance decisions. Those in the low-compliance group were less likely to agree that noncompliance goes unpunished.
- Most respondents agreed the tax rules are so complicated that it is very difficult to get a tax return exactly right. Those in the high-compliance group were somewhat more likely to agree with this statement, potentially suggesting they were more concerned about getting a return exactly right.

TAS’s preliminary analysis of the Community Survey results revealed the following key findings:

- There were more low-compliance communities than high compliance communities because taxpayers with high compliance were not concentrated in communities.
- Respondents from the low-compliance communities were suspicious of the tax system and its fairness, whereas those from the high-compliance communities viewed government positively.
- Respondents from the high-compliance communities were more likely to rely on preparers.
- Among business classifications, the biggest cluster in low-compliance communities was under “professional, scientific, or technical services”; in high-compliance communities, the “other” service industry (*e.g.*, repair & maintenance, personal & laundry, and private household services).
- The low-compliance community respondents reported more participation in civic institutions than their high-compliance counterparts.
- The high-compliance community respondents were motivated by morals and deterrence.
- The effect on compliance of financial concerns was unclear.
- Those in the high- and low-compliance communities responded similarly to questions addressing tax complexity.

In sum, all groups and communities agreed that it is morally wrong to cheat and that they would feel embarrassed if others learned they were not reporting all of their income. Surprisingly, those in the low-compliance group were also more likely than those in the high-compliance group to believe that the IRS detects and penalizes noncompliance. Thus, other factors appeared to overshadow these positive moral, social, and economic pressures for those in the low-compliance group and communities.

Specifically, the results of both surveys associate distrust of the national government and the IRS with the low-compliance groups and communities. For example, respondents from the low-compliance group were more likely to report that the government is too big and wastes tax dollars, that tax laws are unfair, and that the IRS is unfair (*e.g.*, often believing the IRS is more concerned with collecting as much as possible instead of the correct amount, and indicating less satisfaction with IRS services).

The community survey selection process also revealed that those with low compliance levels clustered in geographic communities, while those with high compliance levels were more dispersed. Perhaps those with low levels of compliance are more likely to associate with each other.

In addition, those in the low-compliance group and communities were more likely to participate in local organizations and to report that other members of those organizations believe the law and the IRS are unfair. The closer association with local organizations by members of the low-compliance group and communities could have undermined their connection with the nation and the national tax system as a whole. The negative views they attributed to other members appeared to mirror their own views. In other words, they affiliated with others who reinforced noncompliance norms locally, feeling a closer connection here than nationally.

Those in the low-compliance group were somewhat more likely to use a preparer, who could have persuaded them to comply or facilitated noncompliance. However, they were also less likely to follow the preparer's advice than those in the high-compliance group, potentially weakening any positive influence that the preparer may have sought to exert.

These preliminary findings may suggest that traditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behavior (*i.e.*, behavior that may be addressed by increasing deterrence) is prevalent. Rather, they may suggest that the government could improve reporting compliance by improving the perceived fairness and efficiency of the government, the tax law, and the IRS; and by simplifying the tax code, improving procedural protections, and minimizing the IRS's reliance on procedures that may seem unfair (*e.g.*, excessive automation and lack of personal contact). As a practical matter, this might include tax simplification, an expansion of taxpayer protections and remedies, improved or expanded tax services, and taxpayer education.

To address the perception by members of local organizations that the tax law and the IRS are unfair, the IRS might retain a local presence and conduct outreach and education events, particularly in low-compliance communities. Such treatments might pay for themselves if they improve reporting compliance by those responsible for the largest portion of the tax gap and most resistant to other treatments.

## 2. Study of Tax Court Cases in Which the IRS Conceded the Taxpayer Was Entitled to the Earned Income Tax Credit (EITC)

When the IRS takes a “second look” at denied EITC claims, taxpayers often recover part or all of the credit. In the meantime, however, they are burdened by uncertainty, the cost of contesting the IRS’s position, and refund delays. The IRS in turn is burdened by the cost of handling contested cases through increasingly higher paid employees and interest charges on delayed refunds. The Taxpayer Advocate Service (TAS) undertook a study to examine a random sample of cases in which the taxpayer petitioned the Tax Court for review of IRS disallowance of the EITC and the IRS conceded the EITC issue in full without trial. The objective of the study is to identify impediments that prevent the IRS from conceding cases before the taxpayer filed the Tax Court petition.

The study found that taxpayers often had to wait almost a year and a half to receive the EITC refunds to which they were entitled. The average EITC claimed was \$3,479 and taxpayers’ average adjusted gross income was \$17,024. For more than half the taxpayers, the claimed EITC represented more than a quarter of their adjusted gross incomes. The government paid interest on delayed refunds in more than a third of the cases, amounting to about \$200 per return.

In most cases, taxpayers try to resolve their cases by repeatedly calling the IRS before they file their Tax Court petitions. They also submit documentation, but usually after petitioning Tax Court. However, taxpayers who submit their documents after petitioning the Tax Court have usually spoken with an IRS examiner beforehand, five times on average. Evidently, taxpayers do not receive from examiners adequate explanations of what documents are needed, but they do receive adequate explanations once they have exited the examination phase of the case. Only infrequently do taxpayers not speak to the IRS or submit any documentation until after they file their Tax Court petitions.

Even when taxpayers submit documentation before petitioning Tax Court, the case may be unnecessarily prolonged. In about a fifth of the cases, taxpayers submit documentation before filing a Tax Court petition that the examiner rejects but an Appeals Officer or Chief Counsel attorney later accepts. The documentation is usually listed in the Internal Revenue Manual (IRM) as acceptable substantiation of the claim. Moreover, examiners sometimes deny EITC because they misapply the law — this happened five percent of the time.

Appeals Officers and Chief Counsel attorneys do not often accept testimony as a substitute for documents, and the cases are rarely conceded due to the hazards of litigation. The findings suggest that taxpayers are willing to talk with the IRS before they petition the Tax Court and are able to provide acceptable supporting documentation, but do not obtain the information about how to substantiate their claims from their conversations with examiners. Moreover, it appears that Appeals Officers and Chief Counsel employees are more adept at evaluating the documents taxpayers provide or more willing to elicit additional documentation as necessary, or both.

### 3. Investigating the Impact of Liens on Taxpayer Liabilities and Payment Behavior

Last year, TAS Research published its lien study, “Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income,” in Volume 2 of the 2011 Annual Report to Congress. TAS Research completed this study in response to the National Taxpayer Advocate’s concern that the IRS’s use of the Notice of Federal Tax Lien (NFTL) may be harming taxpayers, especially those experiencing economic hardships, while not significantly enhancing the IRS’s ability to collect liabilities.

The study examined the impact of lien filing on taxpayer compliance behavior and income. To conduct it, TAS Research analyzed a cohort of delinquent individual tax return filers (those who file Forms 1040, *U.S. Individual Income Tax Return*) in taxpayer delinquent account (TDA) status who incurred unpaid tax liabilities in 2002 and had no such liabilities at the beginning of 2002. We identified the subgroup of these taxpayers against whom IRS filed liens between 2002 and 2004, as well as a comparable subgroup against whom the IRS did not file liens.

In the current study, we analyze the impact of lien filing on the tax liabilities and revenue collected from these taxpayers and whether the installment agreement (IA) and offer in compromise (OIC) collection alternatives can improve these outcomes for both taxpayers and the IRS. We also update the 2011 propensity scoring model to incorporate some model enhancements.

#### *Methodology*

This study employs a two-phase approach. In Phase 1, we construct our cohort of comparable lien and non-lien taxpayers from the initial population of delinquent taxpayers. In Phase 2, we use subsets of the study population created in Phase 1 to conduct our analyses. We look at the change in total tax liability of our various groups of taxpayers during the study period (2002 through 2010). We also look at the total dollars the IRS actually collected from these taxpayer groups.

#### *Findings*

Our results show that in general, and given the lien filing criteria in place during 2002 — 2004, lien filing was associated with unfavorable outcomes for both the IRS and the taxpayer, *i.e.*, the IRS collected significantly less revenue from lien taxpayers and the total tax liabilities of lien taxpayers increased more. However, both the lien and non-lien taxpayer groups had difficulty paying down their tax liabilities, and, on average, were in more debt to the IRS in 2010, the end of the study, than at the time of lien filing or proxy lien filing. This problem was most severe for currently not collectible (CNC) hardship taxpayers, who on average ended up owing about 50 percent more to the IRS in 2010 than at the time of lien (or proxy lien) filing.

The subgroups with IA and OIC collection alternatives had better outcomes for taxpayers and the IRS. Over 50 percent of IA taxpayers and over 70 percent of OIC taxpayers were out of debt to the IRS at the end of the study period. Further, the IRS collected about 45 percent more tax revenue from IA taxpayers than from those without IAs, and almost twice as much in percentage terms based on the amount owed at the time of lien filing or proxy lien filing.

While the IRS collected significantly less from taxpayers with approved OICs than from the other taxpayers included in this study, the accepted offer amount represents the full amount the IRS estimated it could collect from these taxpayers. Moreover, when we looked at CNC hardship taxpayers, the study group with the most unfavorable outcomes for both the taxpayer and the IRS, we found that they paid considerably more to the IRS if they were granted OICs and were generally out of debt at the end of the study period.

These study findings demonstrate the need for continued study of IRS lien filing criteria to maximize the benefits of lien filing to the IRS and minimize its adverse effects on taxpayers. Additionally, the findings underscore the benefits of active promotion and use of the IA and OIC collection alternatives and highlight the likely benefits to the IRS and taxpayers of increased use of OICs for CNC hardship taxpayers.



#### 4. Options for Expanding the Remedies to Address Taxpayer Rights Violations

Most U.S. taxpayers willingly meet their obligation to tell the government about their filing status, family structure, earnings, investments, expenses, and losses in an honest effort to pay the correct amount of tax. This willingness places a heavy responsibility on the IRS to treat these taxpayers fairly — in ways that comport with concepts of procedural justice. Failure to do so reduces our tax system to one based on compulsion alone, undermining our system of voluntary compliance. Moreover, survey results suggest that the perception that the IRS is fair promotes voluntary compliance. Thus, strengthening taxpayer rights could both make the tax system more fair and raise revenue.

While Congress has enacted various taxpayer rights, survey results suggest that less than 50 percent of taxpayers believe they have rights, and even fewer know what their rights are. Perhaps taxpayer rights are easy to forget because taxpayers feel they have no recourse when the IRS violates them. While remedies exist for some, they may be too costly or time consuming for many to pursue.

This study discusses ways to improve remedies available for the violation of taxpayer rights. One option adopted by the Republic of Chile is to expand the authority of the judiciary to quickly and efficiently remedy violations of taxpayer rights. Another option adopted by Australia and the United Kingdom is to empower the tax administrator — or the National Taxpayer Advocate — to make *de minimis* “apology” payments to those whose rights were violated, as previously recommended by the National Taxpayer Advocate.

## 5. **Research Prospectus: Comparing the Impact of Revenue Officers and the Automated Collection System on Future Compliance**

When a taxpayer does not pay his or her tax liability, the IRS may assign the case to a revenue officer (RO) in the Collection Field function (Cf), to a group of Automated Collection System (ACS) employees in centralized call sites, or to the “queue” to wait until collection resources become available to work the case. Thus, the IRS has to decide which cases to assign to ROs, ACS, or the “queue,” and which to prioritize.

Direct comparisons between ACS employees and ROs present challenges. The IRS-wide measures — Collection Coverage and Collection Efficiency — assume that ACS is more effective than ROs because ACS generally works “fresh” cases, and closes them using fewer resources and lower-graded employees. These measures create an incentive for IRS executives to divert resources from the Cf to ACS, even though ROs could bring in more dollars by protecting revenue (*e.g.*, preventing future delinquencies) and increasing voluntary compliance.

The importance of voluntary compliance cannot be overstated. Taxpayers voluntarily and timely pay about 34 times as much as the IRS collects through enforcement and voluntary late payments. Moreover, about 78 percent of all late payments come in voluntarily as the result of a notice or an installment agreement, meaning only about 22 percent of all late payments — less than one percent of all dollars collected — come in through less voluntary means of enforcement. For example, ROs work priority Federal Tax Deposit (FTD) Alerts — cases where employment tax deposits have inexplicably dropped. One recent IRS study found that ROs working these cases improved the likelihood that the taxpayer would become compliant by 12 percentage points (from 28 percent to 40 percent); increased future tax deposits by an average of \$1,832 per case over a 12-month period; and reduced the average penalties assessed against the taxpayer, as compared to priority Alerts that were not worked. It also concluded that every dollar spent on ROs working FTD Alerts brought in \$69 by preventing future FTD non-compliance.

ACS employees do not undertake similar proactive activities. Thus, the IRS needs to know the relative impact of ACS and ROs on voluntary compliance for different types of cases. Such information could help to improve both IRS “decision analytics” and “business rules” used to assign cases, as well as collection performance measures. Without it, the IRS’s collection function is operating based on unproven assumptions, assigning cases and allocating resources inefficiently, and potentially undermining long-term voluntary compliance.

Specifically, TAS Research plans to identify similar cases that were assigned to an RO, the ACS, or the queue, and then compare the collection results. Not only will this analysis compare direct collections, but also the revenue protected, penalties assessed, and future payment compliance by each group of taxpayers.

## 6. **Research Prospectus: When Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?**

The National Taxpayer Advocate and other stakeholders have long urged the IRS to research the effect of penalties on voluntary compliance. Given the large number of penalties, the likelihood that each one may affect different taxpayer groups in different ways, and IRS data limitations, TAS will focus on the taxpayers and penalties that could have the greatest impact on the tax gap: accuracy-related penalties applied to Schedule C filers.

One objective of this study is to determine if an accuracy-related penalty assessment improves reporting compliance by the taxpayer in the future. In light of the IRS's increasing use of automated processes to assess penalties before communicating with the taxpayer, this study will also try to measure the effect of "default" penalty assessments, those appealed by the taxpayer (*i.e.*, through an audit reconsideration or the IRS Appeals function), and those that the IRS ultimately abates.

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