THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS: Introduction

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to prepare an Annual Report to Congress that contains a summary of at least 20 of the most serious problems encountered by taxpayers each year. For 2013, the National Taxpayer Advocate has identified, analyzed, and offered recommendations to assist the IRS and Congress in resolving 25 such problems.

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

To simply report on the top 20 problems would limit our effectiveness in focusing congressional, IRS, and public attention on critical issues. It would require us to repeat much of the same data and propose many of the same solutions year to year. Thus, the statute gives the National Taxpayer Advocate flexibility in selecting both the subject matter and the number of topics to be discussed and to use the report to put forth actionable and specific solutions instead of mere criticism and complaints.

Changes in Approach from Prior Years' Reports

This year, we have altered the format of the Most Serious Problem discussions in two important respects. First, we are not including an IRS response to our initial discussions and thus are no longer including the National Taxpayer Advocate's response to the IRS's comments. Second, we will be publishing the IRS formal response in conjunction with the National Taxpayer Advocate's report issued on June 30.[1] In large part, this change was necessary so that we could issue the Annual Report as close as possible to the December 31 statutory deadline, given the 16-day government shutdown, which hit at a particularly crucial time in the report's editing and review schedule.[2]

This change in approach, however, also brings us into conformity with the specific statutory language of IRC § 7803(c)(2)(B)(iii), which requires the National Taxpayer Advocate to submit her reports "directly" to the House Committee on Ways and Means and the Senate Committee on Finance "without any prior review or comment from the Commissioner, the Secretary of the Treasury, the Oversight Board, any other officer or employee of the Department of the Treasury, or the Office of Management and Budget."[3]

This statutory directive was designed to enhance and protect the independence of the National Taxpayer Advocate's observations and comments.[4] It reflects a radical change from prior law, which required the Taxpayer Ombudsman to co-author the report to Congress with the IRS Assistant Commissioner

1 IRC 7803(c)(2)(B)(i).

2 IRC 7803(c)(2)(B)(ii) requires the National Taxpayer Advocate to submit an "activities" report to the tax-writing committees of Congress not later than December 31 of each calendar year.

3 IRC § 7803(c)(2)(B)(iii).

4 The stated objective of these reports is "for Congress to receive an unfiltered and candid report of the problems taxpayers are experiencing and what can be done to address them. The reports by the Taxpayer Advocate are not official legislative recommendations of the Administration; providing official legislative recommendations remains the responsibility of the Department of Treasury." Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, JCS 12-96, 21 (Dec. 18, 1996).

(Taxpayer Services).[5] Congress provided for the IRS's ability to comment and respond to the National Taxpayer Advocate's recommendations (both in the Annual Reports and elsewhere) by requiring the Commissioner to "establish procedures requiring a formal response to all recommendations submitted to the Commissioner by the National Taxpayer Advocate within 3 months after submission to the Commissioner."[6]

In past years, as noted above, the National Taxpayer Advocate submitted her initial analyses with preliminary recommendations to the IRS responsible officials prior to publication and delivery to Congress. We allowed the IRS 30 days to respond to our preliminary recommendations. Included in that 30-day period was a seven-day timeframe within which the IRS could identify any factual errors we may have made in the analyses. We asked the IRS to respond specifically to our preliminary recommendations in the hope we could reach agreement and thus not include them in the final recommendations. Regrettably, as discussed below, the IRS agreed to very few preliminary recommendations.

The historic approach to the Annual Report to Congress, which appears to have been carried over from at least 2000, is very difficult to square with the direct and explicit statutory language. The IRS Commissioner and his officers and employees are specifically prohibited from "prior review or comment" with respect to the Annual Report. And yet, as many as 500 pages each year were reviewed and commented on by IRS officers and employees prior to direct delivery to Congress.[7]

This year, we have altered the format of the Most Serious Problem discussions in two important respects.

In past years, following publication of the Annual Report, the National Taxpayer Advocate forwarded to the Commissioner of Internal Revenue a memorandum including all of the recommendations contained in the report, which formally triggers the 90-day period for providing the Commissioner's response to those recommendations. Upon receipt of the Commissioner's formal response to her recommendations, the National Taxpayer Advocate and her staff discuss any concerns and ultimately post the IRS response and the National Taxpayer Advocate's position on the IRS website.[8]

Over the years, we have found the 90-day process to be much more meaningful than the responses we receive from the IRS as a result of the (statutorily prohibited) 30-day review. For example, in the 2012 Annual Report to Congress, the National Taxpayer Advocate made preliminary recommendations for 17 Most Serious Problems. As a result of the IRS's 30-day comments, the number of final recommendations remained the same for 11 Most Serious Problems, the number increased for three Most Serious Problems, and the number decreased for three Most Serious Problems. Overall, the IRS agreed to only 17.6 percent

5 Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, Title VI, Sec. 6235, 102 Stat. 3342, 3737 (Nov. 10, 1988). The Taxpayer Bill of Rights 2 (TBOR 2) amended IRC § 7802 (the predecessor of the IRC § 7803) by replacing the Office of the Taxpayer Ombudsman with the Office of the Taxpayer Advocate and replacing the joint Assistant Commissioner/Taxpayer Advocate Report to Congress with two annual reports to Congress issued directly and independently by the Taxpayer Advocate. Pub. L. No. 104-168, Sec. 101, 110 Stat. 1452, 1453 (July 30, 1996). However, post-TBOR 2, the reports continued to include IRS comments.

6 IRC § 7803(c)(3).

7 We note that the statutory authority for the Treasury Inspector General for Tax Administration (TIGTA) contains no express prohibition as to sharing or including reports with IRS officers or employees or including the IRS's comments. *See* The Inspector General Act of 1978, Pub. L. No. 95-452, as amended by Pub. L. No. 105-206, §1103, 112 Stat. 685, 705 (July 22, 1998). Likewise, IRC § 7803(d), which details additional duties of TIGTA, contains no prohibition on review or comment by the IRS on TIGTA's reports. We speculate that is because the Inspector General and his employees do not report to the Commissioner of Internal Revenue and therefore his independence does not require the extra safeguard of providing the National Taxpayer Advocate and her employees protection from censorship or undue pressure.

8 2012 Annual Report to Congress Report Card, at http://www.irs.gov/Advocate/Annual-Report-to-Congress-Report-Cards.

of our preliminary recommendations. Yet, as a result of the 90-day process for formally reviewing and responding to the National Taxpayer Advocate's recommendations, the IRS agreed to over 46 percent of the final recommendations.[9]

Thus, this year we decided to adhere closely to the statutory language. We have dispensed with the step of sharing the initial analyses with the IRS for its comment. Instead, we have provided the IRS with all of the IRS-sourced data we cite in the Most Serious Problems along with any underlying assumptions that relate to data interpretation. We have provided the IRS ten days in which to identify any factual inaccuracies. Following submission of the report to the tax-writing committees of Congress, the National Taxpayer Advocate will submit the report to the IRS Commissioner. At the same time, she will provide the formal listing of recommendations which will trigger the 90-day period for IRS response.

We plan to publish the IRS responses and our own response on the Internet, and use those responses to identify the "objectives of the Office of the Taxpayer Advocate" in our Objectives Report for the next fiscal year, published in June of each year.[10] In this way, we will retain full transparency regarding the IRS's perspective on our recommendations to address the Most Serious Problems while still complying with the statutory protections. At the same time, we will link the IRS's responses to the Most Serious Problems with the Taxpayer Advocate Service's objectives for the upcoming fiscal year.

Methodology of the Most Serious Problem List

The National Taxpayer Advocate considers a number of factors in identifying, evaluating, and ranking the most serious problems encountered by taxpayers. The 25 issues were ranked according to the following criteria:

- Impact on taxpayer rights;
- Number of taxpayers affected;
- Interest, sensitivity, and visibility to the National Taxpayer Advocate, Congress, and other external stakeholders;
- Barriers these problems present to tax law compliance, including cost, time, and burden;
- The revenue impact of noncompliance; and
- Taxpayer Advocate Management Information System (TAMIS) and Systemic Advocacy Management System (SAMS) data.

After reviewing this ranking, the National Taxpayer Advocate identified five issues, which are, in her judgment after taking into consideration all of the above factors, the ones most in need of attention and thus requiring the most prominent placement in the ranking. Finally, the National Taxpayer Advocate and the Office of Systemic Advocacy examine the results of the ranking on the remaining issues and adjust it where editorial or numeric considerations warrant a particular placement or grouping.

9 2012 Annual Report to Congress Report Card, at http://www.irs.gov/Advocate/Annual-Report-to-Congress-Report-Cards. This percentage includes ARC recommendations adopted in full or in part in MSPs where the NTA offered preliminary recommendations.

10 IRC § 7803(c)(2)(B)(i).

Taxpayer Advocate Management Information System List

The identification of the Most Serious Problems reflects not only the mandates of Congress and the IRC, but TAS's integrated approach to advocacy — using individual cases as a means for detecting trends and identifying systemic problems in IRS policy and procedures or the Code. TAS tracks individual taxpayer cases on TAMIS. The top 25 case issues, listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts in fiscal year 2013, a period spanning October 1, 2012, through September 30, 2013.

Use of Examples

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

MSP #1 TAXPAYER RIGHTS: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration

RESPONSIBLE OFFICIAL

John Koskinen, Commissioner of Internal Revenue

DEFINITION OF PROBLEM

The U.S. tax system is built on voluntary compliance. The IRS estimates that it collects 85.5 percent of all tax owed.[1] Of that amount, 98 percent is paid timely and voluntarily. Only two percent derives from late and enforced collection actions.[2]

For the government, voluntary compliance is much cheaper than enforced compliance, because the government does not have to spend money to collect amounts that are voluntarily paid. Thus, the IRS's overriding goal is to maximize voluntary compliance.[3]

Taxpayer rights are central to voluntary compliance. If taxpayers believe they are treated, or can be treated, in an arbitrary and capricious manner, they will mistrust the tax system and be less likely to comply with the laws voluntarily. If taxpayers have confidence in the fairness and integrity of the system, they will be more likely to comply.

The Internal Revenue Code (IRC) provides dozens of real, substantive taxpayer rights. However, these rights are scattered throughout the Code and are not presented in a coherent way. Consequently, most taxpayers have no idea what their rights are and therefore often cannot take advantage of them.

Not surprisingly, in response to a survey of U.S. taxpayers conducted for the Taxpayer Advocate Service (TAS) in 2012, less than half said they believed they have rights before the IRS, and only 11 percent said they knew what those rights are.[4]

We can and must do a better job of making taxpayers aware of their rights and enabling them to assert these rights. Since 2007, the National Taxpayer Advocate has repeatedly recommended adoption of a Taxpayer Bill of Rights (TBOR) that takes the multiple existing rights embedded in the code and groups them into ten broad categories, modeled on the U.S. Constitution's Bill of Rights.[5] A thematic, principle-based list of core taxpayer rights would provide a foundational framework for taxpayers and IRS employees alike that would promote effective tax administration.

1 IRS News Release, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012).

2 *Id.* Enforcement and Late Payments percentage is computed by dividing enforcement and late payments of $65 billion by total tax liabilities of $2,660 billion.

3 *See* IRS Strategic Plan 2009-2013 ("Goal 1: Improve service to make voluntary compliance easier").

4 Forrester Research Inc., *The TAS Omnibus Analysis*, from North American Technographics Omnibus Mail Survey, *Q2/Q3 2012* 19-20 (Sept. 2012).

5 Congress has passed several pieces of legislation with "Taxpayer Bill of Rights" in the title. *See* Technical and Miscellaneous Revenue Act, Pub. L. No. 100–647, § 6226, 102 Stat. 3342, 3730 (1988) (containing the "Omnibus Taxpayer Bill of Rights," also known as TBOR 1); Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996) (also known as TBOR 2); Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) (Title III is known as "Taxpayer Bill of Rights III" or TBOR 3). These laws create specific rights in certain instances, but they do not create a thematic, principled-based list of overarching taxpayer rights.

Simply put, labels and presentation matter. Almost all Americans know we have a Bill of Rights, and many can name specific ones. The First Amendment right to free speech, for example, is widely known. When one digs deeper, it becomes clear that the right is not absolute (*e.g.,* the First Amendment does not protect an individual's right to falsely scream "Fire!" in a crowded theater), and there are dozens of Supreme Court decisions that delineate the scope of the right. But the simplicity and clarity of a thematic Bill of Rights help Americans understand their rights in general terms, and this knowledge empowers them to assert their rights and learn the nuances when the need arises.

Taxpayer rights are central to voluntary compliance. If taxpayers believe they are treated, or can be treated, in an arbitrary and capricious manner, they will mistrust the tax system and be less likely to comply with the laws voluntarily. If taxpayers have confidence in the fairness and integrity of the system, they will be more likely to comply.

A thematic Taxpayer Bill of Rights would serve the same purpose and its value can scarcely be overstated. A Taxpayer Bill of Rights would serve as an organizing principle for tax administrators in establishing agency goals and performance measures, provide foundational principles to guide IRS employees in their dealings with taxpayers, and provide information to taxpayers to assist them in their dealings with the IRS.

At the same time, the tax system will work best if we provide transparency, not only about taxpayer rights but also about taxpayer responsibilities. The National Taxpayer Advocate views the relationship between the government and its taxpayers as a social contract of sorts — the U.S. government requires its tax collector to treat taxpayers with courtesy and respect and asks taxpayers to cooperate with the tax collector. In recognition of this two-way relationship, we recommend the Taxpayer Bill of Rights also contain a section outlining taxpayer responsibilities.[6] Overall, the document would lay out in general but very clear terms what taxpayers must do to comply with the tax laws and what rights taxpayers possess in that process. The document would serve to heighten awareness of these rights and responsibilities among taxpayers and IRS employees alike.

Thus, the National Taxpayer Advocate recommends that the IRS adopt and promote a Taxpayer Bill of Rights, and actively apply its principles to all IRS strategic planning, compliance and taxpayer service activities, and to outreach and education.[7] Doing so will ensure taxpayers know their rights, enable them to avail themselves of those rights, and restore trust in the tax system.[8] A TBOR provides organizing principles — a framework — for effective tax administration.

6 While the National Taxpayer Advocate believes a statement of taxpayer responsibilities would promote effective tax administration by providing taxpayers with greater clarity about what is expected of them, the IRS's obligation to respect taxpayer rights should not be contingent on whether a taxpayer has fulfilled these responsibilities. For example, a taxpayer who did not keep all records or did not pay all tax timely does not forfeit his right to retain a representative to assist him in dealing with the IRS.

7 In her preface to the Fiscal Year 2014 Objectives Report to Congress, the National Taxpayer Advocate analyzed the IRS's processing of applications for tax-exempt status and showed that the IRS had violated eight of the ten rights she has proposed. Had there been a published Taxpayer Bill of Rights, organizations applying for tax-exempt status, IRS employees processing their applications, IRS executives overseeing the program, and Congressional offices receiving complaints likely would have flagged the inconsistencies between the applicants' rights and the IRS's actions more quickly. There is no guarantee that would have happened, of course, but the existence and broad awareness of a Taxpayer Bill of Rights would have substantially increased the odds that the problems would have surfaced and been addressed sooner.

8 For a comprehensive analysis of the role taxpayer rights play in effective tax administration, see National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (*Recommendations to Raise Taxpayer and Employee Awareness of Taxpayer Rights*) (Nov. 4, 2013), *available at* www.TaxpayerAdvocate.irs.gov/2013AnnualReport.

ANALYSIS OF PROBLEM

I. TAXPAYER BILL OF RIGHTS SERVES AS AN ESSENTIAL FRAMEWORK FOR EFFECTIVE TAX ADMINISTRATION

> "A bill of rights is what the people are entitled to against every government on earth, general or particular; and what no just government should refuse, or rest on inferences." — Thomas Jefferson[9]

The federal Bill of Rights provides citizens with indispensable freedoms and guarantees rights that were not explicitly granted in the U.S. Constitution, such as the right to free speech and the right to be free from unreasonable searches and seizures.[10] These rights are fundamental to the functioning of our society. Citizens follow the laws because they trust the government to uphold their rights and treat them fairly. Similarly, the federal tax system is based on an unwritten social contract between the government and its taxpayers: taxpayers agree to report and pay the taxes they owe to enable their government to function, and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so.[11] Taxpayers are more likely to uphold their side of this agreement and voluntarily pay taxes when they trust the government and the IRS.[12] In order for taxpayers to trust the IRS, they must understand that they have fundamental rights that apply throughout their dealings with the IRS, and they must believe that the IRS will respect these rights. For this reason, it is vital that the IRS adopt a Taxpayer Bill of Rights.

The Internal Revenue Code includes specific provisions that are crafted to ensure a fair and just tax system and protect all taxpayers from potential IRS abuse. However, the Code contains no organizing principles or formal acknowledgement of the fundamental taxpayer rights from which these statutory rights derive.[13] The National Taxpayer Advocate has recommended numerous times that a statement of taxpayer rights, a Taxpayer Bill of Rights, be formally codified.[14] While codifying a TBOR would require Congressional

---

9 Thomas Jefferson to James Madison, 1787. ME 6:388, Papers 12:440.

10 *See* U.S. Const. amends. I, IV.

11 The 16th Amendment to the U.S. Constitution provides Congress with the authority to tax. The Internal Revenue Code, which provides the legal basis for our tax system, is codified in Title 26 of the U.S. Code.

12 *See* National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, at 13 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

13 For example, the right of a taxpayer to be informed is included in a number of different IRC provisions. IRC § 6213(a) requires the IRS to provide a notice of deficiency giving the taxpayer 90 days (150 days if the notice is addressed to a person outside of the United States) to petition Tax Court and, as required by IRC 7522(a), it should provide the basis for and the amount of tax, interest, and penalties due. IRC § 6330 requires the IRS to notify taxpayers at least 30 days before a notice of intent to levy and provide the amount of unpaid tax, the IRS's proposed action, the IRC provisions relating to levy, the procedures available to the IRS, the administrative appeals available to the taxpayer, and the alternatives available to prevent the levy. IRC § 6320(a) requires the IRS to notify a taxpayer of the notice of federal tax lien within five days of when the lien is filed.

14 *See* National Taxpayer Advocate 2011 Annual Report to Congress 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*); National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*).

…the National Taxpayer Advocate recommends that the IRS adopt and promote a Taxpayer Bill of Rights, and actively apply its principles to all IRS strategic planning, compliance and taxpayer service activities, and to outreach and education. Doing so will ensure taxpayers know their rights, enable them to avail themselves of those rights, and restore trust in the tax system.

action, the IRS can articulate these rights by adopting a TBOR on its own.[15] Internally, the National Taxpayer Advocate has had several discussions with senior IRS officials over the last few months about publishing a Taxpayer Bill of Rights, and she is hopeful the IRS will decide to do so in the near future if Congress does not act first.

Congress has passed multiple pieces of legislation with the title of "Taxpayer Bill of Rights," but none of these laws provides a foundational, general description of taxpayer rights. Taxpayers need a TBOR to enable them to understand their basic rights without having to consult a multitude of Code sections that apply in specific circumstances. The U.S. Bill of Rights provides taxpayers with a clear statement of general rights so taxpayers understand they have a right to free speech, even if they do not know the court decisions that define and limit its scope. A TBOR would operate the same way. For example, a taxpayer needs to know he or she has a basic right to appeal when facing a collection action such as a levy, even if the taxpayer does not know the specific information in the Code regarding Collection Due Process hearings.

The National Taxpayer Advocate's recommendation that Congress codify a thematic, principle-based Taxpayer Bill of Rights has attracted considerable bipartisan support. This summer, the House of Representatives by voice vote passed an earlier version of the proposal, which is now pending in the Senate.[16] At the same time, we have heard very few concerns about the proposal. That is because it does not aim to create new rights or remedies — only to group existing rights into categories that are easier for taxpayers and IRS employees to understand and remember.

In response to allegations that the IRS used inappropriate criteria to screen applications for tax-exempt status,[17] the Principal Deputy Commissioner issued a "30-day report" providing an initial assessment of the allegations and describing actions the IRS planned to undertake to address underlying causes.[18] Among other things, the Principal Deputy Commissioner asked the National Taxpayer Advocate to provide him with recommendations to:

1) Improve taxpayer and employee awareness of the Taxpayer Advocate Service and the role it plays assisting taxpayers and advocating for systemic improvements; and
2) Raise awareness of taxpayer rights, including updating IRS Publication 1, *Your Rights as a Taxpayer*.

15 There is ample precedent for the IRS to adopt a TBOR administratively before Congress enacts legislation. In 1977, for example, the IRS established a problem resolution program nationwide to help taxpayers when regular contacts with the IRS failed. In 1979, the IRS created the Office of the Taxpayer Ombudsman to serve as the primary advocate within the IRS for taxpayers, with responsibility for managing the problem resolution program. Yet the first reference to the Taxpayer Ombudsman did not appear in the IRC until 1988. *See* Pub. L. No. 100-647, § 6235, 102 Stat. 3342, 3737 (Nov. 10, 1988). Similarly, in March 1988, then Commissioner Gibbs announced a new initiative authorizing problem resolution officers to issue "taxpayer assistance actions" to suspend enforcement actions or expedite procedures in certain cases. These "taxpayer assistance actions" were the precursor to "taxpayer assistance orders" created by Congress in 1988 with the enactment of IRC § 7811. *See* Pub. L. No. 100-647, § 6230, 102 Stat. 3342, 3733 (Nov. 10, 1988).

16 Taxpayer Bill of Rights Act of 2013, H.R. 2768, 113th Cong. (as passed by House, July 31, 2013).

17 *See* Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 14, 2013).

18 *See* Principal Deputy Commissioner, *Charting a Path Forward at the IRS: Initial Assessment and Plan of Action* (June 24, 2013).

In response to the first charge, the National Taxpayer Advocate submitted a report to the Principal Deputy Commissioner on August 23, 2013.[19] In response to the second charge, the National Taxpayer Advocate submitted a report, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration,* on November 4, 2013.[20] This latter report is a comprehensive analysis of the role a Taxpayer Bill of Rights could and should play in tax administration, and contains 22 action items for the National Taxpayer Advocate and 23 recommendations to the Commissioner of Internal Revenue. The National Taxpayer Advocate has also developed an updated draft color version of Publication 1, illustrated in Figure 3.

A. OECD and Other Countries Provide Models for a Taxpayer Bill of Rights

In 1988, the Organisation for Economic Co-operation and Development (OECD) sent a questionnaire to its member countries, asking about their systems of taxpayer rights and obligations. OECD published the results of the survey in 1990.[21] The survey found that although most countries did not have an explicit charter or bill of rights, there were certain basic rights present in all tax systems that responded:

- The right to be informed, assisted, and heard;
- The right of appeal;
- The right to pay no more than the correct amount of tax;
- The right to certainty;
- The right to privacy; and
- The right to confidentiality and secrecy.[22]

The OECD also identified certain "behavioral norms" that governments expect of taxpayers and are essential to the proper functioning of tax administration. These taxpayer responsibilities include:

- The obligation to be honest;
- The obligation to be cooperative;
- The obligation to provide accurate information and documents on time;
- The obligation to keep records; and
- The obligation to pay taxes on time.[23]

Many countries have adopted taxpayer charters that officially articulate taxpayer rights and obligations. The charters vary, as some consist of general statements of broad principles while others offer detailed explanations of taxpayer rights for each stage of the tax process."[24] The OECD explains that most taxpayer charters are a guide to the legal rights a taxpayer already has and they generally do not create additional rights that are not granted by legislation.[25]

19 *Available at* www.TaxpayerAdvocate.irs.gov/2013AnnualReport.

20 *Id.*

21 OECD, Committee of Fiscal Affairs, *Taxpayers' Rights and Obligations – a Survey of the Legal Situation in OECD Countries* (Apr. 27, 1990).

22 *Id*.

23 *Id*.

24 OECD, Centre for Tax Policy and Administration, *Taxpayers' Rights and Obligations – Practice Note* 3-4, (Aug. 2003).

25 OECD, Centre for Tax Policy and Administration, *Taxpayers' Rights and Obligations – Practice Note* 6 (Aug. 2003).

The Canada Revenue Agency (CRA) has adopted and published a TBOR as well as a Commitment to Small Business.[26] Canada's TBOR consists of 16 provisions, including:

- The right to have the law applied consistently;
- The right to expect CRA to be accountable;
- The right to be treated professionally, courteously, and fairly; and
- The right to expect CRA to warn you about questionable tax schemes in a timely manner.[27]

Recently, the Canadian Minister of National Revenue accepted the recommendation of the Taxpayers' Ombudsman to add an additional article to the Taxpayer Bill of Rights, which would "provide assurance to Canadians that lodging a service complaint or requesting a formal review would not lead to biased treatment by the CRA in the future."[28]

The Australian Taxation Office (ATO) also has created and adopted a Taxpayer Charter, which outlines not only a taxpayer's rights and obligations, but also what the taxpayer can expect from the ATO and what a taxpayer can do if he or she is not satisfied.[29] The United Kingdom has a taxpayer charter that outlines what taxpayers can expect from Her Majesty's Revenue and Customs (HMRC), including the expectation to be treated as honest and with respect.[30] The United Kingdom charter, which includes three taxpayer obligations, also commits HMRC to do everything it can to keep the cost of dealing with HMRC as low as possible.[31]

Several states, including New York,[32] Pennsylvania,[33] Indiana,[34] Kentucky,[35] Montana,[36] and Nebraska,[37] have adopted a Taxpayer Bill of Rights. While these charters vary in scope — Montana's is statutory, Nebraska's provides its taxpayers with "Freedom from Red Tape" — all contain most of the fundamental components identified by the OECD, and several outline taxpayer obligations in addition to rights. New York State also has a Consumer Bill of Rights Regarding Tax Preparers, which aims to protect taxpayers that use tax return preparers from unfair treatment.[38]

---

26 The CRA Commitment to Small Business is a "a five-part statement through which the CRA pledges to support the competitiveness of the Canadian business community by ensuring that interactions with the CRA are as effective and efficient as possible." *See* http://www.cra-arc.gc.ca/gncy/txpyrbllrghts/tbrfq-eng.html (last visited Sept. 15, 2013).

27 CRA, Taxpayer Bill of Rights, *available at* http://www.cra-arc.gc.ca/gncy/txpyrbllrghts/menu-eng.html (last visited Sept. 15, 2013).

28 Office of the Taxpayers' Ombudsman, Perspectives; Issue 3 (Aug. 2013), *available at* http://www.oto-boc.gc.ca/rprts/nslt3-eng.html.

29 *See* ATO, Taxpayer's Charter: What You Need to Know (2011), *available at* http://www.ato.gov.au/About-ATO/About-us/In-detail/Taxpayers–charter/Taxpayers–charter—what-you-need-to-know.

30 HMRC, Your Charter, *available at* https://www.gov.uk/government/publications/your-charter (last visited Sept. 24, 2013).

31 *Id*.

32 N.Y. Tax Law § 3000. *See* http://www.tax.ny.gov/tra/rights.htm (last visited Sept. 15, 2013).

33 72 Pa. Stat. Ann. § 3310-101 (1996); *see* Taxpayer Bill of Rights, *available at* http://www.portal.state.pa.us/portal/server.pt/community/taxpayers'_rights_advocate/13152 (last visited Sept. 24, 2013).

34 *See* Indiana Department of Revenue, The Taxpayer Bill of Rights, *available at* http://www.in.gov/dor/3660.htm (last visited Sept. 15, 2013).

35 Kentucky Revised Statements Annotated 131.041-131.081, Taxpayer Bill of Rights; *see also* Your Rights as a Kentucky Taxpayer, *available at* http://www.revenue.ky.gov/nr/rdonlyres/c343eebb-2975-4f0b-82a6-855c9d15cdd2/0/10f100713.pdf (last visited Sept. 24, 2013).

36 Montana Codes Annotated 15-1-222; *see* http://revenue.mt.gov/tax_appeal_process/taxpayer_bill_rights.mcpx (last visited Sept. 15, 2013).

37 *See* http://www.revenue.ne.gov/rights.html (last visited Sept. 15, 2013).

38 *See* State of New York, Department of Taxation and Revenue, Publ. 135, *Bill of Rights Regarding Tax Preparers* (Aug. 2011), *available at* http://www.tax.ny.gov/pdf/publications/income/pub135.pdf.

B. It Is Essential that the IRS Adopt a Taxpayer Bill of Rights

A formal acknowledgement of taxpayer rights is vital to restoring and maintaining taxpayers' confidence in the IRS to fairly and impartially administer the tax laws. In a recent lecture, the National Taxpayer Advocate stated:

> At their core, taxpayer rights are human rights. They are about our inherent humanity. Particularly when an organization is large, as is the IRS, and has power, as does the IRS, these rights serve as a bulwark against the organization's tendency to arrange things in ways that are convenient for itself, but actually dehumanize us. Taxpayer rights, then, help ensure that taxpayers are treated in a humane manner.[39]

A TBOR that simply articulates the basic rights and obligations of every taxpayer should provide the organizing principle around which tax administration operates. Whenever the IRS proposes a new initiative, it should analyze the initiative to ensure that it comports with the fundamental taxpayer rights set forth in the TBOR and the Internal Revenue Code. The IRS needs a TBOR to guide not only its big-picture policy and programming decisions but the individual actions of its employees.

The National Taxpayer Advocate has used OECD's guidance to develop a list of taxpayer rights and responsibilities to be included in the TBOR.[40] Taxpayer rights apply to taxpayers in all situations, regardless of whether they have met their obligations, such as filing a tax return on time. That is, taxpayer rights are not conditioned on taxpayers' compliance. Still, including taxpayer responsibilities in the TBOR reinforces the social contract between taxpayers and the IRS. The following make up the TBOR proposed by the National Taxpayer Advocate:

Ten Taxpayer Rights

1. **The Right to Be Informed**
   Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the law and IRS procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes.

2. **The Right to Quality Service**
   Taxpayers have the right to receive prompt, courteous, and professional assistance in their dealings with the IRS, to be spoken to in a way they can easily understand, to receive clear and easily understandable communications from the IRS, and to have a way to file complaints about inadequate service.

3. **The Right to Pay No More than the Correct Amount of Tax**
   Taxpayers have the right to pay only the amount of tax legally due and to have the IRS apply all tax payments properly.

---

39 Nina E. Olson, *A Brave New World: The Taxpayer Experience in a Post-Sequester IRS* (the Laurence Neal Woodworth Memorial Lecture), Tax Notes Today 106-118 (June 3, 2013).

40 The National Taxpayer Advocate has shared this TBOR with the IRS Office of Chief Counsel and the Chief of Communications and Liaison, and has adopted several of their suggestions.

4. **The Right to Challenge the IRS's Position and Be Heard**
   Taxpayers have the right to raise objections and provide additional documentation in response to IRS actions or proposed actions, to expect that the IRS will consider their objections and documentation promptly and impartially, and to receive a written response if the IRS finds them insufficient.

5. **The Right to Appeal an IRS Decision in an Independent Forum**
   Taxpayers are entitled to a prompt and impartial administrative appeal of IRS actions and have the right to receive a written response explaining the Appeals Division's decision. Taxpayers generally have the right to take their cases to court to challenge an adverse final determination.

6. **The Right to Finality**
   Taxpayers have the right to know the maximum amount of time they have to challenge the IRS's position as well as the maximum amount of time the IRS has to audit a particular tax year. Taxpayers have the right to know when the IRS has finished an audit.

7. **The Right to Privacy**
   Taxpayers have the right to expect that any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary, and will respect all due process rights, including search and seizure protections and a collection due process hearing where applicable.

8. **The Right to Confidentiality**
   Taxpayers have the right to expect that any information they provide to the IRS will not be disclosed unless authorized by the taxpayer or by law. Taxpayers have the right to expect the IRS to investigate and take appropriate action against its employees, return preparers, and others who wrongfully use or disclose taxpayer return information.

9. **The Right to Retain Representation**
   Taxpayers have the right to retain an authorized representative of their choice to represent them in their dealings with the IRS. Taxpayers have the right to be told that if they cannot afford to hire a representative they may be eligible for assistance from a Low Income Taxpayer Clinic.

10. **The Right to a Fair and Just Tax System, Including Access to the Taxpayer Advocate Service**
    Taxpayers have the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely. Taxpayers have the right to receive assistance from the Taxpayer Advocate Service if they are experiencing financial difficulty or if the IRS has not resolved their tax issues properly and timely through its normal channels.

Five Taxpayer Responsibilities

1. **The Responsibility to Be Honest**
   Taxpayers have the responsibility to be truthful in preparing their tax returns and in all other dealings with the IRS.

2. **The Responsibility to Provide Accurate Information**
   Taxpayers have the responsibility to answer all relevant questions completely and honestly, to provide all required information on a timely basis, and to explain all relevant facts and circumstances when seeking guidance from the IRS.

3. **The Responsibility to Keep Records**
   Taxpayers have the responsibility to maintain adequate books and records to fulfill their tax obligations, preserve them during the time they may be subject to IRS inspection, and provide the IRS with access to those books and records when asked so the IRS can examine their tax liabilities to the extent required by law.

4. **The Responsibility to Pay Taxes on Time**
   Taxpayers have the responsibility to pay the full amount of taxes they owe by the due date and to pay any legally correct additional assessments in full. If they cannot pay in full, they have the responsibility to comply with all terms of any full or partial payment plans the IRS agrees to accept.

5. **The Responsibility to Be Courteous**
   Taxpayers have the responsibility to treat IRS personnel politely and with respect.

By establishing an official taxpayer charter, the IRS can show its current and future commitment to protecting fundamental taxpayer rights. The TBOR will also provide a valuable framework for evaluating IRS policies, programs, actions, and initiatives.

C. Recognition of Taxpayer Rights Requires Adequate Funding for the IRS

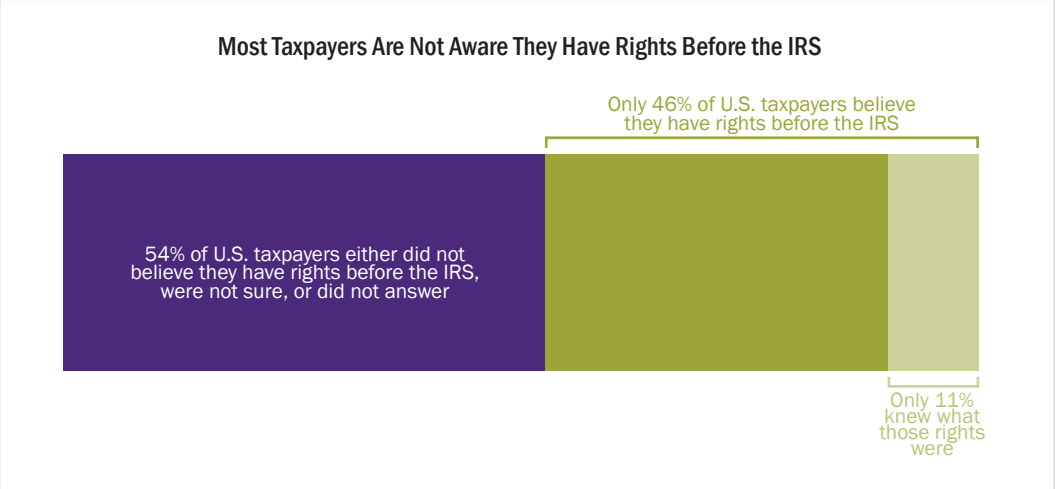
Throughout this report are examples of actions the IRS can take to implement the TBOR. However, taxpayer rights may be impaired if the IRS is not adequately funded. If there is agreement that taxpayers have certain basic rights, then Congress and the Executive Branch have a responsibility to ensure the IRS has sufficient resources to deliver these rights. For example, if taxpayers have the *right to quality service*, then the IRS must be funded so that it has the capability to provide quality service. A TBOR will be limited in its effectiveness without an adequate budget for the IRS to take actions to protect and fulfill taxpayer rights.

II. TAXPAYER AWARENESS OF TAXPAYER BILL OF RIGHTS

As noted above, the Internal Revenue Code includes a number of statutory taxpayer rights that are specific to certain situations, but it contains no organizing principles or formal acknowledgement of the fundamental taxpayer rights from which these statutory protections derive. Thus, taxpayers may not realize they have rights or know what they are. TAS research shows that many taxpayers are not aware they have

rights. The results of a recent nationwide survey of taxpayers found that fewer than half of U.S. taxpayers believed they have rights before the IRS, and only 11 percent said they knew what those rights were.[41]

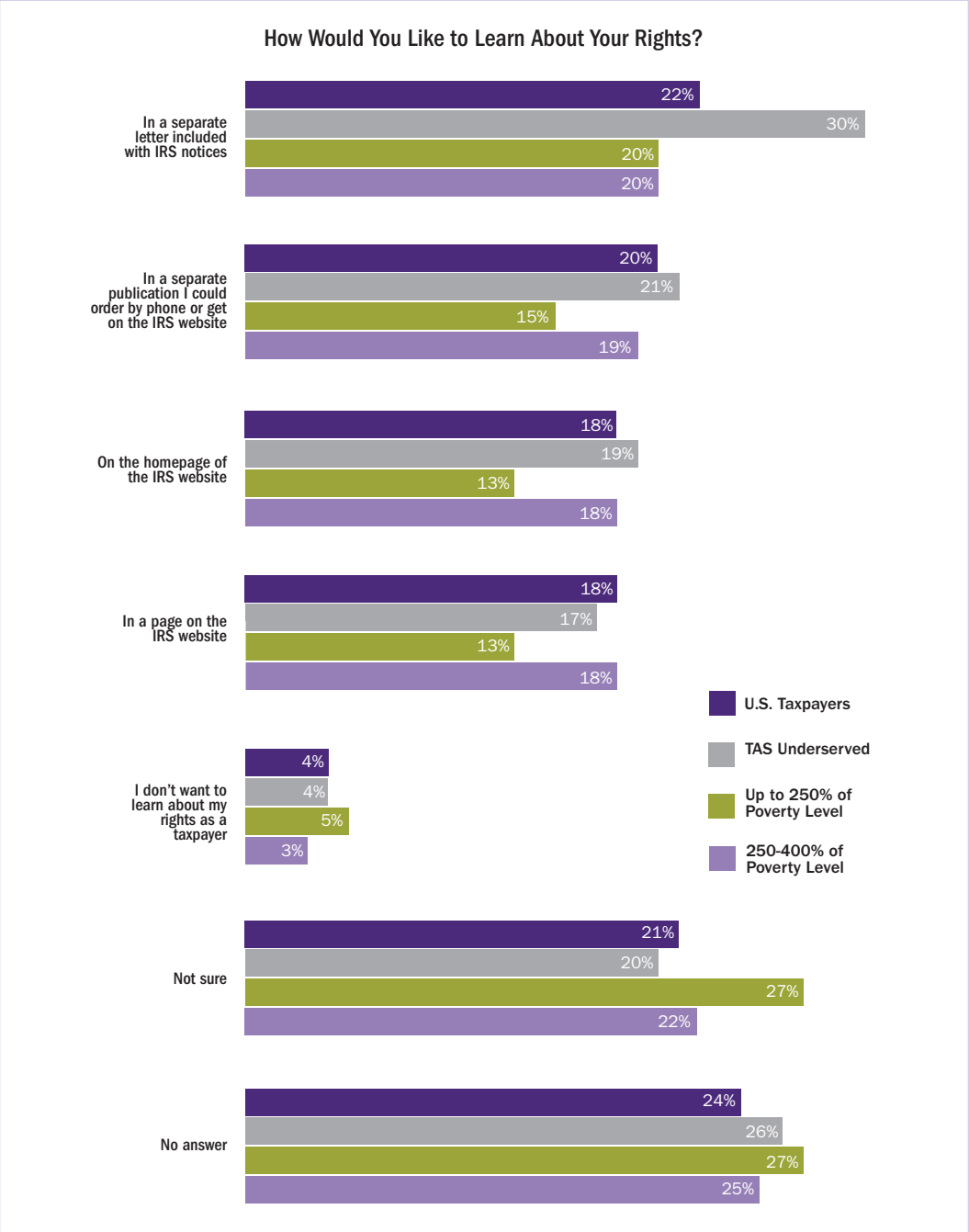
FIGURE 1.1.1, Taxpayers' Knowledge of Taxpayer Rights



The IRS relies largely on distribution of Publication 1, *Your Rights as a Taxpayer*, to inform taxpayers about their rights. As discussed below, with revisions Publication 1 can be an important vehicle for taxpayer education about their rights, but the IRS should also educate and inform taxpayers through its public website and with posters and brochures in IRS offices. Taxpayers prefer a variety of sources, according to a 2012 TAS study that asked a statistically representative nationwide sample of 8,911 U.S. taxpayers how they would like to learn about their rights.

41 Forrester Research Inc., *The TAS Omnibus Analysis, from North American Technographics Omnibus Mail Survey*, Q2/Q3 2012, 19-20 (Sept. 17, 2012).

FIGURE 1.1.2, "How would you like to learn about your rights?"[42]



Thus, taxpayers are best served if the IRS provides them with multiple channels of taxpayer rights information and education.

42 Forrester Research Inc., *The TAS Omnibus Analysis, from North American Technographics Omnibus Mail Survey*, Q2/Q3 2012, 21 (Sept. 17, 2012). "TAS underserved" refers to taxpayers who qualify for but do not seek TAS help with their tax problems. This survey was conducted only in English; TAS is seeking to administer it to Spanish-speaking taxpayers. See National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (*Recommendations to Raise Taxpayer and Employee Awareness of Taxpayer Rights*) 12-16 (Nov. 4, 2013), *available at* www.TaxpayerAdvocate.irs.gov/2013AnnualReport.

Recent TAS Focus Groups Confirm that Taxpayers Would Like to Know About Their Rights

In November 2013, a contractor for TAS conducted eight focus groups with taxpayers and tax preparers to evaluate the level of taxpayers' knowledge and understanding of their rights and responsibilities relating to federal taxes.[43] Specifically, the focus groups were designed to qualitatively assess:

- The extent of taxpayers' and preparers' knowledge (and desire to know) of taxpayer rights and responsibilities;
- How they would like to learn about their rights and responsibilities;
- From whom, when, where, and in what form would they like to receive this information;
- Their reaction to TAS's proposed TBOR;
- Their reaction to Publication 1 (both original version and a revised version developed by TAS);[44] and
- How they would change or improve this publication.

The report found that taxpayers had little knowledge of, but high interest in, the list of taxpayer rights in our proposed TBOR, and they reacted very positively to it overall.[45] One taxpayer from Los Angeles said:

> It summarizes it in one piece of paper, what everybody wants and needs to know about the IRS and that's rare.

Taxpayers were particularly happy to learn about the *right to challenge the IRS's position and be heard*;[46] the *right to appeal an IRS decision to an independent forum*;[47] and the *right to retain representation*.[48] Overall, taxpayers felt that learning about their rights made them view the IRS in a more favorable light.[49] On the other hand, they felt that publishing the rights alone would have little effect on tax compliance — which is consistent with the observation that it is *how* rights are protected and implemented that has the greatest impact on compliance. Among the rights they questioned, taxpayers found the *right to finality* and the *right to pay no more than the correct amount of tax* unclear. Significantly, they doubted the IRS's ability to fulfill the *right to quality service*.[50]

---

43 The focus groups were conducted between November 18, 2013 and November 21, 2013 in four sites: East Rutherford, New Jersey; Chicago, Illinois; Dallas, Texas; and Los Angeles, California. At each site, the contractor conducted one focus group of taxpayers and one focus group of preparers. The taxpayers participating in the focus groups had filed taxes for the past three years, which included a mix of preparer-, professional, and self-prepared returns. Russell Research, *Final Report from a Focus Group Study of Taxpayer Rights & Responsibilities* (Dec. 6, 2013).

44 In the first Taxpayer Bill of Rights legislation (TBOR 1), Congress required the IRS to prepare a statement of taxpayer rights and IRS obligations and distribute it to taxpayers when contacting them regarding the determination of tax or collection of tax. Technical and Miscellaneous Revenue Act of 1988, Pub L. No. 100-67, § 6227, 102 Stat. 3342, 3730-31 (Nov. 10, 1988). Currently, the IRS outlines these rights for taxpayers in Publication 1, *Your Rights as a Taxpayer*.

45 *Id*. at 14.

46 "I've had some experience with the IRS…Like the right to appeal and be heard…There were some issues that I had challenged, and the IRS was overturned and I received full restitution." (Chicago taxpayer). *Id*. at 11.

47 "The one I like best is the right to appeal an IRS decision in an independent forum. I've been through that, so I know how important that was. I think all these are actually very important." (Los Angeles taxpayer). *Id*.

48 "The right to retain representation [is the most important right to me]…In theory they could call you in and have you and them (representation) there and that is basically that." (New Jersey taxpayer). *Id*.

49 "To me, I kind of like it. It looks like they're making an attempt [to be less intimidating]. Maybe they will be a little more fair." (Los Angeles taxpayer). *Id*.

50 "Seriously, if you don't have money to pay an accountant, do they provide quality service that you can go somewhere and have them do your taxes for you?" (New Jersey taxpayer). *Id*. at 10.

Overall, the taxpayers felt most of the responsibilities were "a given" and obvious.[51] Taxpayers had a negative reaction to two of the responsibilities, *to be honest*[52] and *to be courteous*.[53] The National Taxpayer Advocate will use these observations, as well as those from future focus groups, to revise our proposed explanations of rights and responsibilities.[54]

CONCLUSION

The Taxpayer Bill of Rights would reassure taxpayers that they have rights that the IRS must respect, reinforcing the social contract between taxpayers and the IRS. With the adoption of a TBOR, taxpayers may be more likely to perceive the IRS as fair and just, which may increase voluntary compliance. The IRS can make great strides toward protecting taxpayer rights through the adoption of a TBOR and making it the foundation for effective tax administration.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Adopt the Taxpayer Bill of Rights, including ten fundamental taxpayer rights and five taxpayer responsibilities.
2. Prominently display a link on the IRS.gov homepage ("Know Your Rights as a Taxpayer") to a taxpayer rights webpage, which will further link to specific explanations of taxpayer rights and responsibilities.
3. In collaboration with the National Taxpayer Advocate, post taxpayer rights language on the business operating division pages of IRS.gov that refers to TAS, Low Income Taxpayer Clinics, specific taxpayer rights and responsibilities and contains links to the U.S. Tax Court webpage, where appropriate.
4. Require all public- and taxpayer-facing IRS sites and offices to display a poster and brochures about the Taxpayer Bill of Rights, to be developed in collaboration with the National Taxpayer Advocate.
5. Require all IRS operating divisions and functions when proposing initiatives, including budget initiatives, to include in their business case justifications an analysis of the proposed operation in terms of the Taxpayer Bill of Rights.

---

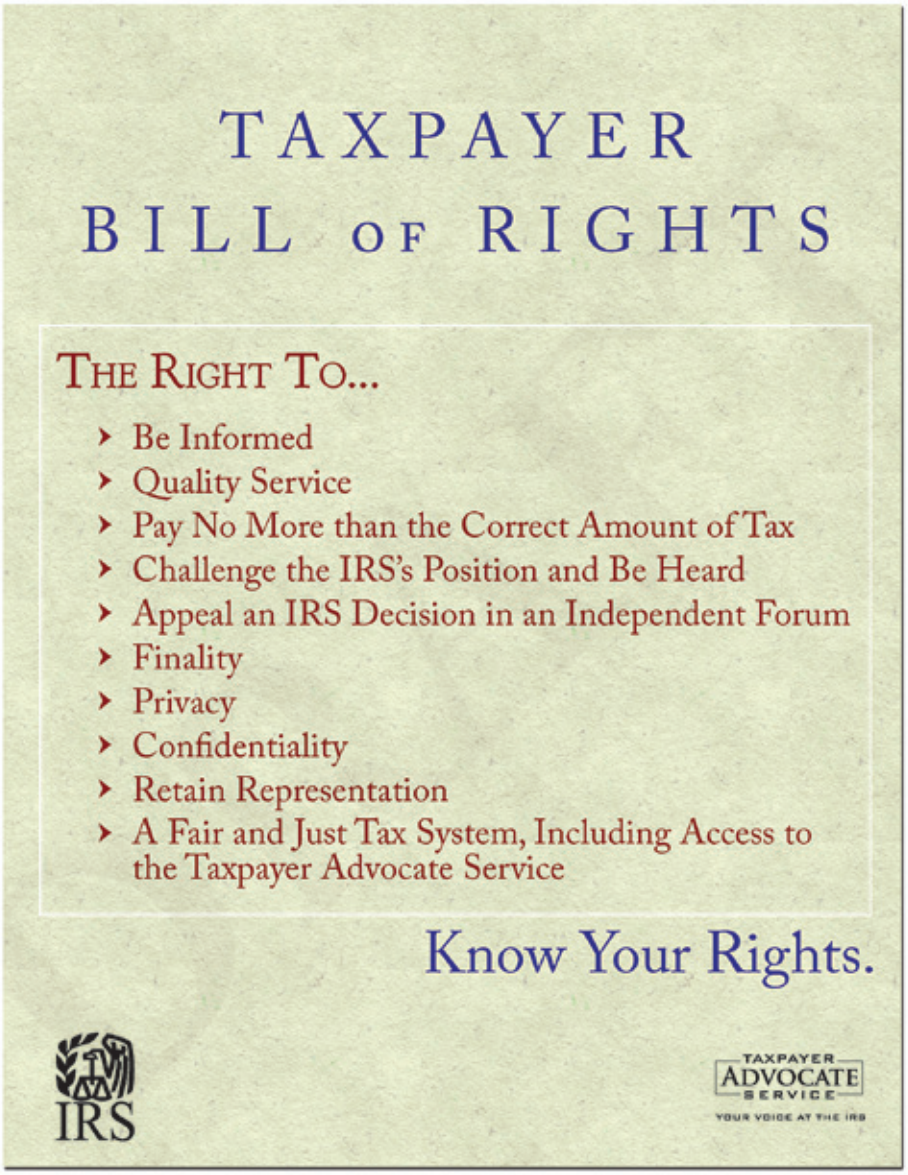
51 "I can't imagine that you wouldn't think you were responsible to provide accurate honest information…To me, that's a no-brainer." (Dallas taxpayer). *Id*. at 13.

52 "Obviously if you are not honest you are going to get audited or you could get audited." (New Jersey taxpayer). *Id*.

53 "Well then that shouldn't even be on there. It's common sense to be courteous." (Chicago taxpayer); "You better believe it. If there's anybody I'm going to be courteous, it's, you know, the IRS." (Chicago taxpayer); "That, I would definitely take out…every individual in this room as a professional working adult is professional and courteous." (Dallas taxpayer). *Id*.

54 For an in-depth discussion of the Taxpayer Advocate Service's revised Publication 1 initiative, see National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* 18 (Nov. 4, 2013), *available at* www.TaxpayerAdvocate.irs.gov/2013AnnualReport.

FIGURE 1.1.3, Updated Draft Version of Publication 1



Ten Taxpayer Rights

1 The Right to Be Informed

Taxpayers have the right to know what they need to do to comply with tax laws. They are entitled to clear explanations of the law and IRS procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes.

2 The Right to Quality Service

Taxpayers have the right to receive prompt, courteous, and professional assistance in their dealings with the IRS, to be spoken to in a way they can easily understand, to receive clear and easily understandable communications from the IRS, and to have a way to file complaints about inadequate service.

3 The Right to Pay No More than the Correct Amount of Tax

Taxpayers have the right to pay only the amount of tax legally due and to have the IRS apply all tax payments properly.

4 The Right to Challenge the IRS's Position and Be Heard

Taxpayers have the right to raise objections and provide additional documentation in response to IRS actions or proposed actions, to expect that the IRS will consider their objections and documentation promptly and impartially, and to receive a written response if the IRS finds them insufficient.

5 The Right to Appeal an IRS Decision in an Independent Forum

Taxpayers are entitled to a prompt and impartial administrative appeal of IRS actions and have the right to receive a written response explaining the Appeals Division's decision. Taxpayers generally have the right to take their cases to court to challenge an adverse final determination.

6 The Right to Finality

Taxpayers have the right to know the maximum amount of time they have to challenge the IRS's position as well as the maximum amount of time the IRS has to audit a particular tax year. Taxpayers have the right to know when the IRS has finished an audit.

7 The Right to Privacy

Taxpayers have the right to expect that any IRS inquiry, examination, or enforcement action will comply with the law and be no more intrusive than necessary, and will respect all due process rights, including search and seizure protections and a collection due process hearing where applicable.

8 The Right to Confidentiality

Taxpayers have the right to expect that any information they provide to the IRS will not be disclosed unless authorized by the taxpayer or by law. Taxpayers have the right to expect the IRS to investigate and take appropriate action against its employees, return preparers, and others who wrongfully use or disclose taxpayer return information.

9 The Right to Retain Representation

Taxpayers have the right to retain an authorized representative of their choice to represent them in their dealings with the IRS. Taxpayers have the right to be told that if they cannot afford to hire a representative they may be eligible for assistance from a Low Income Taxpayer Clinic.

10 The Right to a Fair and Just Tax System, Including Access to the Taxpayer Advocate Service

Taxpayers have the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely. Taxpayers have the right to receive assistance from the Taxpayer Advocate Service if they are experiencing financial difficulty or if the IRS has not resolved their tax issues properly and timely through its normal channels.

Five Taxpayer Responsibilities

1 The Responsibility to Be Honest

Taxpayers have the responsibility to report their income, deductions, and credits accurately according to the law; to answer all questions completely, accurately, and honestly; and to explain all relevant facts and circumstances when seeking guidance from the IRS.

2 The Responsibility to Provide Accurate Information

Taxpayers have the responsibility to answer all relevant questions completely and honestly, to provide all required information on a timely basis, and to explain all relevant facts and circumstances when seeking guidance from the IRS.

3 The Responsibility to Keep Records

Taxpayers have the responsibility to maintain adequate books and records to fulfill their tax obligations, preserve them during the time they may be subject to IRS inspection, and provide the IRS with access to those books and records when asked so the IRS can examine their tax liabilities to the extent required by law.

4 The Responsibility to Pay Taxes on Time

Taxpayers have the responsibility to pay the full amount of taxes they owe by the due date and to pay any legally correct additional assessments in full. If they cannot pay in full, they have the responsibility to comply with all terms of any full or partial payment plans the IRS agrees to accept.

5 The Responsibility to Be Courteous

Taxpayers have the responsibility to treat IRS personnel politely and with respect.

MSP #2 IRS BUDGET: The IRS Desperately Needs More Funding to Serve Taxpayers and Increase Voluntary Compliance

DEFINITION OF PROBLEM

In fiscal terms, to be blunt, the mission of the IRS trumps the missions of all other federal agencies. The IRS's stated mission is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[1] If the IRS lacks adequate funding to do its job effectively, the government will have fewer dollars available to fund all federal programs, including national defense, Social Security, Medicare, Veterans' benefits, medical research, and disaster relief — or simply to reduce the deficit.

Since fiscal year (FY) 2010, the IRS budget has been cut by nearly eight percent.[2] Over the same period, inflation has risen by about six percent, further eroding the IRS's resources.[3] Because of these budget reductions, the IRS has been significantly hampered in its ability to provide "top quality service" and maintain effective enforcement programs that minimize noncompliance.

Consider that in FY 2013:

- The IRS received about 109 million telephone calls. Only 61 percent of calls seeking to reach a customer service representative got through, and those callers had to wait an average of 17.6 minutes on hold.[4]
- The IRS received about 8.4 million letters from taxpayers responding to proposed adjustments to their tax accounts.[5] At the end of the fiscal year, 53 percent of the correspondence in open inventory had not been answered within the timeframes the IRS itself has established.[6]
- The IRS is continuing a trend of reducing and in some cases eliminating services to taxpayers who visit any of its nearly 400 walk-in sites. Ten years ago, it answered more than 1.4 million tax-law questions at its walk-in sites. In FY 2014, the IRS will answer only "basic" tax law questions during the filing season (January through April), and it will not answer any tax law questions at all (even basic ones) beyond April, including questions from the millions of taxpayers who obtain filing extensions and prepare their returns later in the year.[7] This new policy applies to taxpayers who seek assistance with tax law questions by phone as well. In addition, the IRS will discontinue

1 *See* IRS Policy Statement 1-1, IRM 1.2.10.1.1 (Dec. 18, 1993).

2 IRS Chief Financial Officer, Corporate Budget.

3 *See* Office of Management and Budget, *Fiscal Year 2014 Budget of the U.S. Government, Historical Tables*, Table 10.1, at 215 (showing Gross Domestic Product and year-to-year increases in the GDP (Chained) Price Index). Data has been re-based from FY 2005 to FY 2010.

4 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2013). The Accounts Management phones lines (previously known as the Customer Account Services phone lines) receive the significant majority of taxpayer calls and are used by the IRS to compute its "Level of Service." In this discussion, all phone data pertains to the Accounts Management lines, except where otherwise noted. Calls to compliance phone lines and certain other categories of calls are excluded from this total.

5 IRS, Joint Operations Center, *Adjustments Inventory Reports: FY13 July-September Fiscal Year Comparison*.

6 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 28, 2013).

7 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), *at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources.

In fiscal terms, to be blunt, the mission of the IRS trumps the missions of all other federal agencies…. If the IRS lacks adequate funding to do its job effectively, the government will have fewer dollars available to fund all federal programs, including national defense, Social Security, Medicare, Veterans' benefits, medical research, and disaster relief — or simply to reduce the deficit.

its longstanding practice of preparing tax returns for low income, elderly, and disabled taxpayers who seek help.[8]

- The IRS workforce has been reduced from nearly 95,000 full-time-equivalent employees in FY 2010 to about 87,000 in FY 2013, a decrease of eight percent.[9]
- The IRS training budget has been slashed from about $172 million in FY 2010 to about $22 million, a staggering 87 percent reduction.[10] Thus, the IRS not only has fewer employees than four years ago, but those who remain are less equipped to perform their jobs.[11]

Recent cuts to the IRS budget are shortsighted and counterproductive for two reasons.

- First, the requirement to pay taxes is generally the most significant burden a government imposes on its citizens. The National Taxpayer Advocate believes the government has a practical and a moral obligation to make compliance as simple and painless as possible. It is not acceptable that taxpayers seeking help cannot get through to the IRS nearly two-fifths of the time, and then when they do get through, they have to wait on hold for extended periods. The taxpaying public deserves better treatment.
- Second, each dollar appropriated for the IRS generates substantially more than one dollar in federal revenue. In FY 2013, the IRS collected about $2.86 trillion[12] on an appropriated budget of about $11.2 billion.[13] That translates to an average return-on-investment (ROI) of 255:1. The marginal ROI of additional funding will not be nearly so large, but virtually everyone who has studied the IRS budget has concluded that it is positive.

The reduction in taxpayer services is particularly concerning because the U.S. tax system is built on voluntary compliance. About 98 percent of the revenue collected by the IRS each year is paid timely and voluntarily. Only two percent comes from IRS enforcement actions.[14] The IRS's overriding goal is to

8 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), *at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources.

9 IRS Chief Financial Officer, Corporate Budget. Some calculations in this section are affected by rounding. Percentage changes were computed using actual numbers rather than rounded numbers.

10 IRS Chief Financial Officer, Corporate Budget. For a discussion about the impact of training reductions, see Most Serious Problem: *Employee Training: The Drastic Reduction in IRS Employee Training Impacts the Ability of the IRS to Assist Taxpayers and Fulfill Its Mission, infra*.

11 For a discussion about the importance of taxpayer rights training, see Most Serious Problem: *Taxpayer Rights: Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights, infra; see also* National Taxpayer Advocate Report to the Acting Commissioner of Internal Revenue, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration: Recommendations to Raise Taxpayer and Employee Awareness of Taxpayer Rights* (Nov. 4, 2013).

12 Government Accountability Office (GAO), GAO-14-169, *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements* 76 (Dec. 2013), *available at* http://www.gao.gov/products/GAO-14-169.

13 IRS Chief Financial Officer, Corporate Budget.

14 In FY 2013, the IRS collected about $2.86 trillion in revenue. GAO, GAO-14-169, *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements* 76 (Dec. 2013). Of that total, enforcement revenue accounted for $53.3 billion. *Id*. at 24.

maximize voluntary compliance, because voluntary compliance is much more cost efficient; with enforced compliance, the government must devote significant resources to detecting and collecting amounts that are not voluntarily reported or paid.[15] In addition, several studies published in Volume 2 of this report find that top-quality taxpayer service is a more significant driver of overall tax compliance than IRS enforcement actions.[16]

The main reason the IRS is underfunded is because the congressional budget rules were written with classic spending programs in mind — namely, a dollar spent is treated as increasing the budget deficit by one dollar. As the government's revenue collector, the IRS is the only significant exception to that rule — a dollar spent generates substantially more than one dollar in additional revenue and thus *reduces* the deficit.

To address this anomaly, the National Taxpayer Advocate recommended seven years ago that Congress adopt new procedures to set the IRS's budget.[17] Because any change to the budget rules would require study and ultimately concurrence by the House and Senate budget committees, appropriations committees, potentially tax-writing committees, and other key players, making such a change will require a concerted effort.

The effects of applying across-the-board budget reductions to the IRS over the past three years underscore the importance of making this concerted effort. If the government continues to underserve its taxpayers, it risks further undermining public confidence in the fairness and integrity of the tax system, and thereby reducing tax compliance.

ANALYSIS OF PROBLEM

Over the past ten years, the workload of the IRS has increased significantly. The upward trend has continued during the last three years. Since FY 2010, however, IRS funding has declined. The combination of more work and less funding predictably has impaired the IRS's ability both to meet taxpayer needs and to collect tax.

A. Taxpayer Services: More Work and Less Funding Means Taxpayer Needs Are Not Being Met.

1. More Work

The increase in the IRS's workload can be demonstrated in several ways. For one, the IRS is receiving significantly more individual and business tax returns today than ten years ago.

For individual income tax returns, the number rose from about 131.3 million in FY 2004 to about 146.0 million in FY 2013, an increase of 11 percent. About one-third of that increase has occurred since FY 2010, when about 141.2 million returns were filed.[18]

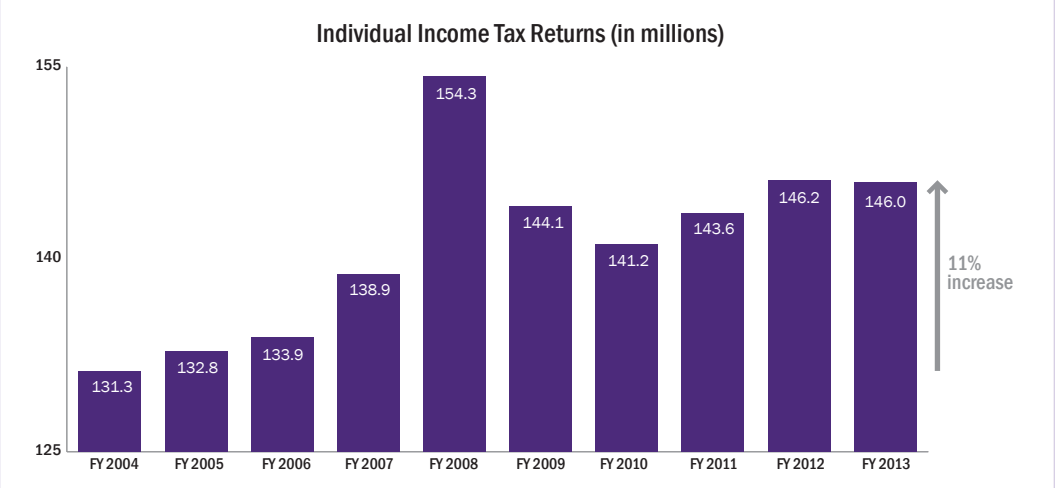
15 See IRS Strategic Plan 2009-2013 ("Goal 1: Improve service to make voluntary compliance easier").

16 See Volume 2: *Research Study: Small Business Compliance: Further Analysis of Influential Factors*, *infra*; Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*, *infra*.

17 See National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

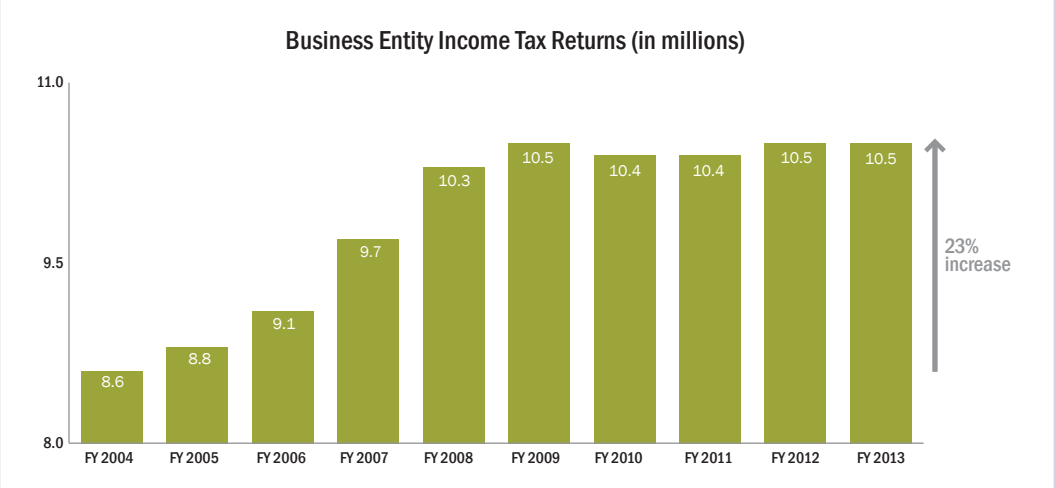
18 IRS Data Books, Table 2, for FY 2004 through FY 2012. Data for FY 2013 was provided by the IRS Office of Research, Analysis, and Statistics.

FIGURE 1.2.1



For business income tax returns, which include the returns of C corporations, S corporations, and partnerships, the number rose from about 8.6 million in FY 2004 to about 10.5 million in FY 2013, an increase of 23 percent.[19]

FIGURE 1.2.2



More tax returns mean more work for the IRS. The IRS must answer more taxpayer phone calls, process the additional returns, conduct more compliance checks, and in some cases conduct more audits or take more collection actions. To maintain its audit rate, the IRS would have to examine these additional returns at the same rate it examines other returns. Thus, an increase of ten percent in individual returns and 23 percent in business returns should translate to roughly the same percentage increases in taxpayer service demands, audits, and other processing and compliance activities.

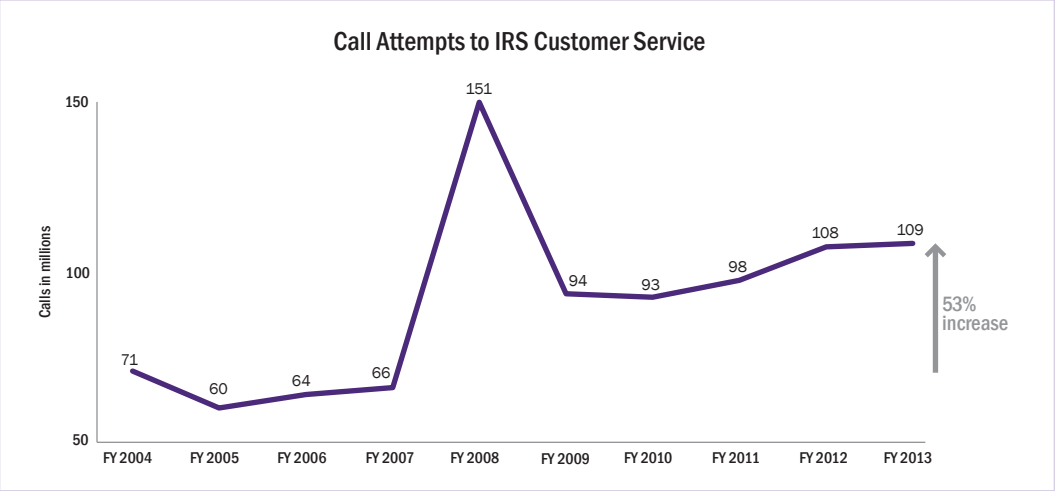
19 IRS Data Books, Table 2, for FY 2004 through FY 2012. Data for FY 2013 was provided by the IRS Office of Research, Analysis, and Statistics.

(As these charts and others in this section show, the increase in the IRS's workload has followed a fairly consistent path, with the notable exception of FY 2008, when the IRS was charged with administering the Economic Stimulus Act and was deluged with an unprecedented number of tax returns and phone calls.[20])

Another indicator of the workload increase is the number of phone calls the IRS receives, which has grown substantially.

From FY 2004 to FY 2013, the number of calls received on the IRS's Accounts Management telephone lines rose from about 71 million to about 109 million, or 53 percent. Notably, more than 40 percent of that increase has occurred since FY 2010, when the IRS received about 93 million calls.[21]

FIGURE 1.2.3



Answering taxpayer telephone calls effectively is labor-intensive. While some callers can be assisted through automation, tens of millions of taxpayers want to speak with an IRS customer service representative (CSR) each year. In FY 2013, CSRs handled some 30 million calls on the Accounts Management lines and another nine million phone calls in other parts of the agency.[22] Nearly 20 million calls to CSRs went unanswered because the IRS does not have enough employees to handle them. There is simply no way for the IRS to deal with this large and increasing volume of work without the funding to hire more CSRs.

20 The Economic Stimulus Act of 2008 required the IRS to make one-time payments to nearly 119 million taxpayers. *See* IRS News Release, IR-2009-10, *IRS Offers Tips to Avoid Recovery Rebate Credit Confusion* (Jan. 30, 2009), *at* http://www.irs.gov/uac/IRS-Offers-Tips-to-Avoid-Recovery-Rebate-Credit-Confusion. The procedures for claiming these "stimulus payments" required millions of individuals otherwise without a filing obligation to file a tax return. The stimulus payments were paid out over several months, and and taxpayers who did not receive their payments early in the process inundated the IRS with telephone calls. As a result, many IRS measures reflect the effects of this one-time event. The number of calls the IRS received on its Accounts Management telephone lines more than doubled, from FY 2007 to FY 2008 (from 66 million to 151 million), and the number of Form 1040-series returns jumped from 139 million to 154 million — the highest annual totals in the past ten years and probably ever.

21 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (final week of each fiscal year for FY 2004 through FY 2013).

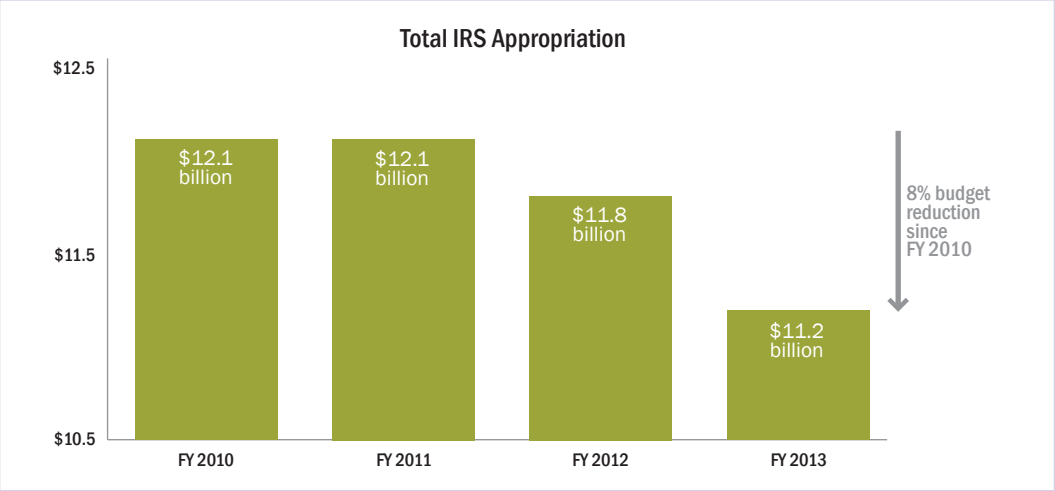
22 *Id.*

During the last few years, the IRS has also had to address a huge spike in tax-related identity theft and refund fraud. In FY 2013, the IRS assigned more than 3,000 employees to work on identity theft cases.[23] Because of the harm identity theft victims suffer, that was the right call to make.[24] But for an overworked agency absorbing budget cuts, the reassignment of so many employees has meant other work in crucial taxpayer service and enforcement areas could not be done.[25]

2. Less Funding and Reduced Resources

Since FY 2010, the IRS's budget has been reduced from about $12.1 billion to about $11.2 billion, or eight percent.[26] Over the FY 2010 through FY 2013 period, inflation has increased by an estimated six percent, and it is expected to increase by an additional two percent in FY 2014, further impacting IRS resources.[27]

FIGURE 1.2.4



These funding reductions translate to fewer employees and less training. The majority of the IRS's costs are employee-related, so not surprisingly, the eight percent drop in the budget has required a reduction in the number of full-time equivalent IRS employees from nearly 95,000 to some 87,000, or eight percent.[28]

23 *Fiscal Year 2014 Treasury and IRS Budget: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 113th Cong. (2013) (statement of Steven T. Miller, Acting Commissioner of Internal Revenue).

24 For a discussion about tax-related identity theft, see Most Serious Problem: *Identity Theft: The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers, infra*.

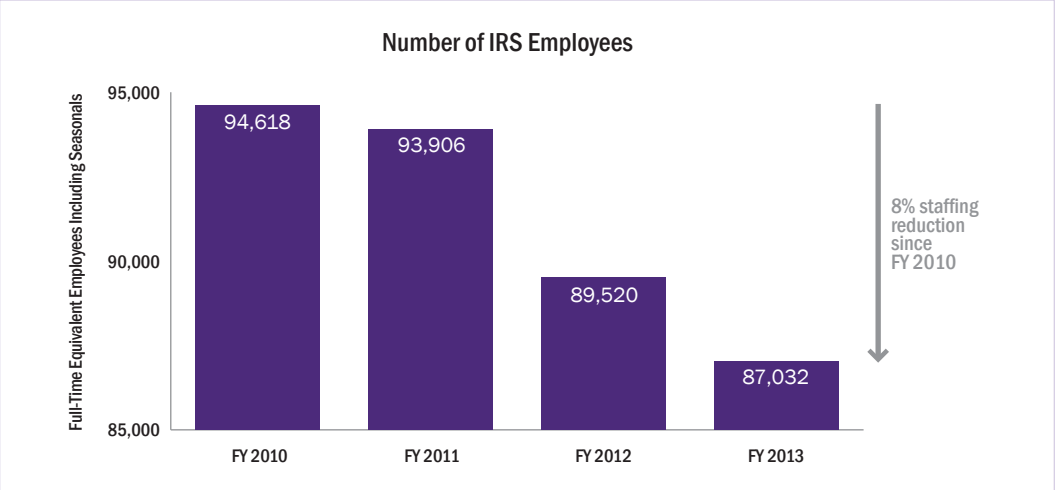
25 See Danny Werfel, Acting Commissioner of Internal Revenue, Address at the American Institute of Certified Public Accountants 2013 National Tax Conference (Nov. 5, 2013).

26 IRS Chief Financial Officer, Corporate Budget.

27 See Office of Management and Budget, *Fiscal Year 2014 Budget of the U.S. Government, Historical Tables*, Table 10.1, at 215 (showing Gross Domestic Product and year-to-year increases in the GDP (Chained) Price Index). Data has been re-based from FY 2005 to FY 2010. Because of the federal pay freeze, it is likely that the IRS's costs have risen by less than the amount of inflation. However, many employees continued to receive within-grade step increases each year (which translate to increases in pay), the costs of non-salary benefits continued to rise, and non-employee costs continued to rise as well. Thus, inflation since FY 2010 has had a significant impact on the IRS budget beyond the eight percent reduction in nominal dollars shown in the chart above.

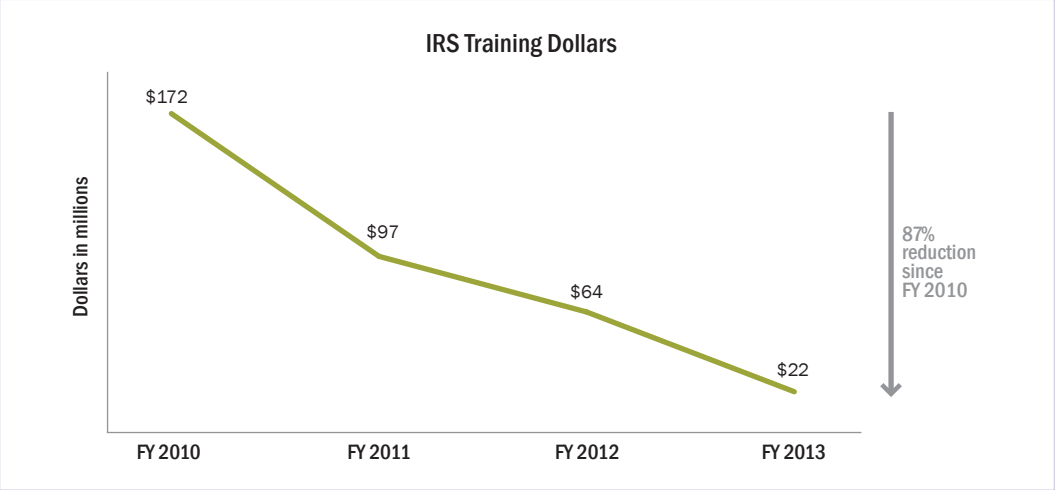
28 IRS Chief Financial Officer, Corporate Budget. This total includes seasonal employees apportioned on a full-time-equivalent basis.

FIGURE 1.2.5



Like most agencies, the IRS has been reluctant to terminate employees other than through attrition, so it has cut costs in other areas. One of the largest and most concerning cuts has been in training. From FY 2010 to FY 2013, the IRS reduced its training budget by 87 percent, from about $172 million to about $22 million.

FIGURE 1.2.6



A large complex organization cannot possibly cut its training budget by 87 percent without undermining the ability of its staff to perform their jobs effectively. This is particularly true at the IRS, where employees must administer an extraordinarily complex tax code and apply it to 146 million individual taxpayers and more than ten million business taxpayers, many of which present unique facts or special circumstances. If IRS customer service employees are not well trained, taxpayers calling for help are more likely to receive incorrect information or no information. If IRS enforcement employees are not well trained, auditors may make inappropriate adjustments and assessments, and collection employees may issue inappropriate levies or file inappropriate liens.

[T]he requirement to pay taxes is generally the most significant burden a government imposes on its citizens. The National Taxpayer Advocate believes the government has a practical and a moral obligation to make compliance as simple and painless as possible. It is not acceptable that taxpayers seeking help cannot get through to the IRS nearly two-fifths of the time, and then when they do get through, they have to wait on hold for extended periods. The taxpaying public deserves better treatment.

The stakes for taxpayers are simply too high to allow the IRS workforce to be undertrained.[29] In most years, workforce attrition exceeds five percent.[30] When employees leave, the IRS must identify existing employees or find new ones to pick up the slack — sometimes through internal promotions, sometimes with limited new hires. In addition, the IRS employed more than 11,000 seasonal employees during the last filing season and for other limited tasks throughout the year.[31] Even employees who do not change jobs face constant changes in the nature of their workloads. For example, as the problem of tax-related identity theft increased, the IRS trained at least 37,000 employees on various aspects of victim assistance.[32]

The IRS has tried to train employees at lower cost by replacing in-person training with remote or virtual instruction.[33] That is a constructive approach — to a point. Some virtual training can be effective. But other types of training, such as teaching taxpayer-facing employees how to interview taxpayers and working through case studies, do not lend themselves well to a remote setting. In addition, employees of many IRS functions are spread around the country, and it is difficult for managers to do their jobs properly if they cannot meet periodically — face to face — with the employees they supervise.

3. Taxpayer Needs Are Not Being Met

The combination of more work and less funding has left the IRS stretched too thin, compromising its capacity to meet taxpayer needs.

a. Taxpayer Telephone Calls

The IRS's ability to field taxpayer telephone calls has declined markedly over the past decade. In FY 2004, the IRS answered 87 percent of calls from taxpayers seeking to speak with a CSR (which, in IRS parlance, is referred to as the "Level of Service" or "LOS"). In FY 2013, the IRS answered only 61 percent of such calls, a reduction of 26 percentage points, or 30 percent, in the LOS. Meanwhile, the time successful taxpayers waited on hold rose from 2.6 minutes to 17.6 minutes, a nearly six-fold increase.[34]

29 For a discussion about the impact of training reductions, see Most Serious Problem: *Employee Training: The Drastic Reduction in IRS Employee Training Impacts the Ability of the IRS to Assist Taxpayers and Fulfill Its Mission, infra*; Most Serious Problem: *Taxpayer Rights: Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights*, *infra*.

30 *See, e.g.*, Partnership for Public Service, *Beneath the Surface: Understanding Attrition at Your Agency and Why It Matters* 3 (Nov. 2010) (finding that attrition in the federal government, although "relatively low," was 7.6 percent in FY 2008 and 5.85 percent in FY 2009).

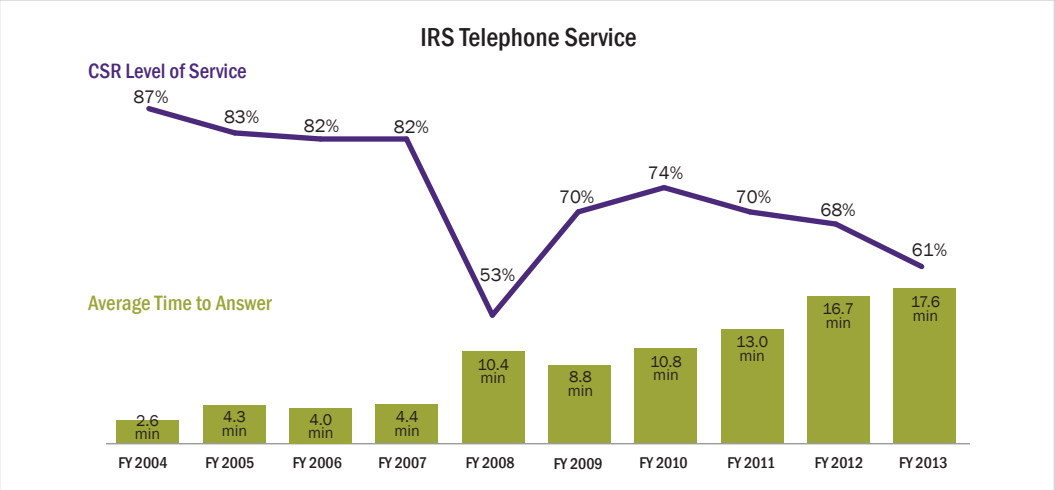
31 *See* data compiled for IRS 2013 Data Book, Table 30 (not yet published). This total reflects seasonal employees placed on a full-time-equivalent basis. The actual number of employees was higher.

32 *Fiscal Year 2014 Treasury and IRS Budget: Hearing Before the Subcomm. on Financial Services and General Government of the S. Comm. on Appropriations*, 113th Cong. (2013) (statement of Steven T. Miller, Acting Commissioner of Internal Revenue) (stating that the IRS has assigned 3,000 employees to work on identity theft and has trained 37,000 employees who work with taxpayers to recognize identity theft and assist victims).

33 *See* Danny Werfel, Acting Commissioner of Internal Revenue, Address at the American Institute of Certified Public Accountants 2013 National Tax Conference (Nov. 5, 2013) (stating that the IRS has "expanded the use of alternative delivery methods for in-person meetings, training, conferences, and operational travel").

34 IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (final week of each fiscal year for FY 2004 through FY 2013).

FIGURE 1.2.7



While the IRS's decline in the LOS and increase in hold times have been a long-term trend, it should be noted that a significant portion of the decline has occurred since FY 2010. Since FY 2010, the LOS has declined by 18 percent (from 74 percent to 61 percent) and the average hold time has increased by 63 percent (from 10.8 minutes to 17.6 minutes).

To try to improve its LOS, the IRS recently announced several "service changes" for FY 2014. During the filing season (January through April), it will answer only "basic" tax law questions; it will not answer "more detailed" questions. After April, it will not answer any tax law questions (even basic ones), including from the millions of taxpayers who obtain filing extensions and prepare their returns later in the year.[35] At the risk of vast understatement, it is a sad state of affairs when the government writes tax laws as complex as ours — and then is unable to answer any questions beyond "basic" ones from baffled citizens who are doing their best to comply.

b. Taxpayer Correspondence

The IRS's ability to timely process taxpayer correspondence has taken a similar hit. When the IRS sends a taxpayer a notice proposing to increase his or her tax liability, it typically gives the taxpayer an opportunity to present an explanation or documentation supporting the position taken on the return. Each year, the IRS typically receives around ten million taxpayer responses, known collectively as the "adjustments inventory."[36] The IRS has established timeframes for processing taxpayer correspondence, generally 45 days. During the final week of FY 2004, the IRS failed to process 12 percent of its adjustments correspondence within its timeframes. During the final week of FY 2013, the IRS was unable to process 53 percent of its adjustments correspondence within the timeframes.[37]

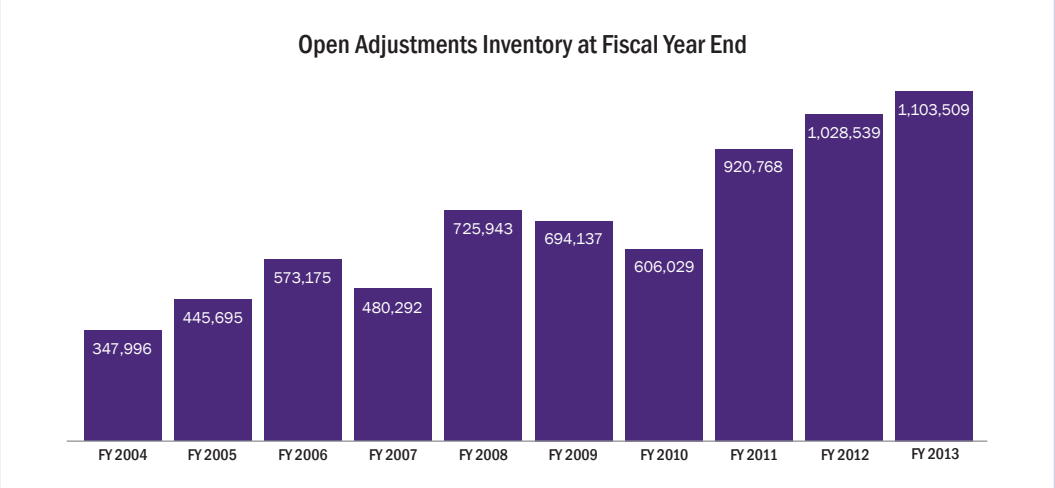
35 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), *at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources.

36 IRS, Joint Operations Center, *Adjustments Inventory Reports: July-September Fiscal Year Comparison (FY 2004 through FY 2013)*. In FY 2013, receipts in the Adjustments Inventory were about 8.4 million, as compared with 10.4 million in FY 2012. We are not certain why the number declined. The Adjustments Inventory is one component of the Accounts Management function's overall Paper Inventory. In FY 2013, receipts in the Paper Inventory were about 20.8 million, and the percentage classified as overage at year-end was 47 percent. IRS, Joint Operations Center, *Account Management Information Report (AMIR) – National Summary* (week ending Sept. 28, 2013).

37 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 28, 2013).

As a corollary, the number of pending pieces of adjustments correspondence in open inventory increased as well. At the end of FY 2004, open inventory stood at about 348,000 letters.[38] At the end of FY 2013, it consisted of about 1.1 million letters.[39]

FIGURE 1.2.8



As with telephone performance, correspondence performance has declined since FY 2010. Comparing the final week of FY 2010 with the final week of FY 2013, the percentage of overage correspondence rose from 28 percent to 53 percent, and open inventory grew from about 606,000 to about 1.1 million — in both cases almost doubling.[40]

c. Taxpayer Walk-In Assistance

At the same time that taxpayers have encountered greater difficulty communicating with the IRS by phone and mail, their opportunities to communicate with the IRS in person have also been limited. As an alternative to telephone or correspondence interaction, the IRS maintains walk-in sites known as Taxpayer Assistance Centers, or "TACs." The TACs are designed to provide a "local presence." As we reported earlier this year, the number of TACs declined from 400 to 392 between the start of the 2012 and 2013 filing seasons, and the number of TACs with just one employee increased from 48 to 65.[41] TACs with one employee are subject to unexpected closure due to employee absence and subject to extended wait times when there are more-than-projected taxpayer visits.

We noted above that the IRS has adopted a new policy of declining to answer many tax-law questions — notably, any questions beyond "basic" ones — on its toll-free telephone lines. The same policy applies to

38 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 30, 2004).

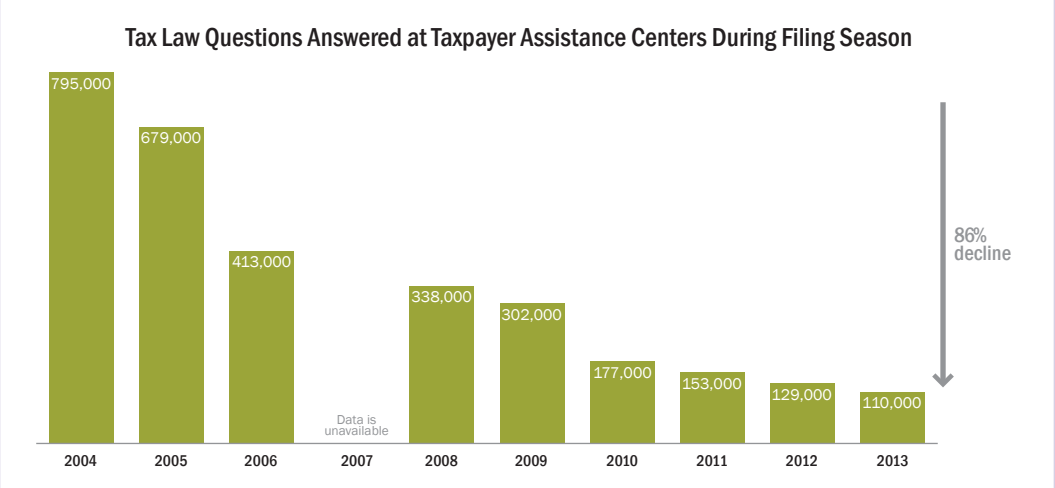
39 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 28, 2013).

40 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Oct. 2, 2010); IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 28, 2013).

41 For more detail, see National Taxpayer Advocate FY 2014 Objectives Report to Congress at 59.

the TACs.[42] This continues an unfortunate trend of service reductions for taxpayers who either do not have Internet access or otherwise require or prefer in-person assistance. According to data compiled by the GAO, the number of tax-law questions answered in the TACs over the last ten years during the filing season has declined by 86 percent — from about 795,000 questions to 110,000.[43]

FIGURE 1.2.9



The annual GAO filing season reports do not list the number of tax-law questions outside the filing season, but the numbers are significant. In FY 2004, for example, IRS data indicate that in addition to handling some 795,000 tax-law questions during the filing season, the IRS handled about 638,000 tax-law questions after the filing season. Thus, 45 percent of the 1.433 million questions received came outside the filing season.[44] None of those 638,000 questions would be answered under the IRS's new policy. It should be emphasized that the reduction in tax-law questions is not necessarily a function of reduced demand. Rather, the IRS has reduced TAC staffing and reduced the scope of the questions it is willing to answer, and wait times have often been unreasonably long. As a consequence, many taxpayers have probably given up.

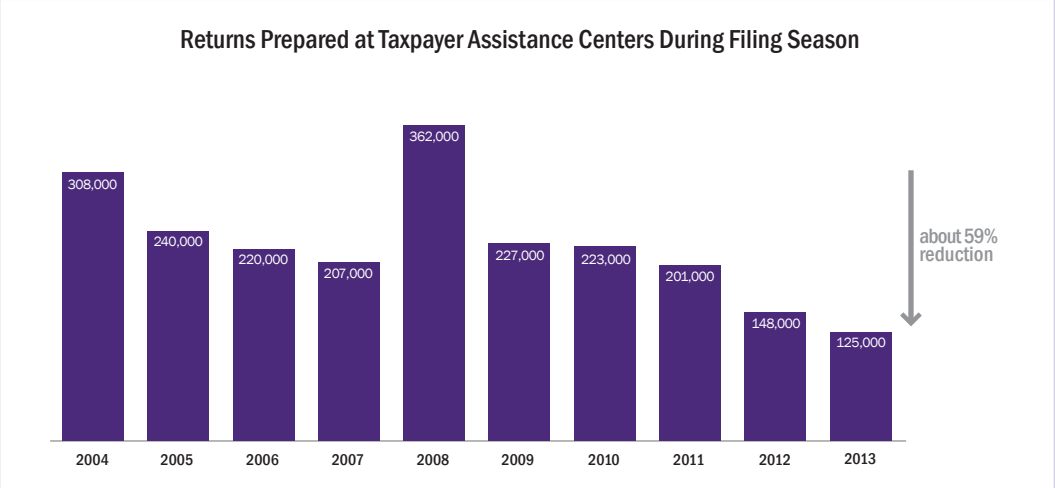
42 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), *at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources.

43 GAO, GAO-14-133, *2013 Tax Filing Season: IRS Needs to Do More to Address the Growing Imbalance between the Demand for Services and Resources* 26 (Dec. 2013); GAO, GAO-11-111, *2010 Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others* 45 (Dec. 2010); GAO, GAO-08-38, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated* 27-28 (Nov. 2007); GAO, GAO-07-27, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* 29 (Nov. 2006) (supplemented with more precise IRS data provided to TAS by the IRS Wage & Investment Division for 2004 through 2006). TAS does not have data for 2007.

44 This data was provided to TAS by the IRS Wage & Investment Division in connection with the National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: *Service at Taxpayer Assistance Centers*). TAS does not have data on tax-law questions asked outside the filing season for more recent years.

Historically, the TACs have also prepared tax returns for taxpayers seeking assistance, particularly low income, elderly, and disabled taxpayers. According to the GAO filing season reports, the number of returns prepared during the filing season over the past decade has declined by 59 percent.[45]

FIGURE 1.2.10



As with tax-law questions, data covering solely the filing season understates the assistance the IRS has provided to taxpayers. In FY 2004, IRS data indicates that in addition to preparing some 308,000 returns during the filing season, the IRS prepared an additional 168,000 returns after the filing season. Thus, roughly 35 percent of the returns prepared by the TACs were prepared after April 15.[46] But with dwindling resources, the IRS has been placing increasing limits on return preparation assistance, and in its recent announcement, it made clear it will discontinue *all* return preparation assistance at the TACs beginning this filing season.[47]

d. Local Availability of Enforcement Personnel

The "local presence" of enforcement personnel has also declined. From FY 2010 through FY 2013, the number of Revenue Agents, who conduct field audits, decreased by 12 percent (from 13,879 to 12,270). The number of Revenue Officers, who perform field collection, declined by 21 percent (from 6,042 to 4,748).[48]

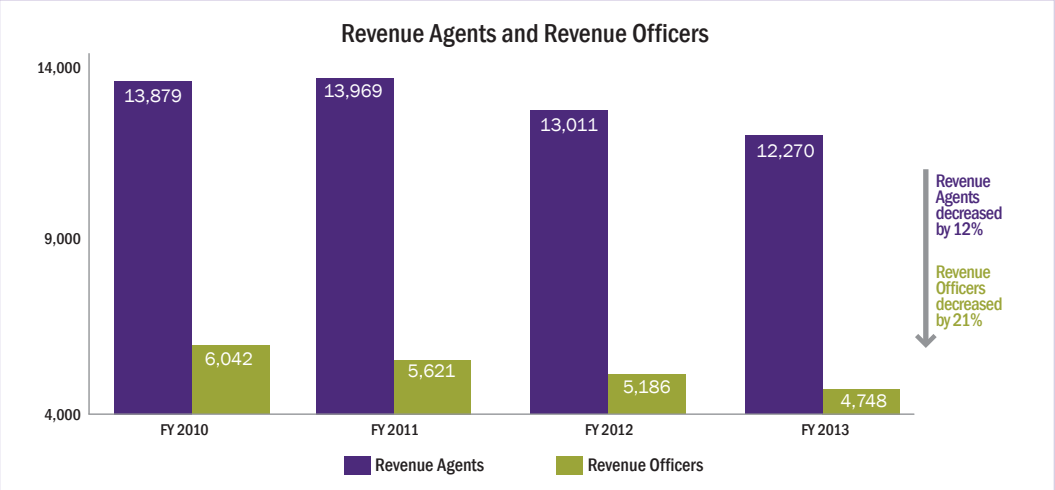
45 GAO, GAO-14-133, *2013 Tax Filing Season: IRS Needs to Do More to Address the Growing Imbalance between the Demand for Services and Resources* 26 (Dec. 2013); GAO, GAO-11-111, *2010 Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others* 45 (Dec. 2010); GAO, GAO-08-38, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated* 27-28 (Nov. 2007); GAO, GAO-07-27, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* 29 (Nov. 2006) (supplemented with more precise IRS data provided to TAS by the IRS Wage & Investment Division for 2004 through 2006); GAO, GAO-05-67, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed* 18 (Nov. 2004). The GAO filing season reports do not provide a total for 2007. However, the report on the 2007 filing season said the number of TAC-prepared returns was almost 74 percent less than the number of TAC-prepared returns in 2001, and the report on the 2004 filing season said the number of TAC-prepared returns in 2001 was about 790,000. We therefore have provided an approximate total for 2007 in the chart above.

46 This data was provided to TAS by the IRS Wage & Investment Division in connection with the National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: *Service at Taxpayer Assistance Centers*).

47 IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), *at* http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources.

48 IRS Data Books, Table 30.

FIGURE 1.2.11



In addition, the number of Appeals Officers, with whom taxpayers historically have had the option of meeting personally, declined by four percent (from 847 to 811). Of particular concern, many taxpayers no longer have the practical option of meeting with Appeals Officers personally. Eleven states and Puerto Rico have no Appeals or Settlement Officers with a post-of-duty within their geographic borders.[49]

We find the sharp reduction in local enforcement personnel concerning. While no taxpayer wants to be audited or face collection action, it is important that taxpayers who find themselves in that position have the option of talking with an IRS employee face-to-face. On audit, a taxpayer may have documentation that is difficult to mail in and requires a conversation to explain. In collection, a taxpayer may have special circumstances or face hardships that are obvious in person but difficult to convey by email or over the phone.

A local presence is also important because economic conditions and types of noncompliance vary from community to community. A Revenue Officer (RO) who lives in a community typically is better equipped than employees in a centralized site to determine how to work with a delinquent taxpayer claiming financial hardship. The RO may, for example, know that a large local employer has just laid off workers or that a payroll service provider who kept payrolls for small businesses was just arrested for misappropriating funds. In Volume 2 of this report, we publish a study showing that ROs generally are more effective than the Automated Collection System in resolving employment tax delinquencies.[50]

49 IRS, *Discovery Directory* (searched on Dec. 30, 2013). Alaska, Arkansas, Delaware, Idaho, Kansas, Montana, North Dakota, Rhode Island, South Dakota, Vermont, Wyoming, and Puerto Rico are not listed as having either an Appeals Officer or a Settlement Officer. Settlement Officers hold Collection Due Process hearings under IRC §§ 6320 and 6330, and hear appeals of installment agreement denials and offer in compromise rejections under IRC § 7122(e). The IRS Restructuring and Reform Act of 1998 directed, among other things, that the Office of Appeals ensure that an Appeals Officer is regularly available within each state. *See* RRA 98 §§ 1001(a)(4); 3465(b). In recent years, the Office of Appeals has eliminated offices in some states and substituted a system of traveling Appeals Officers. Under this system, visits may not be sufficiently frequent or sufficiently spread throughout the state to make meetings accessible to taxpayers.

50 *See* Volume 2: *Research Study: A Comparison of Revenue Officers and the Automated Collection System in Addressing Similar Employment Tax Delinquencies*, *infra*.

The bottom line is that reduced funding has left the IRS substantially less able to assist taxpayers across all service platforms other than the Internet — by phone, by mail, and in person.[51]

B. Revenue Collection: Reduced Funding Means Reduced Revenue Collection and a Larger Budget Deficit.

The reduction in the IRS's budget since FY 2013 has generally been made pursuant to government-wide cuts designed to reduce the imbalance between federal spending and federal revenue. However, the logic behind budget cuts simply does not apply to the funding of the IRS. The IRS collects more than 90 percent of federal revenue.[52] As noted above, the IRS in FY 2013 took in about $2.86 trillion[53] on an appropriated budget of about $11.2 billion,[54] which translates to an average return-on-investment of 255:1. While the marginal ROI of additional funding will not be nearly so large, virtually everyone who has studied the IRS budget has concluded that the ROI of additional funding is positive. This includes the most recent four IRS commissioners (two appointed by Democratic Presidents and two appointed by Republican Presidents).

At his confirmation hearing in December, IRS Commissioner John Koskinen said:

> [W]e need to solve the funding problem of the IRS. This is not just my opinion. I have met with every IRS Commissioner from the past 20 years and the consensus was that a major challenge and constraint was the funding limitations they faced. This is a view shared today by the IRS Oversight Board, the Taxpayer Advocate and, most recently, the Treasury Inspector General for Tax Administration (TIGTA) and the Internal Revenue Service Advisory Council. As a TIGTA report this fall noted, the government has saved $1 billion in cuts to the IRS budget and lost $8 billion in compliance revenues.
>
> I don't know any organization in my 20 years of experience in the private sector that has said "I think I'll take my revenue operation and starve it for funds to see how it does." The IRS will have 11,000 fewer people working during this upcoming filing season while processing the largest number of returns in its history. I don't care how efficient you become, that is not a recipe for success or improved compliance and taxpayer service.
>
> This is not a new message. It has been delivered before. We often think that a discussion about a problem means we have dealt with it. Let me just say

Because the IRS is the federal government's Accounts Receivable Department and generates a substantially positive return on investment, it is self-defeating to treat the agency like a pure spending program. With most spending programs, a dollar spent is simply a dollar spent from a budget perspective. With the IRS, a dollar spent generates many dollars in additional revenue.

51 In an effort to reduce costs, the IRS has been trying for years to persuade taxpayers to make greater use of the Internet in the hope it can reduce taxpayer demand for more costly telephone and walk-in services. While Internet usage has indeed increased, the 54 percent increase in telephone calls from taxpayers seeking to reach a CSR over the past decade demonstrates that the need for personal contact, far from decreasing, has risen substantially at the same time.

52 *See* GAO, GAO-14-169, *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements* 26 (Dec. 2013).

53 *Id*. at 76.

54 IRS Chief Financial Officer, Corporate Budget.

> that we have not dealt with the problem and it is not going away. I look forward to working with you to find a solution.[55]

This issue arises because the federal budgeting rules generally treat the IRS in the same manner as all other federal agencies, giving it no "credit" for the revenue it collects. Once the House and Senate Appropriations Financial Services and General Government subcommittees receive their "Section 302(b) allocations" for the upcoming fiscal year, funding all of the agencies under their jurisdiction essentially becomes a zero-sum game — each dollar allocated to one agency reduces the pool of funds available for others.[56]

As we have noted in prior reports, this procedure makes little sense when applied to the IRS. For virtually every other spending program, a dollar spent is just that — it increases the budget deficit by one dollar. But a dollar spent on the IRS generates substantially more than one dollar in return — it reduces the budget deficit.

If the Chief Executive Officer of a Fortune 500 company were told that each dollar allocated to his company's Accounts Receivable Department would generate multiple dollars in return, it is difficult to see how the CEO would keep his job if he chose not to provide the department with the funding it needed. Yet that is essentially what has been happening with respect to IRS funding for years, and as Commissioner Koskinen indicated, there has been some discussion but little effort to fix this obvious problem.

In the National Taxpayer Advocate's 2006 Annual Report to Congress, we discussed the IRS funding challenge in detail and recommended, among other things, that Congress consider revising its budget rules in a manner that allows the relevant congressional committees simply to set IRS funding at whatever level they believe will maximize tax compliance, particularly voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.[57]

In the course of developing and presenting that recommendation, the National Taxpayer Advocate or her senior advisor met with 14 separate congressional staffs — the House and Senate majority and minority staffs of the appropriations committees, budget committees, and tax-writing committees as well as tax counsel for the House and Senate majority leaders. In our discussions, there appeared to be no disagreement with the premise that the IRS generates a positive return on investment and is underfunded. However, we were repeatedly told that creating a new set of rules to establish IRS funding levels would be a "heavy lift" and would raise jurisdictional issues that have to be worked through.

---

55 *Hearing to Consider the Nomination of John Andrew Koskinen to Be Commissioner of Internal Revenue, Hearing Before the S. Comm. on Finance*, 113th Cong. (Dec. 10-11, 2013) (citing Treasury Inspector General for Tax Administration, Ref. No. 2013-30-078, *Trends in Compliance Activities Through Fiscal Year 2012* (Aug. 2013)). *See also* Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 278 (2005) ("When I talked to business friends about my job at the IRS, they were always surprised when I said that the most intractable part of the job, by far, was dealing with the IRS budget. The reaction was usually 'Why should that be a problem? If you need a little money to bring in a lot of money, why wouldn't you be able to get it?'").

56 *See* Congressional Budget and Impoundment Control Act, Pub. L. No. 93-344, § 302(b)(1), 88 Stat. 297, 308 (1974) (providing that the Appropriations Committee of each House shall subdivide its allocation of funding under the annual budget resolution among its subcommittees). The "program integrity cap adjustment" mechanism, which we discuss in the text below, is a limited but in our view flawed exception to this rule.

57 *See* National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

In light of the IRS's increasing inability to meet the needs of the taxpaying public, we submit that the time for the "heavy lift" is now. Not only are cuts to the IRS budget harmful from a taxpayer service perspective, but to the extent they are designed to reduce the budget deficit, they are self-defeating.

C. The "Program Integrity Cap Adjustment" Mechanism Has Significant Drawbacks.

In a partial attempt to provide the IRS with additional funding within the existing budget rules, several Appropriations acts in recent years have given the IRS more funding by using a mechanism known as a "program integrity cap adjustment." Under this mechanism, new funding appropriated for IRS *enforcement* programs generally does not count against otherwise applicable spending ceilings provided:

1. The IRS's existing enforcement base is fully funded; and
2. A determination is made that the proposed additional expenditures will generate an ROI of greater than 1:1 (*i.e.,* the additional expenditures will increase federal revenue on a net basis).

For FY 2014, the Administration's budget proposal recommended a change to the Balanced Budget and Emergency Deficit Control Act of 1985 to provide program integrity cap adjustments for the next ten years.[58] While this cap adjustment mechanism may provide an easier path to providing the IRS with more resources than a fundamental change in congressional budget rules, we are concerned that taxpayer service activities have been excluded from this enhanced funding mechanism in the past and would continue to be excluded under the Administration's proposal. The rationale has been that the IRS can measure the direct ROI of its enforcement activities — *i.e.,* it can compute to the dollar the amounts collected by its Examination, Collection, and document-matching functions — but cannot quantify the ROI of taxpayer services. Thus, it is not possible to document whether or to what extent its taxpayer services generate an ROI greater than 1:1.

Creating a mechanism that allows more funding for enforcement actions, while excluding taxpayer service activities like outreach and education, would be a mistake for two reasons. First, common sense tells us that taxpayer services are a significant driver of tax compliance and generate a very high ROI. Publishing tax forms and instructions, conducting outreach and education, assisting taxpayers, tax preparers, and tax-software manufacturers, and otherwise administering the tax filing season are absolute prerequisites for tax compliance. In general, the ROI of these service activities is probably greater than the ROI of enforcement actions.

Three TAS research studies published in Volume 2 of this report illustrate the value of taxpayer service and the limitations of enforcement measures to improve tax compliance:

- A study regarding tax compliance by sole proprietors found that taxpayer service and social norms were the two most influential factors affecting compliance behavior. Contrary to expectation, it found that traditional deterrence theory did not play a significant role in promoting compliance, possibly because the taxpayers were motivated by short-term cash flow needs.[59]
- A study regarding the impact of penalties on tax compliance analyzed the future compliance behavior of two groups of sole proprietors who were audited and whose examinations were closed in 2007. One group faced tax adjustments and was subject to penalties. The other group faced

58 *See* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals* 187 (Apr. 2013).

59 *See* Volume 2: Research Study: *Small Business Compliance: Further Analysis of Influential Factors*, *infra*.

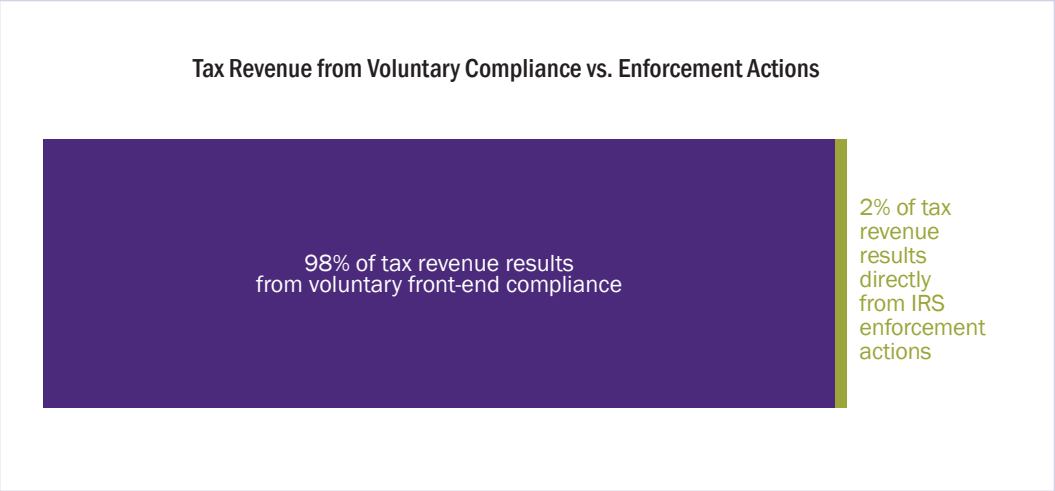
similar tax adjustments but was not subject to penalties. The study found that the future compliance behavior of the penalized group was no better than the future compliance behavior of the group that was not penalized.[60]

- A study regarding the relative effectiveness of Revenue Officers and the Automated Collection System in addressing delinquent employment tax liabilities found that neither ROs nor ACS affected future compliance.[61] That is a significant finding that should guide IRS strategic and resource-allocation decisions, because long-term revenue collection is much greater where IRS actions improve future voluntary compliance.

These studies underscore that the ROI of taxpayer service, despite being unquantifiable, is significant and should figure prominently in any strategy designed to improve tax compliance.

Second, an enforcement-only cap adjustment will inherently push the IRS to become more of a hard-core enforcement agency. It should be emphasized that in FY 2013, direct enforcement revenue amounted to only $53.3 billion,[62] or two percent of total IRS tax collection of $2.86 trillion.[63] The remaining 98 percent resulted from voluntary front-end tax compliance.

FIGURE 1.2.12



If cap adjustments are applied solely to bolster enforcement funding, the relative allocation of the IRS budget between enforcement and taxpayer service will shift over time in a direction that causes taxpayers to fear the IRS more and voluntarily cooperate less. Primarily because of the proposed cap adjustments, the Administration's ten-year funding projections showed that funding for the IRS Enforcement appropriation would increase by more than twice as much as funding for the IRS's Taxpayer Services

60 *See id*.

61 See Volume 2: *Research Study: A Comparison of Revenue Officers and the Automated Collection System in Addressing Similar Employment Tax Delinquencies*, *infra*.

62 GAO, GAO-14-169, *Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements* 24 (Dec. 2013).

63 *Id*. at 76.

appropriation.[64] In our effort to enforce the laws against noncompliant taxpayers, we must take care to avoid steps that may alienate compliant taxpayers and thereby jeopardize the existing tax base.

For that reason, if program integrity cap adjustments are used, we recommend that compliance initiatives be defined more broadly so they include both an enforcement component and a service component (*e.g.,* better outreach, education, and assistance for small businesses). Because the projected ROI of many enforcement programs is high, a more broadly constructed initiative could still produce a demonstrable ROI of greater than 1:1 even if it contained service components with ROIs that are unquantifiable.[65]

CONCLUSION

Because the IRS is the federal government's accounts receivable department and generates a substantially positive return on investment, it is self-defeating to treat the agency like a pure spending program. With most spending programs, a dollar spent is simply a dollar spent from a budget perspective. With the IRS, a dollar spent generates many dollars in additional revenue, and conversely, a dollar unspent translates to a greater decrease in revenue collection, thereby adding to the budget deficit. Recent cuts in the IRS budget have also limited the IRS's ability to meet the basic service needs of the taxpaying public, which erodes public confidence and trust in the tax system and may also lead to greater noncompliance. For these reasons, we believe the time has come for Congress to "fence off" decisions about IRS funding from the otherwise applicable spending ceilings that apply to discretionary appropriations under the budget rules.

64 Budget of the United States Government: Analytical Perspectives, Supplemental Materials, Fiscal Year 2014: Table 32-1, Federal Programs by Agency and Account, at 304-305, *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/32_1.pdf. Taxpayer service spending is shown on the top line, which is labeled "Taxpayer Services: Appropriations, discretionary . . . 803." Enforcement spending is the sum of the line labeled "Federal law enforcement activities: Appropriations, discretionary … 751" and the line labeled "Central fiscal operations: Appropriations, discretionary … 803." Over the FY 2014 through FY 2023 period, these projections show that Taxpayer Services spending would rise by 23 percent, while Enforcement spending would increase by 54 percent.

65 In our past annual reports, we have written about local compliance initiatives the IRS has undertaken that include integrated enforcement and outreach and education components. *See, e.g.*, National Taxpayer Advocate 2008 Annual Report to Congress 176-192 (Most Serious Problem: *Local Compliance Initiatives Have Great Potential but Face Significant Challenges*). One example: In the early 1990s, the IRS launched an initiative designed to address noncompliance by fishermen in Alaska that resulted from confusion as well as community norms and attitudes. The IRS combined stepped-up enforcement activities with an extensive outreach and education campaign in remote fishing villages and on fishing vessels that included assisting with tax return preparation and training local volunteers to assist taxpayers. By the end of the initiative, the number of nonfilers among the target population declined by 30 percent. *Id*. at 177-178.

RECOMMENDATIONS

The National Taxpayer Advocate reiterates her recommendations that Congress consider the following actions:

1. Revise the budget rules so that the IRS is "fenced off" from otherwise applicable spending ceilings and is viewed more like an accounts receivable department. It should be funded at a level designed to maximize tax compliance, particularly voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.
2. In allocating IRS resources, keep in mind that tax compliance requires a combination of high quality taxpayer service, outreach and education, and effective tax-law enforcement, and the IRS should continue to maintain a balanced approach toward that end. We are concerned that the program integrity cap adjustment procedures used in the past skew this important balance and should be avoided, but if cap adjustments continue to be used, we recommend they be written in a manner that applies to broadly defined compliance initiatives that include both taxpayer service (including outreach and education) and enforcement components.

This page intentionally left blank.

MSP #3 EMPLOYEE TRAINING: The Drastic Reduction in IRS Employee Training Impacts the Ability of the IRS to Assist Taxpayers and Fulfill its Mission

RESPONSIBLE OFFICIAL

John Koskinen, Commissioner of Internal Revenue

DEFINITION OF PROBLEM

The IRS mission is to "provide 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."[1] With a complex and constantly changing tax law, it is essential that IRS employees receive prompt and appropriate training and education in order to provide taxpayers with complete and accurate service. However, budget cuts and sequestration have led the IRS to reduce its training budget by over 85 percent since fiscal year (FY) 2009.[2] Most of the IRS operating divisions that interact directly with taxpayers fared worse than the agency as a whole. Lacking appropriate training and education, IRS employees will be unable to fulfill their mission, and service to taxpayers will continue to erode.[3]

- In FY 2013, the IRS spent less than $250 per employee on training compared to $1,450 per employee in FY 2009, a reduction of over 83 percent.[4]
- The IRS created two review boards, the Training Review Board and the Video Review Board, in FY 2013 to review training requests for recommendation to the Deputy Commissioner for Operations Support.
- The Deputy Commissioner for Operations Support declined approval for over 35 percent of proposed courses between April and June of 2013.[5]
- Training hours delivered to employees in key job series have been reduced by as much as 89 percent since FY 2009.[6]

1 Internal Revenue Manual (IRM) 1.1.1.1, *The IRS Mission* (Mar. 1, 2006).

2 IRS response to TAS research request (Nov. 22, 2013). In fiscal year (FY) 2009, the IRS spent $153,155,686 on training versus $22,574,539 in FY 2013, a reduction of 85.26 percent. The IRS training budget includes both training and conferences.

3 The IRS's training effort was determined as follows. In a research request, TAS asked the IRS to provide the training budget by operating division from FY 2009 through FY 2013. TAS identified 15 key taxpayer-facing job series in the five main IRS operating divisions (Wage & Investment (W&I), Small Business/Self-Employed (SB/SE), Tax Exempt and Government Entities (TE/GE), Appeals, and Large Business and International (LB&I)). We asked the IRS to provide, by job series, the training titles, number of students in each session, and number of hours per course for FYs 2009 and 2013. TAS also requested that the IRS break training hours down into two categories: in-person training (in person is defined as coached self-study, instructor-led classroom, on-the-job training and paper-based self-study) and virtual training (virtual training is defined as online, computer-based, CD or DVD, Electronic Knowledge Product, interactive video tele-training (IVT) studio produced). TAS acknowledges that the IRS may provide training in individual offices on an ad hoc basis that is not recorded in a formal manner in IRS training databases. This type of training has always occurred and we are treating it as a constant. In this piece, we have focused on formal training provided across the IRS.

4 IRS, Human Resources Reporting Center, *available at* https://persinfo.web.irs.gov/ (last visited Oct. 22, 2013). The IRS had 105,783 employees as of the last week of FY 2009 and spent $153,155,686 on training. In the last week of FY 2013, the IRS had 94,378 employees and spent $22,574,539 on training. Per employee, the IRS spent $1,447.83 in FY 2009 and only $239.19 in FY 2013. The IRS spent 83.48 percent less per employee on training in FY 2013 compared to FY 2009. IRS response to TAS Research Request (Nov. 22, 2013).

5 IRS response to TAS research request (Sept. 16, 2013). Training was proposed between April and June 2013.

6 IRS response to TAS research request (Nov. 22, 2013). For example, total training hours provided to Small Business/Self-Employed Revenue Officers in FY 2013 decreased by 89.29 percent, Large Business International Revenue Agents received 68.45 percent fewer hours of training in FY 2013, Tax Exempt Government Entity Tax Examiners received 80.63 percent fewer hours of training in FY 2013.

Delivering continuing education timely and in appropriate formats to employees is essential to the core function of the IRS. Faced with a declining budget, the IRS training and education programs have been reduced to bare minimums without consideration for the type of training employees need to perform basic job functions, protect taxpayer rights, and prevent harm and undue burden for taxpayers.[7]

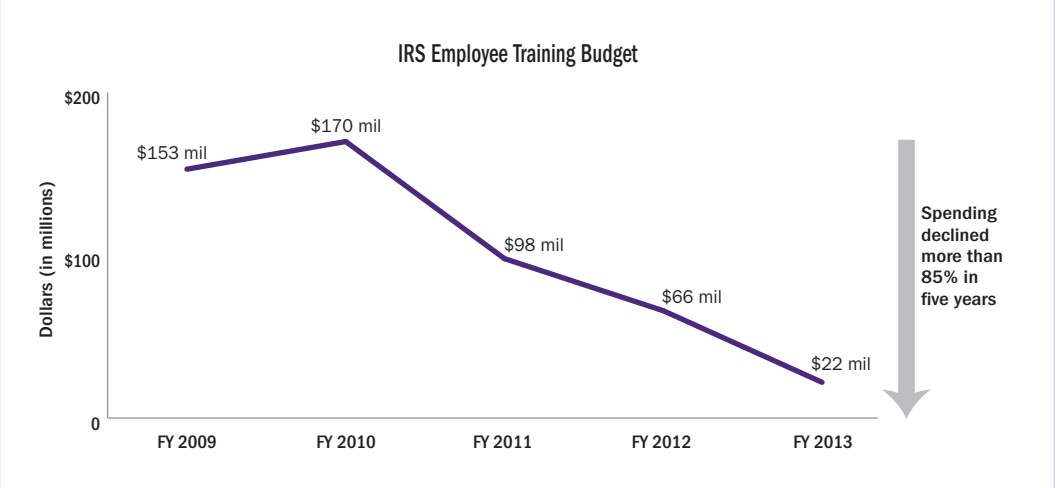
ANALYSIS OF PROBLEM

Background

Set into motion by the Budget Control Act of 2011 and beginning March 1, 2013, the sequester required federal agencies, including the IRS, to significantly cut their spending.[8] The IRS employee training budget experienced drastic cuts to ensure the IRS met its required overall reductions. Even before the sequester, however, the IRS had already sharply reduced dollars spent on training in response to a decrease or stagnation in its total operating budget since FY 2010.[9]

The IRS has drastically reduced spending on employee training.

FIGURE 1.3.1, IRS Training Budget, FY 2009–2013[10]



Faced with funding constraints, the IRS training budget declined by over 85 percent between FY 2009 and FY 2013.[11] Per-employee spending dropped from nearly $1,450 per full time equivalent employee in

7 For a complete discussion of the National Taxpayer Advocate's concerns regarding IRS employee training in taxpayer rights, see Most Serious Problem: *Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights, infra/supra*. For a further discussion of the National Taxpayer Advocate's concerns about the impact of the failure to properly train IRS employees, see Most Serious Problem: *The Automated Collection System's Flawed Approach to Working Cases and the Types of Cases it Works Results in Low Collection Yields and Harms Taxpayers, infra/supra*; and Most Serious Problem: *Indian Tribal Taxpayers: Inadequate Consideration of Their Unique Needs Causes Burdens, infra/supra*.

8 Budget Control Act of 2011, Pub. L. No. 112-25.

9 See Department of the Treasury, FY 2014 *Budget in Brief, available at* http://www.treasury.gov/about/budget-performance/budget-in-brief/Pages/index_14.aspx (last visited Sept. 26, 2013) and Department of the Treasury, *FY 2012 Budget in Brief, available at* http://www.treasury.gov/about/budget-performance/budget-in-brief/Pages/index_12.aspx (last visited Sept. 26, 2013).

10 IRS response to TAS research request (Nov. 22, 2013).

11 IRS response to TAS research request (Sept. 16, 2013). In FY 2009, the IRS spent $153,155,686 on training versus $22,574,539 in FY 2013, a reduction of 85.26 percent.

2009 to less than $250 in 2013.[12] Most of the IRS operating divisions that interact directly with taxpayers fared worse than the agency as a whole. The IRS Appeals division reduced its training budget from nearly $6 million in FY 2009 to about $250,000 in FY 2013, or almost 96 percent.[13] During the same period:

- The Tax Exempt and Government Entities division slashed its training budget by almost 96 percent, or approximately $7 million;[14]
- The Small Business/Self-Employed division training budget declined by 93 percent;
- The Large Business and International division training budget fell by about 92 percent;
- The Taxpayer Advocate Service decreased its training budget by almost 78 percent; and
- Wage and Investment fared the best, weathering a nearly 74 percent decrease.[15]

The IRS is providing less training to employees.

Reductions in spending have resulted in fewer hours of training for employees. For those in several key professional IRS job series, training hours delivered have almost universally declined.[16] Among the job series reviewed by TAS, SB/SE Revenue Officers (ROs) experienced the heaviest cuts in training. In FY 2009, SB/SE ROs received over 700,000 hours of training compared to just 76,000 hours in FY 2013, a decrease of almost 90 percent.[17] Key duties of Revenue Officers include:

- Investigating and interviewing taxpayers (and those associated with their businesses);
- Fact finding;
- Examining business records to determine if tax liabilities have been accurately reported;
- Researching precedential court decisions; and
- Communicating complex audit findings to taxpayers and their representatives, including the RO's interpretation of the tax laws and regulations.[18]

12 IRS, Human Resources Reporting Center, *available at* https://persinfo.web.irs.gov/ (last visited Oct. 22, 2013).

13 IRS response to TAS research request (Nov. 22, 2013). The Appeals division spent $5,803,332 on training in FY 2009 compared to $250,408 in FY 2013, a 95.68 percent decrease.

14 *Id*. TE/GE's training budget was reduced from $7,121,332 in FY 2009 to $316,263 in FY 2013, a 95.56 percent decrease.

15 IRS response to TAS research request (Nov. 22, 2013). SB/SE spent $52,391,207 in FY 2009 compared to $3,582,641 in FY 2013, a 93.16 percent decrease. LB&I's budget decreased from $11,738,428 in FY 2009 to $975,278, a 91.69 percent reduction. TAS spent $4,929,483 in FY 2009 and $1,091,310 in FY 2013, a 77.86 percent decrease. W&I spent $15,310,478 in FY 2009 compared to $3,987,023 in FY 2013, a 73.96 percent decrease.

16 IRS response to TAS research request (Nov. 22, 2013). TAS requested information from the IRS on 15 key taxpayer facing job series across the five main IRS operating divisions. In all but two job series examined, training hours delivered to employees decreased significantly since FY 2009. The W&I 0592 (Tax Examiner) and W&I 0962 (Contact Representative) job series employees received substantially similar hours of training in FY 2009 and FY 2013.

17 *Id*. In FY 2009, SB/SE provided 713,935 hours of training to its Revenue Officers, compared to 76,448 hours in FY 2013, an 89.29 percent decrease.

18 IRS, *Standard Position Description* GS-1169-12.

Budget cuts and sequestration have led the IRS to reduce its training budget by over 85 percent since fiscal year 2009.

Failing to train the ROs and other employees in the skills needed to do their jobs can have dire consequences for their ability to reach the right answer and provide quality service to taxpayers, as well as for protection of taxpayer rights.[19]

The IRS has reduced the number and variety of courses offered to employees.

Not only has the IRS reduced the funding and number of hours of training for employees, it has also cut the number of courses offered and eliminated entire subject areas. In FY 2009, SB/SE offered over 2,000 different in-person and virtual learning courses to its ROs, compared to just over 900 in FY 2013, a nearly 60 percent decrease.[20] Other job series saw even more drastic cuts. TE/GE Tax Examiners were offered 166 in-person training courses in FY 2009[21] but only three in FY 2013, a 98 percent decrease.[22]

19 For a complete discussion of the National Taxpayer Advocate's concerns regarding IRS employee training in taxpayer rights, see Most Serious Problem: *Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights, infra/supra*. For a further discussion of the National Taxpayer Advocate's concerns about the impact of the failure to properly train IRS employees, see Most Serious Problem: *The Automated Collection System's Flawed Approach to Working Cases and the Types of Cases It Works Results in Low Collection Yields and Harms Taxpayers, infra/supra*; Most Serious Problem: *Indian Tribal Taxpayers: Inadequate Consideration of Their Unique Needs Causes Burdens, infra/supra*; and National Taxpayer Advocate's Report to the Acting Commissioner, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013).

20 IRS response to TAS research request (Nov. 22, 2013). In FY 2009, SB/SE offered 2,263 courses to employees in the Revenue Officer 1169 job series compared to 925 course offerings in FY 2013, a 59.12 percent reduction in course offerings.

21 *Id.*

22 *Id*.

FIGURE 1.3.2, Courses Offered In Person to TE/GE Tax Examiners in FY 2009[23]

1120 ES PENALTIES
1120 Refresher
11972 Module B Form 1120
2008 CUMULATIVE LIST ON EXAM ISSUES VIA CENTRA
2008 Cumulative Via CENTRA
2008 Form 990 Refresher
2009 IRM Updates
2009 New Hire AaGI & CP12 Phone Training
94x New Hire Training
94X-X ALERTS/FTDPN
990 CPE
990 N Training for E-Help Desk Accurint
ADVANCED BUSINESS MASTER FILE TRAINING PROGRAM
AGI IMF Default Screener Class #3
AM CPE - Tax Law Changes - Business Tax Returns
AM CPE 2008 - BALANCE DUE
AM KC FY09 NEW HIRE TRAINING
AM KC NEW HIRE TRAINING FY09
AM Ops1 New Hire FTP/FTF & DMI
AM Refresher: Tax Exempt/Government Entities
AM Refresher: Employment Taxes
AMO TE FTD Penalties Training
AMS 2.1 Updates
AMS DI REFRESHER TRAINING TEGE
ASFR Returns Refresher Training
ASFR Returns Training
ASFR RH & Refund Hold Training
AUR CPE 2009 - Case Analysis
BMF Modernized e-file: Lessons 1 – 8
BMF94X e-file: Lessons 1 - 4
BMF e-file Form 1041: Lessons 1 – 5
CAWR SESSION 2
CAWR, 6020B, DUPF
CI - EUP eFile Applications - Los Angeles Class
CI Media Writing
CLASSROOM INSTRUCTOR TRAINING COURSE
Clerical Mandatory CPE
COMMUNICATIONS TESTING
Complex Interest CPE
Course Development Graphics and Manipulation
CPE
CPE 2 PART A
CPE 2 Part B
CPE For TEGE
CPE II
CPE TEGE Enhanced Job Aid Training
CPE, Systemic and Other Updates
CPE/REFRESHER 2010 EXAMINATION TOPICS
E&G CPE for TE's
EBE
E-CASE DOCUMENTATION
e-help update training
E-HELP UPDATE-DISCLOSURE
Electronic Research for EP Via Centra
EMBEDDED QUALITY TRAINING CORE COURSE
EO Classification Database Referral Procedures
EO ENTITY UNPOSTABLES
EO Refresher
EP Training
e-Postcard
EPSS Individual Master File (IMF)
e-file-Recruit
e-services Training for Help Desk Assistors: Refresher Training
Exam Development Day
EXTRACTION & SORTING NEW HIRE CLASS
FDC Annual CPE Refresher Training
First Time Homebuyer/Acct.
Form 1041 (Item # 11972 Module C)
FORM 1065 (11972 MODULE A)
FORM 940 REFRESHER
FORM 941 Component 11964
FORM 944 REFRESHER
Form 94XX
Fraud CPE
FRONT LINE MANAGER COURSE (FLMC)
Front Line Manager Course (FLMC)
Front Line Manager Course (FLMC)
FTF/FTP/RCA 11964 L1
Fundamental Management Skills (FMS)
GovTrip Briefing
GovTrip Workshop
IDAP IA Tool Training
Identity Theft Training for AM Customer Service Representatives
IDRS - Basic TXMOD Comprehension (online course) Project Meeting
IMF INQUIRIES
Instructor Symposium
Intermediate/Advanced FTD Computation
Internal Control Workshop Via CENTRA
[illegible]
[illegible]
UPDATE
ITIN- Without Return UPDATE
LARGE CORP FORM 1065
MANDATORY CPE
MANDATORY CPE SESSION 2
Manual Refund Training
Manual Refunds
MR Refresher Training
NAME CONTROL CLASS
New Hire Orientation 2008 POSH & UNAX & ETHICS
Normal Retirement Age IRC 401(a) (26) & 1.401(a) Final Regs Via Centra
NRP Transcription
OAR TRAINING
Obsolete - BMF Modernized e-file: Forms 1065 and 1065 - B
Obsolete - BMF Modernized e-file: Forms 1120, 1120S, 1120F, and 7004
Obsolete - BMF Modernized e-file: Forms 990, 990EZ, 990N, 990PF, 1120PF, and Extensions
Obsolete - Lesson 3 - IMF e-file: EMS Communication Testing
Oct 08 IRS Revision CPE TEGE
ON-THE-JOB INSTRUCTOR (OJI) WORKSHOP
OVERVIEW OF WRERA 2008 VIA CENTRA
Pallet Jack/Tug Training
Paying Employement Tax CP 267s
Pre-Assessed IA CPE
PROCESSING BUSINESS MASTER FILE ENTITY UNPOSTABLES (RECRUIT)
PROCESSING BUSINESS MASTER FILE ENTITY UNPOSTABLES (RECRUIT)
PROCESSING BUSINESS MASTER FILE ENTITY UNPOSTABLES (REFRESHER)
Refresher: EIN
Restricted Interest CPE
Restricted Interest CPE
SB-CO-ICS Windows for SBSE Collection-Full Access Users
SB-CS-EXCOR: Correspondence Examination Program Procedures - Alimony
SB-EX-TS Technical Services Statutory Notice of Deficiency Training
SCAMPS ORIENTATION
SEIZING THE POWER & CUSTOMER SERVICE POWER
SOI FORM 8038
SOI FORM 8832
SOI FORM 990 EO
SOI FORM 990 PF
Suitability Training for e-help Desk Assistors: Recruit Training
TAP FY 2009 INTRODUCTION TO ACCOUNTING I
TAP FY09 - COLLEGE MATH I
TAP FY09 - COLLEGE MATH II
TAP-2009 HUMAN RESOURCE MANAGEMENT
TAPS 2008 - FINANCIAL ACCOUNTING I
TAPS FY2009 - FUND OF ACCTG I
Taxpayer and Third Party Authentication and Authorization
TCB MANDATORY CPE
TE/GE Enhanced Job Aid
TE/GE Enhanced Job Aid Orientation
Tefra CPE
[illegible]FRA TEIR TRAINING
TEGE EOCA TE TRNG
TEGE EP Refresher
TEGE JIT Refresher
TEGE REFRESHER
TG: TEGE Leadership CPE
TG: EMPLOYEE PLANS CPE
TG:EO Examinations Secretarial CPE
TG:EO EXEMPT ORGANIZATIONS EXAMINATIONS - BASIC
TG:EO Tax Exempt Determination Systems (TEDS)
TG:EP Determinations - Phase IA, Non-Pension Defined Contribution Plans
TG:EP Determinations - Phase IB, Plan Terminations
TG:EP SUPPORT STAFF CPE
TG:GE TEGE INDIAN TRIBAL GOVERNMENTS (ITG) CPE
TG:HQ Data Security
TG:LE TE/GE Functional Management Course
Third Party Sick Pay, Course 26596, Les 9 Tiers CPE
TOTAL EVALUATION PERFORMANCE SYSTEM (TEPS) EMPLOYEE JOB AID
TRAINING FOR HELP DESK ASSISTORS - E SERVICES
TRANSMISSIONS & ACKNOWLEDGEMENTS
Unpostable Follow-up Refresher Training #1
UNPOSTABLE PHONE TRAINING
WESTLAW ELECTRONIC RESEARCH TRAINING – CLASSROOM
XML Instructor Cadre Training

FY 2009: 166 courses
in-person for TE/GE Tax Examiners

23 IRS response to TAS research request (Nov. 22, 2013). In FY 2009, SB/SE offered 2,263 courses to employees in the Revenue Officer 1169 job series compared to 925 course offerings in FY 2013, a 59.12 percent reduction in course offerings.

FIGURE 1.3.3, Courses offered in person to TE/GE Tax Examiners in FY 2013[24]

FY 2013: 3 courses
in-person for TE/GE Tax Examiners

TE/GE Penalties (FTF, FTP, Negligence, Accuracy, and IRC 6684)
SFR NON-FILER TRAINING CSB 217 5/1/13
New to ERS 2/25/2013 1.5 hours

24 IRS response to TAS research request (Sept. 16, 2013).

TE/GE Tax Examiners are expected to make contact with taxpayers and representatives to clarify information or inform taxpayers of procedural or processing issues.[25] They must be able to

- Accurately and promptly determine assessment statute dates;
- Respond to complex statute-related questions from reviewers and management; and
- Determine if statute expiration dates could interfere with tax accounts.[26]

TE/GE Tax Examiners received a total of about 1,100 hours of training in FY 2013 compared to nearly 6,000 hours in FY 2009, a cutback of almost 81 percent.[27]

Failing to train employees, especially new hires with no previous IRS background, will harm both the taxpayers and the IRS's ability to fulfill its mission.

Of even greater concern are the courses that the operating divisions have substituted for substantive training on interviewing skills, interpretation of the law, and research. In FY 2013, Tax Examiners in Appeals were offered courses in topics such as furlough time-keeping, preparing for Windows 7 and Microsoft Office 2010, resume writing, and organizational change.[28] Courses offered to Tax Examiners in FY 2009, but eliminated in FY 2013, include Fundamental Tax Law, Processing Resolutions and Closing Collection Due Process Cases, and Communications Skills, all core functions of the Tax Examiner job series.[29] If the IRS fails to train employees in the substantive knowledge and skills they need to perform their jobs successfully, taxpayers cannot expect to receive assistance from employees with the knowledge and skills to help them.

The multi-level training approval process delays training.

While reductions to the IRS training budget have severely impeded the ability of the IRS to effectively and appropriately train its employees, the new training approval process adds complications. In May 2012, the Office of Management and Budget (OMB) issued a memorandum to all heads of executive-level departments and agencies requiring that any proposed spending of over $100,000 on a single conference event be reviewed at the level of the agency Deputy Secretary or equivalent.[30] The Department of Treasury issued a subsequent directive outlining approval for spending on conferences, and requiring agencies in the Department to obtain approval for conferences as follows:[31]

- The authority to approve conferences with a total cost of under $3,000 remains with the agency;
- For the IRS, the Commissioner may approve costs of $3,000–$24,999;
- Spending of $25,000–$99,999 must be approved by the Assistant Secretary for Management of Treasury;
- Spending of $100,000–$249,999 requires the approval of the Deputy Treasury Secretary; and

25 IRS, *Standard Position Description GS-0592-072*.

26 *Id*.

27 IRS response to TAS research request (Sept. 16, 2013). TE/GE Tax Examiners received 5,711 hours of training total in FY 2009 compared to 1,106 hours in FY 2013, an 80.63 percent reduction.

28 IRS response to TAS research request (Nov. 22, 2013).

29 *Id*.

30 Office of Management and Budget, *Memorandum to the Heads of Executive Departments, and Agencies* (May 11, 2012).

31 Department of Treasury, *Treasury Directive 12-70* (May 6, 2013), *available at* http://www.treasury.gov/about/role-of-treasury/orders-directives/Pages/td12-70.aspx (last visited Sept. 30, 2013).

- All amounts above $250,000 must be approved by the Treasury Secretary.[32]

The spending levels and required approvals outlined by the Department of Treasury are far more restrictive than those set forth by the OMB, further hindering the ability of the IRS to properly train its employees.

Following the directive, the IRS in July granted the authority to approve conference amounts of under $3,000 to the heads of the business divisions, such as the National Taxpayer Advocate, the Chief of Appeals, or the Commissioner of W&I.[33] However, the IRS added the requirement that any training event, even if it falls under the $3,000 threshold, must be recommended for approval by the IRS Training Review Board (TRB).[34] While final approval on any training lies with the Commissioner, the new TRB uses the following criteria to make recommendations to the Commissioner:[35]

- Is the training event mission critical?
- Can costs be reduced or eliminated, including travel, course materials, development costs, and/or vendor costs by use of alternative training methods?
- Can a less costly venue be used?
- Can the training event be conducted in a location where the majority of students are located or travel can be minimized?
- Can the training event be effectively converted to online learning and delivered virtually?
- Can participation in a vendor-taught event be maximized and thus reduce the number of classes?
- Can the number of attendees recommended be justified?

After the TRB makes recommendations for changes to, approval of, or cancellation of training events, training requests are forwarded to the Deputy Commissioner for Operations Support for review.

While the IRS needs to ensure that appropriate training is provided to employees, punishing an entire organization and the millions of taxpayers it serves as a result of the misguided actions of one IRS business unit is neither wise nor effective.[36] From April through June 2013, the operating divisions proposed over $15 million in spending for training.[37] The Deputy Commissioner for Operations Support recommended approval of only 25 percent of those dollars.[38] Courses not recommend for approval include:

- Training in Basic Offers In Compromise (OIC) for new Appeals Settlement Officers who had not previously been trained or had any experience in working OIC cases;

32 Department of Treasury, *Treasury Directive 12-70* (May 6, 2013), *available at* http://www.treasury.gov/about/role-of-treasury/orders-directives/Pages/td12-70.aspx (last visited Sept. 30, 2013).

33 IRS, *Interim Guidance Memorandum Interim Guidance on the Approval Process for Event Related Spending CFO-01-0713-05* (July 29, 2013).

34 IRS, *Treasury Directive 12-70 – FAQs* (June 24, 2013), *available at* http://hco.web.irs.gov/devtrain/PROGADMIN/TrDir12-70/TRDirFAQ.html (last visited Sept. 30, 2013).

35 IRS response to TAS research request (Sept. 16, 2013).

36 Treasury Inspector General for Tax Administration, Ref. No. 2013-10-037, *Review of the August 2010 Small Business/Self-Employed Division's Conference in Anaheim, California* (May 13, 2013). See also the concerns raised by the National Taxpayer Advocate in the National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress regarding the potential impact to all IRS training in light of the actions of employees at one conference.

37 IRS response to TAS research request (Sept. 16, 2013). The operating divisions proposed $15,407,690 in training from April through June 2013.

38 *Id*. The Deputy Commissioner for Operations Support recommended approval of $3,884,099.

- An in-person training for LB&I International Examiner new hires covering penalties, allocation and apportionment, branch profits tax, corporate mergers, and acquisitions in a case study and group discussion format;
- Basic employment tax training for new SB/SE Revenue Agents (auditors); and
- Core filing season training in basic tax law for new W&I Field Assistance employees.[39]

Between April and June 2013, the Deputy Commissioner for Operations Support received proposals for nearly 800 courses and recommended for approval almost 500, a reduction of over 35 percent.[40] The Deputy Commissioner for Operations Support did not recommend many courses designed to train employees new to their positions to perform the core functions of their jobs. Without such training, IRS employees may not be able to assist taxpayers in complex or even basic matters and thus cannot provide quality service. Failing to train employees, especially new hires with no previous IRS background, will harm both the taxpayers and the IRS's ability to fulfill its mission.

Failure to Train Employees will Harm Taxpayers

Taxpayers seeking assistance and relief from the IRS will find a workforce lacking the knowledge and ability to provide assistance if the IRS continues to meet budgetary obligations by simply not training its employees. While the National Taxpayer Advocate is well aware of the budgetary constraints, and is subject to a similar inability to provide certain core training to TAS employees, she believes the IRS cannot continue denying basic and essential training to employees. An untrained workforce is one that does not understand basic taxpayer rights, a problem underscored by an already limited training in that area.[41]

An untrained workforce is one that does not understand basic taxpayer rights.

Beyond being ill-prepared to protect taxpayer rights, an employee untrained in the core functions of his or her job may provide limited assistance, reach the wrong conclusion for the taxpayer, or be unable to provide any assistance at all. The IRS is charged with administering the tax law – an ever-expanding, complex set of rules and requirements — which its employees cannot possibly do without adequate training. If taxpayers cannot turn to the IRS for assistance, they may have no option but to pay a tax professional or attempt to research a confusing law on their own. Some may simply choose to give up, causing even more problems for themselves and the IRS. Consequences to the taxpayers for non-compliance or errors in interpretation of the tax law include liens on homes, levies on paychecks or bank accounts, and destruction of credit records.[42]

39 IRS response to TAS research request (Sept. 16, 2013).

40 *Id*. The operating divisions proposed 767 courses between April 2013 and June 2013 and the Deputy Commissioner for Operations Support declined to approve 275 courses, a reduction of 35.85 percent.

41 For a full discussion of the National Taxpayer Advocate's concerns regarding the lack of training in taxpayer rights, see National Taxpayer Advocate's Report to the Acting Commissioner, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013) and Most Serious Problem: *Insufficient Education and Training about Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect their Rights, infra*.

42 For further discussion of the effects of noncompliance on taxpayers, see, *e.g.*, Most Serious Problem: *The Automated Collection System's Case Selection and Processes Result in Low Collection Yields and Poor Case Resolution, Thereby Harming Taxpayers and the Public Fisc, infra.*, and Most Serious Problem: *Accuracy Related Penalties: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Still Continues to Assess Them Automatically, infra*.

The IRS says that it recognizes the need for and importance of training its employees. The then-Principal Deputy Commissioner wrote in his initial assessment of the IRS:

> If we do not have funds to invest in our people in terms of recruiting new talent and sufficiently training our existing staff, as well as investing in the technology necessary to continue to build on the modernization efforts delivered over the last several years, there is no question that our service levels will suffer.[43]

It is clear from the current training provided to both experienced and new IRS employees that employees are not receiving sufficient training. While the then-Principal Deputy Commissioner stressed the need for training, he proceeded, in the same report, to laud the savings the IRS has achieved from the training budget, writing:

- The IRS limited employee travel and training to mission-critical projects beginning in FY 2011. Training travel alone has been reduced by $83 million from FY 2010 to FY 2012.
- The IRS has expanded the use of alternative delivery methods for in-person meetings, training, conferences, and operational travel. The IRS estimates that, by the end of FY 2013, training costs will have been reduced by about 83 percent and training-related travel costs by 87 percent when compared to FY 2010 levels.[44]

This report indicated that the IRS has expanded the use of alternative delivery methods for training. However, when the hours of training delivered to employees in key taxpayer-facing job series in FY 2013 are compared to the hours delivered in FY 2009, it is clear that training has not shifted to other methods, it has been eliminated.

CONCLUSION

IRS employees administer a complicated, ever-changing set of tax laws that are difficult to interpret and apply. A workforce lacking proper (or any) training in how to perform core job functions will be unable to provide service to taxpayers. Taxpayers will be harmed when they cannot contact the IRS and be assured that they will receive a prompt and correct answer to their inquiries or proper resolution of their account issues. The IRS cannot continue to meet budgetary obligations at the expense of training employees.

43 IRS, *Charting a Path Forward at the IRS: Initial Assessment and Plan of Action* (June 24, 2013) at 41.

44 *Id.*

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Propose that Congress appropriate sufficient funding for the IRS to train its employees through the most effective means (in person, conference call, self-study, outside courses, etc.) for the subject matter in all aspects of their jobs including the protection of taxpayers' rights.
2. Prioritize funding for training employees in critical job skills.
3. Request and obtain from the Department of Treasury authority to approve training within the OMB stated guidelines.
4. Clearly define the criteria for TRB approval of training.

MSP #4 TAXPAYER RIGHTS: Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights

RESPONSIBLE OFFICIALS

John Koskinen, Commissioner of Internal Revenue
John M. Dalrymple, Deputy Commissioner, Services & Enforcement
Peggy Sherry, Deputy Commissioner for Operations Support
Karen Schiller, Commissioner, Small Business Self-Employed Division
Debra Holland, Commissioner, Wage & Investment Division
Heather C. Maloy, Commissioner, Large Business & International Division
Sunita B. Lough, Commissioner, Tax Exempt Government Entities Division
Kirsten B. Wielobob, Chief, Office of Appeals

DEFINITION OF PROBLEM

While the Internal Revenue Code (IRC) guarantees certain rights to taxpayers, IRS employees do not always clearly communicate these rights to taxpayers at appropriate times. A recent nationwide survey found only 46 percent of U.S. taxpayers believed they have rights before the IRS, and only 11 percent knew what those rights were.[1] When employees inform taxpayers of their rights, they rely on Publication 1, *Your Rights as a Taxpayer*.[2] However, TAS focus groups indicate that taxpayers often do not read the publication.[3]

This lack of awareness of taxpayer rights is further compounded when IRS employees themselves do not sufficiently understand taxpayer rights. Only some employees receive initial training about taxpayer rights, and this information is not regularly reinforced during later periodic training, such as Continuing Professional Education (CPE). Information about taxpayer rights is scattered throughout the Internal Revenue Manual (IRM) and pertains to narrow circumstances or specific phases of taxpayers' dealings with the IRS. The IRS should provide employees with an overarching, comprehensive education about taxpayer rights, supplemented by training and guidance about how those rights adhere in specific situations.

1 Forrester Research Inc., *The TAS Omnibus Analysis*, from North American Technographics Omnibus Mail Survey, Q2/Q3 2012, 19-20 (Sept. 17, 2012).

2 The Technical and Miscellaneous Revenue Act of 1988 requires the IRS to distribute to taxpayers a statement of their rights and the obligations of the IRS during an audit when the IRS contacts the taxpayer regarding the determination or collection of tax. *See* Pub. L. No. 100-647, 102 Stat 3342 (1988). The IRS generally satisfies this requirement by providing taxpayers with Publication 1.

3 2011 IRS Nationwide Tax Forums TAS Focus Group Report, *Publication 1 - Taxpayer Rights* (Oct. 2011).

ANALYSIS OF PROBLEM

Background

The Code includes a number of taxpayer rights specific to certain situations, but it contains no organizing principles or formal acknowledgement of the fundamental taxpayer rights from which these statutory rights derive.[4] The information about taxpayer rights is scattered throughout the IRM and, as a result, IRS employees might be inclined only to uphold taxpayer rights in specific situations.

The National Taxpayer Advocate has recommended that a Taxpayer Bill of Rights (TBOR), a list of fundamental taxpayer rights and obligations, modeled after the United States Constitution's Bill of Rights, be formally codified.

The National Taxpayer Advocate has recommended that a Taxpayer Bill of Rights (TBOR), a list of fundamental taxpayer rights and obligations, modeled after the United States Constitution's Bill of Rights, be formally codified.[5] However, the IRS does not have to wait for legislative action. As recommended in this year's Annual Report to Congress, the IRS could follow the lead of other countries by adopting a TBOR through a taxpayer charter or other administrative statement of agency policy.[6] The TBOR would be a formal declaration of taxpayer rights and responsibilities written in plain language.[7] It would not provide additional rights not already statutorily or administratively granted. A TBOR is an essential platform for employee training, for taxpayer education, and, ultimately, for enabling taxpayers and employees to reach just and fair resolutions of tax liabilities."[8]

Recent IRS Actions to Improve Taxpayer Rights Awareness

As a result of the IRS's review of its handling of exempt organization applications, Acting Commissioner Werfel committed the IRS to evaluate training for employees to ensure taxpayers know their rights.[9] In her report to the Acting Commissioner on November 4, 2013, the National Taxpayer Advocate urged the adoption of the TBOR and outlined mechanisms that raise taxpayer and employee awareness of taxpayer rights.[10] TAS is examining taxpayer rights training and has begun a comprehensive review of the Internal Revenue Manual (IRM) to identify places to insert:

- References to taxpayer rights;
- Guidance for employees to refer a taxpayer to a Low Income Taxpayer Clinic (LITC); and

4 For example, the right of a taxpayer to be informed is included in a number of different IRC provisions. IRC § 6213(a) requires the IRS to provide a notice of deficiency at least 90 days (150 days for taxpayers residing abroad) before it can take collection action. This notice informs taxpayers of the right to petition Tax Court and, as required by IRC § 7522(a), and must describe the basis for and the amount of tax, interest, and penalties due. IRC § 6330 requires the IRS to notify taxpayers 30 days before a levy and provide the amount of unpaid tax, the IRS's proposed action, the IRC provisions relating to levy, the procedures available to the IRS, the administrative appeals available to the taxpayer, and the alternatives available to prevent the levy. IRC § 6320(a) requires the IRS to notify a taxpayer of federal tax lien within five days of when the lien is filed.

5 *See* National Taxpayer Advocate 2011 Annual Report to Congress 493-518; National Taxpayer Advocate 2007 Annual Report to Congress 478-89.

6 *See* OECD Committee of Fiscal Affairs Forum on Tax Administration, Centre for Tax Policy and Administration, GAP002, *Taxpayers' Rights and Obligations* 3 (2003), *available at* http://www.oecd.org/ctp/taxadministration/14990856.pdf (analyzing survey results published in 1990).

7 *See* OECD Committee of Fiscal Affairs Forum on Tax Administration, Centre for Tax Policy and Administration, GAP002, *Taxpayers' Rights and Obligations* 6 (2003), *available at* http://www.oecd.org/ctp/taxadministration/14990856.pdf (analyzing survey results published in 1990).

8 *See* Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration, supra. See also* National Taxpayer Advocate's Report to the Acting Commissioner, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013).

9 *See* IRS, *Charting a Path Forward at the IRS: Initial Assessment and Plan of Action* 34 (June 24, 2013), *available at* http://www.irs.gov/uac/Newsroom/IRS-Charts-a-Path-Forward-with-Immediate-Actions.

10 National Taxpayer Advocate's Report to the Acting Commissioner, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013), *available at* (insert link). *See* Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration, supra.*

- Instructions to provide Publication 1 where it is not currently required.

The Taxpayer Advocate Service recently collaborated with the IRS to develop language for the TBOR, and is planning to launch its own taxpayer rights website that includes the TBOR in 2014. TAS is drafting new versions of Publication 1 for the IRS to give to taxpayers at different points in the tax controversy process, including examination, appeals, and collection. TAS will conduct focus groups on the new publications in early 2014 and finalize them during the year. While these actions are encouraging, the lack of comprehensive training and education for employees on taxpayer rights remains a significant problem.

Employee training on taxpayer rights varies across the IRS.

The initial training for many new IRS employees contains only minimal instruction on taxpayer rights and varies greatly by employee position. A lack of continuing education on taxpayer rights negatively reflects on employees' ability to assist taxpayers and protect their rights because the basic knowledge acquired at initial training gradually fades over time without continuing education or reminders about how rights apply in specific contexts. TAS requested from the IRS detailed information about taxpayer rights training and education for new and current employees. Below are some of TAS's findings based on the IRS responses.

Examination[11]

- The Core Competency Training for newly hired Revenue Agents *(i.e.,* auditors or examiners) includes a 575-page participant guide, but only six paragraphs mention discussing taxpayer rights and the audit process with taxpayers.[12]
- For compliance employees[13] working examination cases, taxpayer rights are covered as parts of various processes, for example, review of installment agreements; but the actual rights are not explicitly explained. The IRS's response to TAS's information request includes six Automated Underreporter courses that discuss representation. However, the response merely states, "Tax examiners are trained when and how to accept 3rd party representation."[14] Issues relating to representation go beyond when and how to accept a power of attorney. The course should discuss informing taxpayers of their right to retain representation, as well as information on access to representation, including through Low Income Taxpayer Clinics that provide low to no-cost tax assistance.
- The Examination Toll-Free Telephone Assistor Training covers only selected taxpayer rights topics, such as taxpayer authentication and power of attorney.[15] While the scripts used in the training touch on a taxpayer's right to appeal by discussing Tax Court deadlines, they lack comprehensive information explaining taxpayers' appeal rights, the significance of the Tax Court as a pre-payment judicial forum, and the consequences of failing to act.

11 This section pertains to examination employees in the Small Business/Self-Employed (SB/SE) Operating Division and the Wage and Investment (W&I) Operating Division.

12 SB/SE Core Competency Training 29689-102 (May 2011).

13 Compliance employees include examination and collection employees, primarily in centralized locations.

14 IRS response to TAS information request (Oct. 22, 2013).

15 Exam Toll-Free Telephone Assistor Training Course 12256-102 (Rev. June 2013).

- The fiscal year (FY) 2013 CPE schedule for Revenue Agents has six required and ten optional courses that focus primarily on technical topics, with no mention of taxpayer rights in the descriptions.[16]

Tax Exempt / Government Entities (TE/GE) Division

- TE/GE has multiple courses for Revenue Agents that cover taxpayer rights. Chapter 1 of the Employee Plans Examination Phase II course includes an entire section on taxpayer rights.[17] This training surpasses merely mentioning taxpayer rights. One section states: "Publication 1(EP) is mailed with the initial appointment letter and explains these rights and the examination process. **This, however, is merely the first step.**"[18] The course details how the employee must continue communicating taxpayer rights during the process. The Exempt Organizations Basic Law Course includes a roleplaying session where employees discuss Publication 1 with taxpayers and representatives.[19]
- Conversely, the TE/GE response showed Tax Examiners receive only one course on taxpayer rights, which is only for new hires and does not mention Publication 1. Taxpayer rights material includes two ten-minute mock interviews conducted by the instructors.[20]

Collection[21]

- The training module for newly hired Revenue Officers (ROs) provides a comprehensive introduction to taxpayer rights with two hours of lessons focusing on all aspects of rights related to collection.[22]
- Automated Collection System (ACS) employees, who work the majority of IRS lien and levy cases,[23] have two lessons on taxpayer rights as part of the ACS Basic New Hire Course.[24] One lesson explains communicating with the taxpayer about appeal rights, and the other provides training on appeal rights after an installment agreement is denied. Unlike the RO training, there is no stand-alone course that emphasizes overall rights.[25]
- ACS's e-guide is lacking when it comes to explaining and educating taxpayers on their rights as they go through the collection process.[26] For example, the "Refusal to Pay Situations" section of the e-guide advises the employee to tell the taxpayer that if he or she cannot pay, the IRS will

16 IRS, FY 13 Exam CPE, Mandatory Lessons (June 28, 2013); FY 13 Exam CPE, Optional Lessons (July 18, 2013).

17 *See* IRS response to TAS information request (Sept. 19, 2013).

18 Employee Plans Examinations – Phase II course, Chapter 1 Pre-Contact Analysis/Pre-Audit, 11313-002, 1-37 (course delivered Jan. 31, 2013).

19 *See* IRS response to TAS information request (Sept. 19, 2013).

20 *See id.*

21 This section pertains to employees in Field Collection, part of the SB/SE Division and employees in the Automated Collection System, part of the Wage and Investment (W&I) Division.

22 IRS, Revenue Officer Training Unit 1, Module I Introduction to Taxpayer Rights Overview (Apr. 2012).

23 In fiscal year (FY) 2013, there were: 638,793 field levies versus 1,216,302 ACS levies; 63,944 field installment agreements versus 699,200 ACS installment agreements; and 228,318 currently not collectible field cases versus 346,576 currently not collectible ACS cases. Collection Activity Reports No. 5000-24 (Oct. 29, 2013), No. 5000-6 (Oct. 29, 2013), No. 5000-149 (Oct. 29, 2013). Currently not collectible numbers are hardship only.

24 *See* IRS response to TAS information request (Oct. 17, 2013) (discussing the ACS Basic-Taxpayer Appeal Rights and the ACS Basic-Independent Review).

25 *Id*.

26 The e-guide provides employees with an ongoing reference and source of education while on the job. *See* IRM 5.19.16.3.1 (Oct. 25, 2011).

take enforcement action.[27] There is no emphasis on explaining rights, specifically appeal rights or collection due process hearings.

Office of Appeals

- The Appeals Basic Training Course for new hires contains numerous references to appeal rights, including advising employees to explain these rights to the taxpayer at different points in the process. However, most of the course deals with procedures without emphasizing the taxpayer rights underlying those procedures. For example, the mediation training contains information about how a taxpayer can request mediation, the modification of *ex-parte* rules in mediation, and impartiality; but the course is mainly focused on how to conduct a mediation and reach a mutually acceptable agreement rather than on explaining and preserving foundational taxpayer rights in the process.
- The FY 2013 Appeals CPE schedule includes ten Customer Satisfaction courses, nine of which are from an outside vendor and focused on customer relationships in the private sector, along with one internal course on Cultural Competence and Effective Communication.[28] While the courses may encourage effective communication, they do not discuss taxpayer rights at all.

The Internal Revenue Manual (IRM) frequently lacks comprehensive information about taxpayer rights and their importance for due process and fair tax administration.

The IRS frequently relies on the IRM to educate employees. IRM sections that cover specific situations may include reminders about taxpayer rights that apply in those situations, but do not provide comprehensive information about the rights and why they are important. For example, the Collection Appeals Rights section of the Collection IRM states broadly, "The CDP appeal provisions give taxpayers an opportunity for an independent review by Appeals, to ensure that the proposed levy or lien filing is warranted."[29] However, the description does not contain information about the fundamental elements of a Collection Due Process (CDP) hearing, including the statutorily mandated determination of "whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[30] As a result, employees may not fully understand the purpose of a CDP hearing, its role in ensuring the fairness of tax administration, and the scope of a taxpayer's right to appeal. Thus, some may view CDP hearings as a nuisance or a delaying tactic and discourage taxpayers from acting upon their rights, instead of encouraging them to take advantage of an important due process protection.

The initial training for many new IRS employees contains only minimal instruction on taxpayer rights and varies greatly by employee position.

Another example of the IRM failing to properly educate employees is the section regarding transferring taxpayer examinations to a field office.[31] The IRM cites Treas. Reg. 301.7605-1(e)(2), which provides that requests for transferring an

27 ACS E-guide, *Refusal to Pay* (July 23, 2013).

28 FY13CPE_TopicSchedule.xls posted on the IRS Office of Appeals internal website (last modified July 1, 2013).

29 IRM 5.19.8.4.1 (Aug. 27, 2010).

30 IRC § 6330(c)(3). Congress created CDP hearings not merely to ascertain whether the collection action was warranted, but, *inter alia*, to verify that the IRS had followed proper procedures in filing the lien or notice of levy and whether collection alternatives had been considered.

31 IRM 4.19.13.14.1 (Aug. 1, 2012).

exam are generally granted. However, the IRM fails to explain this procedure as an aspect of the taxpayer's right to be heard. Instead the IRM instructs employees to rely on a decision tree (If/Then) chart, which, in turn, directs the examiner to "provide assurance that the issue can be resolved at the campus" when a taxpayer requests a transfer to an area office.[32] Employees may simply rely on the chart without understanding how a taxpayer's request for a local transfer may be vital to that taxpayer being able to present his case in the format most conducive to his concerns being heard. If the request is viewed as simply an inventory and work assignment problem rather than the realization of a fundamental taxpayer right, the employee may discourage or improperly dissuade a taxpayer from making a legitimate request.

IRM sections sometimes instruct employees to take a specific action as a part of a process or procedure without explaining the underlying taxpayer right. In examination cases where the IRS issues a statutory notice of deficiency and the taxpayer requests additional time to respond, the IRM advises employees to inform the taxpayer that any extension to submit documents will not extend the time to petition the Tax Court.[33] However, employees may not understand why this is important for taxpayers, *i.e.,* if the taxpayer does not petition the Tax Court within a certain number of days, he or she will lose the ability to challenge the liability in Tax Court, which is the *only* federal judicial forum available to litigate a tax liability *before* paying the tax first.[34]

As these examples demonstrate, the lack of comprehensive information about taxpayer rights may be detrimental to employees' ability to assist taxpayers and protect their rights. The IRS could improve employees' understanding of fundamental taxpayer rights by incorporating the TBOR in the IRM and including examples of potential impact in key enforcement sections such as Lien and Levy actions in Collection, and Statutory Notices of Deficiency in Exam.

Employees need a framework of taxpayer rights that shows them where fundamental taxpayer rights arise in their daily work and assists them in communicating these rights to taxpayers.

Because the Code does not list fundamental rights, an employee has no framework to reason how rights apply in a particular context. While the IRS has tried to come up with a statement of rights with Publication 1, this publication may be confusing to taxpayers. In addition, there are situations where taxpayers would benefit from information about their rights, but the IRS is not required to distribute Publication 1. Notably, the Acting Commissioner in his review of IRS exempt organizations practices found applicants for exempt status never received Publication 1 because the Code only requires the IRS to give Publication 1 to taxpayers who are selected for audit or are in collection.[35] Also, relying solely on Publication 1 to educate taxpayers runs the risk of furthering a "checkbox" mentality.[36]

---

32 IRM 4.19.13.14.1 (Aug. 1, 2012).

33 IRM 4.19.13.9.6 (Apr. 9, 2012).

34 *See* IRC § 6213(a).

35 *See* IRS, *Charting a Path Forward at the IRS: Initial Assessment and Plan of Action* 34 (June 24, 2013), *available at* http://www.irs.gov/file_source/PUP/newsroom/Initial%20Assessment%20and%20Plan%20of%20Action.pdf. The Technical and Miscellaneous Revenue Act of 1988 requires the IRS to distribute to taxpayers a statement of their rights and the obligations of the IRS during an audit when the IRS contacts the taxpayer regarding the determination or collection of tax. Pub. L. No. 100-647, § 6227, 102 Stat 3342, 3731 (1988).

36 An example is the Revenue Agent's classroom training, which teaches that employees can accomplish the task of informing taxpayers of their rights by providing Publication 1 and Privacy Act Notice 609. Revenue Agent Basic Classroom 1 Training, Trng. 31828-102, 9-20.

What the IRS needs is an improved Publication 1, and additional documents that explain the application of these rights in particular contexts, such as examination (Publication 1-E), collection (Publication 1-C), and appeals (Publication 1-A). This multi-step approach would enable taxpayers to:

1. Learn about their rights in general, so they know they have them and know to ask about them when a problem arises;
2. Learn about their specific rights as they need them within specific stages of the tax controversy process (Publication 1-E, Publication 1-A, Publication 1-C); and
3. Hear about these rights from IRS employees because the more contextual Publication 1 versions provide a vehicle for employees to explain the rights to taxpayers.

Although IRM sections direct employees to distribute Publication 1, they do not always instruct employees to engage the taxpayer regarding his or her rights.[37] The sections that do require the employee to explain rights to the taxpayer generally apply to only field collection and field examiners, who handle a minority of taxpayer cases.[38] Yet in FY 2013, ACS issued nearly double the number of levies, initiated nearly 11 times the number of Installment Agreements, and closed over half as many more (51.8 percent) cases as currently not collectible than the Collection Field function (CFf) .[39] In FY 2012, about 76 percent of all exams were correspondence exams.[40]

The majority of taxpayers with compliance issues, whose cases are worked by ACS or correspondence exam, will never receive a phone or in-person contact, and thus will never receive an explanation of their rights. Many of these taxpayers are unrepresented and thus unlikely to know their rights. Providing employees with expanded versions of Publication 1 that contain more detailed information about taxpayer rights would give employees a tool to use in explaining these rights to taxpayers and ensuring they understand them.

Employees' Lack of Understanding of Taxpayer Rights Leads to Poor Policy Decisions.

When employees are not adequately trained on taxpayer rights, they may make poor policy decisions, as evidenced by the IRS's recent revisions to one version of the Statutory Notice of Deficiency (SNOD).[41] The IRS attempted to put the SNOD in plain English, but removed some critical information that appeared in previous versions. Although the revised notice states that the taxpayer has the right to petition the United States Tax Court, nowhere does it explain that the Tax Court is the only judicial forum in which to contest the liability before paying it. The ability to appeal without pre-payment is a major

37 *See, e.g.*, IRM 4.23.3.7.5 (July 19, 2013) (requiring examination employees to provide Publication 1 to taxpayers with initial contact letters regarding an employment tax exam); IRM 4.81.5.6.1 (Oct. 1, 2009) (requiring tax exempt bonds examination employees to include Publication 1 with all examination letters pursuant to IRC § 7521(b)(1)(A)).

38 As part of the initial contact, field collection employees must determine whether the taxpayer received Publication, ask the taxpayer if he or she has any questions about Publication 1, and answer those questions. IRM 5.1.10.3.2 (Oct. 28, 2011). Exam employees who make initial contact by phone or in person must explain the taxpayer's rights as outlined in Publication 1 and answer any questions the taxpayer may have. This generally only applies to field examiners because correspondence examiners generally contact the taxpayer by letter. IRM 4.10.2.7.3 (Aug. 1, 2007).

39 In fiscal year 2013, there were: 638,793 field levies versus 1,216,302 ACS levies; 63,944 field installment agreements versus 699,200 ACS installment agreements; and 228,318 currently not collectible field cases versus 346,576 currently not collectible ACS cases. Collection Activity Reports No. 5000-24 (Oct. 29, 2013), No. 5000-6 (Oct. 29, 2013), No. 5000-149 (Oct. 29, 2013). Currently not collectible numbers are hardship only.

40 IRS Data Book, Fiscal Year 2012, Table 9a, Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return. There were 1,122,216 correspondence exams in FY 2012 out of 1,481,966 total examinations.

41 *See* IRS, *Understanding Your CP3219A Notice*, http://www.irs.gov/Individuals/Understanding-Your-CP3219A-Notice for a sample CP 3219A notice (page last updated or reviewed Nov. 1, 2013).

component of the overall fairness and integrity of our tax system. Otherwise, only those who could afford to pay the tax would have the benefit of judicial review. Comments from practitioners participating in a Low Income Taxpayer Clinic listserv reflect the problems with this new notice:

- "This one looked just like another balance due notice."
- The new notice is "[b]ordering on deceptive and coercive for the less sophisticated."
- "I did a double take because it looked just like a collection notice. The previous client had the normal notice of deficiency. What a stark contrast!"[42]

It appears that the employees redesigning and reviewing the SNOD may not have been properly trained about the significance of the language on contesting the determination in a pre-payment judicial forum. They may also have been confused about the underlying purpose of the notice — *i.e.*, providing the taxpayer a "ticket to Tax Court." Without comprehensive training on taxpayer rights, employees may continue to make poor decisions, such as this one, that harm taxpayers.

IRS measures do not sufficiently take into account taxpayer rights.

The broad, overall guidelines for critical job elements (CJEs), which the IRS uses to assess employees' performance, do not include taxpayer rights.[43] The description for "Customer Satisfaction - Application" focuses on communicating with taxpayers, but makes no mention of communicating taxpayer rights to taxpayers.[44] CJEs for different positions vary greatly in their focus on taxpayer rights. For example, the Revenue Officer CJEs include an entire subsection devoted to taxpayer rights under the category of Customer Satisfaction - Knowledge.[45] To receive an "Exceeds" rating in this category, an employee must always:

- Educate the taxpayer on his or her rights throughout the collection process;
- Ensure the taxpayer's rights are observed and protected throughout the process;
- Protect the confidentiality of taxpayer return and case-related information; and
- Accurately explain the collection process throughout the case progression.[46]

In contrast, the CJEs for Customer Service Representatives (CSRs), who make up much of the ACS, only have one taxpayer rights measure, even though CSRs have contact with more taxpayers than other employees. This measure, "ensures that taxpayer rights are appropriately protected," is part of the broader subsection, Technical Knowledge/Research, and provides little specific guidance on how, precisely, the employee is to ensure such protection.[47] The contrast between CJEs for Revenue Officers and ACS

42 Comments from ABA-Tax Low Income Taxpayer Clinic Discussion (Oct. 10, 2013).

43 IRS, Guidelines for Developing Critical Job Element (CJE) Performance Plans.

44 *Id*.

45 *See* Performance Plan for Revenue Officer Advisor / Reviewer and Revenue Officer / Independent Administrative Reviewer GS-1169 (Mar. 2006).

46 *Id*.

47 *See* Performance Plan for Customer Service Representative GS-0962 (Dec. 2004).

employees is troubling because ACS employees work far more collection cases and have contact with more taxpayers than Revenue Officers.[48]

In addition, case quality scores do not include taxpayer rights measurements, other than ascertaining whether the employee provided the taxpayer with the required written notice or Publication 1. For example, the Office of Appeals Case Quality standards include "Did Appeals Provide Appropriate Taxpayer Customer Service and Respect Taxpayer's Rights?"[49] To meet the standard of informing the taxpayer, employees only have to provide the Uniform Acknowledgement Letter timely (within 30 days of case receipt in Appeals) and communicate the status of the case within a reasonable time (generally every 90 days) until Appeals completes processing. Employees can demonstrate that the taxpayer was informed of his or her rights, including appeal rights, by providing the taxpayer with notices and publications. In contrast, TAS includes in its case quality attributes a measure for whether the employee educated the taxpayer and explained preventive actions to taxpayers. The IRS should adopt similar measures.

CONCLUSION

Many taxpayers have no knowledge of their rights, including specific rights that arise in certain situations or their fundamental rights as taxpayers. When employees also lack comprehensive knowledge of these rights, they may end up taking actions or establishing polices that violate these rights and harm taxpayers. At a time when the IRS budget is forcing difficult decisions across the agency, protecting taxpayer rights is more important than ever.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Require all future updates of training modules to include a significant segment on taxpayer rights.
2. Require all training modules that will not be updated in the next year to include the independent taxpayer rights training module to be developed by TAS.
3. Require all IRS employees to take the TAS *Roadmap to a Tax Controversy* Level One training.
4. Require all operating divisions to include in their Business Performance Reviews an analysis of how employees were trained on taxpayer rights issues and what actions the operating divisions took to incorporate the TBOR into their programs.
5. Require operating divisions to update their case quality attributes to measure whether the employee informed the taxpayer of his or her rights beyond just requiring the mailing of a publication or notice.
6. Update the IRS's guidance for developing CJE's to include a focus on taxpayer rights.

48 In fiscal year 2013, there were: 638,793 field levies versus 1,216,302 ACS levies; 63,944 field installment agreements versus 699,200 ACS installment agreements; and 228,318 currently not collectible field cases versus 346,576 currently not collectible ACS cases. Collection Activity Reports No. 5000-24 (Oct. 29, 2013), No. 5000-6 (Oct. 29, 2013), No. 5000-149 (Oct. 29, 2013). Currently not collectible numbers are hardship only.

49 Appeals Quality Measurement System Reviewer's Guide for Non-Collection Cases Standard 1, Did Appeals Provide Appropriate Customer Service and Respect Taxpayers' Rights? 29-63 (Revised Oct. 1, 2012).

7. Distribute taxpayer rights posters to managers and require all employee offices to place them where the maximum number of employees will see them.
8. Update all IRM sections identified by TAS with language provided by TAS to incorporate the TBOR into the IRM.
9. Update all IRM sections identified by TAS to include requirements for employees to provide either Publication 1 or separate publications that explain the application of taxpayer rights in particular contexts, such as examination (Publication 1-E), collection (Publication 1-C), and appeals (Publication 1-A). Update all notices identified by TAS to include Publication 1, Publication 1-E, Publication 1-A, or Publication 1-C as a stuffer.

MSP #5 REGULATION OF RETURN PREPARERS: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined From Continuing its Efforts to Effectively Regulate Unenrolled Preparers

RESPONSIBLE OFFICIAL

John Koskinen, Commissioner of Internal Revenue

DEFINITION OF PROBLEM

The IRS collects more than 90 percent of all federal revenue ($2.52 trillion in fiscal year 2012), with the largest portion coming from the individual income tax.[1] For tax year (TY) 2011, taxpayers filed about 142 million 1040-series individual returns,[2] with nearly 79 million taxpayers using paid preparers.[3] More than half (over 42 million) of these returns were prepared by preparers who are unregulated by the IRS.[4]

As preparers play a critical role in tax administration, it is essential that the IRS ensure that they are competent, visible, and accountable. In fact, the IRS was recently implementing a program to impose minimum competency requirements on the tax preparation profession. However, in *Loving v. Internal Revenue Service,* the District Court for the District of Columbia enjoined the IRS from further enforcing the testing and continuing education components of the program.[5] Thus, unless the District Court's ruling is overturned on appeal, U.S. taxpayers will continue to find themselves without meaningful IRS oversight of preparers, where anyone can hang out a shingle as a "tax return preparer" with no knowledge or experience required.

The case for IRS oversight over the return preparation industry is clear. Problems with return accuracy and ethical standards were substantiated by a series of "shopping visits" the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) conducted, where auditors posed as taxpayers and visited tax return preparation businesses.[6] Accordingly, the National

1 2012 IRS Data Book, at 3 (Mar. 25, 2013) (Doc 2013-7103); Table 1, col 2; Department of Treasury, *Budget in Brief: Internal Revenue Service FY 2014* 1.

2 The TY 2011 returns were prepared in 2012. For TY 2011, the IRS received 142,424,022 individual income tax returns. IRS Compliance Data Warehouse, Individual Returns Transaction File, TY 2011 (filed through Mar. 2013).

3 IRS Compliance Data Warehouse, Individual Returns Transaction File and Return Preparers and Providers Database, TY 2011 (filed through Mar. 2013).

4 For a more detailed discussion of this data and its import, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31, Tax Analysts Tax Notes Today (May 13, 2013). IRS Compliance Data Warehouse, Individual Returns Transaction File and Return Preparers and Providers Database, TY 2011 (filed through Mar. 2013). The category "unregulated preparer" reflects returns prepared by individuals with preparer tax identification numbers who did not list a profession when registering with the IRS. IRS Compliance Data Warehouse, Individual Returns Transaction File and Return Preparers and Providers Database, TY 2011 (filed through Mar. 2013). IRS records show about one million returns as paid preparer returns that did not have a Preparer Tax Identification Number (PTIN) match in the Return Preparers and Providers Database.

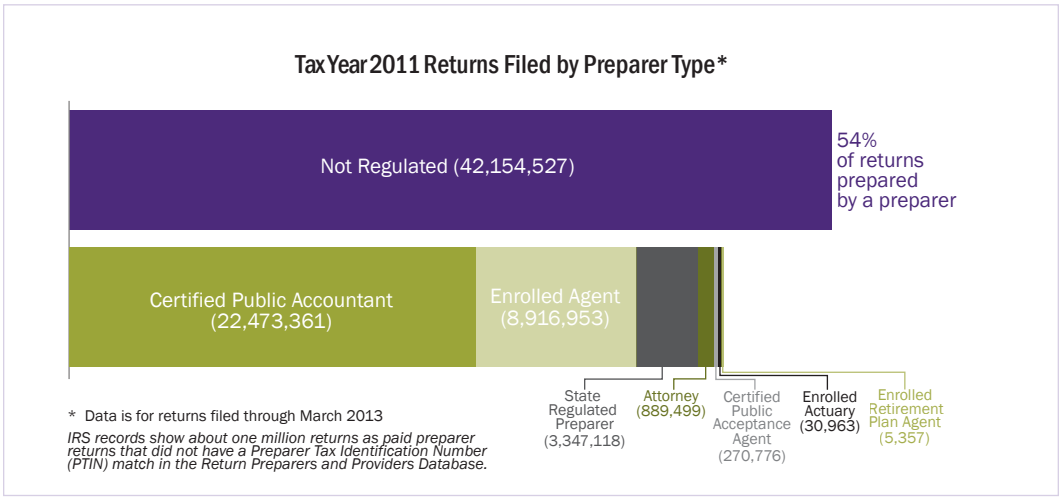
5 111 A.F.T.R.2d (RIA) 589 (D.D.C. Jan. 18, 2013).

6 Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 2 (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008).

Taxpayer Advocate continues to recommend that the IRS establish minimum standards for return preparers as an essential consumer protection measure. Minimum standards would also improve professionalism and reduce preparer-facilitated noncompliance.[7]

While the question of regulatory authority is ultimately up to the courts to decide, the IRS has the responsibility to protect taxpayers by pursuing education and enforcement options that are undeniably within its purview. In the event that the courts decide that the IRS does not have authority to impose testing and continuing education requirements on preparers, the National Taxpayer Advocate urges the IRS to implement the following six-part strategy to protect taxpayers from preparer incompetence and misconduct:

1. Offer unenrolled preparers the opportunity to earn a voluntary examination and continuing education certificate.
2. Restrict the ability of unenrolled preparers to represent taxpayers in audits of returns they prepared unless they earn the voluntary examination and continuing education certificate.
3. Restrict the ability to name an unenrolled preparer as a Third Party Designee on Form 1040, *U.S. Individual Income Tax Return*.
4. Mount a consumer protection campaign to educate taxpayers about the need to select competent preparers who can demonstrate competency.
5. Develop a research-driven, Servicewide preparer compliance strategy similar in nature to the Earned Income Tax Credit (EITC) preparer compliance strategy.
6. Recommend that Congress revise 31 U.S.C. § 330(a)(2) to clarify that the IRS has the authority to regulate unenrolled preparers.



7 By statute, the IRS cannot require attorneys and accountants to pass the competency exam or satisfy continuing education requirements to prepare returns. 5 U.S.C §§ 500(b) & (c) grant attorneys and certified public accountants, respectively, the authority to represent clients before federal agencies (upon submitting a written declaration stating that he or she is currently qualified).

ANALYSIS OF PROBLEM

Background

The National Taxpayer Advocate Has Long Proposed a Program to Regulate Return Preparers

Since 2002, the National Taxpayer Advocate has advocated for a system to regulate return preparers. Her proposals included a program to register, test, and certify unenrolled preparers, as well as increased preparer penalties and improved due diligence requirements. The National Taxpayer Advocate has also recommended that the IRS mount a comprehensive education campaign to inform taxpayers how to choose a competent preparer and remind them to obtain a copy of the tax return with the preparer's signature.[8]

The National Taxpayer Advocate's recommendations to regulate the return preparer profession received widespread support. Most organizations representing established preparers supported her call for minimum industry standards. For example, in 2005 the House Ways and Means Subcommittee on Oversight held a hearing at which representatives of five outside organizations testified in support of regulating return preparers.[9] Preparer oversight has received similarly broad support from members of Congress. The Senate Finance Committee has twice approved legislation to regulate federal tax return preparers (once under Democratic and once under Republican control).[10] The full Senate also once approved similar legislation.[11] However, the House of Representatives never took up companion measures. More recently, several bills included proposals to regulate preparers — S.1219, the Taxpayer Protection and Assistance Act of 2007; H.R. 5716, the Taxpayer Bill of Rights Act of 2008; and S. 3215, the Taxpayer Bill of Rights of 2010.[12] All of these bills would have required preparers to have the knowledge and skills to prepare accurate returns.[13]

IRS Implements Return Preparer Strategy

In January 2010, the IRS published a study of federal tax return preparers that in most important aspects reflected the proposals made by the National Taxpayer Advocate.[14] As a result of the study, the IRS issued regulations requiring all preparers to register with the IRS by obtaining a preparer tax identification number (PTIN).[15] The IRS also required certain preparers to meet testing and continuing education standards.[16] Implementation began with the 2011 filing season, when the IRS required paid return preparers to obtain PTINs.[17] The IRS launched the registered tax return preparer competency test in November

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

9 The organizations were the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals. *See Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109th Cong. (2005).

10 H.R. 1528 (incorporating S. 882) (108th Cong.); S. 1321 (incorporating S. 832) (109th Cong.).

11 H.R. 1528 (incorporating S. 882) (108th Cong.).

12 S. 1219, § 4, 110th Cong. (2007); H.R. 5716, § 4, 110th Cong. (2008); S. 3215, §202. 111th Cong. (2010).

13 *See also* GAO, GAO-08-781, *Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* (Aug. 15, 2008).

14 IRS Publication 4832, Return Preparer Review (Dec. 2009).

15 Treas. Reg. § 1.6109-2(d).

16 31 C.F.R. §§ 10.4(c) (testing) and 10.6(e) (continuing education).

17 *See* IRS News Release, IR-2010-106, *IRS Begins Notifying Tax Return Preparers on PTIN Renewals* (Oct. 25, 2010).

2011 with a deadline to take the test by December 31, 2013. The continuing education requirement began during the 2012 calendar year.[18]

The District Court Enjoined IRS Preparer Initiatives

In January 2013, after the new return preparer program was substantially in place, a U.S. district court judge in *Loving v. Internal Revenue Service* enjoined the IRS from enforcing the testing and continuing education requirements. The outcome of *Loving* rests on the reviewing court's application of the *Chevron* analysis.[19]

Under *Chevron*, the court must first ask if Congress's intent in enacting the statute giving rise to the challenged government action — here, the regulation — is clear. If so, the court must give full effect to this expressed intent of Congress. Pursuant to 31 U.S.C. § 330(a)(1), Congress granted the Secretary of the Treasury authority to "regulate the practice of representatives of persons before the Department of the Treasury." The *Chevron* analysis turns on how "practice of representatives" is defined in the context of tax return preparation.

In *Loving*, the District Court reasoned that the statute equates "practice of representatives" to the presentation of a case before the IRS, and held that the mere preparation of a return for submission to the IRS does not amount to "practicing" before the IRS.[20] Thus, the District Court held that the statute unambiguously limits the IRS's authority to regulate the "practice of representatives." Therefore, under a *Chevron* analysis, 31 U.S.C. § 330(a)(1) does not authorize the Secretary of Treasury to regulate the practice of representatives who prepare federal tax returns on behalf of other persons for filing with, and review by, the IRS.[21] The Justice Department has appealed the District Court's decision.[22]

The District Court's Decision in *Loving* is Based on an Outdated Understanding.

The National Taxpayer Advocate believes that the District Court decision in *Loving* is based on an outdated understanding of the return preparation function.[23] For purposes of determining what constitutes "practice" before the IRS, the court excluded return preparation because, it reasoned, at the time of filing there is no dispute before the IRS and thus, no "case" to present, as required by 31 U.S.C. § 330(a)(2)

---

18 IRS News Release, IR-2011-111, *IRS Moves to Next Phase of Return Preparer Initiative; New Competency Test to Begin* (Nov. 22, 2011).

19 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984). "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress" (step one). If, however, the reviewing court determines that the statute is ambiguous or silent regarding Congress's intent, the court must ask whether the agency position "is based on a permissible construction of the statute" (step two).

20 *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. Jan. 18, 2013). The government filed a motion to suspend the injunction pending appeal. The U.S. District Court for the District of Columbia denied the motion but then modified the terms of the injunction to make clear that the IRS is not required to suspend the preparer tax identification number (PTIN) program, and not required to shut down all of its testing and continuing centers. *See Loving*, 111 A.F.T.R.2d (RIA) 702 (D.D.C. Feb. 1, 2013). On February 25, 2013, the government filed a motion for a stay pending appeal. On March 27, 2013, the U.S. District Court for the District of Columbia denied the motion for stay. *Loving*, 111 A.F.T.R.2d (RIA) 1384 (D.D.C. Mar. 27, 2013). Oral argument was held before the Court of Appeals for the D.C. Circuit on September 24, 2013.

21 *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. Jan. 18, 2013).

22 *See Government Files Brief in D.C. Circuit Court in Return Preparer Oversight Case*, 2013 TNT 62-20, Tax Analysts Tax Notes Today (Apr. 3, 2013); *Loving v. IRS*, No. 1:12-cv-00385 (D.D.C. 2013) (USCA Case No. 13-5061). The oral arguments were held at the D.C. Circuit on September 24, 2013. *See* Matthew R. Madara, *Appeals Judges Turn Skeptical Eye Toward IRS Return Preparer Requirements,Tax Analysts* Tax Notes Today (Sept. 24, 2013).

23 For a more detailed discussion of the National Taxpayer Advocate's views, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31, Tax Analysts Tax Notes Today (May 13, 2013).

(D).[24] However, the filing of a tax return is not merely a ministerial act. The taxpayer is taking a position before the federal government regarding items of income, expenses, and eligibility for government benefits that are administered by the IRS. A preparer is not merely the taxpayer's scrivener. Taxpayers pay preparers for their knowledge and skills because they are uncomfortable navigating the complexity of the tax laws by themselves.[25]

Tax return filing is almost always "presenting a case" and return preparers are representatives before the IRS when they advise and assist taxpayers in making their claims to the IRS and Treasury.[26] More than 80 percent of individual income tax returns are actually claims for refund under IRC § 6402, and nearly 80 percent of those refund returns are prepared by preparers.[27]

The case for IRS oversight over the return preparation industry is clear.

In addition, IRC § 6695(g) imposes due diligence requirements for paid preparers of individual income tax returns claiming the EITC and a penalty of $500 for each failure to comply with the requirements. The regulations thereunder require the preparer to complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist,* which includes a series of questions to determine the taxpayer's eligibility as well as the preparer's affirmative acknowledgement that he or she complied with the due diligence requirements. The preparer must also complete an EITC worksheet, and comply with recordkeeping and knowledge requirements.[28]

The due diligence requirements result in the preparer anticipating and preparing for an IRS challenge to the taxpayer's eligibility for EITC by answering certain questions, verifying to the IRS that the preparer asked certain questions and retained documentation probative of eligibility. In TY 2012, over 76 percent of preparers who prepared returns claiming EITC were unenrolled.[29] The chart below provides further information on EITC claims and the use of preparers in tax years 2010 through 2012:

24 *Loving v. IRS*, 917 F. Supp. 2d 67, 74 (D.D.C. Jan. 18, 2013). The Secretary of the Treasury has the authority to require that a representative demonstrate:

> (A) good character; (B) good reputation; (C) necessary qualifications to enable the representative to provide to persons valuable service; and (D) competency to advise and assist persons in presenting their cases.

31 U.S.C. § 330(a)(2)(A)-(D). In its reply brief, the government argues that the factors listed in § 330(a)(2) are discretionary and therefore not all required to constitute practice before the IRS. *See* Reply Brief for the Appellants, *Loving v. Internal Revenue Service*, No. 13-5061, page 18 (D.C. Cir. filed June 5, 2013).

25 *See also* Brief of Former Commissioners of Internal Revenue as amici curiae, supporting defendants-appellants, *Loving v. IRS*, No. 13-5061 (D.C. Cir. filed Apr. 5, 2013).

26 *See* Lawrence B. Gibbs, Loving v. IRS: *Treasury Has the Authority to Regulate Unregulated Commercial Preparers*, 2013 TNT 203-50, Tax Analysts Tax Notes Today (Oct. 21, 2013). In the article, the former IRS Commissioner argues in favor of the government's position and provides that the preparation of a return is the presentation of a case. Moreover, the article analogizes the preparation of return to the preparation of a will, which is undeniably considered representation, despite the absence of a principal-agent relationship.

27 For TY 2011, the IRS received 142,424,022 individual income tax returns, of which 114,511,777 (80.4 percent) claimed refunds. IRS Compliance Data Warehouse, Individual Returns Transaction File, TY 2011 (filed through Mar. 2013). For TY 2011, preparers prepared 79,008,158 individual returns, of which 61,680,140 (78.1 percent) claimed refunds. IRS Compliance Data Warehouse, Individual Returns Transaction File, TY 2011 (filed through Mar. 2013).

28 Treas. Reg. § 1.6695-2. For tax returns and claims for refund for tax years ending on or after December 31, 2011, preparers are required to submit Form 8867, with the taxpayer's return. T.D. 9570. This recent revision is consistent with recommendations made by the National Taxpayer Advocate in 2003. National Taxpayer Advocate 2003 Annual Report to Congress 270-302. The knowledge requirement provides that the preparer have no knowledge that any of the information used to determine if a taxpayer is eligible for the EITC is incorrect.

29 IRS, Returns Preparer and Provider Database.

TABLE 1.5.1, The Preparation of EITC Claims by Unenrolled Preparers in TY 2010-2012[30]

Tax Year	EITC Paid	Count	Total Preparers	Unenrolled Preparers	Percent Unenrolled
2010	$58,573,186,452	27,627,852	16,464,493	12,430,967	75.5%
2011	$61,109,934,146	27,816,576	16,549,166	12,198,085	73.7%
2012	$62,981,818,983	27,081,228	15,132,562	11,523,814	76.2%

In addition, the act of filing is also the first step for millions of U.S. taxpayers every year in what will become a formal tax controversy. For example, in the 2013 filing season, the IRS identified potential errors in approximately 18.9 million returns during processing, causing the IRS to send the returns to "error resolution," and requiring some of the taxpayers to present additional information.[31] Further, the IRS issued over 270,000 math error notices, disallowing dependency exemptions and tax credits tied to dependents for tax year 2012.[32] The following chart illustrates the use of paid preparers by taxpayers claiming refundable credits in tax years 2010 and 2011.

TABLE 1.5.2, Taxpayers Claiming Refundable Credits, Claim Amounts, and Preparer Usage: Tax Years 2010 and 2011[33]

Tax Credit	Tax Year	Number of Taxpayers	Average Claim (dollars)	Total Claims (dollars in thousands)	Preparer Returns (percentage)
Earned Income Tax Credit	2011	27,362,193	$2,270	$62,119,975	59.3%
Additional Child Tax Credit	2011	20,616,435	$1,347	$27,771,740	65.0%
First-Time Homebuyer Credit	2010	373,880	$6,893	$2,577,155	53.8%
Adoption Credit	2011	55,794	$13,474	$760,365	60.1%
Making Work Pay Credit	2010	106,381,764	$514	$54,784,234	53.6%
American Opportunity Tax Credit	2011	12,525,776	$899	$11,266,488	55.9%

The Availability of Tax Preparation Software Opened Opportunities for Untrained and Even Unscrupulous Return Preparers

Before reasonably priced return preparation software packages became widely available, knowledge of the tax laws was a barrier to entry into the return preparation industry. To gain the competence to prepare a return, preparers needed to read the tax laws, Treasury regulations, IRS publications, and the IRS form instructions, which required a significant investment of time, energy, skill, and knowledge. Once return preparation software became widely available and reasonably priced (as little as $119.95 for a package),

30 IRS, Compliance Data Warehouse Individual Returns Transaction File; IRS, Individual Master File (net of transactions 764, 765, and 768); IRS, Returns Preparer and Provider Database (through Nov. 2013) (Note that the amounts paid out by the IRS may have been subsequently disallowed in post-refund audits).

31 IRS, Submission Processing Miscellaneous Monitoring Report, Headquarters, ERS (IMF/BMF) 2013 vs. 2012 (week ending Sept. 27, 2013).

32 Individual Returns Transaction File (IRTF) tax module table from CDW tax year 2012 (transaction codes 604, 605,and 743) (Oct. 2013). For a detailed description of the path a return takes from submission to assessment and refund issuance, and all the possible controversies arising from that path, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-31, Tax Analysts Tax Notes Today (May 13, 2013).

33 IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File and Individual Master File, TY 2010 and 2011 (through Mar. 2013).

anyone could sit down and have the software walk them through the entire process without any previous knowledge or experience.[34]

The IRS sought to remedy this issue by imposing examination and continuing education requirements on preparers with no previously recognized credentials — unenrolled return preparers. Those preparers could satisfy the IRS's requirements and obtain the designation "registered tax return preparer" if they satisfied the program requirements. However, the current injunction imposed on the IRS by *Loving* prohibits the IRS from administering the testing and education components of the program. Therefore, after *Loving*, once again, anyone can hang up a shingle and be a return preparer.

Taxpayers Remain Vulnerable to Incompetent and Unscrupulous Preparers.

The need for regulation was evident long before the IRS implemented its return preparer program. In 2006 and 2008, GAO and TIGTA, respectively, conducted studies in which auditors posed as taxpayers and visited preparers for help in preparing returns. The results dramatically substantiated the National Taxpayer Advocate's longstanding concerns by suggesting that a high percentage of preparers prepare inaccurate returns, fail to perform sufficient due diligence, and even take positions that they know are not supportable.[35]

Without any regulation, we will continue to see a proliferation of return preparers showing up at check-cashing places, pawnshops, used car dealerships, furniture stores, etc. Anyone who doubts we have devolved into the Wild Wild West of tax return preparation should view two videos. The first is an advertisement for some type of services related to tax returns.[36] The second is a slideshow of photographs taken by Local Taxpayer Advocates in 2010 showing the variety of businesses touting tax preparation services.[37] In addition, the amicus brief of the National Consumer Law Center and the National Community Tax Coalition in *Loving* contains many examples of the virtual absence of professionalism and competency.[38]

Finally, over the past several years, the need for regulation of these preparers has become even more apparent at the Taxpayer Advocate Service. We recently have seen many misconduct cases in which the return preparers have altered return information without their clients' knowledge or consent in an attempt to obtain improperly inflated refunds or divert refunds for their personal benefit.[39]

---

34 Results of Google search "Professional Tax Preparation Software Price" (Apr. 30, 2013).

35 Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 5, 23 (Apr. 4, 2006) (finding preparers made significant mistakes on 17 of the 19 returns prepared for GAO employees posing as taxpayers, including the omission of income on ten); TIGTA, Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* 2 (Sept. 3, 2008) (finding preparers made mistakes on 17 of the 28 returns prepared for TIGTA employees posing as taxpayers, including six willful or reckless errors).

36 http://www.youtube.com/watch?v=W00BmbrlvHk&sns=em (Southern King Taxes promotional video) (last viewed Dec. 10, 2013).

37 Taxpayer Advocate Service, *Tax Preparation Sites Across the United States: A Random Selection of Services Marketed to U.S. Taxpayers, available at* http://www.taxpayeradvocate.irs.gov/preparervideo (Dec. 10, 2013).

38 Brief of National Consumer Law Center and National Community Tax Coalition, as *amici curiae*, supporting defendants-appellants, *Loving v. IRS*, No. 13-5061 (D.C. Cir. filed Apr. 5, 2013) (Doc. #1429234). *See also* National Consumer Law Center, *Riddled Returns: How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do* (Nov. 2013), *available at* http://www.nclc.org/issues/riddled-returns.html (last visited Dec. 20, 2013).

39 For a more detailed description of return preparer misconduct and IRS procedures to assist victims of the misconduct, see Most Serious Problem: *The IRS Still Refuses to Issue Refunds to Victims of Return Preparer Fraud, Despite Ample Guidance Allowing the Payment of Such Refunds, supra*; National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 1-4; National Taxpayer Advocate 2012 Annual Report to Congress 68-94 (Most Serious Problem: *The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully*).

Development of a Six-Part Return Preparer Strategy Would Protect Taxpayers in the Event the Courts Decide the IRS Does Not Have Regulatory Authority.

Given the demonstrated need for regulation of unenrolled preparers, and the uncertainty introduced by the *Loving* litigation, it is imperative that the IRS act to protect taxpayers from the harm that arises in the current unregulated environment. In the discussion below, we lay out an approach for ensuring that taxpayers receive competent and ethical preparation, regardless of the type of tax return preparer they choose. Accordingly, the National Taxpayer Advocate urges the IRS to develop a six-part strategy to protect taxpayers in the event that *Loving* is upheld on appeal. Specifically, the strategy should include the following components:

1. Offer unenrolled preparers the opportunity to earn a voluntary examination and continuing education certificate.
2. Restrict the ability of unenrolled preparers to represent taxpayers in audits of returns they prepared unless they earn the voluntary examination and continuing education certificate.
3. Restrict the ability to name an unenrolled preparer as a Third Party Designee on Form 1040.
4. Mount a consumer protection campaign that educates taxpayers about the need to select competent preparers who can demonstrate competency.
5. Develop a research driven and Servicewide preparer compliance strategy similar in nature to the EITC preparer compliance strategy.
6. Recommend that Congress revise 31 U.S.C. § 330(a)(2) to clarify that the IRS has the authority to regulate unenrolled preparers.

Offer Unenrolled Preparers the Opportunity to Earn a Voluntary Examination and Continuing Education Certificate.

The IRS should offer paid unenrolled preparers the opportunity to *voluntarily* distinguish themselves from untrained preparers. This would involve providing a certificate to preparers who passed an IRS-developed examination and satisfy continuing education criteria similar to those previously implemented by the IRS. This may involve contracting with third parties to administer the examination and continuing education once the IRS follows the appropriate rulemaking processes.

Restrict the Ability of Unenrolled Preparers to Represent Taxpayers in Audits of Returns They Prepared Unless They Earn the Examination and Continuing Education Certificate.

Currently, unenrolled preparers are allowed to engage in limited practice before the IRS, representing taxpayers before revenue agents, customer service representatives, or similar officers and employees of the IRS (including the Taxpayer Advocate Service) during an examination if they signed the tax return or claim for refund for the tax period under examination.[40] These preparers cannot, however, represent taxpayers before Appeals or Collection.[41]

40 Section 10.7 of Circular 230 (31 C.F.R. § 10.7) was amended before *Loving* to remove the authorization for unenrolled, unlicensed individuals to represent before the agency on returns they signed. However, Notice 2011-6, 2011-3 I.R.B. 315 provided interim authority for these individuals to represent in this context during "the transition years" of the return preparer program. It is the opinion of the Office of Professional Responsibility (OPR) that this anticipated temporary authority should be amended to remove this privilege. OPR response to TAS information request 5 (Oct. 31, 2013).

41 31 C.F.R. § 10.3(f)(3).

Without any regulation, we will continue to see a proliferation of return preparers showing up at check-cashing places, pawnshops, used car dealerships, furniture stores, etc.

At the time when Treasury granted unenrolled preparers this limited practice authority, the role of a tax preparer required skill and knowledge of tax laws. Revenue Procedure 81-38 provides that the preparer of the return under audit could assist in the exam by explaining the positions taken.[42] However, as noted above, the advent of commercial preparation and filing software has radically changed the profession by enabling anyone to prepare a return without any training in the tax law. Thus, return preparation by an untrained individual with commercial software does not position that individual to competently assist the taxpayer in the examination.

Representing a taxpayer before Examination requires a certain level of knowledge, competence and skill, the absence of which can have a significant economic impact on the taxpayer. If the courts decide return preparation is not "presenting a case" before the IRS because it is mere preparation, it is in the best interest of taxpayers to restrict the authority granted to unenrolled return preparers to conduct limited practice before the IRS. Unenrolled preparers may not possess the requisite skill and knowledge to represent taxpayers at any level before the IRS.

To ensure that taxpayers have knowledgeable and skilled representation, the IRS should condition the authority for an unenrolled preparer to represent his or her preparation-clients in audits on his or her passing a competency test and satisfying annual continuing education requirements. This approach does not impinge on a preparer's ability to prepare a return. Even the plaintiffs in *Loving* raised no objection to the IRS regulating practitioners who wish to represent taxpayers during an examination.[43] If, as the *Loving* plaintiffs state, these unenrolled preparers are "merely" preparing returns — being scriveners — then, absent passing a test and satisfying continuing education requirements to demonstrate competency, they clearly should not be permitted to represent taxpayers in audits of returns.

Therefore, the National Taxpayer Advocate recommends revising all guidance to ensure that only competent unenrolled preparers have the authority to represent taxpayers under exam with respect to returns they have prepared. Accordingly, revisions are necessary to the current guidance provided by:

- Revenue Procedure 81-38;
- Circular 230[44] (any references relating to the authorization for unenrolled preparers to represent taxpayers in audits of returns they have prepared and signed); and
- 26 C.F.R. § 601.502(b)(5)(iii)).

Restrict the Ability to Name an Unenrolled Preparer as a Third Party Designee on Form 1040.

Form 1040 includes a section for "Third Party Designee" in which the taxpayer can check a box to designate a person who has the authority to discuss the return with the IRS. The Office of Professional

42 *See* Rev. Proc. 81-38, 1981-2 C.B. 592.

43 *Loving v. IRS*, 917 F. Supp. 2d 67, 71 (D.D.C. Jan. 18, 2013).

44 31 C.F.R. Part 10.

Responsibility (OPR) is contemplating prohibiting taxpayers from designating an unenrolled preparer as the Third Party Designee.[45] We support OPR in its efforts and believe this issue warrants consideration.[46]

OPR is considering excepting from such prohibition those preparers who are licensed by the IRS or a state licensing body.[47] The National Taxpayer Advocate believes OPR's position merits further investigation.

In addition, it is unclear whether restricting third party designees on Form 1040 would impact the authorization granted to an appointee in Form 8821, *Tax Information Authorization*. If the taxpayer appoints a preparer on Form 8821, the taxpayer does not authorize the appointee to advocate a position with respect to federal tax laws; to execute waivers, consents, or closing agreements; or to otherwise represent the taxpayer before the IRS.[48] In contrast to the Form 8821 designee, the Third Party Designee authorization on the Form 1040 authorizes the designee to both provide information and receive information, which is one step closer to acting as the taxpayer's agent. This issue requires further analysis.

Mount a Consumer Education Campaign Educating Taxpayers About the Need to Select Competent Preparers.

Consistent with the National Taxpayer Advocate's longstanding position that the IRS should mount a comprehensive taxpayer awareness campaign, we believe it is more important than ever that the IRS increase its outreach and education about choosing a preparer, with particular emphasis on the populations at most risk, such as low income, elderly and disabled taxpayers. Until the IRS is once again permitted to fully administer the return preparer regulations, the National Taxpayer Advocate believes taxpayers must proactively protect themselves when hiring preparers and the IRS should make every effort to provide them with the information they need to do so. In fact, the IRS will cease to provide return preparation services at Taxpayer Assistance Centers (TACs) during the 2014 filing season.[49] Therefore, low income, elderly and disabled taxpayers will have one less avenue to receive reliable tax preparation services at no cost, making this information campaign even more imperative to protect those most vulnerable taxpayers. TAS has already developed communications instructing taxpayers to do the following:

a. Ask the preparer directly about his or her qualifications and experience level in preparing tax returns. The preparer should convince the taxpayer that the preparer possesses sufficient knowledge of relevant tax law — not merely completion of return preparation software training or an "ability" to obtain large refunds for taxpayers. Further, the taxpayer should check with the Better Business Bureau or the state consumer protection website for any complaints or ongoing investigations against the preparer or the firm.[50]

b. Make sure the preparer signs the return and fills in his or her Preparer Tax Identification Number (PTIN) or Employer Identification Number where indicated on the tax forms.

45 OPR response to TAS information request 5 (Oct. 31, 2013).

46 However, the prohibition should clearly exclude persons not in the business of preparing returns, such as parents preparing their child's return.

47 OPR response to TAS information request 5 (Oct. 31, 2013).

48 Instructions, Form 8821, *Tax Information Authorization*.

49 W&I response to TAS information request (Dec. 20, 2013). The IRS will refer taxpayers who visit the TACs for tax preparation to the nearest volunteer site for tax return preparation.

50 The communication should clearly provide that the taxpayer should not select a preparer based on the promised size of the refund.

c. Obtain a copy of the return signed by the preparer and keep the copy in the event there is a problem with the return.[51]

d. Ask the preparer for a business card or brochure and place it in the tax file with a copy of the invoice for the preparation services.

Develop a Research-Driven and Servicewide Return Preparer Compliance Strategy Similar in Nature to the FY 2014 EITC Preparer Compliance Strategy.

While it cannot impose testing and education requirements on preparers pending litigation, the IRS can increase competency and accountability among preparers by using tools that remain available. For example, the IRS holds annual Nationwide Tax Forums to provide preparers with the latest information on tax administration in general. More than half of those attending the forums are unenrolled preparers.[52] However, instead of increasing its presence at the forums, the IRS has drastically reduced the resources allocated to them.[53] For example, the IRS has cut the case resolution program and focus groups conducted at the forums, which represents lost opportunities for both practitioners and the IRS to interact in a mutually beneficial situation.[54]

Another cost-effective way to reach the unenrolled preparer population is through webinars, podcasts and other social media channels to deliver messages impacting vulnerable taxpayers, such as the EITC due diligence requirements in IRC § 6695(g).[55] The IRS currently focuses preparer education on EITC and other refundable credits. However, it has not changed its overall outreach and education strategy for preparers in response to *Loving*.[56]

In addition to education and outreach, the IRS has a wide array of enforcement tools to encourage compliance among return preparers. The IRS can assess Title 26 penalties as well as impose sanctions under Circular 230 (under Title 31), which is generally enforced by the Office of Professional Responsibility.[57] However, the IRS has not altered its compliance strategies in response to the *Loving* opinion.[58] While the National Taxpayer Advocate believes prevention in the form of taxpayer and preparer education and outreach is the most effective way to protect taxpayers, the IRS must enhance its compliance initiatives if it can no longer mandate minimum competency standards.

---

51 The Taxpayer Advocate Service developed a poster (IRS Publication 5074, *Protect Your Refund*), and distributed copies to all W&I taxpayer assistance centers (TACs) and low income taxpayer clinic (LITC) offices. The communication should instruct the taxpayer to require the preparer to include the preparer's name and address on the return.

52 OPR response to TAS information request 3 (Oct. 31, 2013).

53 IRS National Public Liaison response to TAS information request. The IRS made presentations on EITC at the 2012 and 2013 Tax Forums. W&I response to TAS information request 3 (Oct. 28, 2013). In addition, OPR also presented three levels of training at the Tax Forums in 2013. OPR response to TAS information request (Oct. 31, 2013).

54 See National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 51-53.

55 The IRS held webinars on the topic of EITC due diligence in both English and Spanish in 2012. W&I response to TAS information request 3 (Oct. 28, 2013). The IRS website includes comprehensive information about EITC due diligence requirements for preparers. *See* http://www.eitc.irs.gov/rptoolkit/dd/. OPR has also held webinar broadcasts, phone forums, and various other types of broadcasts, press releases, and face-to-face speaking engagements. OPR response to TAS information request (Oct. 31, 2013). RPO also conducts live webinars, video presentations and uses various social media channels. RPO response to TAS information request (Nov. 12, 2013).

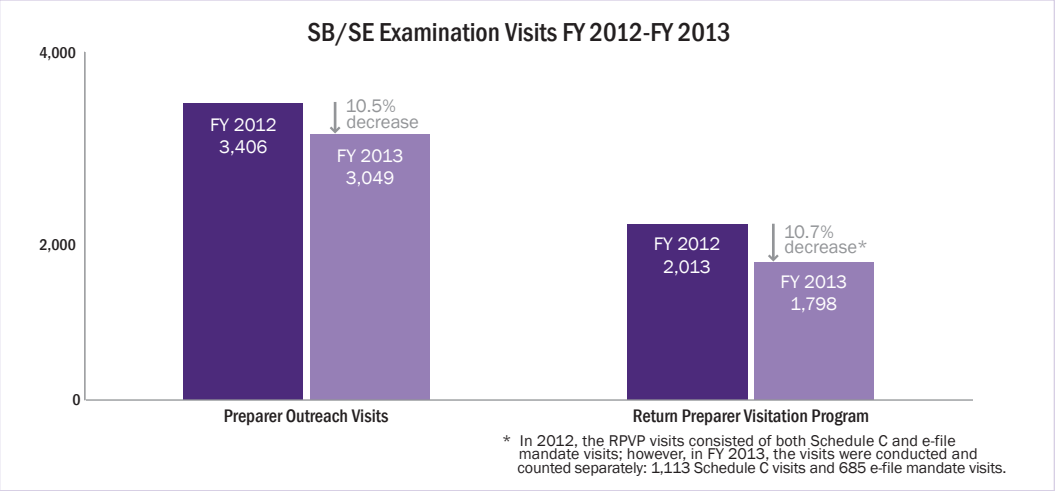
56 W&I response to TAS information request 2 (Oct. 28, 2013) (The IRS did notify examiners to limit education on its Knock and Talk Visits to just PTIN compliance after *Loving*). RPO has noted that its outreach and education has changed due to *Loving* in that there is a reduction in public speaking requests, and their education is directed more at individual preparers and related to program and tax compliance as well as complaints as opposed to more large preparer groups pre-*Loving*. RPO response to TAS information request (Nov. 12, 2013).

57 See IRC §§ 6694, 6695, 6713 and 31 C.F.R. § 10.50.

58 SB/SE response to TAS information request 2 (Nov. 5, 2013) ("SBSE Examination has not increased scrutiny and enforcement of return preparers in response to the injunction ordered by the District Court in *Loving v. IRS*. We have continued to identify, evaluate and conduct appropriate investigations of questionable return preparers referred to Examination or identified through compliance activity.").

SB/SE Examination conducts preparer outreach visits as directed by the IRS Return Preparer Office (RPO) and W&I's return preparer offices. Total outreach visits decreased by 10.5 percent from FY 2012 to FY 2013. In addition, visits conducted as part of the Return Preparer Visitation Program (RPVP), to address PTIN requirements, e-file requirements, and Schedule C preparation, declined from FY 2012 to FY 2013, by approximately 10.7 percent.[59]

FIGURE 1.5.3, SB/SE Exam Visits



In addition to increasing the appropriate assessment and collection of preparer penalties under IRC §§ 6694 and 6695, repeat offenders must also deal with Circular 230 sanctions, which require coordination between various IRS functions. We have learned that the OPR and the Department of Justice have coordinated efforts to make return preparer injunctions a priority. OPR has also taken the position that its enhanced jurisdiction under sections 10.8(a) and (c) of Circular 230 is not impacted by *Loving*, and thus, all PTIN holders are still subject to the ethical standards under Subparts B and C of Circular 230.[60] OPR has also begun initiatives to crack down on preparers taking their fees directly out of taxpayer refunds by improperly setting up a split refund direct deposit using Form 8888, *Allocation of Refund (Including Savings Bond Purchases)*, or directing the refund into a joint bank account in the name of the taxpayer and preparer.[61] These are positive developments that will benefit vulnerable taxpayers.

The National Taxpayer Advocate encourages the IRS to develop a Servicewide Return Preparer Strategy similar in nature to the FY 2014 EITC Return Preparer Strategy. The IRS developed this strategy over

59 SB/SE response to TAS information request (Nov. 5, 2013). SB/SE Exam conducted a total of 3,406 preparer outreach visits in FY 2012 and decreased to 3,049 total visits in FY 2013. The number of planned total return preparer visits in FY 2013 was originally 3,434; however, visitations were reduced due to Hurricane Sandy. SB/SE Exam conducted 2,013 RPVP visits in FY 2012 and then dropped to only 1,798 visits in FY 2013. RPVP visits declined by approximately 10.7 percent from FY 2012 to FY 2013. In 2012, the RPVP visits consisted of both Schedule C and e-file mandate visits; however, in FY 2013 the visits were conducted and counted separately — 1,113 Schedule C visits and 685 e-file mandate visits.

60 OPR response to TAS information request 3 (Oct. 31, 2013). Section 10.8(a) and (c) were added to Cir 230 in the 2011 amendments to insure that ethical oversight of the expanded universe of Circular 230 practitioners was available during the transition period without regard to whether a preparer had tested (or was required to test).

61 Kristin Parillo, *ABA Meeting: OPR and DOJ Coordinating Enforcement Against Return Preparers*, 2013 TNT 185-9, Tax Analysts Tax Notes Today (Sept. 24, 2013); OPR response to TAS information request (Oct. 31, 2013).

several years and based it on findings from a three-year EITC Real Time Return Preparer Test. The IRS has completed two years of the test during 2012 and 2013 and evaluated the effectiveness of several treatment streams both pre-filing season and post filing season, including various letters, phone calls, due diligence visits, knock-and-talk visits, and audits. According to the IRS, evaluation of the results showed that the test protected nearly $600 million in revenue during the 2013 filing season.[62] The IRS used the findings of the first two years of the test to design the FY 2014 Return Preparer Strategy, which utilizes improved and research-driven selection techniques and assigns progressive treatments based on the preparer's risk of segment.[63] The National Taxpayer Advocate believes that the IRS should build on the experience of this strategy to develop a servicewide return preparer compliance strategy.

Recommend that Congress Revise 31 U.S.C.§ 330(a)(2) to Make Clear That the IRS Has the Authority to Regulate Unenrolled Preparers.

If *Loving* is upheld on appeal, the National Taxpayer Advocate recommends that Congress revise 31 U.S.C. § 330(a)(2) to clarify that the IRS has the authority to regulate the unenrolled preparer population. Specifically, Congress should modify 31 U.S.C §§ 330(a)(2)(C) and (D) to clarify that the IRS can require a preparer to demonstrate the qualifications necessary to prepare and file returns, and that presenting a case to the IRS includes the preparation and filing of returns. The National Taxpayer Advocate also believes this is an opportunity to ensure that the statute clearly includes the submissions of other documents that determine tax liability, such as financial statements and offers in compromise.[64]

CONCLUSION

Until the IRS is allowed to resume the implementation of the testing and continuing education components of the return preparer program, taxpayers are vulnerable to incompetent and unscrupulous preparers. The IRS and the Taxpayer Advocate Service can assist taxpayers by educating them about the various precautions they can take to prevent becoming a victim. Without the ability to impose minimum standards on unenrolled return preparers, the IRS's only avenue to address competency issues is through targeted outreach and education to this population. However, the IRS is actually decreasing the amount of resources allocated to the tax forums, which has historically been an effective way to reach unenrolled return preparers. It has also significantly decreased preparer outreach visits. Finally, the IRS has not taken steps to enhance its return preparer compliance strategy in response to the *Loving* decision.

62 IRS W&I Research Analysis, *Filing Season 2013 EITC Real Time Return Preparer Initial Findings / Recommendations* (Dec. 5, 2013).

63 FY 2014 EITC Return Preparer Strategy (Dec. 2013).

64 *See* National Taxpayer Advocate 2009 Annual Report to Congress 207 (recommending that the IRS require preparers of offers in compromise to sign the forms to enable the IRS to track such preparers).

RECOMMENDATIONS

Until the IRS is able to continue implementing the testing and continuing education requirements of the return preparer program, the National Taxpayer Advocate recommends that the IRS develop a six-part servicewide return preparer strategy with the following components:

1. Offer unenrolled preparers the opportunity to earn a voluntary examination and continuing education certificate.
2. Restrict the ability of unenrolled preparers to represent taxpayers in audits of returns they prepared unless they earn the voluntary examination and continuing education certificate.
3. Restrict the ability to name an unenrolled preparer as a Third Party Designee on Form 1040.
4. Mount a consumer protection campaign to educate taxpayers about the need to select competent preparers who can demonstrate competency.
5. Develop a research driven and Servicewide preparer compliance strategy similar in nature to the EITC preparer compliance strategy.
6. Recommend that Congress revise 31 U.S.C. § 330(a)(2) to clarify that the IRS has the authority to regulate unenrolled preparers.

MSP #6 IDENTITY THEFT: The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Division
Mary Howard, Director, Office of Privacy, Governmental Liaison, and Disclosure

DEFINITION OF PROBLEM

Tax-related identity theft continues to impose significant burdens on taxpayers and the IRS. Since 2004, the National Taxpayer Advocate has identified this issue as one of the "Most Serious Problems" faced by taxpayers in nearly every annual report submitted to Congress.[1] In addition, the National Taxpayer Advocate has testified at numerous hearings on this subject, including seven since the start of 2012.[2]

Since 2004, the National Taxpayer Advocate has identified this issue as one of the "Most Serious Problems" faced by taxpayers in nearly every annual report submitted to Congress.

To its credit, the IRS has recognized identity theft as a major challenge and has devoted significant resources to addressing it. Yet the IRS still takes much too long to fully unwind the harm suffered by identity theft victims and issue refunds to the legitimate taxpayers. Moreover, the IRS has yet to implement an effective program for overseeing cases with multiple issues that require coordination among different IRS units, and is allowing too many victims to fall between the cracks of IRS bureaucracy. Thus, victim assistance overall, as well as the IRS's specialized but decentralized approach, continues to be inadequate.

To start, the IRS should rethink how it views identity theft. It must recognize that identity theft is a traumatic crime. A person's identity is core to his or her being — when someone steals and uses your identity, it is an invasion of your person. The IRS's approach to assisting the victims ignores this important fact, and in many ways treats the victim as someone experiencing a minor inconvenience instead of a frightening personal disaster. The National Taxpayer Advocate believes the IRS should set up a centralized identity theft unit similar to the centralized innocent spouse unit that assists taxpayers who may have been victims of domestic abuse. Moreover, the IRS should assign one person within the centralized identity theft unit to work with the victim until all actions are taken to resolve all related tax issues; this is the approach that TAS takes with taxpayers that come to our office.

1 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*); National Taxpayer Advocate 2011 Annual Report to Congress 48-73 (Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*).

2 *See, e.g., Examining the Skyrocketing Problem of Identity Theft Related Tax Fraud at the IRS: Hearing Before the H. Comm. on Oversight and Government Reform, Subcomm. on Government Operations*, 112th Cong. (2013) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Fraud, Tax ID Theft, and Tax Reform: Moving Forward with Solutions: Hearing Before the S. Comm. on Finance*, 112th Cong. (2013) (statement of Nina E. Olson, National Taxpayer Advocate).

ANALYSIS OF PROBLEM

Identity Theft May Cause Significant Emotional Trauma.

Identity theft is an invasive crime that can have a traumatic emotional impact. While Post Traumatic Stress Disorder (PTSD) is usually associated with service members returning from war, or victims of violent crimes, some psychiatrists believe the symptoms experienced by victims of identity theft are quite similar.[3] The Identity Theft Resource Center found that victims of identity theft suffer from symptoms resembling those of PTSD.[4]

The IRS must recognize that victims of identity theft are not just experiencing minor tax issues, but are victims of a traumatic crime and re-evaluate its approach to identity theft victim assistance.

The IRS must recognize that victims of identity theft are not just experiencing minor tax issues, but are victims of a traumatic crime and re-evaluate its approach to identity theft victim assistance. The National Taxpayer Advocate suggests that the IRS adopt a design that mirrors its approach to aiding victims of domestic abuse who have filed for relief from joint and several liability, or "innocent spouse" relief and the Taxpayer Advocate Service's approach to taxpayers who experience significant hardship as a result of the IRS's actions or inaction.

In 1998, the IRS was given expanded authority for innocent spouse relief, following hearings that showed the IRS's handling of these cases was not only insensitive but often downright harmful to victims of psychological, physical, or financial abuse.[5] In response, the IRS set up a dedicated unit, the Cincinnati Centralized Innocent Spouse Operation (CCISO), that handles cases by assigning one person to interact with the taxpayer.[6] Employees in CCISO are trained in working with taxpayers in difficult and emotional situations.[7] This approach has enabled the IRS to deal with these taxpayers in a sensitive manner. The IRS needs to adopt a similar approach with identity theft victims.

The IRS Should Assign a Single Employee to Be the Point of Contact with an Identity Theft Victim.

The identity theft victim, who may have experienced significant trauma, needs to have one person at the IRS to contact and rely upon. If the IRS believes the most efficient approach is to utilize a specialized structure with upwards of 20 different units[8] to resolve identity-theft related issues, this back-end process should be invisible to the taxpayer. As far as the victims are concerned, there should be *one* IRS employee who interacts with the taxpayer. That one employee should maintain control of the taxpayer's case,

3 *See* T. Sharp *et al.*, *Exploring the Psychological and Somatic Impact of Identity Theft*, J. of Forensic Sci., Vol. 49:131 (Jan. 2004); J. Monchuk, *Researcher Finds the Psychological Effects of Identity Theft Lingers with Victims*, (Apr. 20, 2011), *available at* http://medicalxpress.com/news/2011-04-psychological-effects-identity-theft-lingers.html.

4 *See* Identity Theft Resource Center, *ITRC Fact Sheet 108: Overcoming the Emotional Impact*, http://www.idtheftcenter.org/Fact-Sheets/fs-108.html (last visited Dec. 13, 2013); L. Carey, *Can PTSD Affect Victims of Identity Theft: Psychologists Say Yes* (July 29, 2009), *available at* http://voices.yahoo.com/can-ptsd-affect-victims-identity-theft-psychologists-3915926.html.

5 *See* IRC § 6015. "Innocent spouse relief" is frequently used to describe relief from joint and several liability under IRC § 6015(b). *See also* Joint Committee on Taxation, JCX-6-98, *Present Law and Background Relating to the Treatment of "Innocent Spouses"* (Feb. 9, 1998); *IRS Restructuring (Innocent Spouse Tax Rules): Hearing Before the S. Comm. on Finance*, 105th Cong. (1998).

6 *See* Internal Revenue Manual (IRM) 25.15.7.4, *First Read at the Cincinnati Centralized Innocent Spouse Operation (CCISO) Overview* (Feb. 19, 2013); IRM 25.15.8.2, *Innocent Spouse Relief* (Aug. 17, 2010); IRM 25.15.8.5.3.2, *CCISO Processing* (Aug. 17, 2010).

7 *See* http://win.web.irs.gov/innocentspouse/innocent_jobaids.htm (intranet site).

8 IRS responses to TAS information request (Oct. 30, 2013, and Nov. 13, 2013).

including ALL peripheral issues stemming from the identity theft. Otherwise, the IRS would be guilty of contributing to the problem and perpetuating the trauma to the victim.

The Taxpayer Advocate Service operates in a similar manner to the innocent spouse unit. Each taxpayer whose case is accepted into TAS is assigned a single case advocate whose toll-free phone number is given to the taxpayer, and every Local Taxpayer Advocate office has a toll-free fax number, eliminating barriers to communication. TAS case advocates speak with the taxpayer to gather relevant information and perform initial triage, route requests to the appropriate unit (often to multiple units), negotiate timeframes for response, and track the IRS responses. TAS case advocates follow up to make sure the IRS meets those deadlines, and keeps the taxpayer updated on the case. If a case advocate will be on leave or otherwise unavailable for an extended time, he or she will find another case advocate or supervisor to conduct the follow-up actions so the case will not stall.

The identity theft victim, who may have experienced significant trauma, needs to have one person at the IRS to contact and rely upon.

We believe the primary reason TAS can resolve identity theft cases in 87 days, while cases worked under normal IRS procedures can languish for more than a year,[9] is because our customers work with a single point of contact who is responsible for all aspects of their cases.[10] Although the cases are complex, TAS case advocates have achieved a relief rate of 87 percent in identity theft cases in FY 2013 (compared to 78 percent for TAS cases overall).[11] An overwhelming 94 percent of identity theft victims who come to TAS in fiscal year (FY) 2013 (through June) have expressed satisfaction (compared to a customer satisfaction score of 90 percent for TAS cases overall in that period).[12]

The IRS can and should operate in a similar manner when assisting identity theft victims. Such an approach may even save resources by cutting down on phone calls and correspondence from the victims. Taxpayers may have more patience if they are assigned a single caseworker who keeps them updated on their accounts. If the IRS wishes to conduct a pilot program, it could test whether these assumptions hold true.

The IRS's Specialized Approach to Identity Theft Victim Assistance Has Proven to Be Inadequate.

As of the end of FY 2013, more than 3,000 IRS employees were working on identity theft — more than double the number at the start of the previous filing season.[13] Yet the IRS has consistently refused to adopt the single point of contact approach that would provide sensitive, holistic assistance to victims of a traumatic crime. The IRS seems to be throwing bodies at the problem, without addressing fundamental problems with its processes.

9 *See* TIGTA, Ref. No. 2012-040-050, *Most Taxpayers Whose Identities Have Been Stolen to Commit Refund Fraud Do Not Receive Quality Customer Service* (May 3, 2012); TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sept. 26, 2013).

10 Analysis conducted by TAS Technical Analysis and Guidance of data obtained from TAMIS (Oct. 1, 2013).

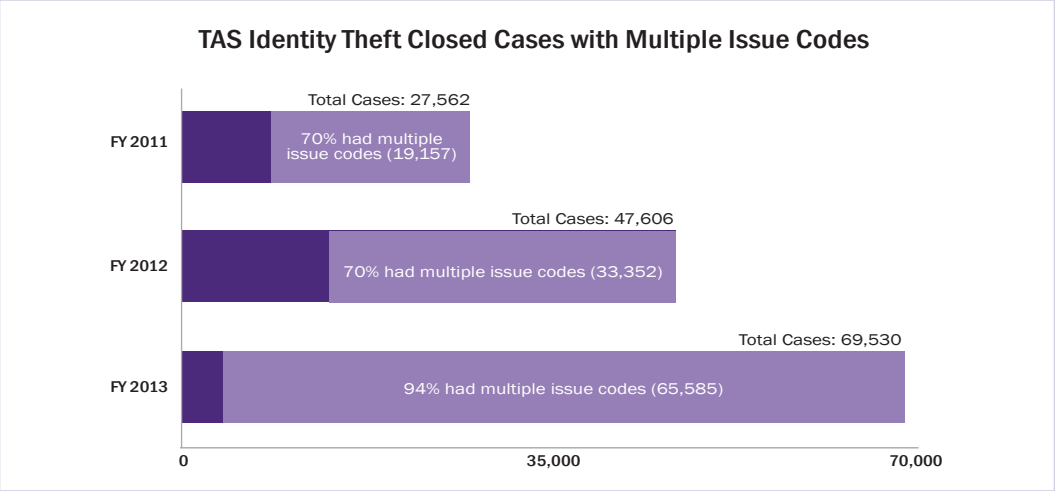
11 *Id*.

12 Analysis conducted by TAS Business Assessment of customer satisfaction scores reported for FY 2013 (through June 2013); data obtained from TAMIS (Oct. 1, 2013).

13 *See* IRS response to TAS information request (Nov. 13, 2013). However, these employees are spread among more than 20 different groups within the IRS. IRS response to TAS information request (Oct. 30, 2013, and Nov. 13, 2013).

In FY 2013, the IRS adopted a specialized approach under which each department (or "function") that deals with identity theft created a dedicated group of employees to work on those issues. Because identity theft cases can be complex, they sometimes require adjustments by multiple functions.[14]

FIGURE 1.6.1, Percent of TAS Identity Theft Cases with Multiple Issue Codes, FY 2011–FY 2013[15]



Even where there is just one issue at hand, a case may still require multiple "touches" from various specialized units. Without a single person responsible for transferring cases from one function to another and for ensuring timely actions, the IRS creates greater risk that cases will become "stuck" or lost in the process.

Although IRS guidance instructs those working identity theft cases to identify all taxpayer issues, including possible multiple year involvement,[16] the current procedures under this specialized approach fall short of having this initial IRS employee be responsible for ensuring all issues are addressed. Under the current approach, the IRS employee working an identity theft case will look only at the one issue being worked by his or her particular function, and not assessing the taxpayer's problem holistically. Instead, because no single employee is responsible for the entirety of the case, the IRS is forcing the taxpayer to navigate an alphabet soup of departments, forms, and notices before the IRS can fully unwind the harm caused by the identity theft.[17]

The IRS has drafted a complex "transfer matrix" outlining situations in which a case must be routed from one specialized function to another. The National Taxpayer Advocate is concerned that routing cases

14 The IRS states that upwards of 20 different functions may touch an identity theft case. IRS responses to TAS information request (Oct. 30, 2013, and Nov. 13, 2013).

15 The IRS does not track the number of issues in a given identity theft case because, unlike TAS, it treats each module (year/tax/issue) as a different case. Accordingly, we can provide TAS data only. This chart is meant to illustrate that the vast majority of TAS identity theft cases involve multiple issue codes. The increase in the percentage of cases with multiple issue codes from FY 2011 to FY 2013 may be due to better coding by TAS case advocates to record secondary issue codes; it does not necessarily mean that TAS identity theft cases have become more complex in recent years.

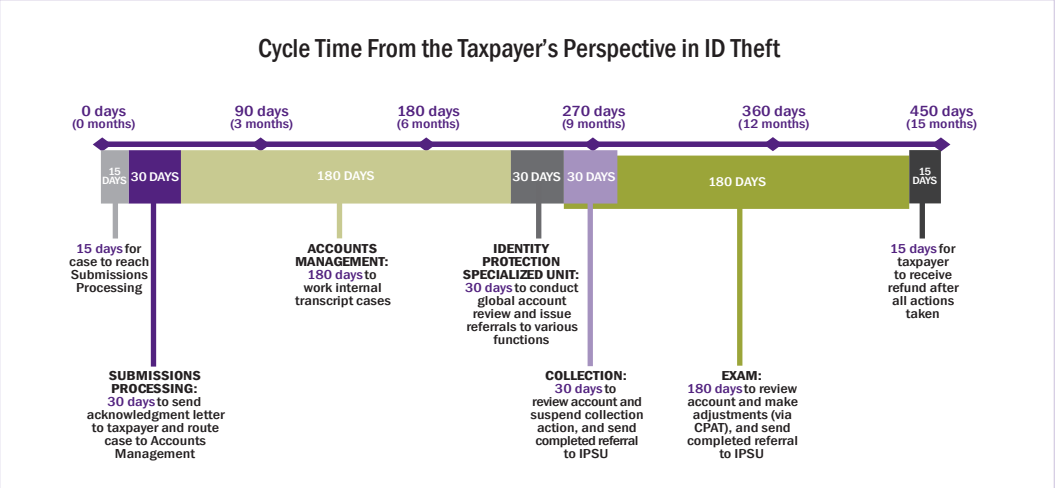
16 *See* IRM 10.5.3.2.1.2, *Assessing Scope of Taxpayer's Issues* (May 8, 2013).

17 *See Examining the Skyrocketing Problem of Identity Theft Related Tax Fraud at the IRS: Hearing Before the H. Comm. on Oversight and Government Reform, Subcomm. on Government Operations*, 112th Cong. (2013) (chart included in statement of Nina E. Olson, National Taxpayer Advocate).

among functions sequentially is inefficient, causing excessive delays. Based on TAS's experience with identity theft cases over the years, the National Taxpayer Advocate believes that transfers among functions will continue to be commonplace.

To illustrate the complexity of an identity theft case and how many "touches" the victim may have with various IRS functions, we have provided a detailed example in congressional testimony that shows how complex identity theft cases are and the multiple units and delays involved.[18] The timeline below illustrates the complex and convoluted process that taxpayers may need to navigate to receive full resolution of their identity theft issue.[19]

FIGURE 1.6.2, ID Theft Cycle Time for Taxpayers



Victims routinely must deal with multiple IRS functions to resolve all of their account issues. Generally, most specialized units operate in a silo, treat the identity theft as a separate case, and work inventory on a FIFO (first-in, first-out) basis from the perspective of that specialized unit. Under such an approach, a taxpayer who reported the identity theft incident two weeks ago may be placed in the queue ahead of a victim who has been trying to obtain a refund for 20 months, if the latter taxpayer had the misfortune of dealing with other IRS departments to resolve related issues.[20] By having the IRS work identity theft cases as FIFO from the perspective of each silo, rather than holistically from the taxpayer perspective, we not only harm taxpayers (the victims) but also give a distorted picture of IRS efficiency and productivity.

The Treasury Inspector General for Tax Administration (TIGTA) has confirmed that identity theft cases are complex and easy for the IRS to lose in the shuffle. In its May 2012 report on IRS identity theft

18 *See Examining the Skyrocketing Problem of Identity Theft Related Tax Fraud at the IRS: Hearing Before the H. Comm. on Oversight and Government Reform, Subcomm. on Government Operations*, 112th Cong. (2013) (statement of Nina E. Olson, National Taxpayer Advocate), *available at* http://www.irs.gov/Advocate/National-Taxpayer-Advocate-Congressional-Testimony.

19 This example is not based on an actual or typical case; the timeline described is a hypothetical meant to show how many functions could be involved, and how much time could elapse, before an identity theft victim receives full relief. IRM 21.9.2.3, *Identity Theft – Telephone Overview* (Oct. 1, 2013); Letter 5073C; IRM 3.11.3-1, *Attachment Guide* (Jul. 25, 2013); IRM 10.5.3.2.4.1, *Multiple Function Criteria (MFC) Cases Requiring Referral to IPSU for Monitoring* (May 8, 2013); IRM 21.6.2.4.2.3, *Preliminary Research* (Oct. 1, 2013) IRM 4.19.13.25.11, *Referrals to CPAT/DITA* (Apr. 4, 2013); IRM 21.9.2.4.2, *Tax-Related Identity Theft - (Andover and Fresno IPSU only)* (Oct. 18, 2013).

20 IRS responses to TAS information request (Oct. 30, 2013, and Nov. 13, 2013).

victim assistance, TIGTA selected a sample of 17 identity theft cases and found the IRS had opened 58 separate cases to resolve the accounts of those 17 victims — an average of nearly three and a half cases for each person.[21] In a follow-up report released in September 2013, TIGTA found that the typical identity theft case was assigned to an average of 10 different assistors (some of whom were within the same function) prior to case resolution.[22]

The National Taxpayer Advocate continues to believe the IRS should follow TAS's approach to case resolution, and allow the IPSU to "own" identity theft cases rather than simply "monitor" them. Yet five years after establishment of the IPSU, it is clear that the IRS has gone in the opposite direction and has adopted a decentralized approach to identity theft victim assistance, one that imposes undue burden on the victims and creates procedures that would make Rube Goldberg proud.[23]

The IRS Should Track Cycle Time from the Perspective of the Victim.

Despite the commitment by former Commissioner Shulman in 2008 that the IRS would resolve identity theft victims' tax accounts "quickly and efficiently," the IRS does not know whether its processing time for identity theft cases has been increasing or decreasing.[24] While some IRS functions can track the length of time a case is in their inventory, the IRS still cannot provide an overall cycle time from the taxpayer's perspective. For example, specialized units generally measure cycle time solely from the date they receive the case; their cycle time measure does not reflect the time elapsed since the taxpayer filed his or her return or all of the interactions the victim had with the IRS prior to assignment to the function. Thus, the IRS cannot determine how well it has done in meeting this commitment to resolve identity theft cases "quickly and efficiently."

The fact that the IRS cannot accurately track the cycle time of an identity theft case from the perspective of the victim is astonishing, disappointing, and inexcusable.

We recognize that cycle time start dates may differ depending on the facts and circumstances of the cases, but the IRS should be able to count cycle time in a way that more closely reflects the taxpayer's experience and more accurately flags over-aged cases. Currently, as the above case example shows, an identity theft case might not be considered over-aged until the victim has been in the system for more than a year.

In a September 2013 audit, the Treasury Inspector General for Tax Administration (TIGTA) reported the average cycle time for the 100-case sample of identity theft cases it reviewed was 312 days, including 277 days of inactivity.[25] In other words, though the cases lingered in various IRS units for 312 days or approximately ten months, the average case was resolved with just 35 days of direct contact.

21 *See* TIGTA, Ref. No. 2012-040-050, *Most Taxpayers Whose Identities Have Been Stolen to Commit Refund Fraud Do Not Receive Quality Customer Service* (May 3, 2012).

22 *See* TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sept. 26, 2013).

23 Merriam-Webster defines the adjective Rube Goldberg as "doing something simple in a very complicated way that is not necessary." *See* Merriam-Webster online dictionary, http://www.merriam-webster.com/dictionary/rube%20goldberg (last visited Nov. 21, 2013).

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

25 *See* TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sept. 26, 2013).

The National Taxpayer Advocate is concerned that unless the IRS significantly changes its procedures to keep identity theft cases moving, cycle time will continue to increase in the coming year as the IRS struggles to keep up with its inventory. The fact that the IRS cannot accurately track the cycle time of an identity theft case from the perspective of the victim is astonishing, disappointing, and inexcusable.

The IRS Should Institute "Timeliness" Measures to Ensure Identity Theft Cases Do Not Languish.

TIGTA's 2013 report noted that the identity theft cases it reviewed showed an average of 277 days of inactivity.[26] The IRS should adopt an approach similar to TAS's "timeliness" goals that are intended to help our case advocates move cases along. For example, an IPSU employee could:

- Set a goal to contact the taxpayer within three to five days of case receipt, depending on the nature of the case;
- Develop a case action plan within three days of contact with the taxpayer;
- Issue a request to a function within three days of receiving all information from the taxpayer necessary to address the issue; and
- Follow up with the function within one day of a missed requested completion date.

The goal of these "timeliness" measures is to keep cases moving, which in turn will reduce cycle time in an organic way — not by meeting an artificial or arbitrary goal. Moreover, by centralizing cases in the IPSU, the IPSU's case cycle time measure will reflect the taxpayer's experience more closely, and the IPSU can designate certain taxpayer cases for expedited treatment in one function based on the overall cycle time of the case.

The IRS Should Develop an Identity Theft Database or System Accessible to All Functions Working on Identity Theft Cases.

As noted above, the IRS does not track cycle time from the identity theft victim's perspective; rather, each specialized function tracks the cycle time of the particular aspect of an identity theft case within its silo. With many cases requiring action by multiple functions, the IRS cannot track these cases accurately.

By creating a servicewide platform for tracking and monitoring its cases, the IRS could accurately assess the inventory at a given time and measure cycle time from the date the taxpayer identities himself or herself as a victim of identity theft. Such a system would also allow seamless transfers of cases from one function to another. Additionally, a single identity theft database would allow functions to share information. Any employee could see if the taxpayer submitted documentation and what actions the other functions have taken, thereby helping to reduce duplicative actions.

Proposed Enhancements to the Identity Protection Personal Identification Number (IP PIN) Process Make It Easier for Victims to Protect Their Accounts

In January 2011, the IRS initiated a pilot program to issue an Identity Protection Personal Identification Number (IP PIN) to a select group of taxpayers with an active identity theft indicator on their account.[27] An IP PIN is a unique code that the taxpayer must use, along with his or her taxpayer identification

26 *See* TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sept. 26, 2013).

27 IRM 10.5.3.2.16(1), *Identity Protection Personal Identifying Number (IP PIN)* (Jan. 11, 2013).

number, to file electronically and bypass certain filters.[28] In prior years, taxpayers who lost, misplaced, or did not receive their IP PIN were required to contact the IRS to obtain a replacement IP PIN.[29] However, taxpayers who filed a return using a replacement IP PIN would be subject to delay in the processing of their return.

Effective in filing season 2014, the IRS is proposing to have taxpayers who have lost, misplaced, or never received their IP PIN retrieve their original IP PIN using an online application. This will allow the taxpayer's return to post to their account without additional delays. Under this proposal, only in instances where the taxpayer is unwilling or unable to use the online application will a replacement IP PIN be issued. We commend the IRS for considering this enhancement to the IP PIN program.

CONCLUSION

Identity theft causes significant problems for both the taxpayer and the IRS. IRS leadership has responded to this challenge not only by assigning more employees to work on identity theft but also by spending significant resources re-engineering its victim assistance processes over the years.[30] Certainly, some improvements have been made. Yet the IRS is not where it needs to be on this serious taxpayer problem.

The IRS must design its processes around the key fact that victims of identity theft have suffered serious trauma and need a specially trained group of employees working identity theft cases, much like victims of spousal abuse who are helped by employees in the IRS's innocent spouse unit. One key component of such an approach is to ensure that the victim deals with a single employee within the IRS during the duration of the case. That employee will serve as a buffer between the victim and the complex processes and multiple functions necessary to resolve the problem.

Given the multiple points of contact, lengthy inactive periods, and first-in, first-out processing for each unit, we believe the IRS will find, if it adopts our suggestions, that it would actually require **fewer** resources to do the same volume of work. The National Taxpayer Advocate proposes that the IRS conduct a pilot program to test this hypothesis. In such a pilot program, the IRS could detail some of its IPSU employees to TAS and have them work identity theft cases in the same manner that TAS works them — and then measure cycle time and extent of relief (addressing all issues) compared to a control sample of cases handled in the way IPSU currently does.

The National Taxpayer Advocate is confident that taxpayers — our customers — would be much more satisfied with their experience. Unless the IRS wants to continue to add to the victims' grief and trauma, it must do this. There is a clear choice here.

28 IRM 10.5.3.2.16, *Identity Protection Personal Identifying Number (IP PIN)* (Jan. 11, 2013).

29 IRM 10.5.3.2.16(5), *Identity Protection Personal Identifying Number (IP PIN)* (Jan. 11, 2013).

30 The latest example involved the hiring of an external consulting firm to lead the Identity Theft Assessment and Action Group, which recommended the adoption of a specialized approach to identity theft victim assistance.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Designate the Identity Protection Specialized Unit (IPSU) as the centralized function that assigns a single employee to work with identity theft victims until all related issues are resolved.
2. Develop a method of tracking cycle time from the perspective of the victim.
3. Implement "timeliness" measures to ensure identity theft cases do not languish.
4. Develop an identity theft database or system accessible to all functions working on identity theft cases.

MSP #7 HARDSHIP LEVIES: Four Years After the Tax Court's Holding in *Vinatieri V. Commissioner*, the IRS Continues to Levy on Taxpayers it Acknowledges are in Economic Hardship and then Fails to Release the Levies

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The IRS is required by law to release a levy that it knows is causing an economic hardship due to the financial condition of the taxpayer.[1] In the *Vinatieri* case, the U.S. Tax Court held that when the IRS sustains even a *proposed* levy on a taxpayer it knows is in economic hardship, it abuses its discretion.[2] In spite of this ruling, in 2011 the IRS levied on the Social Security Administration (SSA) and Railroad Retirement Board (RRB) benefits of nearly 67,000 taxpayers belonging to a group the IRS considers likely to be experiencing economic hardship — those whose incomes were less than 250 percent of the federal poverty level, or about $27,000 for a single person.[3] The median income of taxpayers subject to these levies was at most about $17,500.[4] The *least* amount of expenses the IRS would routinely allow, known as Allowable Living Expenses (ALE), added up to approximately $17,200 for a single person in 2011.[5] Therefore, it is likely that the expenses of many taxpayers whose benefits were levied exceeded their incomes. The federal poverty level for a single person in 2011 was $10,890, meaning that some of the 67,000 taxpayers whose benefits were levied were likely actually *living in poverty* and not just considered to be low income.

The court in *Vinatieri* held that the fact that the taxpayer has unfiled returns does not justify proceeding with a levy if the taxpayer has shown he or she is in economic hardship.[6] Of the nearly 67,000 low income (or possibly poverty-stricken) taxpayers whose federal payments the IRS levied, TAS determined

1 IRC § 6343(a)(1)(D).

2 *Vinatieri v. Comm'r*, 133 T.C. 392 (2009).

3 Small Business / Self-Employed Division (SB/SE) Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers* Appx. H, 4 Table H7 (May 2013). There were 66,926 taxpayers in this group. The levies were issued pursuant to the Federal Payment Levy Program (FPLP), discussed below. Appendix A of the study contains federal poverty levels.

4 The median income of taxpayers subject to levies on their SSA or RRB benefits was at most $17,439 depending on the source the IRS used to measure it. SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers* Appx. H, 3 Table H5 (May 2013).

5 As explained below, the IRS publishes allowable expense guidelines based on average, actual taxpayer expenditures. The allowable amounts vary by geographical location. The IRS uses these guidelines to determine a taxpayer's ability to pay delinquent tax liabilities. TAS used the lowest allowable housing expense and the lowest allowable vehicle operation cost to generate a conservative measure of ALE, even though these expenses correspond to different geographic areas and therefore could not have actually been sustained by the same taxpayer.

6 *Vinatieri v. Comm'r*, 133 T.C. 392 (2009).

that the IRS would have spared the accounts of nearly 41,000 — more than half — from the automatic levy program that triggered the levies, if not for these taxpayers' unfiled returns.[7]

Whether they are included in automated levy programs or subjected to levies on their wages or bank accounts, some taxpayers in economic hardship turn to TAS or low income taxpayer clinics (LITCs) for assistance in obtaining levy releases.[8] Clinic directors report, and TAS cases confirm, that even when the IRS agrees these taxpayers are experiencing economic hardship, it continues to insist on receiving their unfiled returns as a condition of releasing the levies.[9] When the IRS conditions levy release on securing delinquent returns from taxpayers who have shown they are in economic hardship, it burdens the taxpayers and creates unnecessary work for itself. Most importantly, the IRS in these cases acts in violation of the law, thereby subjecting itself to potential suit for negligent or reckless collection action.[10]

ANALYSIS OF PROBLEM

Background

In* Vinatieri v. Commissioner*, the Tax Court Clarified that Not Only is the IRS Required to Release Levies on Taxpayers who Have Shown they are in Economic Hardship, it Abuses its Discretion When it Sustains a Proposed Levy on These Taxpayers.

IRC § 6343(a)(1)(D) states that a levy shall be released if "the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer." Economic hardship "exists when a levy will cause an individual to be unable to pay his or her reasonable living expenses."[11] In the *Vinatieri* case, the IRS sent Ms. Vinatieri a notice of its intent to levy and of her right to a pre-levy collection due process (CDP) hearing. Ms. Vinatieri requested a hearing and demonstrated she was in economic hardship, but the Appeals Officer sustained the proposed levy. Relying on Internal Revenue Manual (IRM) provisions in effect at the time, the Appeals Officer cited Ms. Vinatieri's unfiled returns as justification for sustaining the proposed levy rather than placing the account into Currently Not Collectible (CNC) status.[12] The Tax Court held it was not appropriate to proceed with the levy given that IRC § 6343(a)(1)(D) requires the IRS to release a levy if it is causing economic hardship, and such economic hardship had already been shown. Sustaining a proposed levy that would have to be immediately released constituted an abuse of discretion.

---

7 TAS analysis of taxpayer accounts that formed the basis of the SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers*. Of the 66,926 levies, TAS found 40,984 accounts (61 percent) that could have been filtered out of the FPLP program but were not, solely because of unfiled returns. TAS Research could not determine how many name mismatches there were, or whether a spouse had an invalid taxpayer identification number. To the extent either of these conditions were present, there may have been fewer than 40,984 such accounts.

8 In recognition of the need for low income taxpayers to have access to representation before the IRS and the courts, Congress in 1998 created the Low Income Taxpayer Clinic (LITC) program. IRC § 7526; Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), § 3601(a), Pub. L. No. 105-206, 112 Stat. 758 (1998). The clinics, which are independent from the IRS, represent low income taxpayers before the IRS and the Tax Court for free or no more than a nominal fee. IRC § 7526(b)(2). According to IRC § 7526(b)(1)(B), taxpayers with income of less than 250 percent of the poverty level are low income taxpayers for purposes of qualifying for LITC assistance.

9 August 7, 2013 conference call with directors of nine low income taxpayer clinics; Taxpayer Advocate Management Information System (TAMIS) cases 5511491, 5503338, and 5379810.

10 IRC § 7433(a) authorizes a taxpayer to bring a civil action for damages if an IRS employee "recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title" in connection with any collection of Federal tax with respect to that taxpayer.

11 Treas. Reg. § 301.6343-1(b)(4).

12 *Vinatieri v. Comm'r*, 133 T.C. 392, 395 (2009). IRS employees may remove an account from active inventory and place it into CNC status where "collection of the liability would create a hardship for taxpayers by leaving them unable to meet necessary living expenses." IRM 5.16.1.1 (May 22, 2012).

Following the Vinatieri *Decision, the IRS Changed Some Provisions of the IRM, but Training Materials, Electronic Job Aids, and Quality Standards Need Adjusting.*

In the light of the *Vinatieri* holding, TAS worked with the IRS and the Office of Chief Counsel to revise the IRM.[13] Various IRM provisions now make clear that unfiled returns are not an impediment to immediate levy release when a taxpayer is in economic hardship, and the account should be classified as CNC even if the taxpayer has unfiled returns.[14] The IRS has also clarified how collection employees should handle the issue of unfiled returns when they talk with taxpayers.[15] The National Taxpayer Advocate applauds the IRS for making these needed changes. They should be incorporated into IRS training materials and job aids, some of which are inadequate. For example, the materials the IRS used to train Automated Collection System (ACS) employees in 2011, 2012, and 2013 did not cover the holding in *Vinatieri*.[16] Moreover, ACS employees and Compliance Services Collection Operation employees rely on automated decision trees, called e-guides, that have not been cleared through the appropriate IRS review process, including vetting by TAS.[17] The IRS should update and vet these materials. More importantly, as the National Taxpayer Advocate has urged, the IRS should evaluate collection employees specifically on whether they recognized, considered, and addressed a taxpayer's economic hardship.[18]

The IRS Adopted a Filter Intended to Prevent Automatic Levies on Social Security Payments to Low Income Taxpayers, but Excluded Accounts of Taxpayers with Unfiled Returns from the Filter.

The IRS has the authority to issue a continuous levy on a variety of federal sources of income, including Social Security and Railroad Retirement Board benefits, and since 2000 has carried out automatic levies on these sources pursuant to the Federal Payment Levy Program (FPLP).[19] The IRS has long recognized that most FPLP levies are on taxpayers' Social Security payments, and has sought to avoid levying on

---

13 National Taxpayer Advocate 2010 Annual Report to Congress 85 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*).

14 *See, e.g.*, IRM 5.19.4.4.10.5(j) (Sept, 10, 2013) (for release of levy); IRM 5.16.1.2.9(9) (May 22, 2012) (for CNC status). IRM 5.16.1.1 (May 22, 2012).

15 IRM 5.19.4.4.10.5(j) (Sept, 10, 2013), which ACS employees consult, now provides: "When the Service determines that the levy is creating an economic hardship, do not refuse, delay or understate the release amount as a means to secure other compliance, *e.g.*, missing tax returns. When there are also open delinquent returns, do not condition relief of the economic hardship upon receiving the delinquent returns. Inform the taxpayer of the financial information needed to make a collection determination and provide relief of the economic hardship if appropriate. You may, as a separate issue, inform the taxpayer of the unfiled tax returns and pursue appropriate actions to resolve them separate from the economic hardship relief issue. You may also inform the taxpayer before an installment agreement can be established delinquent returns must be filed." The IRS agreed to revise IRM 5.11.2.3.1.4(5), directed to Field Revenue Officers, to provide: "When contacted by a taxpayer claiming an inability to meet basic living expenses due to the levy and there are also open Del Rets [delinquent returns], do not condition relief of the economic hardship upon receiving the delinquent returns. These are separate collection issues. Inform the taxpayer of the financial information needed to make a collection determination and provide relief of the hardship if appropriate. You may, as a separate issue, inform the taxpayer of the unfiled tax returns and pursue appropriate actions to resolve them separate from the hardship relief issue. You may also inform the taxpayer before an installment agreement can be established delinquent returns must be filed." TAS Systemic Advocacy Management System Internal Management Document IRM review 27283 (July 30, 2013).

16 IRS response to TAS information request (Sept. 16, 2013).

17 The e-Guides are available at http://serp.enterprise.irs.gov/databases/irm-sup.dr/compliance_eguides.htm For a discussion on how IRS materials are vetted, see National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013; National Taxpayer Advocate's Report in Response to the Acting Commissioner's 30-day Report: *Analysis and Recommendations to Raise Taxpayer and Employee Awareness of the Taxpayer Advocate Service and Taxpayer Rights* (Aug. 23, 2013).

18 See National Taxpayer Advocate 2010 Annual Report to Congress 85 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*) which includes a discussion of collection case quality measurement and the recommendation that the IRS "[e]stablish quality review procedures that measure whether employees considered the possibility that a taxpayer was in economic hardship and managed the account appropriately." The IRS recently revised some quality standards, see IRM 21.10.1-6 (Oct. 1, 2013), *available at* http://serp.enterprise.irs.gov/databases/irm.dr/current/21.dr/21.10.dr/21.10.1.dr/21.10.1-6.htm, but they still do not measure whether the employee considered whether a taxpayer is in economic hardship before taking enforced collection action.

19 IRC § 6331(h)(2). IRM 5.11.7.2.1.1 (2) (Aug. 28, 2012).

Social Security payments to low income taxpayers.[20] In 2002, the IRS developed a filter to exclude from the FPLP program the accounts of low income taxpayers, relying on the total positive income (TPI) reported on the taxpayer's last filed return as its sole measure of the taxpayer's financial situation.[21] The IRS filter did not recognize that taxpayers may not have recently filed a return, making available data potentially dated and unreliable, and did not consider the possibility the taxpayer could have assets from which the tax liability could be paid. For these reasons, the General Accounting Office (GAO, now the Government Accountability Office) in 2003 questioned the effectiveness of the filter, and the IRS removed it in 2005.[22] TAS cases with FPLP levies immediately increased sharply.[23]

In 2008, TAS Research began to design, develop, and test an improved filtering or screening model.[24] The purpose of the low income filter was to identify and remove low income taxpayers that the model demonstrated would experience economic hardship and thus be entitled to immediate levy release under IRC § 6343(a)(1)(D). The new TAS model, in addition to using taxpayers' income information from filed individual income tax returns, used third-party payor documents supplied to the IRS to estimate the taxpayers' incomes.[25] The TAS model then used other tax return data to estimate ALE (living expenses the IRS routinely allows when determining a taxpayer's ability to pay).[26] If the most recent year's tax return was not filed, allowable expenses were based on a household size of one, since the number of dependents could not be determined.[27] The TAS model was designed to offer a conservative estimate of taxpayer expenses, while also using multiple sources to ascertain all taxpayer income, even if unreported. TAS then performed additional analyses to explore the availability of other taxpayer assets to satisfy the liability and investigated whether IRS databases are sufficient to detect such available assets. The study findings suggested that a significant number of taxpayers are subject to a levy on their SSA income even though they cannot afford the levy.[28]

It is likely that the expenses of many taxpayers whose benefits were levied exceeded their incomes.

Subsequent to the publication of TAS's study findings, the National Taxpayer Advocate engaged in ongoing discussions with the IRS Director of Compliance, Wage & Investment Division, to discuss the development of a new low income filter for taxpayers otherwise subject to FPLP levies. The IRS accepted the results of the TAS study, but expressed concern about the difficulties of automating the algorithm TAS

20 For example, in 2008, the IRS received more than two million FPLP levy payments from taxpayers, with more than 83 percent of those payments coming from Social Security benefits. National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 48 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

21 TPI is simply the sum of the values shown in various income fields on a return (wages; interest; dividends; distributions from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as a zero.).

22 GAO, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* 13-15 (Mar. 6, 2003). The General Accounting Office was renamed the Government Accountability Office in July 2004.

23 National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 48 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

24 *Id*.

25 *Id*.

26 Allowable expenses for some items (*e.g.*, food, clothing, and health care) are based on national standards, while allowable expenses for other items (*e.g.*, housing and transportation) are based on local standards. See IRM 5.15.1.7 *Allowable Expense Overview* (Oct. 2, 2012). The IRS ALEs are available at http://mysbse.web.irs.gov/Collection/toolsprocesses/AllowExp/Standards/default.aspx.

27 National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 54 n. 31 (*Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

28 *Id*. at 57.

used in its research study to determine economic hardship.[29] A more administrable measure, such as a minimum dollar amount of income, or income as a percentage of the federal poverty level, was needed as a proxy for economic hardship. The discussions culminated in a meeting on October 6, 2009, at which the IRS proposed a filter that, among other things, would exclude the accounts of taxpayers with unfiled returns, leaving them subject to FPLP levies even though they were low income.[30] Although the National Taxpayer Advocate was uncomfortable with this approach, the IRS assured her that it would exclude these taxpayers from the filter only if they appeared to have a filing requirement.[31] The Deputy Commissioner for Services and Enforcement and the Commissioner of the Wage and Investment Division had collectively determined that the low income filter would be set at 250 percent of the federal poverty level.[32]

This low income filter, which failed to protect the accounts of taxpayers with unfiled returns, was adopted prior to the Tax Court's decision in *Vinatieri*. As discussed above, the court in *Vinatieri* found that IRC § 6343(a)(1)(D) requires the IRS to release a levy that would cause the taxpayer economic hardship, with no exception to that mandate for taxpayers who have unfiled returns. After the *Vinatieri* decision, despite urging by the National Taxpayer Advocate, the IRS refused to adjust the filter to cover accounts with unfiled returns.[33] The National Taxpayer Advocate responded on January 12, 2012 by issuing Taxpayer Advocate Directive 2012-2, "Taxpayers Whose Incomes Are Below 250 percent of the Federal Poverty Level Set by the Department of Health and Human Services and who receive Social Security or Railroad Retirement Board Benefits Should Be Screened Out of the Federal Payment Levy Program, regardless of unfiled returns or outstanding business debts."[34]

The IRS studied the effect that the mandate in the Taxpayer Advocate Directive would have and prepared a report in May of 2013.[35] It stated that about 151,000 low income taxpayers received Social Security or Railroad Retirement Board benefits in 2010, had an outstanding tax liability in 2011, and had unfiled returns or business debt.[36] They were consequently subject to levy under the FPLP program in 2011 rather than excluded through the low income filter. Of these approximately 151,000 taxpayers, the IRS actually

29 It would be difficult for the IRS to create a program that could manually draw data from multiple databases, as the TAS study did, to identify taxpayer income, household size, and allowable expense information.

30 IRS PowerPoint presentation, *Federal Payment Levy Program: Proposed Process to Implement Low Income Filter for Social Security and Railroad Retirement* (Sept. 29, 2009), presented to the National Taxpayer Advocate on Oct. 6, 2009.

31 Notes of Oct. 6, 2009 meeting, on file with National Taxpayer Advocate.

32 *Id*.

33 *See, e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 350, 365 (Most Serious Problem: *The New Income Filter for the Federal Payment Levy Program Does Not Fully Protect Low Income Taxpayers from Levies on Social Security Benefits*).

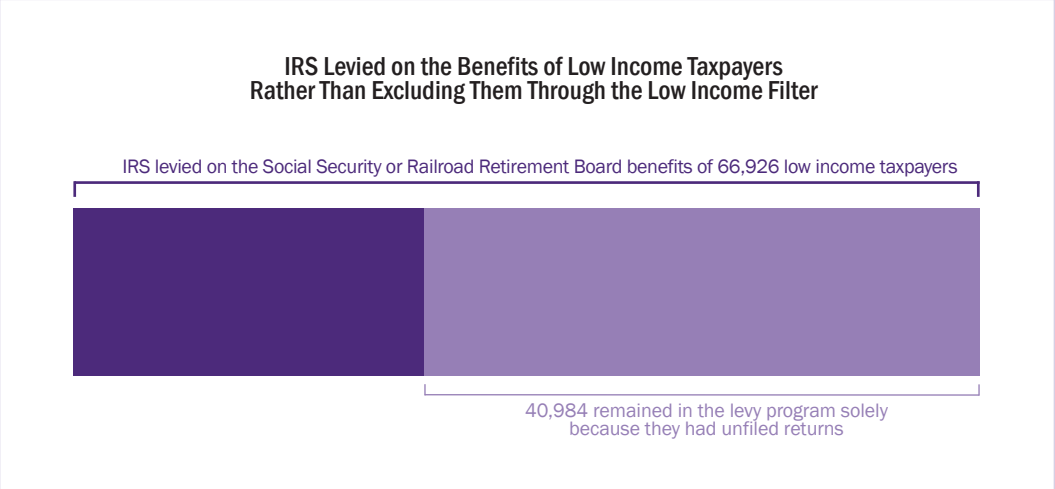
34 Delegation Order No. 13-3 grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers. IRM 1.2.50.4, Delegation Order 0-3 (formerly DO-250, Rev. 1), Authority to Issue Taxpayer Assistance Directives, (Jan. 17, 2001). *See also* IRM 13.2.1.6, Taxpayer Advocate Directives (July 16,2009). Almost two years after the National Taxpayer issued the TAD, the Deputy Commissioner for Services and Enforcement sustained the appeal of the portion of the TAD pertaining to unfiled returns, refusing to adopt the National Taxpayer Advocate's position that the low income filter should cover these accounts. His memo notes: "Nonfilers are not compliant with their filing requirements and, thus, the IRS does not have the information to be able to determine if their income is less than 250% of the poverty level. Failing to comply with filing requirements is a threshold requirement that disqualifies taxpayers from consideration in other collection programs, such as installment agreement or offers in compromise." Memorandum from John M. Dalrymple, IRS Deputy Commissioner, Services and Enforcement to Nina E. Olson, National Taxpayer Advocate, TAD 2012-2, Low Income Filter in the Federal Payment Levy Program (Dec. 20, 2013). The Deputy Commissioner sustained the TAD on the issue of whether outstanding business debt should disqualify an account from the filter, and agreed to change the current policy as soon as practical.

35 SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers* (May 2013).

36 *Id*. at 6, identifying 150,963 of these taxpayers.

levied on the Social Security or RRB benefits of 66,926.[37] Of these 66,926 taxpayers, 40,984 (61 percent) remained in the levy program solely because they had unfiled returns.[38]

FIGURE 1.7.1, IRS Levies on Benefits



Had any of these taxpayers, prior to the levy, demonstrated their economic hardship (which, but for the unfiled returns, the IRS would have already presumed by running them through the low income filter), the IRS would have been prohibited from proceeding with the levy, according to the holding in *Vinatieri*.[39] Post levy, if any of these taxpayers requested a levy release and showed that he or she was experiencing economic hardship because of the levy, the IRS would be required to release it under IRC § 6343. Many taxpayers probably were experiencing economic hardship. For 2011, the *lowest* amount of ALE for a hypothetical single person who lived in the part of the country with the least expensive housing and also lived in the part of the country with the least expensive vehicle operating cost was $17,200.[40] As discussed above, the median income of the taxpayers whose SSA or RRB benefits were levied was at most about $17,500.[41]

37 *Id*.

38 TAS analysis of taxpayer accounts that formed the basis of the SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers*. Throughout the study, SB/SE overstated the number of accounts with unfiled returns. Although the status code that indicates an unfiled return for purposes of the filter is 3, the SB/SE study also included, as accounts with unfiled returns for purposes of the filter, accounts with other status codes. TAS Research could not determine how many name mismatches there were, or whether a spouse had an invalid taxpayer identification number. To the extent either of these conditions were present, there may have been fewer than 40,984 such accounts.

39 As discussed above, the IRS determined that 250 percent of the federal poverty level fairly approximates the regulatory definition of economic hardship and that determination operates as a presumption, at least for purposes of the FPLP levy filter.

40 The lowest amount allowed for housing and utilities was $645 per month, which is the amount allowed for taxpayers who live in Arthur County, Nebraska. The lowest amount of operating costs for one vehicle (not including ownership costs) was $192 per month, the amount allowed for taxpayers who live in Seattle, Washington. The national standard for food and clothing was $534 per month and for health care was $60 per month. Thus, the least amount of ALE for a hypothetical taxpayer who lived in Arthur County, Nebraska but used the vehicle operating cost for Seattle, Washington was $1,431. Total annual expenses for this hypothetical taxpayer would be $1,431 X 12 = $17,172. The October 2011 version of the IRS ALEs is *available at* http://mysbse.web.irs.gov/Collection/toolsprocesses/AllowExp/Standards/default.aspx.

41 The median income of taxpayers subject to levies on their SSA or RRB benefits was at most $17,439 depending on the source the IRS used to measure it. SB/SE Finance, Research and Strategy Project DEN0206 Federal Payment Levy Program (FPLP) and Low Income Taxpayers Appx. H, 3 Table H5 (May 2013). The study does not provide the range of these taxpayers' incomes.

Moreover, Appendix A of the IRS study shows that the federal poverty level in 2011 was:

- $10,890 for one person;
- $14,710 for a couple;
- $18,530 for a family of three; and
- $22,350 for a family of four.[42]

The median annual income of taxpayers whose SSA and RRB benefits were levied was at most about $17,500.[43] Thus, the taxpayers whose payments were levied were not only low income in the sense that their incomes were less than 250 percent of the poverty guidelines, but there is a very real possibility they were actually living in poverty.[44] Taxpayers in these circumstances may not have protested the levies because they were incompetent, infirm, or intimidated by the IRS. Their Social Security benefits may have been payable, but for the levy, directly to nursing homes or other caregivers. That the IRS was able to actually collect money from these vulnerable taxpayers is not a justification for leaving the levies in place.

The characteristics of taxpayers whose SSA payments were levied in FY 2012 demonstrate the needless burden placed on taxpayers who, but for unfiled returns, would have been excluded from levy. A TAS Research analysis found about 53,000 taxpayers were subject to FPLP levies in 2012, and they collectively failed to file about 95,000 returns.[45] By July 2013, only slightly more than 16,000 returns had been secured.[46]

42 SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers* Appx. A, Table 9 (May 2013).

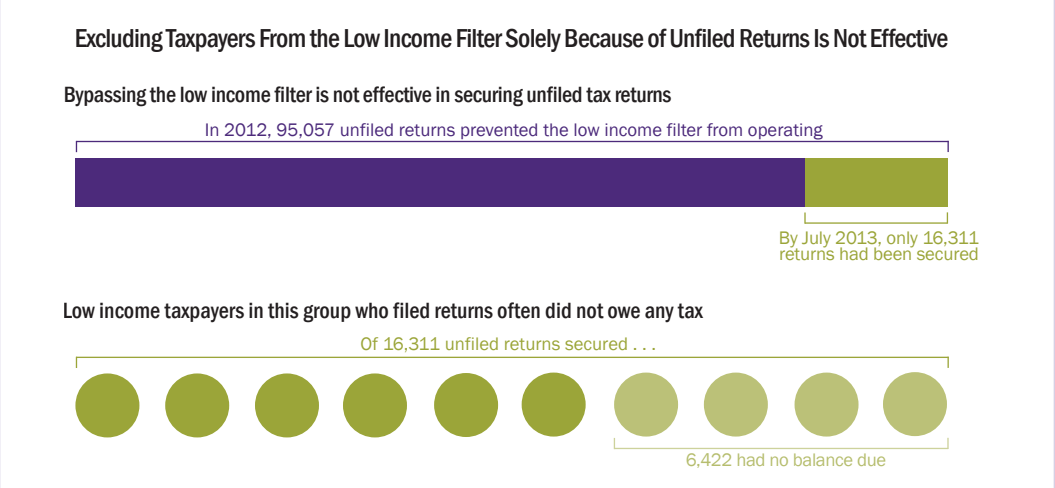
43 The median income of taxpayers subject to levies on their SSA or RRB benefits was at most $17,439 depending on the source the IRS used to measure it. SB/SE Finance, Research and Strategy Project DEN0206 Federal Payment Levy Program (FPLP) and Low Income Taxpayers Appx. H, 3 Table H5 (May 2013), The study does not provide the range of these taxpayers' incomes.

44 Rather than posing to itself the question of whether it proceeded appropriately in automatically levying on these taxpayers who may have been living at or near the poverty level, the IRS appears to congratulate itself on the additional revenue it raised, noting that it collected an average of $793 from each of the 66,926 taxpayers it levied and observing, "[t]he IRS could have lost $53 million revenue if the NTA recommendation had been in place in CY 2011." SB/SE Finance, Research and Strategy Project DEN0206 *Federal Payment Levy Program (FPLP) and Low Income Taxpayers* 12 (May 2013). Moreover, as noted above, SB/SE overstated the number of accounts that had unfiled returns and consequently the "lost revenue" that could have resulted from adopting the National Taxpayer Advocate's recommendation.

45 We found that 52,857 low income taxpayers with 95,057 different unfiled returns received a levy in FY 2012. Individual Master File from IRS Compliance Data Warehouse.

46 Taxpayers filed 16,311 returns. Individual Master File from IRS Compliance Data Warehouse. The IRS filed an additional 4,566 substitutes for return but could have taken this action even without the FPLP levy.

FIGURE 1.7.2, Return Filing by Taxpayers Excluded from Low Income Filter



Of these 16,000 returns, over a third showed no balance due.[47] The total tax reported on the returns was $30.8 million, of which 80 percent remained uncollected as of October 2013.[48] Thus, the insistence on securing returns resulted in returns actually being filed only about 20 percent of the time, and only 20 percent of the tax shown on those returns was collected by October of 2013.[49]

Taxpayers in Economic Hardship Continue to Come to TAS and LITCs Because IRS Employees Persist in Conditioning Levy Release on Filing Delinquent Returns.

Directors of Low Income Taxpayer Clinics across the country have told TAS that about 75 percent of their levy release cases follow a similar fact pattern.[50] Typically, the taxpayer contacts the clinic because the IRS is levying on his or her wages, bank account, or Social Security payments. The taxpayer demonstrates that he or she is in economic hardship, so the LITC representative contacts the IRS and requests release of the levy. The IRS employee does not usually reject the assertion that the taxpayer is in economic hardship, but tells the clinic employee the IRS will not release the levy because the taxpayer has unfiled returns – that "until the returns are filed, I can't help you."[51] Only if the clinic employee specifically cites the *Vinatieri* case, or the IRM requirements for CNC status, or otherwise insists that levy release and CNC status is appropriate does the IRS agree to release the levy without first receiving unfiled returns. TAS cases reflect the same fact pattern.[52] As the LITC directors observed, an unassisted taxpayer would probably find these obstacles insurmountable.

47 Taxpayers filed 16,311 returns, 6,422 of which (39 percent) showed no balance due. Individual Return Transaction file, IRS Compliance Data Warehouse.

48 Of the $30.8 million total tax shown on the returns, $24.6 million remained uncollected as of October 2013. Accounts Receivable Dollar Inventory, IRS Compliance Data Warehouse.

49 Only 17.2 percent (16,311) of the 95,057 returns were secured and 79.9 percent of the $30.8 million of total taxes was still due.

50 August 7, 2013 conference call with directors of nine LITCs in nine different states.

51 As discussed below, the IRS is not required to obtain documentation of the economic hardship before releasing a levy when the assessed amount is below a certain amount and other conditions are present. See IRM 5.11.2.2.1.4 (Aug. 24, 2010), cross referencing IRM 5.16.1.2.9(3) (May 22, 2012).

52 *See, e.g.*, TAMIS cases 5511491, 5503338, and 5379810.

The IRS Can Determine from its Own and Third-Party Databases Whether a Taxpayer is Likely in Economic Hardship Before it Issues a Levy.

The Treasury regulation pertaining to levy release contemplates a taxpayer acting in good faith when requesting a levy release, and providing documentation to support the claim that the levy is causing economic hardship.[53] As discussed above, the IRS identified a proxy for establishing economic hardship within the meaning of IRC § 6343 for one class of taxpayers (those subject to levies on their Social Security payments), and adopted the FPLP low income filter to avoid levying on those taxpayers in the first place. This approach reduces the burden on taxpayers and on the IRS by obviating the need for taxpayers to request the release and substantiate the hardship the IRS already presumes, and for the IRS to release the levies.

Most importantly, the IRS in these cases acts in violation of the law, thereby subjecting itself to potential suit for negligent or reckless collection action.

The IRS could systemically exclude accounts from levies other than FPLP levies (such as wage and bank levies), if not based on a proxy, then on actual data that shows the taxpayer is in economic hardship. Revenue officers are already authorized to release a levy or place an account into CNC status *solely* on the basis of information on returns and in databases (both internal to the IRS and those maintained by third parties) that contain financial information about the taxpayer.[54] As an alternative to simply expanding the existing FPLP filter to include taxpayers who have unfiled returns, the IRS could develop a computer program that identifies taxpayers who, based on IRS records and other databases, are likely in economic hardship. It could deploy the program annually, and adjust it as necessary to identify taxpayers who, if levied, would be entitled to immediate levy release; conversely, annual review would identify taxpayers whose financial circumstances have improved to the point that collection action might be warranted. The National Taxpayer Advocate and TAS Research intend to explore the viability of this approach in the coming calendar year.

CONCLUSION

When taxpayers in demonstrated economic hardship contact the IRS to request levy release, the IRS continues to insist on securing unfiled returns as a condition to releasing the levy, a violation of IRC § 6343(a)(1)(D). Even sustaining a *proposed* levy under these circumstances is unlawful, according to the holding in *Vinatieri*. In addition to failing to appropriately deal with taxpayers when they contact the IRS, the IRS does not consistently ascertain *before levying* whether a taxpayer is likely facing economic hardship, even though information in its own and third-party databases permit it to make this determination. On the contrary, the IRS purposely excludes from a pre-levy filter some taxpayers it would otherwise presume to be in economic hardship solely because they have unfiled returns.

53 See Treas. Reg. 301.6343-1.

54 IRM 5.16.1.2.9(3) (May 22, 2012) provides that where the assessed amount is below a certain amount and other conditions are present, a collection information statement (CIS) is not required. IRM 5.11.2.2.1.4 (Aug. 24, 2010), pertaining to levy release, provides, "[w]hen the taxpayer cannot pay, assuming the levy is released, a CIS is required unless the exceptions listed in IRM 5.16.1.2.9(3), *Hardship*, (CNC exceptions) are met."

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Establish quality review procedures that measure whether employees identified and considered the possibility that a taxpayer was in economic hardship before levying.
2. Establish quality review procedures that measure whether, in cases in which the employee identified economic hardship, the employee adhered to the *Vinatieri* decision by placing the account in Currently Not Collectible status rather than levying.
3. Develop and publish IRM guidelines for how collection employees, on the basis of information in IRS and third-party databases, should consider the possibility a taxpayer is in economic hardship before issuing a levy.
4. Adjust the FPLP low income filter to include accounts with unfiled returns.
5. Inform collection employees of procedural changes described above by issuing a separate alert and a memorandum.
6. Update training materials and job aids to reflect the *Vinatieri* decision and the 2013 changes to IRM 5.19 and 5.11.

MSP #8 RETURN PREPARER FRAUD: The IRS Still Refuses to Issue Refunds to Victims of Return Preparer Misconduct Despite Ample Guidance Allowing the Payment of Such Refunds

RESPONSIBLE OFFICIAL

John Koskinen, Commissioner of Internal Revenue

DEFINITION OF PROBLEM

While most tax return preparers treat their clients with honesty and integrity, some unscrupulous preparers prey on unsuspecting taxpayers by altering return information without their clients' knowledge or divert refunds for their personal benefit. This type of fraud creates significant challenges for the IRS, harms innocent taxpayers, and undermines trust in our tax system.

In 2012, the IRS developed interim guidance[1] that addresses in a taxpayer-favorable manner the type of fraud where the preparer inflates the refund without the taxpayer's knowledge, provides the taxpayer with the accurate refund amount, and pockets the difference.[2] Yet in cases where the preparer alters return information without the taxpayer's consent and directs the entire refund to an account under his or her control, the IRS has refused to make these victims whole — namely, by issuing the refunds claimed on their legitimate returns.

On October 17, 2012, the National Taxpayer Advocate issued a proposed Taxpayer Advocate Directive (TAD) directing the Commissioner of Wage and Investment (W&I) to, among other things, develop procedures to issue refunds to victims of return preparer fraud who are due a refund after they file a correct original return. After receiving an unsatisfactory response, the National Taxpayer Advocate included return preparer fraud as a most serious problem faced by taxpayers in her 2012 Annual Report to Congress.

The National Taxpayer Advocate has elevated 25 preparer fraud Taxpayer Assistance Orders (TAOs) to the Acting Commissioner. *These taxpayers have been waiting an average of more than two years to receive their refunds.* Some of these victims have been waiting for refunds ever since they filed 2008 tax returns.[3] These victims are typically low income taxpayers, with a median adjusted gross income of $17,548; the median refund amount is $2,511. In at least 14 cases, the taxpayer reported the refund fraud to the local police.

1 *See* Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0812-02 (Sept. 6, 2012), superseded by Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

2 In such cases, the taxpayer has a copy of the legitimate return, receives the refund he or she was expecting, and has no reason to suspect fraud. Only when the IRS ultimately discovers the taxpayer's return is incorrect and attempts to recover the excess refund through levies, liens, and other enforcement actions does the taxpayer learn of the preparer's fraud.

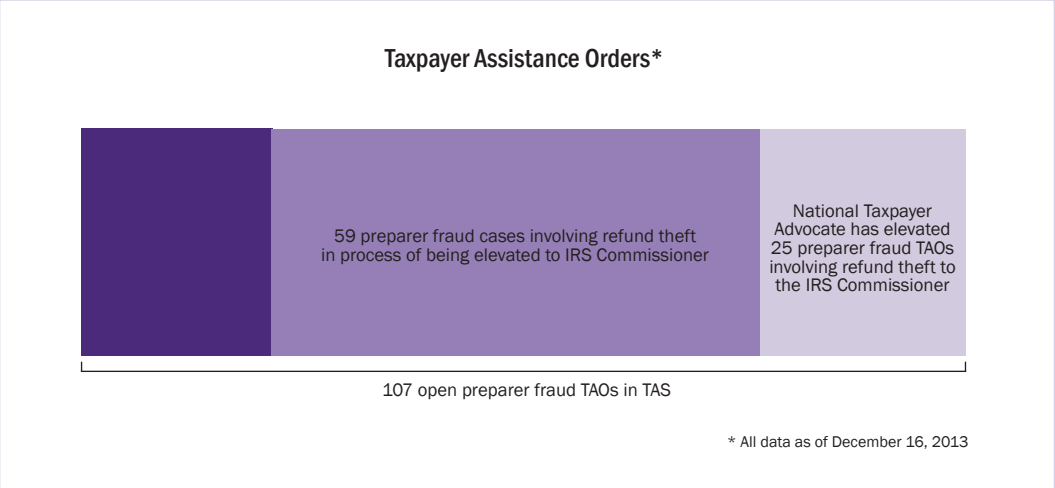
3 *See, e.g.*, Taxpayer Advocate Management Information System (TAMIS) case numbers 4757753, 5269873, and 5361465.

ANALYSIS OF PROBLEM

Background

The IRS has developed interim guidance and procedures to address situations where a victim of return preparer fraud has received the full refund that he or she expected.[4] However, the IRS response is insufficient in cases where the victim of the preparer has not received the full refund to which he or she is entitled because the preparer has stolen it. The guidance falls short of instructing IRS employees to issue refunds to victims of preparer fraud, which from the victim's perspective is likely the most important aspect of the case. Instead, the procedures instruct employees to suspend action on such cases pending further guidance.

TAS began keeping track of preparer fraud TAOs in fiscal year 2012; there are 107 open preparer fraud TAOs within TAS as of December 16, 2013.[5] Of these, the National Taxpayer Advocate has elevated 25 preparer fraud TAOs involving refund theft to the Acting Commissioner of Internal Revenue, with another 59 in the process of being elevated to that level.



Some of the victims who have come to TAS for help have been waiting for refunds ever since they filed 2008 tax returns.[6] In the 25 preparer fraud TAOs elevated to the Acting Commissioner, *the taxpayers have been waiting an average of more than two years to receive their refunds!* These victims are typically low income taxpayers, with a median adjusted gross income of $17,548. In at least 14 cases, the taxpayer reported the refund fraud to the local police, resulting in at least five arrests.

4 See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013); Director, Collection Policy, *Interim Guidance Memorandum on Return Preparer Fraud or Misconduct*, SBSE-05-0613-0034 (June 3, 2013).

5 See email from Director, TAS Technical Analysis & Guidance (Dec. 19, 2013).

6 *See, e.g.*, TAMIS case numbers 4757753, 5269873, and 5361465.

FIGURE 1.8.1, Statistical Snapshot of the 25 Preparer Fraud TAOs elevated to the Acting Commissioner

Median AGI	Median Refund	Average Days Waiting [7]
$17,548	$2,511	745

On December 20, 2013, the Deputy Commissioner for Services and Enforcement responded to the 25 TAOs that had been elevated to the Acting Commissioner level. For victims who did not receive the full amount of refund he or she was expecting, the IRS will not issue any further refunds. The rationale given was that it would be difficult for the IRS to detect collusion between the preparer and the victim.[8]

The National Taxpayer Advocate is not naïve and recognizes that collusion is a legitimate area of concern. However, there are ways to deal with that possibility without harming a whole class of taxpayers. Some taxpayers that have come to TAS have filed police reports (taxpayers did so in 14 of the 25 TAO cases) and even assisted law enforcement personnel in having the preparer arrested for fraud. In such cases, any suspicion of collusion should be allayed. Instead of trying to develop workable documentation requirements to address this concern of collusion, the IRS made a blanket decision to deny payment to all victims of preparer fraud who have not received the full amount of their refund (unless they can show that the return filed was completely unauthorized; the IRS may try to resolve those cases using identity theft procedures).[9]

It Is Permissible for the IRS to Reissue Refunds to Victims of Preparer Fraud, When the Return Preparer Has Absconded with the First Refund.

Since 2000, the IRS has received the benefit of several Chief Counsel opinions that address preparer fraud.[10] These opinions, when read together, authorize the IRS to:

1. Deem the first, falsified return a "nullity;"
2. Accept and process the second, true return submitted by the taxpayer after discovering the preparer fraud; and
3. Issue any refund due to the taxpayer under the second, true return (including any amounts previously paid to and stolen by the preparer), plus interest.

Particularly insightful is the Chief Counsel position in Field Service Advice (FSA) 200038005 from June 6, 2000. While FSA are not precedential, they do offer a glimpse into how the IRS may analyze a similar situation. This FSA involved a taxpayer who visited a Volunteer Income Tax Assistance (VITA) site staffed by military volunteers to have her return prepared electronically. The taxpayer received a copy of the return she authorized and was expecting a refund to be direct deposited. When she did not receive the

7 Measured from the date the taxpayer came to TAS for assistance through December 2013.

8 *See* Deputy Commissioner for Services and Enforcement response to the National Taxpayer Advocate re: Return Preparer Fraud TAOs (Dec. 20, 2013) (stating "It would be extremely difficult to ensure that the taxpayer and the return preparer are not in collusion in order to obtain an additional refund. If collusion is not present in the current cases, establishing a process whereby IRS issues a second refund could certainly create an incentive for taxpayers and preparers to abuse in order to obtain additional Federal monies.").

9 *See* Deputy Commissioner for Services and Enforcement response to the National Taxpayer Advocate re: Return Preparer Fraud TAOs (Dec. 20, 2013).

10 *See* Field Service Advice 200038005 (June 6, 2000); IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003); IRS Office of Chief Counsel Memorandum, *Refunds Improperly Directed to a Preparer*, POSTN-145098-08 (Dec. 17, 2008); IRS Office of Chief Counsel Memorandum, *Tax Return Preparer's Alteration of a Return*, PMTA 2011-20 (June 27, 2011).

refund at the expected date, she contacted the VITA site, which discovered that someone affiliated with the site altered the taxpayer's return information and directed the refund into another account. The FSA concluded that if the taxpayer can show that the direct deposit was stolen, the IRS may reissue a second refund to the taxpayer since it is clear the taxpayer never received the first one. In other words, there is no legal impediment to the IRS reissuing a refund to make the taxpayer whole in situations of return preparer fraud.

An Unauthorized Tax Return Should Not Be Treated as a Legitimate Return of the Taxpayer.

In *Beard v. Commissioner*,[11] involving a taxpayer who altered a Form 1040, *U.S. Individual Income Tax Return*, the Tax Court applied a four-part test to determine whether a document filed with the IRS qualifies as a "return" for tax purposes. Those requirements are that the document:

1. Purport to be a return;
2. Be signed under penalties of perjury;
3. Contain sufficient data to permit a tax to be calculated; and
4. Evince an honest and genuine endeavor to satisfy the requirements of tax law.

The IRS Office of Chief Counsel has routinely referred to the *Beard* analysis in its opinions on preparer fraud as the generally accepted test for determining the validity of a tax return.[12]

Return preparer misconduct occurs when a tax preparer alters return information without their clients' knowledge or consent in an attempt to obtain improperly inflated refunds, or to divert refunds for their personal benefit.

In a typical preparer fraud case scenario, the preparer alters some information on the return after the taxpayer has authorized a prior version. Accordingly, the return submitted by the return preparer was not reviewed, authorized, or signed by the taxpayer under penalties of perjury. It is not a valid return, as it fails the signature requirement of the *Beard* test, and should not be treated as a return of the taxpayer.

Thus, the decision faced by IRS leadership in whether it will pay refunds to victims of preparer fraud is largely one of public policy, rather than a legal question.

Public Policy Concerns Dictate that the IRS Make Victims of Preparer Fraud Whole.

In 2012, the National Taxpayer Advocate has designated the complexity of the Internal Revenue Code (IRC) as one of the most serious problems facing taxpayers.[13] The existing code, by our count, has reached nearly four million words and imposes unconscionable burden on taxpayers.[14] Our analysis of IRS data indicates

11 82 T.C. 766, 777-78 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

12 *See* IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003); IRS Office of Chief Counsel Memorandum, *Tax Return Preparer's Alteration of a Return*, PMTA 2011-20 (June 27, 2011). In discussions with IRS Executives, the Office of Chief Counsel recently advised that the IRS, as an innocent third party, would not be required to pay out these refunds under agency law. Specifically, the IRS could rely on the fraudulent representation of the return preparer (the agent) who filed a return he or she fraudulently altered; thus, any refunds issued by the IRS to the return preparer would satisfy the IRS's obligation to pay a refund to the taxpayer (the principal). The Office of Chief Counsel has not adopted or advanced this position in any of its opinions pertaining to return preparer fraud. Indeed, this theory contradicts all prior opinions on the matter and would result in treating taxpayers who are similarly situated, but for the issuance of a refund, being treated disparately.

13 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 3-23 (Most Serious Problem: *The Complexity of the Tax Code*).

14 *See Id*. at 6.

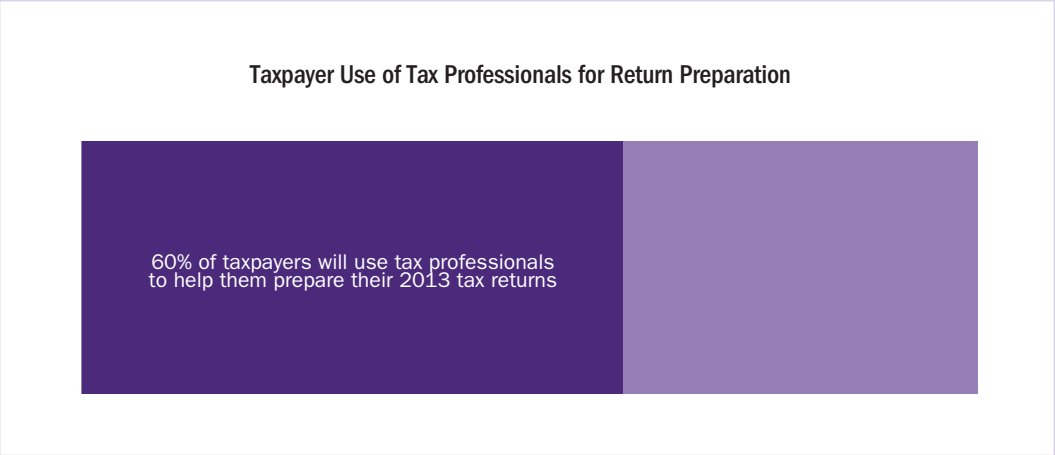
that individuals and businesses spend about 6.1 billion hours a year complying with tax-filing requirements.[15]

Even as tax compliance becomes more complex, the IRS provides fewer resources to help taxpayers file their returns. For example, IRS Taxpayer Assistance Center staff will no longer help customers with return preparation.[16] Many taxpayers, particularly low-income ones who are eligible for various refundable credits, feel pressure to hire a preparer to meet their statutorily-mandated tax filing requirement.

FIGURE 1.8.2, Taxpayers Claiming Refundable Credits, Claim Amounts, and Preparer Usage: Tax Years 2010 and 2011[17]

Tax Credit	Tax Year	Number of Taxpayers	Average Claim (dollars)	Total Claims (dollars in thousands)	Preparer Returns (percentage)
EITC	2011	27,362,193	$2,270	$62,119,975	59.3%
Additional child tax credit	2011	20,616,435	$1,347	$27,771,740	65.0%
First-time home buyer credit	2010	373,880	$6,893	$2,577,155	53.8%
Adoption credit	2011	55,794	$13,474	$760,365	60.1%
Making work pay credit	2010	106,381,764	$514	$54,784,234	53.6%
American opportunity tax credit	2011	12,525,776	$899	$11,266,488	55.9%

Overall, approximately 60 percent of taxpayers will use tax professionals to help them navigate the maze of the tax code and prepare their 2013 tax returns.[18]



15 *See Id*. at 5.

16 *See Id*. at 302 (Most Serious Problem: *The IRS Lacks a Servicewide Strategy that Identifies Effective and Efficient Means of Delivering Face-to-Face Taxpayer Services*); IRS, W&I Business Performance Review (Nov. 20, 2013); IRS, Wage & Investment Division, Response to TAS information request (email dated Dec. 20, 2013). The IRS will refer taxpayers who visit Taxpayer Assistance Centers for tax preparation to the nearest volunteer site for tax return preparation.

17 IRS Compliance Data Warehouse, Individual Returns Transaction File and Individual Master File, tax year 2010 and 2011 (through Mar. 2013).

18 *See* IRS, IR-2013-33, IRS Releases the Dirty Dozen Tax Scams for 2013, *available at* http://www.irs.gov/uac/Newsroom/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2013; IRS, IR-2008-2, *Treasury and IRS Give Taxpayers Greater Control over Information Held by Tax Preparers, Propose Marketing Restrictions on RALs, available at* http://www.irs.gov/uac/Treasury-and-IRS-Give-Taxpayers-Greater-Control-over-Information-Held-by-Tax-Preparers;-Propose-Marketing-Restrictions-on-RALs.

Although the IRS has attempted to test, certify, and regulate return preparers, it has not yet been able to implement such a system.[19] In the absence of a certification program that would differentiate qualified tax return preparers from other individuals or businesses offering the same services, taxpayers may find themselves handing over sensitive tax information to an opportunistic preparer who alters the taxpayer's return without authorization.

When this happens, the IRS response has been underwhelming. While the IRS may eventually untangle the victim's account issues, the IRS's position has been that the taxpayer's sole recourse for any stolen refunds lies with the preparer, not the IRS. Victims of preparer fraud, particularly low income and unsophisticated taxpayers who may not be well-versed in the civil litigation options theoretically available to them, would be right in feeling that the IRS has failed them.

A Victim of Preparer Fraud Is Similar to an Innocent Spouse

Generally, married taxpayers who file jointly are jointly and severally liable for any tax, interest, and penalties due as shown on the return.[20] However, innocent spouses may file for relief from joint and several liability under IRC § 6015. In 1998, the IRS was given expanded authority for innocent spouse relief.[21] Congress wanted the IRS, when it had evidence of misdoing through no fault of the victim, to refund the money to the innocent spouse — even when the other party (the "non-innocent" spouse) was unable to pay.

In the case of preparer fraud, no statutory fix is needed to make the victim whole. A series of Chief Counsel opinions make it clear that the IRS has the legal right to issue refunds to victims of preparer fraud — even in instances where the other party (the preparer) is unable to return the proceeds from the first refund. The Office of Chief Counsel recently reaffirmed that position to the National Taxpayer Advocate and the IRS Commissioner.

Although Preparer Fraud Is Similar to Identity Theft, the IRS Treats Victims Substantially Differently.

Return preparer fraud is similar to identity theft in that both crimes delay refunds and cause account problems, but the IRS deals with the victims in substantially different ways. Over the years, the IRS has developed victim assistance procedures that ultimately unwind the harm to a victim of identity theft. Although it may take much longer than an identity theft victim prefers, the IRS has procedures to "back

19 *See* Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS is Enjoined from Continuing Its Efforts to Effectively Regulate Unenrolled Preparers, supra*. In November 2011, the IRS launched a return preparer competency test with a deadline for completion by December 31, 2013. *See* IRS News Release, IR-2011-111, *IRS Moves to Next Phase of Return Preparer Initiative; New Competency Test to Begin* (Nov. 22, 2011). However, in January 2013, a U.S. District Court judge in *Loving v. Internal Revenue Service* disagreed with the IRS's view that it has the authority to implement these requirements on its own, and invalidated the testing and continuing education requirements. *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. Jan. 18, 2013). The government filed a motion to suspend the injunction pending appeal. The U.S. District Court for the District of Columbia denied the motion but then modified the terms of the injunction. *See Loving v. IRS*, 920 F. Supp. 2d 108 (D.D.C. Feb. 1, 2013). The Justice Department has appealed the District Court's decision. *Loving v. IRS*, No. 1:12-cv-00385 (D.D.C. 2013) (USCA Case No. 13-5061).

20 *See* IRC § 6013(d)(3).

21 *See* IRC § 6015. "Innocent spouse relief" is frequently used to describe relief from joint and several liability under IRC § 6015(b). Refunds are also available under IRC 6015(f), called "equitable relief." *See also* Joint Committee on Taxation, JCX-6-98, *Present Law and Background Relating to the Treatment of "Innocent Spouses"* (Feb. 9, 1998); *IRS Restructuring (Innocent Spouse Tax Rules): Hearing Before the S. Comm. on Finance*, 105th Cong. (1998).

out" the return filed by the perpetrator, process the true return, and pay out the associated refund claim, if applicable.[22]

In contrast, the IRS has not developed procedures that would fully unwind the harm suffered by victims of preparer fraud. For instance, although the IRS is willing to process the correct original return from the taxpayer, the IRS will not provide full relief by issuing a refund to these victims in cases where the preparer absconded with the initial refund that the IRS issued after receiving the falsified return.[23]

The IRS has the legal authority to issue such refunds to victims of preparer fraud. The National Taxpayer Advocate urges IRS leadership to make these vulnerable taxpayers whole once it is established that they were not complicit in the crime, just as the IRS works to make identity theft victims whole.

The IRS Should Consider Multiple Factors — Including Mitigation, Restitution, and Substantiation — Before Deciding Whether to Release a Refund to a Victim of Preparer Fraud.

In the absence of any regulation of return preparers, taxpayers have many options when choosing someone to prepare and file their tax returns. Return preparers run the gamut from attorneys and certified public accountants to large, national tax preparation firms to nonprofessionals who have purchased off-the-shelf software and volunteer to prepare a neighbor's return. Undoubtedly, some taxpayers are swayed by claims made by certain preparers to obtain a refund amount that may seem too good to be true. The IRS, rightfully, must be cognizant of the possibility of collusion between the preparer and the "victim" in an attempt to defraud the government. Moreover, the IRS does not want to serve as the *de facto* insurer of taxpayers who choose a preparer solely based on the size of the refund they were promised. Doing so would create a moral hazard by encouraging taxpayers to engage in high-risk behavior.

With these concerns in mind, the National Taxpayer Advocate proposes a framework of analysis the IRS can undertake when deciding whether to issue refunds to purported victims of preparer fraud. This framework includes mitigation, restitution, and substantiation.

Mitigation

The IRS should ask the victim what actions were taken to prevent the preparer fraud or to minimize the loss. For example, did the victim request a copy of the return that he or she authorized for filing? If the refund was not received by the expected date, did the victim promptly follow up with the preparer to check on the status? Did the victim contact the IRS to request a refund trace?

If the fraud was committed by an employee of a national, franchised tax preparation firm, did the victim request a settlement from the firm? To take the onus off the victim, the National Taxpayer Advocate suggests that the IRS establish a liaison with the nation's largest tax preparation firms to present these cases and request that they make the victims whole. TAS could spearhead coordination with the Wage & Investment division, the Criminal Investigation division, Chief Counsel, the Return Preparer Office, and the Office of Professional Responsibility.

22 *See generally* IRM 21.6.2, *Individual Tax Returns, Adjusting TIN-Related Problems* (Oct. 1, 2013).

23 See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

These taxpayers who have been victimized by return preparers are being harmed again by the IRS inaction.

Restitution

The IRS should not be obligated to pay out the full amount of the refund when restitution is available and recovered. If the preparer, whether out of guilt or under a court order, paid the victim a portion of the refund after being confronted or convicted, the IRS should subtract the amount of any money recovered by the victim. In these cases, emphasis should be on restitution *received*. Some preparers may be indigent or incarcerated. Thus, they may be unable to comply with a court order to pay restitution.

Substantiation

Victims of preparer fraud should be encouraged to provide the IRS with as much documentary evidence of the claim as possible. In addition to the required forms,[24] victims may wish to submit:

- A copy of the unaltered return (if provided by the preparer);
- A business card, flyer, or other advertisement with the preparer's contact information;
- A copy of any refund traces requested;
- A copy of bank statements showing the expected refund was not deposited into the victim's account; and
- Taxpayer statement (signed under penalties of perjury).

The IRS should encourage victims of preparer fraud to contact local law enforcement and file a report or complaint against the preparer. Doing so would ease the IRS's concern that the preparer and taxpayer may have been acting collaboratively to defraud the government. Victims should provide a copy of the police report (and conviction, if applicable). However, some jurisdictions may not be willing to receive a victim's complaint or issue a police report. Thus, the absence of one or more of these documents should not count against the taxpayer's claim. Moreover, none of the factors discussed above need be dispositive of the matter.

CONCLUSION

In many return preparer fraud cases, refunds are directed to an account under the preparer's control, leaving the taxpayer with no monetary benefit from the fraudulent filing and having to deal with the IRS in the aftermath. Although there is no legal impediment to the IRS reissuing refunds to victims of preparer fraud, IRS leadership has refused to make the policy call to do so. These taxpayers, who have been victimized by return preparers, are being harmed again by IRS inaction.

In the case of a return altered by a preparer, the IRS should have even more reason to assist the taxpayer than in refund fraud cases not involving a preparer. While a non-preparer third party who alters a return may be a mere thief, an errant preparer is not only a thief but is violating his or her fiduciary duty to the taxpayer and the tax system.

24 The IRS requires victims of preparer fraud to submit Forms 14157, *Return Preparer Complaint*, and 14157-A, *Tax Return Preparer Fraud or Misconduct Affidavit*, to the Memphis Accounts Management office. *See* Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

Not long ago, an IRS report stated that, "tax return preparers and the associated industry play a pivotal role in our system of tax administration and they must be a part of any strategy to strengthen the integrity of the tax system."[25] To protect the integrity of tax administration, the IRS must develop procedures that address the 21st-century version of return preparers' misappropriation of their clients' federal tax refunds.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Develop comprehensive guidance providing full relief to victims of return preparer fraud, including the issuance of a refund.
2. Direct TAS, W&I, Criminal Investigation, Chief Counsel, the Return Preparer Office, and the Office of Professional Responsibility to develop referral procedures for and establish a liaison to national tax preparation firms, to seek recovery of refunds for taxpayers defrauded by their employees or agents.

25 IRS Pub. 4832, *Return Preparer Review*, at 32 (Dec. 2009).

MSP #9 EARNED INCOME TAX CREDIT: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

Section 32(k) of the Internal Revenue Code (IRC) authorizes the IRS to ban taxpayers from claiming the earned income tax credit (EITC) for two years if the IRS determines they claimed the credit improperly due to reckless or intentional disregard of rules and regulations.[1] This standard requires more than mere negligence on the part of the taxpayer.[2] According to IRS Chief Counsel guidance, a taxpayer's failure to participate in an EITC audit does not justify imposing the ban.[3] Once the IRS imposes the ban, any EITC claimed in the next two years will be disallowed even if the taxpayer is otherwise eligible for the credit.

IRS data shows:

- The IRS imposed the ban improperly almost 40 percent of the time in 2011;[4]
- Taxpayers who were (but for the 2011 ban) eligible for the credit in the following two years were deprived of a tax benefit that averaged more than $4,600 for the two years combined.[5]

In a representative sample of two-year ban cases, the Taxpayer Advocate Service (TAS) found:

- In 19 percent of the cases, the IRS imposed the ban solely because EITC had been disallowed in a previous year;[6]
- In only ten percent of the cases did a taxpayer's response to the audit raise the *possibility* that he or she had the requisite state of mind to justify the two-year ban;[7]

1 IRC § 32(k)(1)(B)(ii) provides for a two-year "disallowance period" of "2 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to reckless or intentional disregard of rules and regulations."

2 For example, as discussed below, for purposes of the accuracy-related penalty under IRC § 6662, "negligence" includes "any failure to make a reasonable attempt to comply with the provisions of this title" and is distinguished from a "disregard" which is "reckless" or "intentional." IRC § 6662(c).

3 IRS Service Center Advisory SCA 200245051 (Nov. 8, 2002). As discussed below, IRS procedures permitted *automatic* imposition of the ban in some in which the taxpayer did not respond to IRS audit notices.

4 Of the 5,438 taxpayers on whom the IRS imposed the ban in 2011, the accounts of 2,121 are designated on IRS records as "no show/no response" or carry the notation that mail sent to them was returned as undelivered. 2,121 out of 5,438 is 39 percent. IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File (Tax Year 2011).

5 The average amount of EITC for eligible taxpayers was $2,274 in 2012 and $2,358 in 2013. The combined average was $4,632. IRS response to TAS fact check (Dec. 20, 2013).

6 In 62 cases out of 333, the *only* explanation for imposing the ban was the prior year's disallowance. Sixty two out of 333 is 19 percent. As described below, the IRS assigned project codes to some audits that resulted in *automatic* imposition of the two-year ban because of a previous disallowance of the credit.

7 Of the 330 cases in which the IRS requested substantiation of claimed EITC, the taxpayer responded by submitting documents that were clearly insufficient in 32 cases. Thirty two out of 330 is ten percent.

- In 69 percent of the cases, the ban was imposed without required managerial approval;[8]
- In almost 90 percent of the cases, neither IRS work papers nor communications to the taxpayer contained the required explanation of why the ban was imposed;[9] and
- Taxpayers' average income was about $15,500.[10]

Low income taxpayers face unique obstacles in learning EITC rules and substantiating their entitlement to the credit, but IRS procedures do not take this into account. Instead, the IRS applies the two-year ban on the basis of unexamined assumptions about the taxpayer's state of mind or even *presupposes* reckless or intentional disregard of the rules and regulations, potentially causing significant harm to taxpayers who may be entitled to EITC in a subsequent year.

Addressing the inaccurate and unsupported application of the two-year bans is even more urgent and necessary if the Administration's proposal to permit the IRS to use math error authority in the context of these bans is adopted by Congress.[11] The National Taxpayer Advocate does not support such a proposal unless and until the IRS improves its procedures to ensure its auditors make affirmative and reasonable determinations that a taxpayer acted with reckless or intentional disregard of rules or regulations before imposing the two-year ban. Moreover, Congress should clarify that IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.

ANALYSIS OF PROBLEM

Background

IRC § 32(k) Authorizes a Two-Year Ban on Claiming EITC, But Only If the IRS Determines the Taxpayer's Actions or Intent Meets Statutory Criteria.

IRC § 32(k)(1)(B)(ii) disallows EITC claims for two taxable years if there has been "a *final determination* that the taxpayer's claim of credit was due to *reckless or intentional disregard of rules and regulations*."[12] Neither section 32 nor its regulations define the terms "reckless or intentional disregard," nor is there any judicial interpretation of the subsection.[13] However, IRS Chief Counsel guidance provides that if EITC

8 Internal Revenue Manual (IRM) 4.19.14.6.1 (Jan. 1, 2013). Of the 333 cases in the sample, there was no evidence of managerial approval of the ban in 229 cases. Two hundred twenty nine out of 333 is 69 percent.

9 IRM 4.19.14.6.1 (Jan. 1, 2013). Of the 333 cases in the sample, there was no explanation (or there was only a conclusory or cursory statement that the ban applied, or the "explanation" for imposing the ban was that EITC had been disallowed in a previous year) in 295 cases. Two hundred ninety five out of 333 is 89 percent.

10 The average adjusted gross income for the 333 taxpayers in the sample was $15,478. TAS Research, CDW, Individual Returns Transaction File.

11 Budget of the United States Government, Fiscal Year 2014 212, 219, *available at* http://www.whitehouse.gov/omb/budget/Overview. Under IRC § 6213(b), the IRS may correct mathematical or clerical errors on returns and send notices to taxpayers explaining the changes. Taxpayers who do not request an abatement of the resulting tax within 60 days after the notice is issued are assessed the additional tax and they do not have the right to petition the Tax Court on the basis of the notice.

12 IRC § 32(k)(1)((B)(ii) (emphasis added). IRC § 32(k) was enacted as part of the Tax Reform Act of 1997, Pub. L. No. 105-34, § 1085(a)(1), 111 Stat. 788, 956. IRC § 32(k(1)(B)(i) authorizes the IRS to impose a ten-year ban on taxpayers who fraudulently claim EITC, but the IRS imposes the ten-year ban infrequently (13 times, 27 times, and 17 times in 2009, 2010, and 2011 respectively). IRS CDW, *Individual Returns Transaction File* (Tax Years 2009, 2010, 2011).

13 Neither the statute nor the regulations cross reference any other Code section (such as IRC § 6662) or regulations that contain similar language. Under IRC § 6662(b)(1), an accuracy-related penalty may be imposed on certain underpayments due to "negligence or disregard of rules or regulations." IRC § 6662(c) provides: "For purposes of this section, the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term 'disregard' includes any careless, reckless, or intentional disregard." Treas. Reg. § 1.6662-3(b)(2) provides: "A disregard is 'reckless' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is 'intentional' if the taxpayer knows of the rule or regulation that is disregarded.

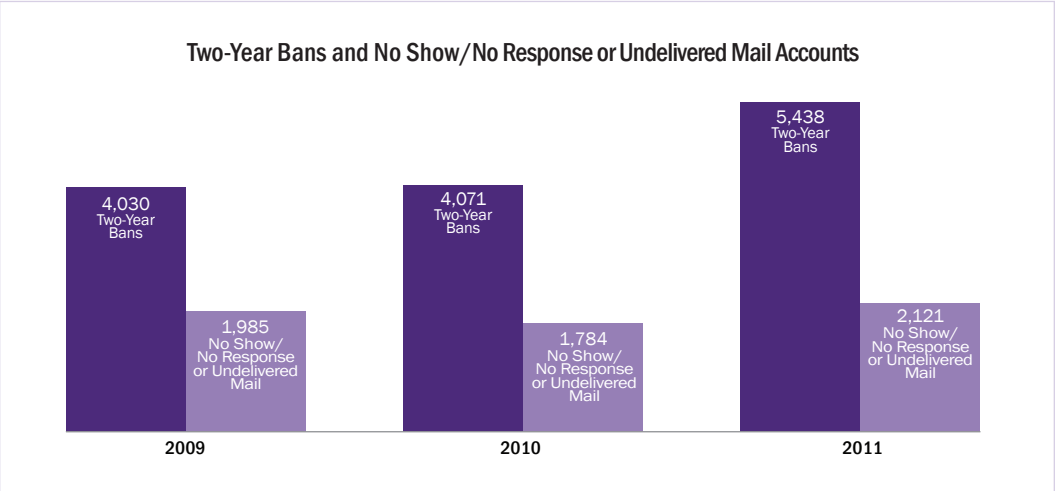
was disallowed because the taxpayer did not respond (or did not respond adequately) to a request for substantiation of claimed EITC, the ban should not be imposed.[14]

Recognizing that "each case may have a different reason for asserting the penalty/ban," the IRM requires examiners who propose the two-year ban to note in their work papers the reason for the decision.[15] A manager must approve all two-year bans.[16]

IRS Data Shows the IRS Frequently Imposes the Two-Year Ban Inappropriately.

TAS research of IRS databases shows that the IRS imposed the two-year EITC ban in tax years 2009-2011 as follows:

FIGURE 1.9.1, Total Number of Two-Year Bans and Number of Accounts Designated as No Show/No Response or Undelivered Mail[17]



With startling frequency, the IRS imposed the ban on taxpayers with whom it had had no interaction 49 percent of the time in 2009, 44 percent of the time in 2010, and 39 percent in 2011. There was no occasion on which the IRS could ascertain anything about these taxpayers' states of mind. As discussed below, IRS procedures permitted *automatic* imposition of the ban in some cases because the taxpayer did not respond to IRS audit notices, despite Chief Counsel guidance to the contrary.

Analysis of a Random Sample of EITC Ban Cases Also Shows the IRS Frequently Imposes the Two-Year Ban Inappropriately.

To learn more about how the IRS handles the two-year ban, TAS Research extracted a random, statistically valid sample of 333 instances of the 5,438 cases in which the IRS imposed the two-year ban in

14 IRS SCA 200245051 (Nov. 8, 2002).

15 IRM 4.19.14.6.1 (Jan. 1, 2013).

16 *Id*. The 2013 version of this IRM cross references to IRM 20.1.5.1.6, which describes managerial approval as mandated by IRC § 6751(b).

17 TAS Research, CDW, Audit Information Management System (AIMS) Closed Case Database (Tax Year 2011). As described below, for tax year 2011, the TAS sample only found 28 percent (with margin of +/- about 5 percent) of accounts were designated as "no show/ no response" or "undelivered mail."

2011.[18] The TAS team reviewed records stored on IRS databases and ordered hardcopy files from IRS storage facilities as necessary.[19] Among the study's principal findings:

- Of the 333 two-year ban cases in the sample, almost 80 percent stemmed from audits of tax year 2011.[20]
- The average adjusted gross income of taxpayers in the sample was $15,478.[21]
- The average amount of denied EITC was $3,731, or 24 percent of adjusted gross income on average.[22]
- In almost 30 percent of the sample cases, the taxpayer did not participate in the audit (*i.e.*, did not respond to notices or requests for information).[23]
- In almost 90 percent of the cases, there was no clear explanation of why the ban was imposed or the "explanation" was that EITC had been disallowed in a prior year.[24]

Part of the reason satisfactory explanations were so infrequent may be because some bans were imposed *systemically*. When the IRS disallows claimed EITC for a particular tax year, it places an indicator on the taxpayer's account and if the taxpayer claims EITC in a later year, the IRS requests the taxpayer to recertify eligibility for the credit.[25] If the recertification is not submitted and the case is selected for audit, the case is assigned a project code. Two project codes are:

- PC 0027 - Full scope EITC with 2 year ban proposed
- PC 0028 - Schedule C and full scope EITC with 2 year ban proposed.

A separate IRM provision explains how the IRS handles cases assigned project codes 27 or 28:

> These cases will be worked as EITC Recertification cases; using existing aging and purging time frames, however both the initial contact letter and report will propose a 2 year EITC ban. If the taxpayer does not reply the 2 year EITC ban will post to Master File along with the EITC disallowance. If the taxpayer replies, evaluate the documentation and determine if

18 A TAS Examination Senior Technical Analyst, together with a team of TAS employees consisting mainly of three experienced Internal Revenue Agent Technical Advisors, developed a data collection instrument to analyze cases in the sample. The sample is statistically valid at the 95 percent confidence level with a margin of error of about five percent, which allows study findings to be projected to the population. TAS originally intended to review 365 cases but succeeded in getting all relevant information for 333.

19 Among other databases, the TAS team consulted the IRS Correspondence Examination Automation Support (CEAS) database that includes copies of correspondence with taxpayers. Where CEAS records did not contain an explanation of why the ban was imposed, the team ordered the paper case file and reviewed it for the missing information.

20 In the sample cases, 261 of the bans stemmed from audits of tax year 2011, 63 stemmed from audits of tax year 2010, eight stemmed from audits of tax year 2009, and one stemmed from a 2008 audit. 261 out of 333 is 78 percent. Most of the audits (206 or 62 percent), were handled by the Wage and Investment division (W&I), while 127 or 38 percent were handled by the Small Business/Self Employed divisions (SB/SE). TAS Research, CDW, AIMS Closed Case Database.

21 TAS Research, CDW, Individual Returns Transaction File.

22 TAS Research, CDW, Individual Master File.

23 Out of 333 cases in the sample, 92 or 28 percent were no-response cases — there was no interaction between the IRS and the taxpayer.

24 There were 233 cases in which there was no clear explanation for imposing the ban other than the prior year's disallowance. There were 62 cases in which the *only* explanation for imposing the ban was the prior year's disallowance. Two hundred thirty-three + 62 is 295, and 295 out of 333 is 89 percent. A typical statement in a communication to a taxpayer was simply: "Based upon the information we have available, we propose that you should be restricted from receiving the EITC for the following 2 years. This 2-year ban is asserted for the reckless or intentional disregard of the rules and regulations regarding the EITC under IRC Section 32(k)(1)(B)(ii)." Moreover, the TAS team reviewing the cases in the sample reported that IRS examiners sometimes indicated they were imposing the ban because they believed the taxpayer acted *negligently* (as opposed to *recklessly* or with *intentional* disregard of the EITC rules). The team did not quantify the number of cases in which the examiner gave this explanation for imposing the ban and therefore we cannot project the frequency with which it occurs. However, this terminology certainly suggests inappropriate application of the ban.

25 IRM 4.19.14.6, *Recertifications* (Jan.1, 2013).

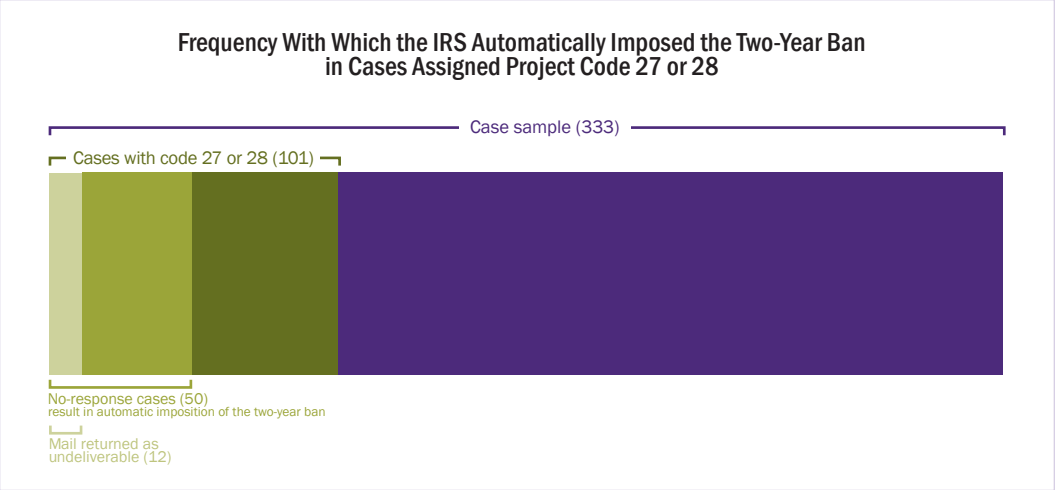
circumstances exist not to assert the 2 year EITC ban. If taxpayers request a Reconsideration of PC 0027 or 0028 cases, use existing Reconsideration guidelines for taxpayers with a 2 year EITC ban.[26]

This IRM provision means the IRS will *automatically* impose the two-year ban on certain taxpayers who do not respond to audit notifications: taxpayers who were required to recertify eligibility for EITC and whose audits are assigned project codes 27 or 28. There is no attempt to ascertain whether the reason for the previous disallowance is different from the reason for the current year's disallowance (*e.g.*, whether the same children were claimed as qualifying children), or whether there was ever any contact with the taxpayer from which to surmise he or she understood the reason for either disallowance. According to this provision, if these taxpayers do respond to audit notifications, it is their burden to show that two-year ban should not apply, rather than the IRS's burden to show that it does apply.[27]

IRS data show that the IRS imposed the ban improperly almost 40 percent of the time in 2011.

As Figure 1.9.2 shows, of the 333 cases in the sample, taxpayers' audits were designated with project code 27 or 28, and the taxpayer did not participate in the audit, in 50 cases, or in 15 percent of the cases in the sample. This resulted in *automatic* imposition of the two-year ban. In some cases, mail to the taxpayer had been returned as undeliverable — the taxpayer may have never realized he or she was being audited.

FIGURE 1.9.2, Frequency with Which the IRS Imposed the Two-Year Ban in Cases Assigned Project Code 27 or 28[28]



26 IRM 4.19.14.6.1.5 *Project Codes 0027 and 0028 – EITC Recertification with a Proposed 2 Year EITC Ban* (Jan. 1, 2013).

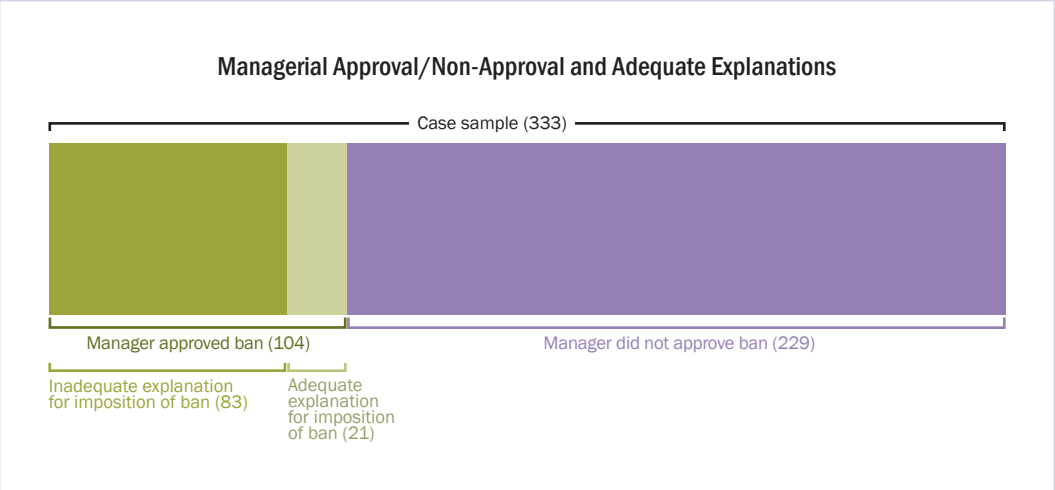
27 The National Taxpayer Advocate recommends that Congress amend IRC § 32 to clarify that the burden is on the IRS to show the ban should apply. *See* Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit, infra.*

28 In the TAS sample of cases, 101 cases had been assigned project code 27 or 28. Of these 101 cases, 50 were no-response cases, 12 of them with undelivered mail. Fifty out of 333 is 15 percent.

The IRS rarely follows its own procedures for imposing the two-year ban. Specifically, the TAS study found:

- In more than two-thirds of the sample cases, the required managerial approval of the ban was not secured.[29]
- When a manager approved the ban, the explanation was insufficient 80 percent of the time.[30]
- *In only six percent of the cases did the IRS follow its own procedures by adequately explaining why the ban was imposed and obtaining managerial approval.*[31]

FIGURE 1.9.3, Managerial Approval/Non-Approval and Adequate Explanations



In terms of IRS requests for substantiation, analysis of the sample cases showed that the IRS almost always (in 330 out of 333 cases) requested documentation from the taxpayer to substantiate the claimed EITC. In these 330 cases:

- In 122 cases, or almost 40 percent of the time, it appeared from the documents submitted that the taxpayer actually believed he or she qualified for the EITC.[32] An example of a case in this category is one in which a taxpayer claimed the credit with respect to her children and provided birth certificates to show the qualifying relationship. The documentation the taxpayer initially submitted to satisfy the residency was for a year other than the year under exam. The taxpayer then provided a letter from the children's school that showed where the children resided for the year under exam, but did not show the children lived with the taxpayer.

29 Of the 333 cases in the sample, there was no evidence of managerial approval of the ban in 229 cases, or 69 percent.

30 In the 104 cases in which a manager approved the ban, in 83 cases the explanation was not clear explanation or the only explanation was that EITC had been disallowed in a prior year. Eighty three out of 104 is 80 percent.

31 Only 21 cases contained an adequate explanation of why the ban was imposed (other than because EITC had been disallowed in a prior year) and had the required managerial approval. Twenty one out of 333 is six percent.

32 Of the 330 cases in which the IRS requested substantiation, the taxpayer responded by submitting documents that were reasonable attempts to substantiate the claimed credit in 122 cases, or 37 percent of the time.

- About 50 percent of the time, it was unclear whether the taxpayer understood whether he or she qualified for the credit.[33] For example, in an audit that encompassed 2009-2011, the taxpayer submitted birth certificates for two children and his marriage certificate, which substantiated a qualifying relationship for only one child. The taxpayer also submitted school records and receipts for rent and after-school care for both children, but only for 2010. In this instance, the taxpayer made an effort to provide some substantiating documentation, but not for both children and not for all audit years, although it is not clear whether he understood the law or the procedural requirements.
- In only ten percent of the cases were the documents clearly insufficient to support the claimed EITC, raising the *possibility* that the taxpayer had the requisite state of mind to justify the two-year ban.[34] For example, a taxpayer submitted copies of school records that did not reflect the taxpayer's address, paperwork from a doctor's office showing the other parent's address, and a birth certificate that appeared to have been typed.[35]

IRS Procedures Do Not Take Into Account That the Unique Challenges Low Income Taxpayers Face in Substantiating Claimed EITC May Shed Light on these Taxpayers' State of Mind or Actions.

The National Taxpayer Advocate has repeatedly described the unique difficulties low income taxpayers face in attempting to comply with IRS requests for substantiation of claimed EITC.[36] Each year, the composition of the EITC population changes by about a third.[37] A chart prepared by the Treasury Inspector General for Tax Administration (TIGTA), reproduced below as Figure 1.9.4, shows how taxpayers move in and out of EITC.[38] Thirty-seven percent are intermittent or first-time filers, meaning they do not have any experience in claiming the credit or they have no recent experience.[39] Only 20 percent of taxpayers are termed "continual filers" who might be expected to have learned from their experience.[40]

33 Of the 330 cases in which the IRS requested substantiation, in 176 cases, or 53 percent, it was unclear whether the taxpayer believed he or she was entitled to the claimed EITC.

34 Of the 330 cases in which the IRS requested substantiation, the taxpayer responded by submitting documents that were clearly insufficient in 32 cases, or ten percent of the time.

35 When questioned, the taxpayer admitted the children lived with their other parent five days a week.

36 *See, e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*) ("IRS letters are legalistic, not tailored to the taxpayer's particular situation, and do not discuss alternate sources of documentation. Low income persons may live without written leases or may not have school records for their children because of their living situation or patterns of moving. Migratory living patterns, lack of education, lack of time (*e.g.* holding multiple jobs), lack of transportation, and limited access to technology (internet, faxes, etc.) add to the difficulty of finding and submitting documents."); National Taxpayer Advocate 2009 Annual Report to Congress 110 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*) ("Although a diverse population, low income taxpayers do share common characteristics. Low income taxpayers are found more frequently among the elderly, the disabled, Native Americans, and taxpayers who may have limited English proficiency (LEP) relative to the general Wage and Investment (W&I) taxpayer population. Many require extra assistance to understand tax law changes, as demonstrated by the widespread confusion about the 2008 Economic Stimulus Payment (ESP) and the resulting flood of calls to the IRS toll-free line. Low income taxpayers tend to be more transitory than the general population, with 27.5 percent of those below the poverty level moving in 2007 while only 15 percent of the general population moved during the same time.").

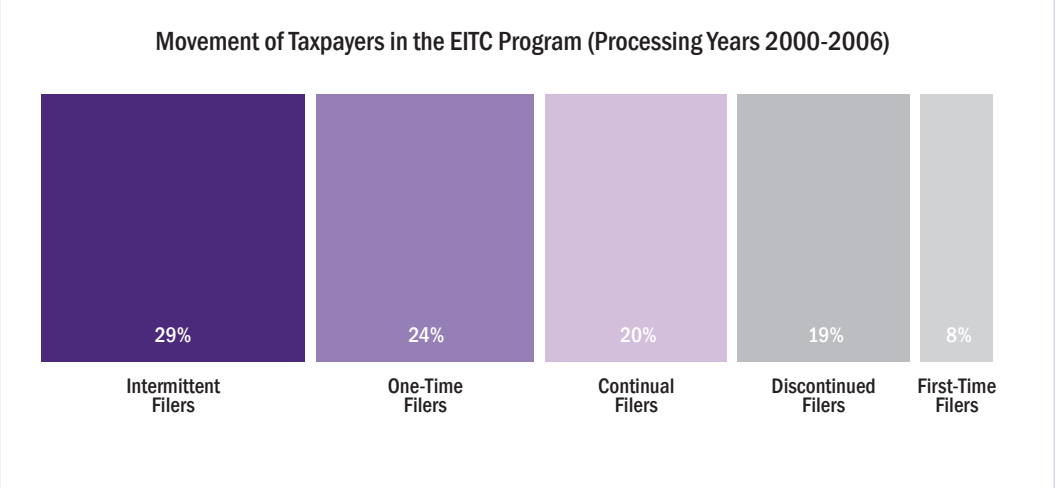
37 Kathleen M. Carley, *Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study*, prepared for the National Taxpayer Advocate. National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2.137.

38 Treasury Inspector General for Tax Administration (TIGTA) Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* 2 (2008), *available at* http://www.treas.gov/tigta/auditreports/2009reports/200940024fr.pdf. The report refers to taxpayers who claim EITC as being "in the EITC program."

39 Intermittent Filers are taxpayers who claim the EITC in one year but not the next, then file and claim the credit again at a later time.

40 Discontinued Filers are taxpayers who had consistently claimed the EITC but who stopped filing a tax return or no longer qualified for the EITC.

FIGURE 1.9.4, Movement of Taxpayers in the EITC Program (Processing Years 2000–2006)



These taxpayers' circumstances would be relevant to a determination under other Code sections, such as the innocent spouse provisions of IRC § 6015 or with respect to certain penalty provisions.[41] In other areas of the law, these circumstances might establish the absence of negligence (and necessarily the absence of recklessness or intentional disregard).[42] For purposes of the two-year ban, however, IRS procedures do not take these factors into account or adequately consider that taxpayers claiming EITC may be in "learning mode." In fact, the applicable IRM provisions result in the IRS punishing EITC taxpayers while they are learning these complex rules.[43] A better approach, in view of the shifting population of EITC claimants and the consequent need to continuously educate taxpayers about the rules for EITC eligibility, would be for the IRS to regard the EITC audit as an opportunity. If the education is effective, taxpayers not only understand whether they are eligible to claim EITC in the audit year, but they can also remain compliant or avoid future noncompliance as their circumstances change.

41 IRC § 6015(f), for example, allows for relief from liability for a taxpayer who did not know or have reason to know, of an understatement of tax shown on a joint return, or of an underpayment of the tax. Rev. Proc. 2013-34, 2013-43 I.R.B. 397, § 4.03(2)(c)(iii) provides "[t]he facts and circumstances that are considered in determining whether the requesting spouse had reason to know of an understatement, or reason to know whether the nonrequesting spouse could or would pay the reported tax liability, include, but are not limited to, the requesting spouse's level of education, any deceit or evasiveness of the nonrequesting spouse, the requesting spouse's degree of involvement in the activity generating the income tax liability, the requesting spouse's involvement in business or household financial matters, the requesting spouse's business or financial expertise, and any lavish or unusual expenditures compared with past spending levels." IRC § 6664 provides that reasonable cause for an underpayment and the taxpayer acting in good faith with respect to the underpayment may constitute a defense to imposition of the IRC § 6662 accuracy related penalty. Treas. Reg. § 1.6664-4(b) provides that "[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." The regulation also provides that reliance on the advice of a professional tax advisor may constitute reasonable cause and good faith. As discussed below, most of the returns in our sample of cases were prepared by paid tax preparers.

42 *See ,e.g.*, Restatement 2d of Torts § 283, which provides "[u]nless the actor is a child, the standard of conduct to which he must conform to avoid being negligent is that of a reasonable man under like circumstances." Comment d notes that "[i]n determining whether the actor should realize the risk which his conduct involves, the qualities which are of importance are those which are necessary for the perception of the circumstances existing at the time of his act or omission and such intelligence, knowledge, and experience as are necessary to enable him to recognize the chance of harm to others involved therein."

43 IRS employees, who apply these complex rules by relying on IRM lists of "acceptable documentation" to substantiate claimed EITC, may not evaluate the claim accurately and completely. *See* National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 71, *Study of Tax Court Cases in Which the IRS Conceded the Taxpayer was Entitled to Earned Income Tax Credit (EITC)*; National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 77 *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*. Historically, taxpayers often recover substantially all of the credit when the IRS takes a "second look" at denied EITC claims. In the 2004 EITC Audit Reconsideration study, TAS Research found that in audit reconsiderations, 40 percent of EITC claimants working with IRS Exam employees, and 45 percent of those working with TAS, recovered EITC payments. The 2010 TAS *EITC No Relief, No Response Review* showed that on average, TAS obtains full or partial relief in approximately 48 percent of EITC cases. *See* TAS Business Performance Review, 2nd Qtr. 2011, 15 (Mar. 2011).

IRM Provisions May be Leading IRS Employees to Impose Bans Inappropriately.

The main IRM provision that explains when to impose the two-year ban clarifies that first-time disallowance of EITC should not generally trigger the ban and, in an "if/then" formulation, gives eight scenarios in which the examiner *should* impose it.[44] Two of these scenarios are reasonable formulations — they presume the examiner actually spoke with the taxpayer and gathered enough information to ascertain the taxpayer's state of mind.[45] Two other scenarios at least remind the examiner that the decision to impose the ban depends on the facts and circumstances of the case.[46] Three of the scenarios, however, contain unexamined assumptions about the taxpayer's state of mind or even *presuppose* reckless or intentional disregard of the rules and regulations.[47]

One scenario in the IRM table merges the substantive requirements for claiming EITC with the requirements for imposing the ban, and reflects a misconception of the law. It provides:

> "**IF** The taxpayer filed MFJ [married filing a joint return] in prior tax years, is now filing as HOH [head of household], and our records show the taxpayers still live at the same address and/*or are still married* (emphasis added), **AND** Is unable to establish he/she is divorced or legally separated (They may be splitting the children to maximize the EITC) **THEN** The two year ban should be imposed."

Actually, divorce or legal separation is not required for a taxpayer living apart from his or her spouse to be considered as not married, so a taxpayer described by this "if/then" sequence could still be entitled to claim EITC as a head of household.[48] An examiner who disallows EITC in this scenario without ascertaining more about the taxpayer's situation may very well be misapplying the law. When this error occurs, it disproportionately affects racial and ethnic minorities, who predominate in the group of

---

44 IRM 4.19.14.6.1(7) (Jan. 1, 2013). The scenarios are shown in a table, referred to as a nonexclusive "starting point to help determine if the two-year ban is appropriate," but no additional analytical framework is provided.

45 IRM 4.19.14.6.1(7) (Jan. 1, 2013). The first example, which would justify imposing the ban even on a first-time disallowance, is: "During a conversation, the taxpayer admits he/she knew they did not meet the eligibility requirements but decided to 'try it anyway.' In this instance, the ban would be justified because the taxpayer intentionally disregarded the rules and regulations." TAS found that this occurred in seven of the 333 sample cases. The second example is: "If the taxpayer is claiming different qualifying children each year and when asked to identify the qualifying children, the taxpayer does not know who they are claiming," then "[t]he two year ban should be imposed."

46 The first scenario is: if "[t]his is a Recertification case [*i.e.*, the taxpayer's claimed EITC was previously denied and the taxpayer is now required, per Treas. Reg. § 1.32-3(c), to file Form 8862, *Information To Claim Earned Income Credit After Disallowance*], and "[i]nadequate documentation is received from the taxpayer and the case results in the EITC being disallowed again," then '[b]ased on facts and circumstances presented apply the two-year ban." The example also says, however, "The taxpayer was previously informed of the requirements and the specific rules and regulations pertaining to EITC." This may or may not be true — the taxpayer may not have received any explanation for the previous disallowance, or may not have understood an explanation that was received. Moreover, the reason for the second disallowance may differ from the reason for the first disallowance. The second scenario is: if "[a] decedent's SSN is used for a qualifying child" and "[t]he person died before the year under examination," then "[b]ased on facts and circumstances presented apply the two-year ban."

47 They are: if "[t]he technician can determine the taxpayer's claim was due to reckless or intentional disregard rather than misunderstanding or confusion of the rules" then the two year ban should be imposed; if "[t]here is a lack of acceptable records" and "[t]he taxpayer understood what types of documentation could be accepted" the ban should be imposed; if "[t]he taxpayer agreed with the assessment and denial of EITC in the previous tax year(s)" and '[i]s again unable to verify eligibility for claiming the EITC and qualifying children" the ban should be imposed.

48 A married taxpayer need only be "treated as" not married within the meaning of IRC § 7703(b) to file a separate return using a filing status of Head of Household, if the other requirements of IRC § 2(b) are also met. IRC § 2(c), *Certain married individuals living apart*, provides: "For purposes of this part, an individual shall be treated as not married at the close of the taxable year if such individual is so treated under the provisions of section 7703(b)." IRC § 7703(b)(3) provides that married taxpayers who are not members of the same household for the last six months of the year may be considered as not married if the requirements of IRC § 7703(b)(1) and (2) (pertaining to maintaining a household) are also met.

married-but-indefinitely-separated taxpayers.[49] This single IRM provision invites examiners to first disallow EITC by misapplying the law, and to then compound the error by imposing the two-year ban.[50]

The Avenues Available to a Taxpayer to Challenge an IRS Application of the Two-year Ban Are Procedurally Complex.

When the IRS audits a taxpayer's return and determines to disallow claimed EITC and impose the ban, it issues a statutory notice of deficiency which includes notice of the IRS's determination to impose the two-year ban.[51] The taxpayer may petition the Tax Court for review of the disallowed EITC as well as the determination to impose the ban.[52] If the taxpayer petitions the Tax Court, he or she may bear the burden of proving the IRS erred in imposing the ban.[53] If the taxpayer does not timely file a Tax Court petition, the additional tax, if any, will be assessed and the two-year ban will remain uncontested. IRS records will reflect the two-year ban, and if the taxpayer claims EITC the following year, the credit will be automatically disallowed even if the taxpayer otherwise qualifies for it.[54] The same deficiency procedures also apply to a later year's disallowance.[55] If the taxpayer files a Tax Court petition for review of a later disallowance due to the ban, the court may consider whether the ban was properly imposed in the earlier year because this is relevant to determining the tax for the later year, but the court would not have jurisdiction to redetermine the tax for the earlier year when the ban was imposed.[56]

We note that the Treasury Department's fiscal year (FY) 2014 revenue proposals would allow the IRS to use math error authority to disallow EITC if the taxpayer claimed the credit while subject to the two-year ban.[57] Math error authority permits the IRS to assess a tax deficiency without issuing a statutory notice

---

49 *See, e.g.*, The Ohio State University Research and Innovation Communications, *Marital Separations an Alternative to Divorce for Poor Couples* (Aug.13, 2012), *available at* http://researchnews.osu.edu/archive/maritalsep.htm (last visited Sept,12, 2013). The research, carried out by Dmitry Tumin and Zhenchao Qian showed that 15 percent of separations did not end in either divorce or reconciliation within ten years and that couples in these prolonged separations tended to be racial and ethnic minorities. These couples also tended to have young children. and low family income — the very population EITC is intended to reach.

50 The error is perpetuated in the IRM audit reconsideration provisions. IRM 4.13.3.18 (Sept. 30, 2010) describes the audit reconsideration procedures and makes clear that the IRS can remove the ban and reverse disallowance of the EITC. However, it provides that "[i]f the taxpayer failed to substantiate EITC entitlement for the year that triggered the ban, the audit reconsideration will be disallowed." The provision seems illogical because if the taxpayer initially substantiated entitlement to EITC the IRS would have allowed the EITC and not imposed the ban. Moreover, the provision would appear to prevent audit reconsideration of bans imposed on taxpayers who simply did not respond to IRS requests for information or whose mail was returned as undelivered.

51 The statutory notice of deficiency, authorized by IRC § 6212, informs the taxpayer of the additional amount of tax the IRS believes he or she owes and advises of the right to petition the Tax Court for review of that determination. IRM 4.19.14.6.1.1 (6), (11) (Jan. 1, 2013); IRM 4.13.3.18 (Sept. 30, 2010).

52 *See, e.g., Garcia v. Comm'r*, T.C. Summ. Op. 2013-28 (Apr. 3, 2013) for the facts contained therein; under IRC § 7463(b), the opinion is not precedent for any other case.

53 Tax Court Rule of Practice and Procedure 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). The National Taxpayer Advocate recommends that Congress amend IRC § 32 to clarify that the burden of showing the appropriateness of the ban is on the IRS. *See* Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit, infra*.

54 IRM 4.19.14.6.1.1 (6), (11) (Jan. 1, 2013).

55 IRM 4.19.14.6.1.1 (11) (Jan. 1, 2013).

56 IRC § 6214(b) provides that the Tax Court "in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid." IRM 4.19.14.6.1.3 (Jan. 1, 2007) instructs employees that if the taxpayer petitions the Tax Court, they should provide Chief Counsel attorneys with the complete case file for the year that is the subject of the Tax Court petition as well as the year in which the ban was imposed.

57 Budget of the United States Government, Fiscal Year 2014 212, 219, *available at* http://www.whitehouse.gov/omb/budget/Overview; Perspectives, Budget of the United States Government, Fiscal Year 2014 205, *available at* http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

of deficiency with the attendant right to petition the Tax Court for review.[58] The National Taxpayer Advocate does not support the Treasury Department's proposal to extend the use of math error authority in this manner unless and until: 1) the IRS adopts procedures that ensure IRS auditors make a considered (as opposed to automated or presumed) determination that reckless or intentional disregard of rules or regulations occurred; and 2) Congress clarifies that the IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.[59]

The IRS Has Imposed More Stringent Due Diligence Requirements on Paid Preparers who Prepare Returns that Claim EITC, and These Requirements May Increase Compliance.

Paid return preparers were involved in about 71 percent of the returns in the TAS sample of two-year ban cases.[60] In more than half (27) of the 50 cases in which the IRS automatically imposed the ban because EITC had been disallowed in a previous year and the taxpayer did not respond to audit notices, the tax return was prepared by a paid preparer. IRC § 6695(g) provides that:

> [a]ny person who is a tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of $500 for each such failure.[61]

Under the regulations, for returns filed after December 31, 2011, preparers must demonstrate they exercised due diligence in determining earned income eligibility by submitting Form 8867, *Paid Preparer's Earned Income Credit Checklist*, or "Alternative Eligibility Record" and file it with the return or claim for refund.[62] The IRS imposed the section 6695(g) penalty on almost 900 individuals in fiscal year 2012 and the average amount of penalty assessed in each case exceeded $10,000.[63] Unsurprisingly, it appears that preparers subject to the penalty prepared multiple returns.

By not articulating the reason for imposing the ban and securing managerial approval, the IRS does not adhere to its own procedures.

The 2012 version of Form 8867, in Part IV, "Due Diligence Requirements," poses two new questions that relate to relationship and residency of any qualifying

58 IRC § 6213(b)(1). The analysis that accompanies the President's budget proposal explains, "[t]he IRS may correct certain mathematical or clerical errors made on tax returns to reflect the taxpayer's correct tax liability (this authority is generally referred to as 'math error authority')." Perspectives, Budget of the United States Government, Fiscal Year 2014 205, *available at* http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

59 *See* Legislative Recommendation: *Allocate to the IRS the Burden of Proving it Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit, infra*.

60 In 237 out of 333 cases, a paid preparer signed the return or there are other indications, such as a refund anticipation loan, that indicate a paid preparer was involved.

61 The United States-Korea Free Trade Agreement Implementation Act, Pub. L. No. 112–41, § 501, 125 Stat 428, amended IRC § 6695(g) by increasing the amount of the penalty from $100 to $500 for returns filed after December 31, 2011. See Treas. Reg. § 1.6695–2(a). The National Taxpayer Advocate recommended increasing the amount of the preparer penalty in 2003. See National Taxpayer Advocate 2003 Annual Report to Congress 272 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*).

62 Treas. Reg. § 1.6695–2(b)(1). Most of the returns in the TAS sample cases were filed after Dec. 31, 2011. Although a 2009 version of Form 8867 was available, preparers of returns filed before Dec. 31, 2011, were not required to file Form 8867 with the returns they prepared.

63 The penalty was imposed against 881 individuals in FY 2012. IRS response to TAS fact check (Dec. 20, 2013).

children with respect to whom the credit is being claimed.[64] The same portion of the form now asks the preparer to identify, from a list of documents, which one(s) he or she relied on to determine the residence or disability of a qualifying child and which documents supported any claimed Schedule C income or expenses. The preparer can also indicate, by checking a box, that he or she relied on "other" unspecified documents, "did not rely on any documents, but made notes in file," or simply "did not rely on any documents."[65] The preparer is instructed that due diligence requires that he or she keep for three years:

- Form 8867, *Paid Preparer's Earned Income Credit Checklist*;
- The EIC worksheet(s) or the preparer's own worksheet(s);
- Copies of any taxpayer documents the preparer relied on to determine eligibility for or amount of EIC;
- A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained; and
- A record of any additional questions the preparer asked and the client's answers.[66]

The National Taxpayer Advocate applauds the IRS for finalizing the regulation that requires preparers to submit Form 8867 with returns they prepare and for revising Form 8867 to not only reflect the new regulation but also facilitate preparer due diligence.[67]

64 One question is: "If any qualifying child was not the taxpayer's son or daughter, did you ask why the parents were not claiming the child and document the answer?"' Another question is "If the answer to question 13a is 'Yes' (indicating that the child lived for more than half the year with someone else who could claim the child for the EIC), did you explain the tiebreaker rules and possible consequences of another person claiming your client's qualifying child?" A "qualifying child" is a person who among other things meets age requirements, bears a specified relationship to the taxpayer, and has the same principal residence as the taxpayer for more than half the year. IRC §§ 32(c)(3), 152(c). The last two components of EITC eligibility — relationship and residency — can be particularly difficult to substantiate. National Taxpayer Advocate 2011 Annual Report to Congress 296, 304 (Most Serious Problem: *The IRS Should Reevaluate Earned Income Tax Credit Compliance and Take Steps to Improve Both Service and Compliance*).

65 This format, which serves as a prompt for the preparer by suggesting documents that might be appropriate substantiation, appeared for the first time on the 2012 version of the form.

66 These directions correspond to the requirements of Treas. Reg. 1.6695-2(b)(4) that the preparer submit with the return "A) A copy of the completed Form 8867 (or successor form); (B) A copy of the completed Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section); and (C) A record of how and when the information used to complete Form 8867 (or successor form) and the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section) was obtained by the tax return preparer, including the identity of any person furnishing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 (or successor form) or the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section)."

67 The National Taxpayer Advocate first recommended that the IRS impose broader due diligence requirements on EITC return preparers in 2003 (see National Taxpayer Advocate 2003 Annual Report to Congress 36 (Most Serious Problem: *Earned Income Tax Credit Compliance Strategy*). She also in 2003 recommended that Congress amend IRC § 6695(g) to impose the same requirements the Treasury regulation now imposes. National Taxpayer Advocate 2003 Annual Report to Congress 272 (Legislative Recommendation: *Federal Tax Return Preparers: Oversight and Compliance*). The National Taxpayer Advocate renewed these recommendations over the years. *See, e.g*, National Taxpayer Advocate 2009 Annual Report to Congress 56 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*). We note, however, that attorneys, certified public accountants, enrolled agents, or enrolled actuaries, all of whom are regulated by the IRS, may not be willing to prepare returns that claim EITC because of the additional burden Treas. Reg. 1.6695-2(b)(4) and the revised Form 8867 imposes on them. To the extent regulated return preparers are unwilling to prepare returns claiming EITC, the returns may be prepared by unenrolled return preparers (*i.e.*, preparers with no recognized credentials to prepare returns and over whom the IRS does not have regulatory authority). *See Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. 2013); Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS is Enjoined from Continuing Its Efforts to Effectively Regulate Return Preparers, supra*.

CONCLUSION

IRC § 32(k) is a unique penalty provision because it permits the IRS to sanction taxpayers not only for the year they improperly claim EITC, but also for two subsequent tax years, whether or not the taxpayers become eligible for EITC in those later years. Because of its reach, the statute applies only where the taxpayer noncompliance was egregious or is attributable to a particular state of mind, *i.e.*, due to reckless or intentional disregard of the EITC rules. The IRS, by imposing — sometimes automatically — the ban on taxpayers who did not participate in the audit or who submitted documents demonstrating they believed they were entitled to the claimed EITC, does not act within the statutory confines. By not articulating the reason for imposing the ban and securing managerial approval, the IRS does not adhere to its own IRM and acts arbitrarily and capriciously.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Immediately suspend the application of IRM provisions (*e.g.*, IRM 4.19.14.6.1.5) that permit automatic imposition of the two-year EITC ban or require the taxpayer to show why the ban should not be imposed.
2. In collaboration and consultation with the National Taxpayer Advocate, include on the Treasury Guidance Priority List regulations that explain when the IRS should impose EITC bans.[68]
3. Revise, in consultation with the National Taxpayer Advocate, the IRM provisions on the two-year ban to take into account what is reasonable to expect of taxpayers who claim EITC. At a minimum, before imposing the two-year ban, examiners should be required to:
   a. Attempt to speak with the taxpayer;
   b. Determine whether the substantiation the taxpayer submitted is probative of the EITC claim or shows a sincere effort to prove the elements of EITC, even if the documentation is not listed in the IRM as acceptable substantiation or the documentation is insufficient, and
   c. Consider the role, if any, of a paid preparer in claiming disallowed EITC.
4. Conduct quality reviews of every case in which the IRS proposes to impose the two-year ban. One hundred percent quality reviews should continue for at least three years and until the IRS's failure to adhere to the terms of the statute and the IRM is corrected.

68 The Treasury Department's Office of Tax Policy and the IRS use the Annual Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. See IRM 32.1, Chief Counsel Regulation Handbook. The National Taxpayer Advocate's proposal that guidance to determine whether EITC was claimed in "reckless or intentional disregard of rules and regulations" for purposes of IRC § 32(k)(1)(B)(ii) be included in the 2013-2014 Guidance Priority Plan was not adopted. *See* 2013-2014 Priority Guidance Plan, *available at* http://www.irs.gov/uac/Priority-Guidance-Plan (Aug. 9, 2013).

MSP #10 INDIAN TRIBAL TAXPAYERS: Inadequate Consideration of Their Unique Needs Causes Burdens

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage & Investment Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division
Sunita B. Lough, Commissioner, Tax-Exempt & Government Entities Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

In filing season 2013, an IRS filter wrongly flagged Indian tribal member returns as fraudulent due to common filing characteristics that the IRS has identified as indicators of fraud. This error in tax administration is symptomatic of the IRS's failure to recognize legitimate geographic, economic, and cultural circumstances of a unique taxpayer population. Although the National Taxpayer Advocate's 2008 Annual Report to Congress applauded IRS outreach to Indian Nations as exemplary, it is unclear if all IRS functions are responsive to their needs. In certain cases, IRS operating divisions (ODs) remain unaware of the particular characteristics and needs of Indian taxpayers, potentially resulting in unnecessary contact with the IRS and unwarranted audits, taxes, or penalties. Particular concerns relate to the IRS's:

- Improper treatment of tribal distributions;
- Misunderstanding of Native American family structure;
- Ignorance of tribal sovereignty;
- Delays in processing of certain settlement awards; and
- Failure to publish legal guidance for tribes.

In guidance posted on an internal web page, the IRS Indian Tribal Government (ITG) function advises employees to seek help from a TAS Local Taxpayer Advocate (LTA) when an OD fails to respond to an issue within ITG's jurisdiction or expertise. While LTAs welcome referrals, when one function routinely seeks assistance in relaying taxpayer needs to another function, the issue extends beyond case-by-case resolution.

ANALYSIS OF PROBLEM

Indian Tribal Taxpayers Have Unique Status.

Indian tribes have a unique status in federal tax law.[1] In some respects, tribes have a level of sovereignty similar to that of the 50 states, which are not subject to tax on their income.[2] Historically, the Supreme Court classified tribes as domestic dependent nations.[3] The Internal Revenue Manual (IRM) sets forth the following overview of tribal sovereignty.[4]

The Internal Revenue Manual Gives an Overview of Tribal Sovereignty.

The U.S. government has a unique legal relationship with Indian tribal governments as set forth in the Constitution, treaties, statutes, and court decisions. Congress may limit the authority of Indian tribes, but within those limits the tribes retain "attributes of sovereignty over both their members and their territory."[5] Tribal government powers include the authority to choose the form of government, determine tribal membership, regulate tribal and individual property, levy taxes, establish courts, and maintain law and order. Generally, Indian tribes provide governmental services, such as transportation, education, and medical care to tribal members.

Although Congress can limit tribal powers of sovereignty, the states cannot. The general rule in the field of Indian law is that unless there is specific delegation of authority provided by Congress, laws do not apply to Indians on reservations. Thus, Indian tribes are "semi-sovereign" entities, or "distinct, independent political communities" within the borders of the states in which they reside. Their sovereign powers can be limited or defined by an act of Congress or, in some cases, those powers may have been implicitly lost when tribes became subject to overriding federal sovereignty. On the other hand, the laws of any state can have but limited effect on Indian residents of reservations, or on the exercise of tribal sovereign power within reservations.[6]

---

1 According to expert sources, both American Indian and Native American are acceptable terms, although the latter tends to encompass Native Alaskans and Hawaiians as well as Indians *per se*. While each term may connote subtle nuances, authors may use them interchangeably. *See* Kathryn Walbert, American Indian vs. Native American: A Note on Terminology (Univ. of N.C. – Chapel Hill), http://www.learnnc.org/lp/editions/nc-american-indians/5526 (last visited May 6, 2013); Peter d'Errico, Native American Indian Studies: A Note on Names (Univ. of Mass. – Amherst), http://www.umass.edu/legal/derrico/name.html (last visited May 6, 2013); Nat'l Museum of the Amer. Indian, What Is the Correct Terminology: American Indian, Indian, Native American, or Native? (Smithsonian Inst.), http://nmai.si.edu/explore/forfamilies/resources/didyouknow/#2 (last visited May 6, 2013); Native Amer. Rights Fund, Why Are Indians Sometimes Referred to as Native Americans?, http://www.narf.org/pubs/misc/faqs.html (last visited May 6, 2013); Utah Div'n of Indian Affairs, American Indian vs. Native American: Which Is The Proper Term?, http://indian.utah.gov/faq/indian_heritage.html (last visited May 6, 2013).

2 *See* 10th Amend. to U.S. Const.; IRS Pub. 963, Federal-State Reference Guide.

3 *See Cherokee Nation v. Georgia*, 30 U.S. 1 (1831). Further, lands reserved by tribes are defined by statute as Indian Country. *See* 18 U.S.C. § 1151; IRM 4.86.1.1.1(2), *Who We Are* (June 1, 2006); IRM 4.86.1.3(2), *Other Tribal Contacts* (June 1, 2006). "**Indian Country** is a multifaceted term that historically has been used as a geographical designation, as a legal term, and as a cultural concept that encompasses the past, present, and future of American Indian people. It embodies the idea that there is 'a place' for Indians. The existence of Indian Country, through the many evolutions of that term, represents an acknowledgment and agreement that Indian people will survive. It is a concession to the notion that the melting pot is not everyone's idea of the American dream, and that many Indian people desire to live in that place they call Indian Country." *Gale Encyclopedia of U.S. History*, *available at* http://www.answers.com/topic/indian-country#ixzz2TCAIJZCq (last visited July 31, 2013). *See also* Stephen W. Silliman, *The 'Old West' in the Middle East: U.S. Military Metaphors in Real and Imagined Indian Country*, 110 American Anthropologist 237 (2008), *available at* http://www.faculty.umb.edu/stephen_silliman/articles/oldwestinmiddleeast.pdf (last visited July 31, 2013); Rob't Imrie, *Tribes Angered by General's Reference to Enemy Land as Indian Country*, Associated Press (Feb. 21, 1991), *available at* http://www.apnewsarchive.com/1991/Tribes-Angered-By-General-s-Reference-to-Enemy-Land-as-Indian-Country-/id-ce150feb55e4a9058c307295efc07f4a (last visited July 31, 2013).

4 The following passage is taken from IRM 4.86.1.5, *Tribal Sovereignty Overview* (Jan. 1, 2003).

5 IRM 4.86.1.5, *Tribal Sovereignty Overview* (Jan. 1, 2003) (quoting *U.S. v. Mazurie*, 419 U.S. 544, 557 (1975)).

6 IRM 4.86.1.5, *Tribal Sovereignty Overview* (Jan. 1, 2003) (citing Mary B. Magnuson, *Indian Legal Issues*, Minn. Inst. of Legal Educ'n (1995)).

Over the years, presidents have issued executive orders that directed federal agencies, to the extent permitted by law, to "respect Indian tribal self-government and sovereignty, honor tribal treaty and other rights, and strive to meet the responsibilities that arise from the unique legal relationship between the Federal Government and Indian tribal governments."[7]

The IRS Should Follow the Indian Tribal Government Function (ITG) in Exercising Cultural Sensitivity.

The ITG function, which operates within the Tax-Exempt/Government Entities Operating Division (TE/GE), addresses tribal employment, programs, trusts, businesses, and distributions to individual members. While the 2008 Annual Report to Congress praised the exemplary outreach conducted by ITG toward its customers, it is unclear if the function has received cooperation within the IRS.[8] On the contrary, ITG and TAS staff have heard IRS employees utter culturally insensitive remarks to tribal people. An IRM provision that directs IRS employees to follow ITG protocol when contacting tribes could establish a model for consultation of the ITG function within the IRS.[9] While the ITG function focuses on tribal entities:

> There may be times when it is unclear who should be controlling a situation, such as in the examination of a tribal leader's personal income tax return or the examination of a large number of tribal members. When coordination efforts between divisions do not resolve a tribal issue, Taxpayer Advocate Service referrals should be considered as a potential avenue of resolution when certain criteria are met.[10]

Accordingly, the IRS, led by TAS and ITG, should train campus and field compliance employees about tribal issues. Jointly, federal agencies have produced an online course containing a "Cultural Orientation" module that could counteract reported insensitivity.[11]

Tribal Members Confront Issues Different from Those of the Overall Taxpayer Population.

Indian taxpayers may confront IRS misunderstandings and delays relating to issues such as tribal distributions, presumed fraud or frivolous positions, family relations, settlement awards, and health coverage. As these issues are reflected on individual returns, they would be processed by ODs rather than the ITG function which focuses on Native American issues. Consequently, individual Indians may have to reinvent the wheel to resolve systemic problems on a case-by-case basis. It would be more efficient for the IRS to establish a cross-functional working group on issues of Indian individuals, parallel to the ITG function that focuses on tribal entities.

---

7 *Id*. (quoting Exec. Ord. No. 13175, 65 Fed. Reg. 67249 (Nov. 6, 2000)).

8 National Taxpayer Advocate 2008 Annual Report to Congress 99-100 (footnotes omitted): "Another example of outstanding service is the IRS's Office of Indian Tribal Governments outreach to Indian Nations. During 2008, the office conducted 85 events with a total attendance of more than 3,600 customers. The office also offered large-scale workshops for 227 Alaskan tribal villages and 112 Navajo villages. Services include educational workshops on Title 31, employment tax forms, tip reporting, employment taxes, the Earned Income Tax Credit (EITC), information reporting, and gaming issues. VITA also held sessions at seven events. The IRS should follow the Office of Indian Tribal Governments' model in targeting and bringing programs to other taxpayer populations."

9 *See* IRM 4.86.1.2, *Protocol for Contacting Tribes* (Jan. 1, 2003).

10 *See* IRM 4.86.1.1.3, *Coordination Between Divisions* (July 28, 2008).

11 *Working Effectively with Tribal Governments*, *available at* http://tribal.golearnportal.org/return.php (last visited July 31, 2013).

While the IRS recently issued various pieces of guidance helpful to Indian individuals, major projects remain outstanding, especially those applicable to tribal entities. The resulting uncertainty can sustain a chilling effect on tribal enterprise, distorting economic opportunities.

The IRS Has Treated Tribal Distributions Improperly.

Tribes may distribute funds, such as tax-exempt revenue of the tribe, to individual members. IRS compliance functions consistently subject tribal distributions, that are not from work, to self-employment tax apparently due to misinterpretation of Form 1099, *U.S. Information Return*. For federal tax purposes, these amounts may constitute income, but it is unclear why they would be treated as self-employment earnings. The TE/GE intranet includes a form instructing ITG staff to advise IRS campuses that such distributions are not an individual's self-employment earnings, and to file Form 911, *Application for Taxpayer Assistance Order*, with the LTA if a campus does not comply.[12]

While TAS is pleased that the ITG function shows concern by referring problems for resolution, this approach all but concedes that Automated Underreporter (AUR, the IRS program that processes information returns) may have a harmful effect, and at worst, may discriminate against a particular taxpayer population. For tax year 2011, TAS has identified in LTA inventory at least 42 cases where the IRS inaccurately assumed that a tribal member's Form 1099 was incorrect, either because the withholding amount apparently did not meet expected parameters or otherwise. The data reveal an underlying systemic issue that the IRS should be trying to resolve.

The IRS Has Filtered Returns Inaccurately.

In the 2013 filing season, an IRS filter wrongly flagged returns of tribal members as fraudulent presumably because their characteristics, such as certain mail delivery patterns, happened to resemble those in a fraudulent scheme.[13] This error in tax administration is symptomatic of IRS failure to recognize legitimate geographic, economic, and cultural circumstances of a unique taxpayer population, and to program IRS systems to avoid false positives that have a disparate impact on that population. Given that the IRS routinely changes filters to reflect characteristics of the filing population, this experience should afford an opportunity for greater accuracy in the future. To avoid repeating past mistakes, IRS functions (such as Wage & Investment Pre-Refund, AUR, Automatic Substitute for Return (ASFR), Correspondence Exam, and Field Exam) should consult ITG before implementing filters or similar programs that could erroneously target Indian taxpayers.

The IRS May Misunderstand Native American Family Structure.

Eligibility for various tax benefits may depend on family relations as documented by the taxpayer. However, some Native American families do not fit the standard family structure. Last year, the National Taxpayer Advocate proposed a Legislative Recommendation to recognize children with special needs adopted under tribal law, as the tax law recognizes only those adopted under state law.[14] Generally, the Internal Revenue Code (IRC) allows a credit to parents who adopt children, with a larger amount for

12 See http://tege.web.irs.gov/article.asp?category=tege&title=mytege-ge-itg-government-functions&path=/my-tege/4_govt-entities (last visited Apr. 26, 2013).

13 The IRS uses statistical and other criteria, commonly known as filters, to segregate returns into treatment streams. *See generally* IRM 4.1.3, *Sources of Returns-Priority Programs-DIF and Ordering* (Aug. 10, 2012).

14 See National Taxpayer Advocate 2012 Annual Report to Congress 520 (Legislative Recommendation: *Amend the Adoption Credit to Acknowledge Jurisdiction of Native American Tribes*).

a child who has special needs relating to ethnic background, age, membership in a minority or sibling group, or a medical condition.[15] However, the tax law allows only a state to certify special needs.[16] In specified circumstances, the tax law treats a tribe as a state, but unfortunately the adoption credit is not a specified provision.[17]

Similar legislative or administrative misapprehensions of Indian households, which can consist of multiple generations living together, may arise in the context of filing status, the child tax credit, Earned Income Tax Credit, dependency deduction, or otherwise.[18] The IRS has recognized unique circumstances of tribal members in informal guidance on "Alternative Documentation for Native Americans," which lists tribal — rather than state — documents acceptable for identifying qualifying children.[19] Such informal guidance deserves to be codified in the IRM.

The IRS May Display Ignorance of Tribal Sovereignty.

TAS is aware of cases in which tribal members who may have misunderstood federal tax requirements tell the IRS that they are members of sovereign nations. In response, the IRS asserts a penalty for a frivolous position.[20] While certain allegations of sovereignty may be frivolous, Indian tribes are sovereign entities.[21] In good faith, the taxpayer may have made a true statement that was simply inapplicable to an individual return. Thus, a tribal member's statement about sovereignty may not reflect a desire to delay or impede the administration of federal tax laws within the meaning of the penalty provision. The IRS should clarify that not all statements about sovereignty deserve a frivolous penalty.

The IRS May Delay Processing of Keepseagle Awards.

In 2011, the U.S. Department of Agriculture (USDA) settled a class action lawsuit, known as *Keepseagle,* for discrimination against Indian borrowers in the Farm Loan Program.[22] Under the settlement, 4,200 "Track A" individuals received up to $50,000 each in 2012; 170 "Track B" individuals received up to $250,000 each.[23] In addition, USDA forgave outstanding debt and remitted to the IRS amounts to cover the taxes on the awards, including the forgiveness. In general, forgiven debt constitutes income, with exceptions for insolvent taxpayers, among other cases.[24] TAS is aware of *Keepseagle* cases in which the IRS has not credited USDA remittances to taxpayers' accounts. In addition, taxpayers who claim the insolvency exception may face refund delays pending IRS verification of insolvency.[25] In this case, taxpayers

15 *See* IRC § 23(d)(3).

16 *See id*.

17 *See* IRC § 7871.

18 *See* IRC §§ 2, 24, 32, 151.

19 *See* Service-wide Electronic Research Program (SERP) Alert W 04158 (Mar. 4, 2004).

20 *See* IRC § 6702.

21 *Compare* Rev. Rul. 2007-22, 2007-1 C.B. 866, with IRM 4.86.1.5, *Tribal Sovereignty Overview* (Jan. 1, 2003).

22 *See Keepseagle v. Vilsack*, No. 1:99CV03119 (D.D.C. 2011).

23 *See* Nat'l Cong. of Amer. Indians, *Protect Native Money Update* (Jan. 30, 2013), *available at* http://www.ncai.org/protectnativemoney (last visited July 31, 2013).

24 *See* IRC § 108.

25 *See* IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*.

While the ITG function conducts exemplary outreach, other IRS organizations remain unaware of particular characteristics and needs of Indian individual and tribal taxpayers. This lack of awareness could result in unnecessary contact with the IRS and unwarranted auditing, taxation, or penalties.

may need assistance in submitting the required information.[26] The IRS should render assistance as required, after consultation and collaboration with TAS.

Patients of the Indian Health Service Should Be Exempt from the Affordable Care Act.

The Affordable Care Act (ACA) requires individuals to obtain health insurance or pay a tax.[27] This individual requirement excepts various people, such as those experiencing hardship — as determined by the Department of Health & Human Services (HHS) — as well as Indians, who may receive tribal health care.[28] Technically, the latter exemption covers members of federally-recognized tribes, a category that covers only a portion of the Native American and Alaska Native population, excluding some patients of the federal health care providers such as the Indian Health Service (IHS), which is available to those of Indian descent, even if not enrolled in a recognized tribe.[29] Commentators have complained that penalties should not apply to patients of the IHS or similar services.[30] In response, HHS expanded the hardship exemption to cover those patients, explaining that "HHS does not have the legal authority to modify through regulation the statutory definitions of 'Indian' as referenced in the Affordable Care Act… Any changes to the definition must be legislative."[31]

Tribes Need Legal Guidance.

While the IRS recently issued various pieces of guidance helpful to Indian individuals, major projects remain outstanding, especially those applicable to tribal entities. The resulting uncertainty can sustain a chilling effect on tribal enterprise, distorting economic opportunities.

In particular, integral part regulations, which would offer guidance to tribal entities, have been pending for six years. Historically, a series of IRS rulings has exempted from tax certain entities that are integral parts of governments, which as such are themselves tax-exempt.[32] This patchwork of rulings could affect a variety of entities, including recent forms such as charter schools, as well as enterprises of tribes. In view of the uncertainty of this law with potential economic impact, the Priority Guidance Plan (PGP) annually co-signed by the Commissioner of Internal Revenue, IRS Chief Counsel, and Treasury Assistant Secretary (Tax Policy) has promised, every year since 2007, regulations setting forth criteria for treating an entity as an integral part of a state, local or tribal government.[33] Yet the IRS has issued no such guidance.

26 *Cf.* National Taxpayer Advocate 2008 Annual Report to Congress 39 (Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*), 391 (Legislative Recommendation: *Simplify the Tax Treatment of Cancellation of Debt Income*); 2007 Annual Report to Congress 13 (Most Serious Problem: *Tax Consequences of Cancellation of Debt Income*).

27 IRS, Affordable Care Act (ACA) Tax Provisions, *at* http://www.irs.gov/uac/Affordable-Care-Act-Tax-Provisions-Home.

28 *See* IRC § 5000A(e).

29 *See* Indian Health Serv., *Indian Health Man*. 2-1.2, *available at* http://www.ihs.gov/IHM/index.cfm?module=dsp_ihm_pc_p2c1#2-1.2 (last visited Aug. 1, 2013).

30 *See* Assoc. Press, *Some Native Americans May Be Penalized Under ACA* (May 15, 2013), *available at* http://www.cbsnews.com/8301-204_162-57584676/ap-some-native-americans-may-be-penalized-under-affordable-care-act/ (last visited Aug. 1, 2013).

31 78 Fed. Reg. 39,501 (July 1, 2013); *see also* IHS Press Release, Administration Renews Commitment to American Indians and Alaska Natives (June 26, 2013), *available at* http://www.ihs.gov/newsroom/pressreleases/2013pressreleases/renewcommitment/ (last visited Aug. 8, 2013); *cf. infra* Legislative Recommendation: *Premium Tax Credit: Lower the Affordability Threshold*.

32 *See* Ellen Aprill, *The Integral, the Essential, and the Instrumental*, 23 J. Corp. L. 803 (1998).

33 *See* IRS Priority Guidance Plans, *available at* http://www.irs.gov/uac/Priority-Guidance-Plan (last visited Aug. 2, 2013).

On a related topic, the IRS declined to issue guidance on corporations chartered under tribal law. For federal tax purposes, corporations chartered under state law are corporations, but the status of those chartered under tribal law is unclear.[34] From 2001 to 2007, a PGP commitment to guidance on this topic turned into another broken promise. By way of explanation, tribal corporations could be subsumed under integral part regulations if the IRS completes those regulations.

Nevertheless, the IRS recently issued guidance helpful to tribal members, responding in part to a long-standing executive order that memorializes a U.S. government commitment to consultation with tribes.[35] Significant publications include:

- *General Welfare Exclusion*. Under an administrative doctrine harking back at least to the New Deal era, the IRS has excluded from income government payments to needy individuals. Notice 2012-75 proposes guidance on applying this general welfare exclusion to tribal programs, specifically creating a safe harbor where individual need may be unclear (*e.g.* payments to attend pow-wows).[36] Upon consideration of public comments, the IRS should finalize this guidance.
- *Indian Gaming Regulatory Act (IGRA) Trusts.* Under IGRA, tribes may set aside *per capita* payments derived from tribal-owned enterprises (such as casinos) for children (and other legal incompetents) in trust. In general, trust deposits are income when the beneficiary obtains control of the money.[37] As set forth in prior guidance, judicial (and regulatory) doctrines of constructive receipt (or economic benefit) may allow deferral of inclusion in income when the beneficiary's control is subject to substantial limitations or restrictions, such as claims of the tribe's creditors.[38] Recent guidance maintains deferral while clarifying that trustees may make staggered distributions to beneficiaries at different ages or upon the occurrence of specific events rather than distributing all the trust assets when the beneficiary attains a specified age, broadening the class of survivors who may inherit a beneficiary's trust interest, and modifying trustees' discretion to make health and welfare distributions.[39]
- *Tribal Trust Settlements.* In 2012, the U.S. settled major litigation in which tribes complained that federal agencies had historically mismanaged property that the government holds in trust for tribes. Consequently, the U.S. agreed to pay more than $1 billion to tribes, which may in turn make *per capita* payments to members. Recent IRS guidance clarifies that *per capita* payments are excluded from members' income to the extent attributable to the settlement, while interest earned after transfer to the tribe would be included.[40]

34 *See* Karen Atkinson & Kathleen Nilles, *Tribal Business Structure Handbook* (Dep't of the Interior, 2008), Ch. III, http://www.irs.gov/pub/irs-tege/tribal_business_structure_handbook.pdf.

35 *See* Exec. Ord. 13,175, 65 Fed. Reg. 67,249 (Nov. 9, 2000); supplemented by Pres. Memo. 74 Fed. Reg. 57,879 (Nov. 5, 2009); implemented by O.M.B. Memo. M-10-33 (July 30, 2010).

36 2012-2 C.B. 715 (Dec. 5, 2012).

37 *See* Treas. Reg. § 1.451-2.

38 *See* Rev. Proc. 2003-14, 2003-1 C.B. 319.

39 *See* Rev. Proc. 2011-56, 2011-2 C.B. 834.

40 *See* Notice 2013-55, 2013-38 I.R.B. 207; Notice 2013-1, 2013-3 I.R.B. 281; Notice 2012-60, 2012-41 I.R.B. 445.

CONCLUSION

While the ITG function conducts exemplary outreach, other IRS organizations remain unaware of particular characteristics and needs of Indian individual and tribal taxpayers. This lack of awareness could result in unnecessary contact with the IRS and unwarranted auditing, taxation, or penalties. Informal and published guidance could direct IRS employees to consult the ITG function or otherwise account for special considerations surrounding Native American individuals and tribal governments.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Train all compliance employees about the culture and needs of Native American taxpayers, rendering assistance as required by this population, after consulting with and referring taxpayers to TAS when necessary.[41]
- Establish a cross-functional working group on issues of Indian individuals, parallel to the ITG function which focuses on tribal entities.
- Consult with the ITG function before implementing filters or similar programs (such as those operated by Wage & Investment Pre-Refund, AUR, ASFR, Correspondence Exam; Field Exam) that could have the effect of erroneously targeting Indian taxpayers.
- Correct procedures that result in routine failure to comply with ITG directives.
- Finalize guidance on tribal documentation of qualifying children, frivolous claim penalties, integral parts of governments including tribal corporations, general welfare exclusion of tribal distributions, and other questions as they arise.

41 *Cf.* National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*); 2009 Annual Report to Congress, vol. 2, § 4, 75 (Research Study: *Running Social Programs Through the Tax System*).

MSP #11 COLLECTION STRATEGY: The Automated Collection System's Case Selection and Processes Result in Low Collection Yields and Poor Case Resolution, Thereby Harming Taxpayers

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Automated Collection System (ACS) is a computerized inventory system that sends taxpayers notices demanding payment, issues liens and levies, and answers telephone calls in an effort to resolve balance due accounts and delinquencies.[1] ACS collects tax largely by offsetting taxpayers' refunds, and eliminates much of its inventory by passing cases to other parts of the IRS:

- In fiscal year (FY) 2013, ACS collected approximately $5.4 billion on open Taxpayer Delinquent Accounts (TDA).[2] However, $2.5 billion (about 47 percent) of this amount came through automatic refund offsets, which are generally not attributable to ACS employees' direct efforts.[3]
- While collections on open TDA accounts totaled $5.4 billion, ACS transferred approximately three times as much — $16.1 billion — in unresolved tax liabilities to other IRS collection inventory, *i.e.,* the Queue, the Collection Field function (CFf), or Shelved Inventory.[4]

ACS's failure to resolve cases is due in part to approach to working cases and the types of cases it is assigned.[5] More specifically:

- Rather than applying the appropriate type of contact for each type of taxpayer, ACS generally relies on notices of intent to levy or systemically generated levies, which are often not effective. For instance, in FY 2013 the ACS received 2,889,971 new taxpayer cases and issued 1,216,302 levies, averaging almost one levy for every two cases received.[6] Although this is still a high number of levies, it is about 46 percent lower than in FY 2012.[7] Despite this substantial reduction, ACS's overall collections actually increased for the latter period. This result is not surprising, based on a TAS

1 The ACS call center assigns incoming calls to contact representatives or tax examiners who work with taxpayers. ACS's telephone call center is designed to get taxpayers into the phone-based system as quickly as possible by sending them to the first available contact representative or tax examiner who can assist them, regardless of where the assistor is located geographically.

2 TDAs are collection accounts that remain unresolved at the conclusion of the collection notice process and have been designated for additional collection activity, *e.g.*, ACS or the Collection Field function (CFf). A taxpayer may have multiple TDAs (*e.g.*, one for each delinquent tax period).

3 IRS Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). In FY 2013, the IRS collected $2.8 billion of the $5.4 billion through taxpayers making full or partial payments on their delinquent accounts.

4 *Id.* The Queue is a holding inventory where collection cases sit, usually after being in ACS, and before being assigned to the CFf or reassignment to ACS. Cases sit in the Queue based on business rules and available resources. Shelved Inventory means accounts that are not being worked due to resource limitations. The CFf is predominantly staffed by revenue officers who make field contact with taxpayers, secure delinquent returns and financial information, initiate installment agreements, and take enforcement action including liens, levies, and seizures of property.

5 National Taxpayer Advocate 2012 Annual Report to Congress 381.

6 IRS Collection Activity Report, NO-5000-24, *Levy & Seizure Report* (Sept. 2013).

7 In FY 2012, ACS received 2,758,926 new taxpayer cases and issued 2,247,168 levies. The decrease from FY 2012 to FY 2013 likely results from the IRS's decision to dedicate three ACS call sites to Accounts Management call center duties this past filing season.

review of ACS cases that found about 75 percent of levies were unproductive (*i.e.,* did not attach to a payment source).[8]

- Several studies show that letters and phone calls are superior to levies in generating a response and collecting outstanding tax.[9] In one IRS study, the rate of response from taxpayers after receiving letters was nearly three times greater than the rate for those who received levies.[10] A recent study showed that an expanded use of predictive dialer calls that were connected to live assistors generated a 45 percent contact rate.[11]
- Some types of cases are more suitable to ACS treatment than others. For instance, in FY 2013, only four percent of the cases processed through the Wage and Investment (W&I) division's ACS were sent to the Queue, while Small Business/Self-Employed division (SB/SE) ACS, which receives many employment tax cases, transferred 31 percent.[12]

An ACS collection strategy that places less emphasis on levies and instead identifies which taxpayers would best respond to other collection approaches, and initiates that approach early in the life of the debt, would yield effective contacts and better case resolutions. Further, an early intervention strategy in which the IRS first attempts to talk to the taxpayer by making an outgoing call or sending a notice, and then considers whether a levy is appropriate, would reduce the risk of placing the taxpayer in economic hardship, which could endanger the taxpayer's health or a business's viability. In addition, this approach would prevent the liability from growing to an amount that cannot be resolved and reduce the need for more extreme collection measures.

ANALYSIS OF PROBLEM

Background

ACS Is the IRS's Collection Call Center.

When a delinquent account is not resolved through the normal notice process, the IRS typically assigns it to the ACS.[13] Cases are assigned to contact representatives or tax examiners. If the accounts remain unpaid or unresolved in ACS, they are transferred to the Collection Queue or to the Collection Field function. If a case moves to the Queue, the IRS makes little attempt to stay in contact with the taxpayer, unlike other creditors such as credit card companies that send regular notices.

When in ACS, taxpayers will often find themselves subject to a lien or levy. In cases where a levy source is available, one of ACS's first actions is usually to send out a *Final Notice of Intent to Levy and Your Notice of*

8 TAS reviewed 579 taxpayers in ACS.

9 ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000).

10 *Id*. This only included levies and Letters 16 that were presumed to reach the taxpayer (*i.e.*, did not come back as undelivered).

11 Predictive Dialer Test – ACS Accounts, Wage and Investment, Research and Analysis (May 2013). The 45 percent response rate is for accounts where a call was made and a letter sent. However, when just a call was made on the account the response rate was 37 percent. A predictive dialer is a telephone control system that automatically calls a list of telephone numbers in sequence, screening out no-answers, busy signals, answering machines and disconnected numbers and predicting when a live person will answer the call.

12 IRS Collection Activity Report NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

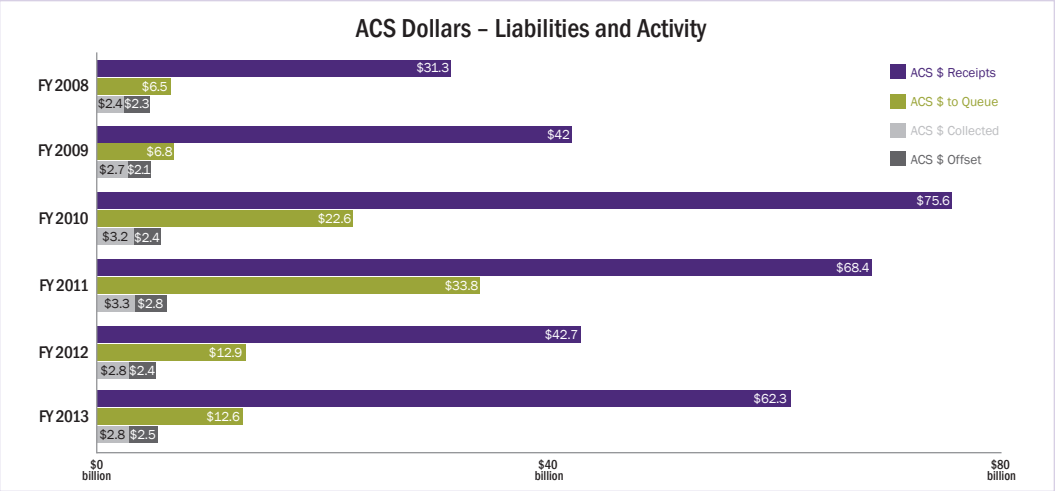
13 Internal Revenue Manual (IRM) 5.19.5.1 (Mar. 6, 2009); IRM 5.19.5.2 (Dec. 1, 2007). When a case is assigned to ACS it may take steps to issue a lien or levy against the taxpayer or send the taxpayer one of the following letters: Letter 16, *Please Call us About Your Overdue Taxes or Tax Return*; Letter 99, *Please Call Us About Your Overdue Taxes or Tax Returns*; Letter 40, *Advisory Notice to Taxpayer of Need to Contact Third Parties*; Letter 11, *Final Notice, Notice of Intent to Levy and Your Notice of a Right to a Hearing*.

a Right to a Hearing, rather than trying to contact the taxpayer through an outgoing call. ACS employees spend only about two percent of all their direct time making outbound calls.[14]

ACS Performance

ACS is not using the most effective methods for resolving cases and collecting liabilities. Over the past six years, ACS has consistently collected a modest percentage of dollars placed in its inventory, and almost half of those dollars came through computer-generated refund offsets, which are not part of ACS employees' direct efforts. Rather than collecting the outstanding liabilities, ACS has routinely transferred a large percentage of its inventory to the Queue or Shelved Inventory where penalties and interest continue to accrue. The chart below details ACS's performance.

FIGURE 1.11.1, ACS Activity by Fiscal Year



The IRS should reassess its ACS collection strategy, which relies almost exclusively on its enforcement power (*i.e.*, issuing a lien or levy) to establish contacts with delinquent taxpayers. The IRS's own studies show a more conscientious and intentional (as opposed to automatic) use of liens and levies, outgoing phone calls, regular reminders of payment due, and "soft" notices to specific segments of taxpayers would be more effective.

ACS's Overreliance on its Levy Authority Is Counterproductive.

A recent study indicates ACS's current practice of relying primarily on its levy authority to generate taxpayer contacts may not maximize case closures. The SB/SE Denver ACS study reviewed 72,770 TDA cases that were in SB/SE ACS, and were closed during May of 2011 either as:

1) Fully Satisfied;

2) Taxpayer entered into an installment agreement (IA); or

14 IRS response to TAS research request (Oct. 24, 2012). In FY 2012, the percentages of ACS employees' direct time spent making outgoing calls on cases were 2.4 percent for SB/SE and 2.0 percent for W&I. A Treasury Inspector General for Tax Administration (TIGTA) report showed SB/SE ACS as spending 62 percent of its time answering incoming calls, 35 percent of its time working correspondence and research on accounts, and three percent of its time making outbound calls. For W&I ACS, 74 percent of its time was spent answering incoming calls, 24 percent of its time was spent working correspondence inventory and research accounts, and two percent making outbound calls. TIGTA, Ref. No. 2010-30-046, *More Management Information Is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010).

3) The liability was currently not collectible (CNC).[15]

To determine what actions led to these case closures, the study reviewed actions taken during the 180 days prior to closure. The study showed that out of the 72,770 TDA cases closed in May of 2011, 25,657 (or 35 percent) had a levy action taken 180 days prior to closure.[16] In other words, the levy action contributed directly to closure in only those 25,657 cases. Despite the fact that levies were only responsible for closing 35 percent of the cases, a primary recommendation of the report was for ACS to issue even more levies to close cases.

A significant omission of the SB/SE Denver ACS study was that it did not consider levies issued during the 180-day period that did not result in a case closure (*i.e.*, unproductive levies). However, TAS did conduct such an analysis in a separate review of a statistically representative sample of 579 ACS cases that were in ACS inventory from about mid-2012 to mid-2013, and found most ACS levies are unproductive. In the analysis of the 579 ACS cases, 227 were issued a levy, but only 56 of these levies (or about 25 percent) were productive (*i.e.*, attached to a revenue source).[17] The remaining 75 percent of levies were unproductive, and possibly discouraged the taxpayer from contacting ACS.

Reliance on ACS Enforcement Powers Can Cause Economic Hardship to Taxpayers and Unnecessarily Tie Up IRS Resources.

ACS's tendency to rely heavily on its levy authority can produce severe consequences for the taxpayer and the IRS alike. For instance, when ACS issues a levy without first attempting to contact the taxpayer, it risks causing economic hardship. Once a taxpayer has shown hardship, the IRS is required by law to release that levy, creating unnecessary work for the IRS.[18] Not only do these levies unnecessarily harm the taxpayer, but the release process unnecessarily ties up IRS resources in resolving problems that could have been avoided altogether. Both the taxpayer and the IRS would be better served if the IRS designed its collection action to be "no more intrusive than necessary."[19] It can do this by attempting to ensure upfront that the levy is the best way to collect the tax and that all other methods of collection, including outgoing calls, are ineffective.

ACS Can Limit its Use of Levies, Reducing Harm to Taxpayers without Reducing Dollars Collected.

ACS's most recent performance supports the premise that more levies do not necessarily translate into more dollars collected. For example, in FY 2013, ACS issued approximately 1.2 million levies, a

15 ACS Closed Case Actions Project DEN0181, SB/SE Research (Aug. 2012). Fully Satisfied applies to cases that were resolved by payment or abatement of assessed amounts. Installment agreements are not fully satisfied at time of closure and the case may reopen if the taxpayer does not keep the terms of the agreement. Cases closed as CNC have a balance due that is not being pursued.

16 Within 180 days of the levy being issued 25,657 cases were closed. Further, 12,455 of these cases were fully satisfied, 9,241 were put into IAs, and 3,961 were placed in CNC status.

17 TAS reviewed 600 taxpayers in ACS. The ACS sample was selected by extracting Individual Master File (IMF) and Business Master File (BMF) taxpayers assigned to ACS at some time from cycle 201230 forward (from mid-2012 to mid-2013). Taxpayers were determined to be assigned to ACS from the Accounts Receivable Dollar Inventory entity table. After identifying this population, a sample of 600 taxpayers was randomly selected. TAS was able to obtain information to complete 579 data collection instruments (DCI). The other 21 DCIs could not be completed. The random sample of 579 taxpayers has a 90 percent confidence level with about a five percent plus or minus margin.

18 IRC § 6343(a)(1)(D).

19 IRC § 6330(c)(3)(C). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 478 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*); National Taxpayer Advocate's Report to Acting Commissioner Daniel Werfel, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* (Nov. 4, 2013) at 2, 3; National Taxpayer Advocate 2011 Annual Report to Congress 493 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*).

When ACS issues a levy without first attempting to contact the taxpayer, it risks causing economic hardship.

reduction of about 46 percent from FY 2012.[20] This decrease likely results from the IRS's decision to dedicate three ACS call sites to Accounts Management call center duties this past filing season. Despite this substantial reduction in levy action, dollars collected on TDAs actually increased for the latter period.[21] Specifically, through FY 2013, the IRS reported collection revenue generated by ACS on TDAs as approximately $2.8 billion, an increase of about $25.5 million compared to 2012.[22] The fact that revenue secured through ACS operations did not suffer in light of the substantial decline in ACS levies indicates that levies are not the principal drivers of ACS collections, and that other, proactive collection treatments may prove more effective, and reduce unnecessary harm inflicted on taxpayers.

ACS Could Improve Its Case Resolution Rate by Increasing the Use of Notices and Phone Calls.

Although levies are an important tool for the IRS in addressing uncooperative, "won't pay" taxpayers, systemically generated levies will unnecessarily harm many taxpayers, while failing to collect the optimal amount of revenue. By relying on one collection method over others, ACS is ignoring one of its own studies that shows certain letters generate a higher response rate when compared to levies. Ignoring this study, and maintaining a collection strategy that relies heavily on levies, fails to achieve the highest possible response or resolution rate.

Kansas City Customer Service Site Study Conducted in 2000

In a 2000 study by the Kansas City customer service site, the IRS compared the effectiveness of letters and levy actions in generating a telephone response from the taxpayer.[23] The study was conducted by randomly pulling and analyzing 2,000 delinquent accounts that had one of the following actions:

1) Letter 11, *Final Notice, Notice of Intent to Levy and Your Notice of a Right to a Hearing*;[24]

2) Letter 16, *Please Call us About Your Overdue Taxes or Tax Return*;[25]

3) Letter 40, *Advisory Notice to Taxpayer of Need to Contact Third Parties*;[26]

4) Letter 99, *Please Call Us About Your Overdue Taxes or Tax Returns*;[27] and

20 IRS Collection Activity Report NO-5000-24, *Levy & Seizure Report* (Sept. 2013). In FY 2013, the field also issued fewer levies when compared to FY 2012, albeit it was not as significant of a decline as ACS's. Specifically, the CFf issued 11 percent fewer levies in FY 2013 when compared to 2012. IRS Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

21 This revenue is collected by the use of Collection resources. It includes levies, IAs, payments on collection notices, etc. It does not include refund offsets.

22 IRS Collection Activity Report No. 5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). The $2.8 billion collected on TDAs for FY 2013 does not include dollars collected through offsets. When offsets are included for FY 2013, $5.4 billion was collected. About $5.2 billion was collected for FY 2012 when including offsets, which means that ACS actually collected about $200 million more in FY 2013 than it did in FY 2012, despite the reduction in the issuance of levies.

23 *See* ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000). While not specified in the study, the sample size would generally yield results with a margin of plus or minus five percent at the 95 percent confidence level.

24 This letter is sent by certified mail with a return receipt and is required before the IRS can take any enforcement action.

25 This letter asks the taxpayer to call the IRS regarding overdue taxes or tax returns.

26 This letter advises the taxpayer that the IRS could be contacting a third party regarding a balance due and does not require a response. Even though it requires no response by taxpayers, the study found it was the most effective tool in prompting telephonic customer contact, because taxpayers were concerned that their neighbors or employers would become aware of their affairs. (This form letter is no longer in use.)

27 This letter is the same as Letter 16, but mailed out when a new case comes to ACS.

5) Levy.[28]

The 2,000 TDAs were broken up into five groups of 400 (one group of 400 for each of the letters and levies).[29] The sample consisted of TDAs for which the letter or levy had been outstanding for at least 45 days.[30]

This study concluded, "[a]ny of the four letters sent prompted a higher rate of telephone response from the taxpayer than levy action." More specifically, the response rate for levies was about 13 percent, while the response rate for Letter 16, *Please Call Us About Your Overdue Taxes or Tax Return*, was nearly 37 percent, and all letters had a response rate over 30 percent.[31] Further, the study concluded that ACS could increase the effectiveness of its letters by securing better addresses, which could be done by enhancing its efforts to search for a last known address.[32] This step could have a significant impact as the study found about 29 percent of ACS letters were returned as undelivered.[33]

Although the finding that a levy notice was not the most effective way to generate a response from the taxpayer was significant, this was probably not the most important conclusion from the report. The key point was the significance of determining what type of action best generates a resolution. The study found that a case is twice as likely to close when a taxpayer responds to a letter.[34] This finding is consistent with TAS's review of ACS cases described above, which showed a case was resolved in 50 percent of cases where an ACS letter or phone call resulted in a contact with the taxpayer.[35]

The Kansas City study also found certain actions that generated a response led to case resolution more often than others. For instance, the study showed not only that taxpayers are less likely to respond to a levy action than letters, but that when taxpayers do respond to these actions, levy actions were less likely to lead to closed cases. When taxpayers responded by telephone to a levy, the IRS closed only 24 percent of their cases. Conversely, when taxpayers responded by telephone to a letter titled *Please Call Us About Your Overdue Taxes or Tax Returns,* 35 percent of the cases ended in closure. Moreover, only eight percent of the taxpayers who responded by telephone to a levy fully paid their accounts and only six percent entered into installment agreements. By comparison, 17 percent of taxpayers who responded by telephone to a letter paid in full and 12 percent entered into an IA.[36] Therefore, when crafting the best collection strategy, ACS's study shows that considering what action will most likely generate a response and a resolution to the case is critical.

28 After a Letter 11, *Final Notice, Notice of Intent to Levy and Your Notice of a Right to a Hearing*, has been sent, a levy is sent to both the levy source and the taxpayer. The levy sources may have been contacted on some of the cases in order to verify financial relationship with the taxpayer.

29 The sample was further divided to 200 of each for W&I and 200 each for SB/SE.

30 The data was captured in date increments to show the impact of letter mailing over the 30 days.

31 *See* ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000). This only included levies and Letters 16 that were presumed to reach the taxpayer (*i.e.*, did not come back as undelivered).

32 National Taxpayer Advocate 2009 Annual Report to Congress 221 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

33 *See* ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000).

34 ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000). Case closure actions include: full payment of the liability, the taxpayer has entered into an IA, case is CNC, case is in bankruptcy status, or the case has been sent to the Queue or CFf.

35 TAS reviewed a sample of 579 taxpayers who were assigned to ACS at some time from cycle 201230 forward (from mid-2012 to mid-2013).

36 ACS Telephone Response Study, Kansas City Customer Service Site (Mar.–Apr. 2000). Taxpayers were responding to Letter 99, *Please Call Us About Your Overdue Taxes or Tax Returns*.

A Predictive Dialer Study Showed that a Number of Taxpayers Are Best Reached by an Outgoing Call.

A recent study provides more evidence that methods more effective than levies are at ACS's disposal. In 2013, W&I Research and Analysis tested the effectiveness of the W&I ACS predictive dialer system.[37] The study showed that when a live person answers predictive dialer calls, and the number of attempted calls is not limited, the system generated a contact rate of up to 45 percent.[38] This far exceeded the response rate when only Letter 16, *Please Call us About Your Overdue Taxes or Tax Return*, was sent out to taxpayers, which was at most 17 percent. Further, the contact rate for the predictive dialer calls exceeds the results of ACS levies in the SB/SE Denver ACS study, discussed above, which showed a 25 percent productive contact rate.[39] The predictive dialer study also observed that predictive dialer calls where the number of attempts was not limited and live assistors operated the line generated a "significantly higher proportion of contacts," and a "significantly higher proportion of IAs" than predictive dialer calls using a recorded voice.[40]

ACS Is Not Very Successful at Working Business Cases.

In addition to using the right method to generate a contact with the taxpayer, and ultimately resolving the case, another part of making ACS more effective is assigning it the appropriate types of cases to work. An examination of ACS indicates that SB/SE ACS is being assigned cases that would be better worked in the field. More specifically, compared to W&I, SB/SE ACS is significantly less successful at resolving cases and placing taxpayers in installment agreements. For instance, in FY 2013, W&I ACS resolved (as a percentage) twice as many TDA cases with installment IAs as SB/SE ACS.[41]

However, the most significant difference between SB/SE and W&I ACS is the number of cases transferred to the Queue. In FY 2013, only four percent of the cases processed through W&I ACS went to the Queue, while SB/SE ACS transferred 31 percent.[42]

37 Predictive Dialer Test – ACS Accounts, Wage and Investment, Research and Analysis (May 2013).

38 The study conducted a review of the effectiveness of the W&I ACS predictive dialer system by conducting a predictive dialer test with two different groups. In large part, the two test groups were conducted in the same manner. Test group one had a response rate of 37 percent. This test group included 12,497 taxpayers and was conducted in December of 2012, but only made outgoing calls. The 45 percent response rate was for test group two, which included 11,951 taxpayers and was conducted in February of 2013 but made outgoing calls and sent letters.

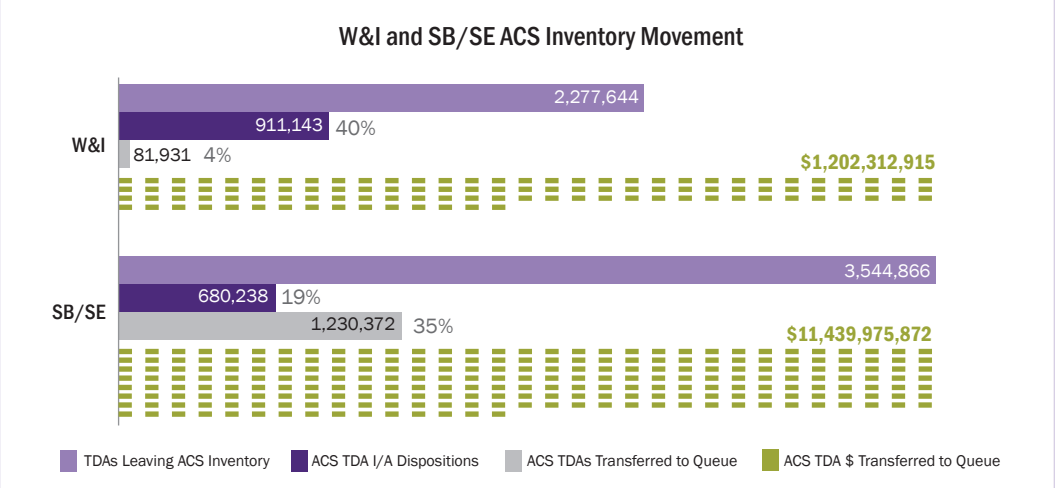
39 ACS Closed Case Actions Project DEN0181, SB/SE Research (Aug. 2012).

40 Predictive Dialer Test – ACS Accounts, Wage and Investment, Research and Analysis (May 2013).

41 IRS Collection Activity Report NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

42 *Id*.

FIGURE 1.11.2, ACS Inventory Movement



A large number of these unresolved cases are small business cases involving trust fund taxes.[43] ACS received $2.9 billion in business trust fund cases, but $1.6 billion — or 55 percent — left ACS as unresolved. Further, in regards to cases that were processed through SB/SE ACS, only $310 million were collected (including refund offsets) while the accounts were in ACS's inventory.[44] The low rate of collection for delinquent business taxes and the delay in resolution results in more accrued debt and increases overall uncollectible debt.[45]

This comparison reveals that ACS can be effective in resolving TDAs of certain segments of the population, notably wage earners, but strikingly ineffective in collecting on other TDAs, namely, business trust fund cases.[46] It is unclear why the IRS places these cases in SB/SE ACS, especially when they are more likely to be resolved in the field. The field closed 57 percent of trust fund modules with a balance between $1,500 and $5,000 as full paid, while SB/SE ACS only closed 42 percent as full paid.[47] Of greater concern is the fact that SB/SE ACS transferred 42 percent of modules that have a liability within the $1,500-$5,000 range to the Queue, while the CFf transferred only four percent. This is yet another indicator that business trust fund cases are not being assigned appropriately, causing them to go unresolved, penalties and interest to accrue, and revenue to be lost. If the field is not available to work business trust

43 IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. These taxes are often referred to as the "trust fund" taxes. Trust fund taxes include employment taxes, income tax withheld from employees' wages, and certain types of excise taxes. IRC § 6672 provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against those deemed responsible persons when these monies are not paid as required.

44 About $1 billion of the $2.9 billion in business trust fund cases received by ACS are uncollected dollars that remain in its inventory

45 IRS Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2012). As discussed further in Most Serious Problem: *Collection Process: IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue, infra*, SB/SE ACS employees are not authorized to consider a business taxpayer's complex financial statements, such as cash flow and profit and loss statements, nor are they trained to complete a financial analysis of BMF cases. Further, ACS employees are limited to granting in-business trust fund express installment agreements (IBTFE) for business accounts with a balance due of $25,000 or less. This means that business taxpayers who call ACS after receiving a notice (potentially a levy notice) will speak with an ACS assistor who has limited authority to agree to an IA.

46 National Taxpayer Advocate 2013 Annual Report to Congress, vol. 2 (*A Comparison of Revenue Officers and the Automated Collection System in Addressing Similar Employment Tax Delinquencies*), *infra*.

47 *Id.* These are rates of cases directly assigned to the CFf. In this Vol. 2 study, TAS focused on newly-delinquent taxpayers with one or two employment tax delinquencies TDA modules in 2003, and those with three delinquencies in 2003, provided they were not pyramiding (*i.e.*, there was a gap between the last two delinquencies).

fund cases at a particular time, the IRS should place those cases with a core ACS unit trained to work them effectively, rather than allowing them to sit in the queue unaddressed.[48]

A Recent Change to the Internal Revenue Manual (IRM) Will Expand the Case Resolution Discussion Between the Taxpayer and ACS and Increase the Likelihood that Certain Cases Will Be Resolved.

Although ACS's overall collection strategy remains counterproductive, positive changes have occurred. A recent revision to IRM 5.19.1, *Liability Collection, Balance Due,* and proper training on the change for ACS assistors will expand collection alternatives to more taxpayers and remove barriers to resolving cases. Under the new provisions, the IRS will not require liquidation of assets or equity in an asset even when such liquidation would result in full or substantial partial payment of the liability, if:

- Factors such as advanced age, ill health, or other special circumstances would prevent the liquidation of the assets; or
- The taxpayer qualifies for guaranteed, streamlined, or in-business trust fund express agreements.[49]

Further, under the IRM revisions, ACS assistors will no longer ask a taxpayer to liquidate or borrow against an asset if doing so will create an economic hardship.

The low rate of collection for delinquent business taxes and the delay in resolution results in more accrued debt and increases overall uncollectible debt.

Past IRS practice has been to push for full payment of the liability through liquidation of assets, and if the taxpayer was unable to make a full payment, the case was likely to land in the Queue. These changes should expand the conversation between ACS assistors and taxpayers. In the circumstances discussed above, assistors will be able to discuss collection options, such as IAs. To be effective, however, the IRS must train ACS assistors on this significant change.[50] Moreover, the IRS should expand these provisions to other taxpayer circumstances. Merely insisting on the taxpayer paying in full is not a realistic position in many situations, and, as the ACS data illustrate, doing so has not yielded and will not yield effective tax collection.

48 *See* Most Serious Problem: *Collection Process: IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue*, *infra*.

49 IRM 5.19.1.5.4.2 (Oct. 18, 2013). In Business Trust Fund Express Agreements can be granted for liabilities up to the aggregate assessed balance (CC SUMRY) of $25,000. The entire liability, including accruals, must be paid within 24 months or before the Collection Statute Expiration Date (CSED), whichever is earlier. In order to qualify, the taxpayer must be in full filing compliance and current on tax deposits.

50 *See* Most Serious Problem: *The Drastic Reduction in IRS Employee Training Impacts the Ability of the IRS to Assist Taxpayers and Fulfill Its Mission*, *supra*; Most Serious Problem: *Taxpayer Rights Training: Insufficient Education and Training about Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights*, *supra*.

CONCLUSION

The ACS plays a vital part in collecting outstanding tax liabilities. However, the National Taxpayer Advocate believes a re-orientation of ACS practices could increase productive case resolutions, while reducing unnecessary harm to the taxpayer. This new approach should place more emphasis on better segmentation of taxpayer debtors and effective initial contacts. It should embody less immediate reliance on levy authority, which harms taxpayers, is not highly productive, and creates IRS re-work. Further, the IRS should immediately assign small business cases to a revenue officer to be worked, or place them with a core ACS unit that is trained and has the necessary skills to work cases when the field is unavailable.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that ACS:

1. Better identify groups of taxpayers that would more likely respond best to a particular collection action or communication.
2. In an attempt to establish contact with the taxpayer, include a soft notice in its systemic procedures that would discuss payment options up front.
3. Send out a monthly (or no less than quarterly) notice to taxpayers whose cases are in the Queue that informs them of the tax owed and penalty and interest accruals as well as payment options.
4. Create and properly train a core ACS unit that can work and resolve small business cases when the field cannot take on more assignments.
5. Expand the guidance under IRM 5.19.1, *Liability Collection, Balance Due,* to require ACS assistors to present all collection alternatives to the taxpayer upfront in all cases.

MSP #12 COLLECTION PROCESS: IRS Collection Procedures Harm Business Taxpayers And Contribute To Substantial Amounts Of Lost Revenue

RESPONSIBLE OFFICIALS

Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The existing IRS collection strategy fails to recognize and meet the needs of business taxpayers in resolving collection issues.[1] The majority of business taxpayers working with the IRS are initially routed through collection units that have neither the authority nor the expertise to fully resolve their problems. Consequently, in fiscal year (FY) 2013, approximately 60 percent of the collection "final" notices involving business-related "trust fund" taxes were not resolved through the notice process.[2] In FY 2013, approximately 3.7 times more delinquent trust fund dollars passed through the Automated Collection System (ACS) with unresolved cases than the ACS actually collected (including refund offsets and installment agreements).[3] As a result, the resolution of these collection accounts is unnecessarily delayed, which contributes to additional tax delinquencies and the rapid accumulation of penalties and interest — factors that increase the risk these taxpayers may never pay the taxes or get back into compliance.

Alternative collection solutions for business taxpayers, *e.g.*, installment agreements (IAs) and offers in compromise (OICs), are exceptionally rare. The IRS's reluctance or failure to proactively consider these options for in-business, trust fund (IBTF) taxpayers contributes to unnecessary delays in resolving their accounts. As a result, at the conclusion of FY 2013:

- Approximately three quarters of the open inventory of trust fund tax cases involved multiple tax delinquencies;[4]
- Almost half involved four or more delinquent tax periods;[5] and

1 In this report, the term "business taxpayers" refers to taxpayers with tax obligations that are tracked by the IRS on the Business Master File (BMF), *e.g.*, employment taxes, corporate income taxes, and partnership returns. The majority of IRS collection cases that pertain to BMF liabilities are associated with small business taxpayers, defined by the IRS as businesses reporting assets of less than $10 million. For example, in FY 2013, 94 percent of the "final" notices issued on Form 941/944 delinquencies involved small business entities. IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Account Receivable Notices* (Sept. 2013).

2 IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Accounts Report, Part 2 Account Receivable Notices* (Sept. 2013). A "trust fund" tax is money withheld from an employee's wages (income tax, social security, and Medicare taxes) by an employer and held in trust until paid to the Treasury. Definition found at IRS, Businesses-&-Self-Employed/Trust-Fund-Taxes, www.irs.gov/Businesses/Small (last visited Aug. 9, 2013.).

3 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). In FY 2013, ACS transferred $1.202 billion in trust fund delinquencies to the Queue (the Queue is an inventory of Taxpayer Delinquent Accounts (TDAs) that are active, but unassigned), $396 million to the Collection Field function (CFf), and reported $20 million as "shelved" (currently not collectible). ACS reported $243 million as collected on open trust fund accounts, $67 million collected through offsets, and $128 million collected on installment agreements established by ACS on BMF accounts.

4 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). As of Sept. 2013, 75 percent of the trust fund cases in inventory involved more than one TDA.

5 *Id*. As of Sept. 2013, 44 percent of the trust fund cases in inventory involved four or more TDAs.

- Over 70 percent of the delinquent trust fund inventory involved debts for tax years at least three years old.[6]

Therefore, it should come as no surprise that from FY 2010 to FY 2013, the IRS has reported as uncollectible an average of $4.2 billion per year in trust fund tax debts — or roughly 1 ½ times the amount the IRS managed to collect on these accounts, including refund offsets and installment agreements.[7]

The National Taxpayer Advocate is troubled by the high percentage of business taxpayers who are unable to resolve their tax problems in response to IRS collection notices or contacts with ACS, noting that:

- The withholding and payment of trust fund taxes are vital components of the voluntary tax system;
- Trust fund tax delinquencies can quickly become unmanageable for business taxpayers;
- The IRS provides inadequate attention and service for emerging trust fund collection cases;
- The IRS insists on assigning trust fund tax cases to employees who are not fully equipped to provide the services needed to resolve them; and
- The full range of collection options are often not available to business taxpayers until the tax debts have become uncollectible.

The IRS could be much more successful in resolving many of these accounts by taking a more proactive, service-oriented approach to these cases. By not providing reasonable, timely solutions for business taxpayers, the IRS is losing opportunities to improve compliance, collect more revenue, and support the nation's economy.

6 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). In FY 2013, the IRS reported in inventory 1,197,082 TDAs involving trust fund taxes associated with tax years 2010 and prior, or 71.2 percent of the total.

7 *Id*; see also IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013). The IRS reported $4.158 billion, $5.091 billion, $4.149 billion, and $3.586 billion in trust fund taxes as currently not collectible in FYs 2010, 2011, 2012, and 2013, respectively. The IRS reported dollars collected/offset on trust fund TDA accounts as $2.192 billion, $2.344 billion, $1.925 billion, and $1.808 billion for FYs 2010, 2011, 2012, and 2013, respectively. The IRS reported $625 million, $728 million, $857 million, and $875 million collected from installment agreements on BMF accounts during FYs 2010, 2011, 2012, and 2013, respectively. Note: the installment agreement figures include all payments on all BMF accounts — not only those involving trust fund taxes.

ANALYSIS OF PROBLEM

The withholding of employment taxes by business taxpayers is a vital component of the voluntary compliance tax system.

Taxpayer businesses contribute to the administration of the nation's voluntary tax system through the withholding and payment of employment-related "trust fund" taxes. IRS studies have confirmed that taxpayers subject to trust fund tax withholding maintain the highest levels of voluntary compliance.[8] In FY 2012, trust fund taxes comprised approximately 70 percent of the total tax revenues collected by the IRS.[9] In a very real sense, trust fund taxes collected by employers help form the "backbone" of the nation's tax system.

By not providing reasonable, timely solutions for business taxpayers, the IRS is losing opportunities to improve compliance, collect more revenue, and support the nation's economy.

Trust fund tax delinquencies are "high risk" debts, which can quickly become unmanageable for business taxpayers.

Bureau of Labor Statistics data reveal that over half of newly established businesses fail within the first five years of operation,[10] and only about a third survive ten years or more.[11] It is not uncommon for a financially struggling business to fail to meet its trust fund tax obligations. Without adequate attention, these debts can multiply rapidly and quickly become very difficult for the taxpayer to resolve. In FY 2013, the IRS reported in inventory over 450,000 taxpayer cases involving delinquent trust fund taxes.[12] As shown in Figure X, of these accounts, 75 percent involved more than one delinquent tax period, and 44 percent involved four or more.[13] These cases accounted for over $14 billion in delinquent trust fund taxes.[14] Consequently, the IRS has traditionally categorized trust fund tax delinquencies as "high risk" debts.[15]

8 IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012). The IRS reports that compliance is highest where there is third-party information reporting and/or withholding. For example, most wages and salaries are reported by employers to the IRS on Forms W-2 and are subject to withholding. As a result, a net of only one percent of wage and salary income was misreported in 2006. In contrast, amounts subject to little or no information reporting had a 56 percent net misreporting rate.

9 IRS, Internal Revenue Service Data Book (October 1, 2011, to September 30, 2012).

10 U.S. Bureau of Labor Statistics, Business Employment Dynamics, www.bls.gov/bdm/entrepreneurship/bdm_chart 3.htm (last visited Aug. 7, 2013).

11 *Id*.

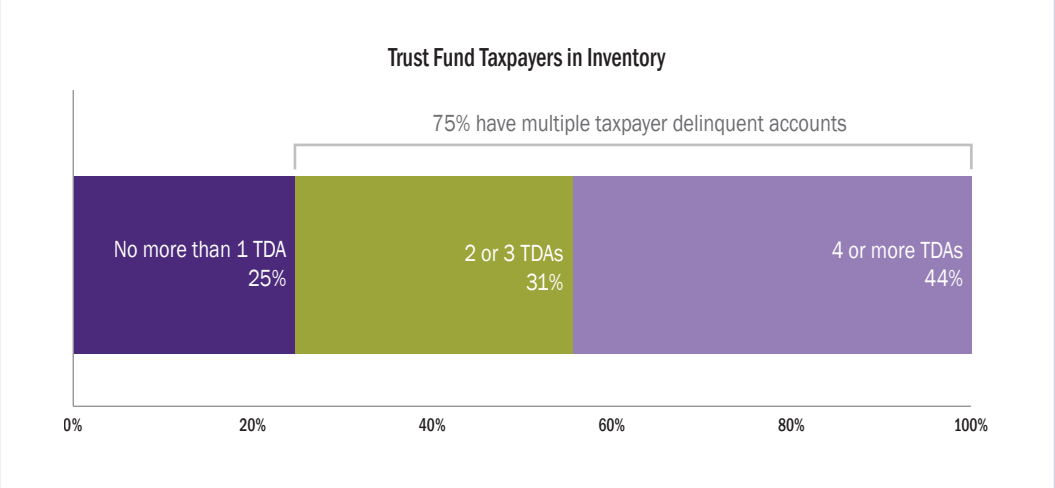
12 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Sept. 2013). The IRS reported 451,861 taxpayer cases in inventory that included trust fund taxes.

13 *Id*. The IRS reported 338,431 taxpayer cases involving more than one delinquent trust fund period, and 198,529 involving four or more such periods.

14 *Id*. The IRS reported in inventory $14,018,345,606 in delinquent trust fund taxes at the conclusion of FY 2013.

15 Internal Revenue Manual (IRM) 5.3.1.2.3, *Case Codes and Subcodes* (Feb. 22, 2012).

FIGURE 1.12.1, Trust Fund Taxpayers in Inventory – 75 Percent Have Multiple Taxpayer Delinquent Accounts[16]



The IRS collection strategy does not adequately recognize and address "high risk" trust fund tax cases in a timely, effective manner.

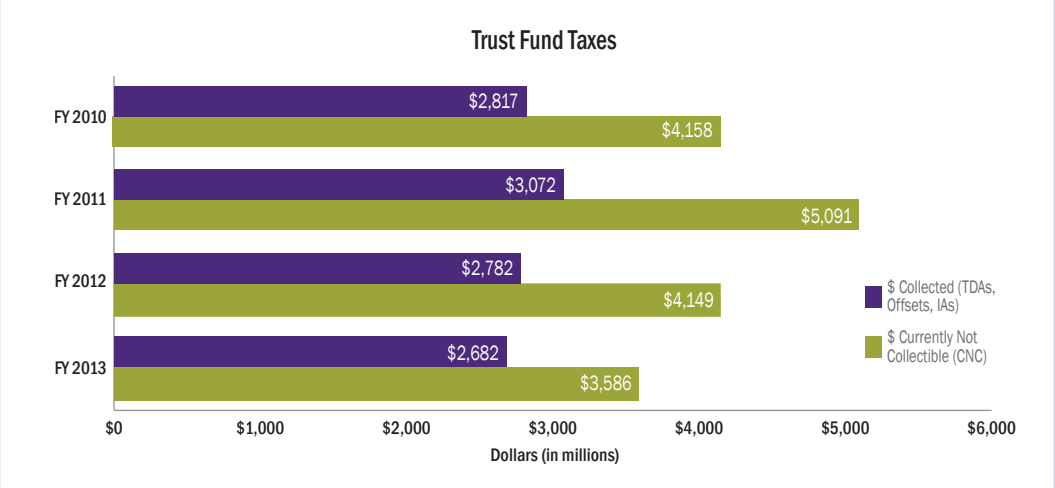
In recent years, the National Taxpayer Advocate has expressed concerns that despite the high-risk nature of cases involving trust fund taxes, the IRS has consistently failed to interact with these taxpayers with a proper sense of immediacy.[17] The IRS continues to view emerging trust fund tax problems as relatively simple cases that do not warrant early intervention by field-based revenue officers. Almost all trust fund tax cases are initially addressed through collection notices and IRS call centers, even though employees in these areas are not trained or empowered to resolve many of these accounts. Consequently, the IRS has lost billions in tax revenues by failing to employ an effective collection strategy for this important taxpayer segment. *From FY 2010 through FY 2013, the IRS reported as uncollectible an average of approximately $4.2 billion per year in trust fund tax debts — or roughly 1 ½ times the amount the IRS collected on these TDA accounts, including refund offsets and installment agreements.*[18]

16 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Sept. 2013).

17 For an in-depth discussion of these issues, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, 39-70 (*An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*) and National Taxpayer Advocate 2012 Annual Report to Congress 358-380 (Most Serious Problem: *The Diminishing Role of the Revenue Officer Has Been Detrimental to the Overall Effectiveness of IRS Collection Operations*).

18 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Sept. 2013); IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013). The IRS reported $4.158 billion, $5.091 billion, $4.149 billion, and $3.586 billion in trust fund taxes as currently not collectible in FYs 2010, 2011, 2012, and 2013, respectively. The IRS reported dollars collected/offset on trust fund TDA accounts as $2.192 billion, $2.344 billion, $1.925 billion, and $1.807 billion for FYs 2010, 2011, 2012, and 2013, respectively. The IRS reported $625 million, $728 million, $857 million, and $875 million collected from installment agreements on BMF accounts during FYs 2010, 2011, 2012, and 2013, respectively. Note: the installment agreement figures include all payments on all BMF accounts — not only those involving trust fund taxes.

FIGURE 1.12.2, Substantial Amounts of Trust Fund Taxes are Reported as Currently Not Collectible (CNC) Each Year[19]



The IRS provides inadequate service and attention to emerging trust fund tax cases, especially when the debts are new and easier to resolve.

In virtually all IRS tax delinquency cases, the collection activity starts with the IRS sending notices to the taxpayer. Generally, delinquencies involving trust fund taxes receive two collection notices. While a significant number of taxpayers resolve debts in response to these notices, the majority of this population does not.

In FY 2013, the IRS issued approximately 1.5 million "final notices" (CP 504B) to small business taxpayers, representing approximately $7.2 billion in unpaid trust fund taxes.[20] About 38.8 percent of these notices were resolved by full payments (37.2 percent) or IAs (1.6 percent).[21] The IRS collected $740 million in response to these notices, or 10.3 percent of the balances due.[22] On the other hand, approximately $5.7 billion in employment tax debts — over 60 percent of the "final" notice accounts went forward in the collecting process as TDAs because the taxpayers did not successfully resolve the balances due after the IRS issued the "final" collection notice.[23]

19 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Sept. 2013); IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013).

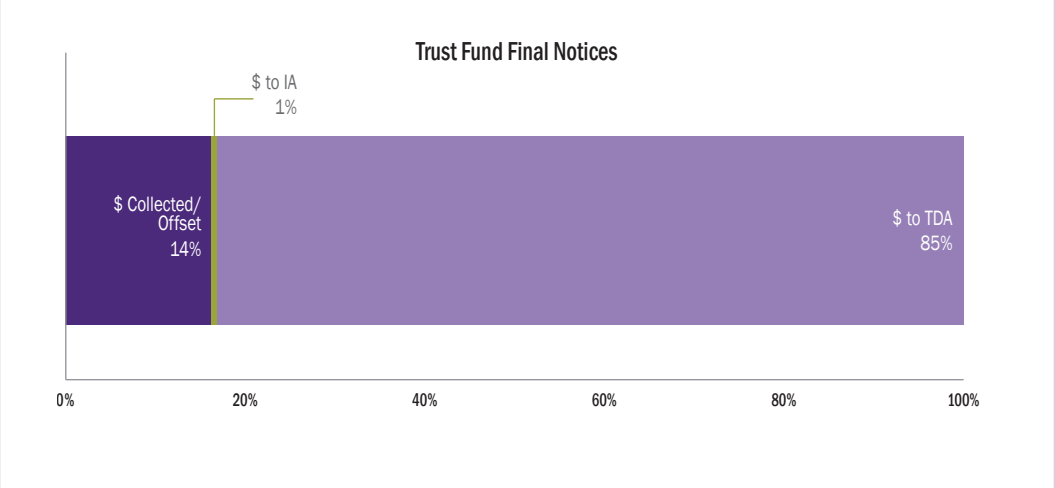
20 IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Accounts Report, Part 2 Account Receivable Notices* (Sept. 2013).

21 *Id*.

22 *Id*.

23 *Id*.

FIGURE 1.12.3, Most Delinquent Trust Fund Taxes are Not Collected Via Final Notices[24]



Collection notices to business taxpayers convey a blunt message that may discourage some from even attempting contact with the IRS.

The first notice (CP 14) issued to delinquent taxpayers employs a curt, matter-of-fact tone, which informs the taxpayer of unpaid taxes, and emphasizes that the taxpayer needs to pay the full amount immediately (in big bold letters). While the second page of the notice does provide information about contacting the IRS to discuss payment arrangements, the front page clearly stresses the message of "full pay now!"

However, if the taxpayer does not respond within five weeks, the final notice (CP 504B) is issued, and the tone is even more harsh.

Notice of intent to levy

Intent to seize your property or rights to property
Amount due immediately: $3,999.86

As we notified you before, our records show you have unpaid taxes for the tax year ending December 31, 2005 (Form 1120). If you don't call us immediately or pay the amount due by March 12, 2009, we will seize ("levy") your property or rights to property and apply it to the $3,999.86 you owe.

Billing summary

Amount you owed	$2,902.68
Failure-to-pay penalty	284.26
Interest charges	812.92
Amount due immediately	**$3,999.86**

What you need to do immediately

Pay immediately
- Send us the amount due of $3,999.86, or we will seize ("levy") your property or rights to property on or after March 12, 2009.

Continued on back...

24 IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Accounts Report, Part 2 Account Receivable Notices* (Sept. 2013). See also IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013). In FY 2013, the IRS reported approximately $935 million as collected or offset from final notices involving business trust fund taxes. Another $84 million in delinquencies were included in installment agreements, and $5.659 billion moved on in the collecting process as TDAs.

Once again, information regarding alternative payment options can be found in the fine print of the second page. Clearly, this notice was designed to encourage taxpayers to take action. However, the front page does little to encourage a financially struggling taxpayer to contact the IRS, especially if he or she cannot "pay immediately." The notice does not even acknowledge the possibility that the business may want to comply but is facing some financial difficulties. In the section "What you need to do immediately," the only option is to pay in full.

Taxpayer responses to collection notices are handled by IRS employees who are not fully equipped to resolve trust fund tax cases.

Business taxpayers responding to collection notices are directed to call an IRS toll-free number, serviced by customer service representatives (CSRs) in the Accounts Management (AM) operation of the Wage and Investment (W&I) operating division. Written responses are worked by tax examiners (TEs) in the Compliance Services Collection Operation (CSCO) of the Small Business/Self-Employed (SB/SE) operating division. However, the IRS imposes significant limitations on the abilities of these employees to provide full service to taxpayers with trust fund tax debts.

Punting a noncompliant taxpayer downstream, when that taxpayer has reached out to the IRS, is foolhardy and costly.

Accounts Management and CSCO employees receive no formal training in performing financial analysis on business cases and have very limited authorities to place taxpayers with trust fund tax debts into installment agreements.[25] For example, AM employees are only authorized to enter into an IA that meets the "streamlined" IA criteria established for AM, limited to cases with balances due of $10,000 or less and payment terms of no more than 24 months.[26] AM employees may not allow any short-term payment extensions to IBTF taxpayers.[27] If the taxpayer owes more than $25,000, or cannot pay in full within 24 months, AM will advise the taxpayer the account is being assigned for a field contact by a revenue officer.[28] If the taxpayer is not in full filing compliance, AM advises the taxpayer to file the delinquent return and call back within 30 days.[29]

Although virtually all collection notices instruct taxpayers to call AM for assistance in resolving delinquent accounts, IBTF taxpayers who do not meet AM's strict criteria for streamlined IAs will generally not succeed in their attempts to resolve their tax liability at the first point of contact, and will be passed on to the next step of the collecting process.[30] The abysmal collection statistics cited above show the consequences of the IRS's failure to work with the taxpayer at the first point of contact. Punting a noncompliant taxpayer downstream, when that taxpayer has reached out to the IRS, is foolhardy and costly.

25 IRS response to TAS information request (Sept. 13, 2012).

26 IRM 21.3.12.4.7, *In-Business Trust Fund (IBTF) Express Agreement Criteria* (Oct. 1, 2012). AM employees are authorized to establish IBTF Express Agreements up to the aggregate assessed balance (CC SUMRY) of $10,000. The entire liability, including accruals, must be paid within 24 months, or before the collection statute expiration date, whichever is earlier. In order to qualify, the taxpayer must be in full filing compliance and current on federal tax deposits (FTDs). If the taxpayer owes more than $10,000 but less than $25,000, the IA request is forwarded to CSCO.

27 IRM 21.3.12.4.2, *Taxpayer Can Full Pay Within 11 to 59 Days - IMF, BMF Out-of-Business or BMF In-Business Non-Trust Fund Accounts* (Oct. 1, 2012) and IRM 21.3.12.4.3, *Taxpayer Can Full Pay Within 60 to 120 Days - IMF, BMF Out-of-Business or BMF In-Business Non-Trust Fund Accounts* (Mar. 27, 2013).

28 IRM 21.3.12.4.7, *In-Business Trust Fund (IBTF) Express Agreement Criteria* (Oct. 1, 2012).

29 *Id*.

30 Note: Written responses from taxpayers are worked in the SB/SE CSCO operation. CSCO has similar restrictions in providing service on IBTF accounts, but works with expanded criteria for considering IBTF Express IAs, *i.e.*, tax balances of $25,000 or less.

The Automated Collection System (ACS) frequently fails to resolve trust fund tax delinquency problems; yet the IRS still assigns almost all business cases to ACS.

When not resolved by notices, almost all business cases involving trust fund taxes are initially assigned to ACS. However, in their efforts to assist these taxpayers, ACS employees are hampered by the same training limitations and procedural restrictions as employees working collection notices. For example, ACS employees do not have the authority to grant extensions to pay on IBTF accounts,[31] will not discuss alternative payment options if the taxpayer has an unfiled return,[32] and are not trained or authorized to enter into non-streamlined IAs for accounts involving business taxes.[33]

In light of these restrictions, ACS has limited success in resolving business cases involving trust fund taxes.

- Of the trust fund cases processed through ACS, approximately 65 percent left ACS as unresolved cases, *i.e.*, transfers to the Queue[34] (52 percent), transfers to the Field (eight percent), or cases that were deferred or shelved (five percent).[35]
- ACS received approximately $2.9 billion in trust fund accounts, but reported only $310 million — or 11 percent — as collected or offset while the accounts were in ACS.[36]
- Of the trust fund dollars that passed through ACS, $1.6 billion left ACS with unresolved accounts, including $1.2 billion transferred to the Queue.[37]
- Including revenue collected through installment agreements and offsets, approximately 3.7 times as many delinquent trust fund dollars left ACS with unresolved cases as were collected by ACS.[38]

31 IRM 5.19.1.5.3, *Full Pay Within 60 or 120 Day Agreement* (Oct. 18, 2013) ("This type of agreement **cannot** be granted for **any** In-Business Trust Fund (IBTF) taxpayer. Any taxpayer with an open employment tax filing requirement is considered in-business and is **not** eligible for this type of agreement.").

32 IRM 5.19.1.5.4.2, *IA Requirements, IBTF Express Agreement* (Oct. 18, 2013) ("Taxpayers must be in filing compliance. If not, the IA will not be granted.").

33 IRS response to TAS information request (Sept. 13, 2012).

34 The Collection Queue is an inventory of TDA accounts that are active, but unassigned to the ACS or CFf functions. *See* IRM 5.1.20.2, *Collection Inventory Management* (May 27, 2008). IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). At the conclusion of FY 2013, 230,550 trust fund taxpayer cases, including 928,472 trust fund TDA modules were assigned to the Queue inventory.

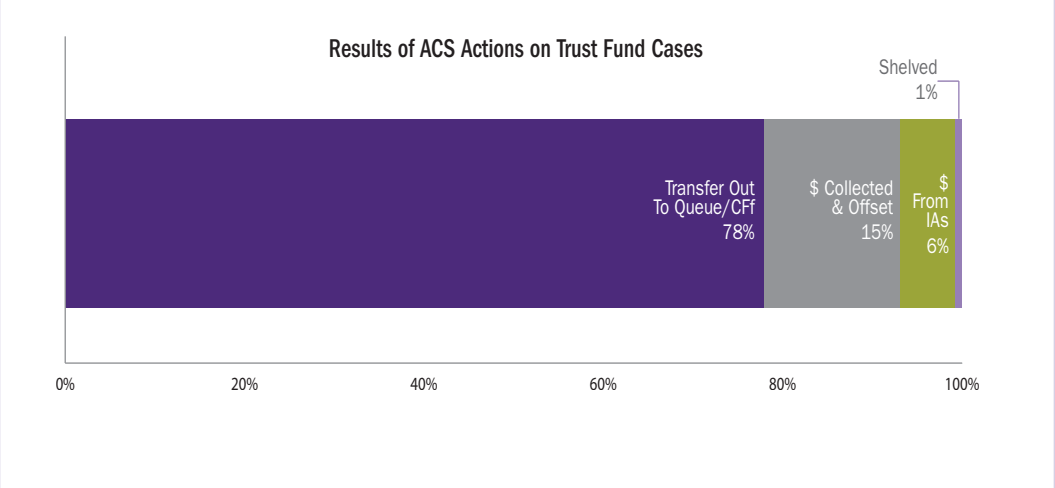
35 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

36 *Id*.

37 *Id*.

38 *Id*.

FIGURE 1.12.4, ACS is Usually Not Successful in Collecting Trust Fund Dollars[39]



"Full service" collection options are often not available until the tax has become uncollectible.

Despite the high risk nature of trust fund tax debts, the IRS collecting process does not allow taxpayers timely access to the services and payment options that can only be provided by revenue officers in the Collection Field operation. IRS focus group participants have indicated that the main reason business taxpayers do not pay their payroll taxes is because "they do not see the immediate consequences of noncompliance."[40] When asked how the IRS could help these taxpayers, the number one strategy participants recommended was "the need for the IRS to react faster."[41] They stated, "The main problem is that many taxpayers are buried too deep by the time the IRS gets involved."[42]

Unfortunately, "reacting faster" from the taxpayer's perspective is not a key component of the IRS collection strategy and "getting involved" is too often limited to issuing collection notices, and restricting the subsequent taxpayer contacts to untrained and unempowered employees. Delays in service delivery are further exacerbated by the IRS's practice of assigning most trust fund cases that are not resolved through the notice process or ACS into the Collection Queue. These questionable assignment practices promote the pyramiding of additional trust fund tax liabilities, and the aging of IRS accounts receivable. At the end of FY 2013, 55 percent of these high risk cases were assigned to the Queue.[43] *Not surprisingly, approximately 71 percent of the current trust fund TDA inventory involved debts for tax years at least three years old.*[44] Studies conducted by the IRS recognize the "collectibility curve" that becomes apparent as delinquent accounts age. This "curve" indicates that after three years of becoming overdue, these accounts

39 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report (Sept. 2013).* See also IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013).

40 IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help*, 4 (Jan. 2010).

41 *Id*.

42 *Id*.

43 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

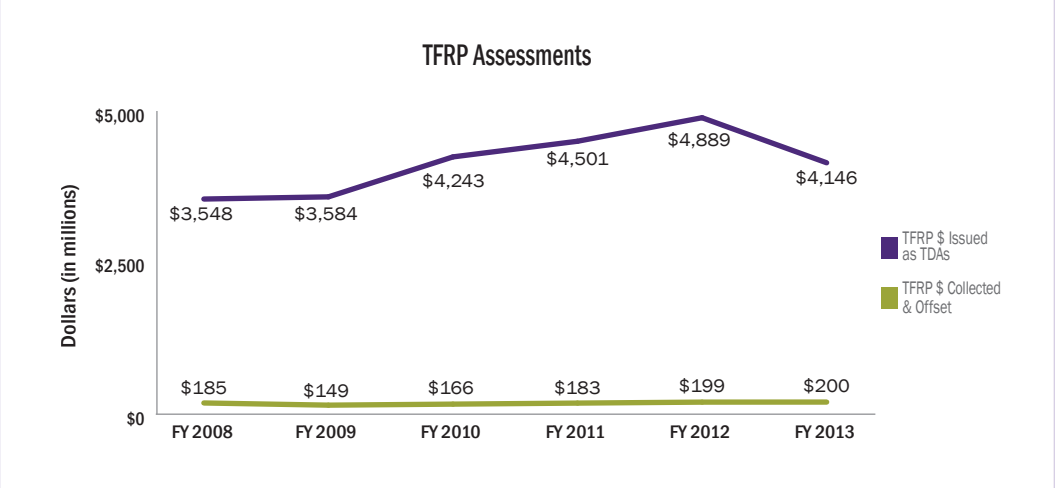
44 *Id*. At the conclusion of FY 2013, the IRS reported in inventory 1,197,082 trust fund TDA accounts related to tax years 2010 and prior.

produce minimal collections.[45] Yet clearly, the assignment practices employed by the IRS for IBTF cases ignore this critically important collecting principle.

The current use of the Collection Field operation does little to improve revenue collection or taxpayer compliance.

The IRS's strategy for dealing with the large, aged inventory of high risk trust fund cases emphasizes the use of the Trust Fund Recovery Penalty (TFRP).[46] However, IRS data indicates the escalating use of TFRP investigations and assessments has been an unproductive use of valuable collection resources. From FY 2007 to FY 2012, the dollar value of TFRP assessments issued as TDAs increased by 61 percent, but TFRP dollars collected actually *decreased* by seven percent.[47] Although $4.9 billion in TFRP assessments were issued as TDAs in FY 2012, only $199 million was collected (including offsets) — about four percent of the dollars issued.[48] Moreover, the IRS's increasing emphasis on the use of the TFRP indicates the IRS is aware that many trust fund tax cases assigned to the CFf are likely to be uncollectible. Nevertheless, the IRS continues to resist changing its collection strategy for servicing these accounts.

FIGURE 1.12.5, Only A Small Portion of TFRP Assessments Is Actually Collected[49]



45 IRS, TACT: *Collection Team VSM Decision Paper* I (July 8, 2009).

46 IRM 5.7.3.1, *Introduction* (Nov. 12, 2010). The TFRP is a penalty provided by Internal Revenue Code § 6672 against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. The penalty is equal to the total amount of tax evaded, not collected, or not accounted for and paid over.

47 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2012).

48 *Id*. Note: in FY 2013, the IRS issued $4.146 billion in TFRP TDA assessments — a significant decrease from FY 2012, and reported $200 million collected on TFRP accounts. While a trend is not yet evident, the decrease in TFRP dollars issued is noteworthy. However, the dollars collected on TFRP accounts remains a very small percentage of TFRP dollars issued — five percent in FY 2013.

49 IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2012).

Further, the IRS places very little emphasis on pre-delinquency education, early intervention on emerging delinquencies, or post-delinquency prevention on recidivists. The use of Federal Tax Deposit (FTD) Alerts and other field contacts on relatively small balance due employment tax accounts is rare.[50] Further, the IRS already has procedures in place that facilitate early intervention by revenue officers in cases where the taxpayers have had prior accounts in TDA status, *i.e.*, very high risk, repeat delinquents. The issuance and delivery of the Letter 903, *You Haven't Deposited Federal Employment Taxes,* systemically generates coding to the IRS computer system, which provides for systemic control and subsequent follow-up on these accounts. If a subsequent TDA, return delinquency, or FTD Alert is issued, it will be accelerated to the field for an early intervention by a revenue officer. However, these procedures are not commonly used.[51]

Improved use of collection payment options, including installment agreements and offers in compromise, employed earlier in the collecting process, would improve revenue collected, reduce revenue loss, and promote compliance within the business community.

The use of IAs and OICs to assist in the collection of trust fund tax delinquencies is astonishingly rare.[52] While the IRS does not track the number of IAs or OICs granted to IBTF taxpayers, it does report the overall numbers of IAs involving taxes reported on the business master file (BMF). The IRS issued 87,875 BMF IAs through September 2013, a 17 percent decline from the same period in FY 2011,[53] the year in which the IRS "Fresh Start" initiative brought more flexibility into the "IBTF Express" IA criteria.[54] Of particular concern is that in FY 2013, only 24,415 trust fund accounts receiving the CP 504B "final notice" were resolved with IAs — only 1.6 percent of the final notices issued — even though 97 percent of these notices met the new "IBTF Express" criteria.[55] Likewise, once cases left the notice stream and moved on in the collecting process, ACS issued only 29,246 BMF installment agreements, representing only 5.5 percent of the BMF taxpayer cases received by ACS during FY 2013.[56]

50 IRM 5.7.1.1, *Federal Tax Deposit FTD Alerts* (May 15, 2012). The FTD Alert process identifies, at an early stage (*i.e.*, before the return is due), taxpayers who have fallen behind in their deposits. FTD Alerts determine an employer's compliance with employment tax deposit requirements for the quarter of Alert issuance, and for subsequent quarters until the taxpayer is brought into full compliance. In FY 2012, the IRS issued 5,217 FTD Alerts to revenue officers in the CFf, a 37 percent reduction from FY 2009. IRS response to information request (Sept. 9, 2013).

51 IRM 5.7.2.2, *Issuance of Letter 903* (Sept. 28, 2012). Issuance of the Letter 903, *You Haven't Deposited Federal Employment Taxes*, systemically generates TC 148-09 to the IDRS database. If a subsequent balance due, return delinquency, or FTD Alert is issued, it will be coded with an "L" and it will be accelerated to the field. IRS data reveals that as of July 2013, the IRS had only 717 taxpayer cases in inventory where issuance of the L-903 had generated the TC 148-09 coding. IRS, Business Return Transaction File (July 2013).

52 IRS response to information request (Sept. 9, 2013). The IRS acknowledges that the number of IAs, SLIAs, and OICs granted to IBTF taxpayers is not systemically tracked. In FY 2012, the IRS reports that 1,376 offers were accepted that included any type of BMF tax delinquency, including those from business taxpayers who were no longer operating at the time the offers were accepted.

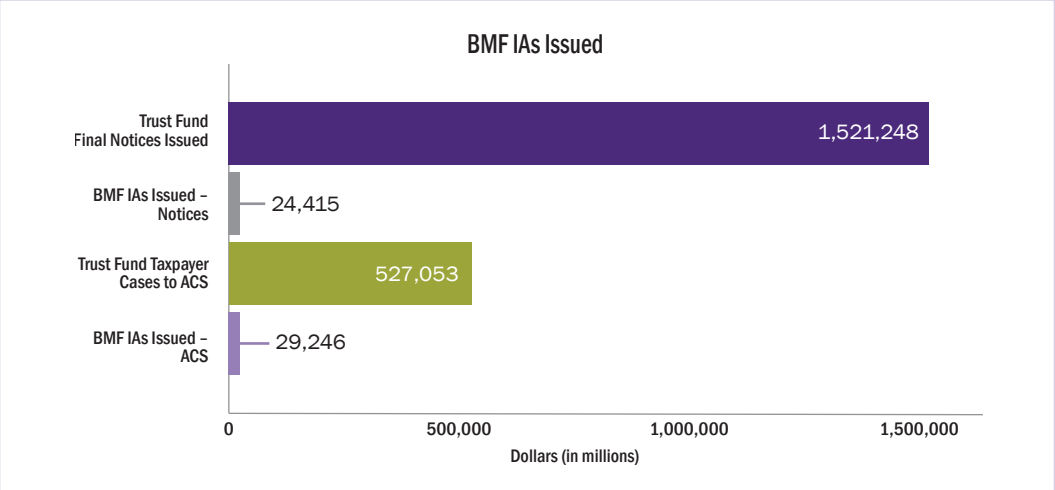
53 IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013).

54 IBTF Express IAs may be granted if the entire liability, including accruals total $25,000 or less, and the taxes will be fully paid within 24 months. (Note: AM employees working notice responses on the toll-free phone lines may only issue IBTF Express IAs on liabilities of $10,000 or less.)

55 IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Accounts Report, Part 2 Account Receivable Notices* (Sept. 2013).

56 IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013); IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013).

FIGURE 1.12.6, BMF IAS Issued By AM, CSCO and ACS Are Rare[57]



A significant contributing factor to the astonishingly low number of BMF IAs issued for collection notice and ACS accounts is the IRS's hard policy of not even discussing the possibility of payment options with a taxpayer who has an unfiled return at the time contact is made with the IRS. The policy guidance provided to AM, CSCO and ACS employees places a great deal of emphasis on taxpayers being "in compliance" before the employees can consider payment options.[58] From the taxpayer's perspective, this IRS position can be confusing, and frustrating. *All collection cases*, by definition, involve taxpayers who are not "in compliance." The unfiled returns are simply part of the problem that these taxpayers need to resolve. However, turning away taxpayers in this manner, while they are attempting to come forward and work out reasonable payment solutions, is remarkably bad taxpayer service. Doing so in high risk trust fund compliance cases is simply irresponsible tax administration.

57 IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Report* (Sept. 2013); IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013); IRS, Collection Activity Report, NO-5000-2/242, *Taxpayer Delinquent Accounts Report*, *Part 2 Account Receivable Notices* (Sept. 2013).

58 Throughout IRM 21 and IRM 5.19, the IRS prohibits the issuance of an IA to any taxpayer with unfiled returns.

CONCLUSION

For case assignment purposes, the IRS collection strategy categorizes collection cases involving business taxpayers with trust fund tax debts as relatively simple delinquencies that do not warrant immediate assignment to revenue officers. Yet, the IRS also views these cases as "high risk," and significantly restricts the ability of employees to provide the services needed to resolve the majority of these accounts. For many business taxpayers, the result is the IRS version of the proverbial "runaround." The delays in providing adequate service for these taxpayers result in not only poor service for business taxpayers, but also billions of dollars of lost revenue.

RECOMMENDATIONS

To improve service delivery for business taxpayers with tax debts, the National Taxpayer Advocate recommends that the IRS:

1. Must reconcile its case assignment practices involving IBTF tax delinquencies with the authorities delegated to employees assigned to work these accounts. Trust fund tax delinquencies should not be assigned to employees who are not fully empowered to resolve them. Current IRS practices create undue burden on taxpayers and contribute to significant delays in case resolution.
2. Should develop and test a new "second" notice for business taxpayers with trust fund tax debts, with an expanded focus on the availability of collection payment options. The notice should proactively invite taxpayers who have not acted since receiving the first notice or who are experiencing financial difficulties to contact the IRS to discuss payment options and should provide more information about the options that may be available. This information should be on the front page of the notice.
3. Should develop and implement an initiative to test the benefits that may be obtained through continued efforts to reach out to IBTF taxpayers whose accounts have been assigned to the Collection Queue. Through regularly issued "reminder" notices, similar to the new notice described in Recommendation 2 above, the IRS may encourage taxpayers to self-correct delinquencies on accounts that would otherwise sit inactive in the Queue.
4. Should allow "conditional IAs" for business taxpayers with trust fund tax debts. These IA procedures would allow ACS, CSCO, and AM to set up IAs for taxpayers' unfiled returns, with a requirement to file the returns included as a condition of finalizing the agreement within a reasonable period.
5. Should revise the collection procedures detailed in IRM 5.7.2.2, *Issuance of Letter 903*, and expand the use of the L-903 process to serve as a delinquency prevention tool. This practice would allow the IRS to clearly identify high-risk, repeat delinquents, and expedite these cases to Revenue Officers for appropriate attention.

MSP #13 COLLECTION STATUTE EXPIRATION DATES: The IRS Lacks a Plan to Resolve Taxpayer Accounts with Extensions Exceeding its Current Policy Limits

RESPONSIBLE OFFICIALS

Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

As of December 31, 2013, 2,371 taxpayers remain subject to IRS collection action because of waivers of the applicable statutory period for collection, which violate the IRS policy limit of five years.[1] Before 2000, IRS collection personnel solicited waivers to extend the collection period when it did not appear the taxpayer could pay the tax owed prior to the collection statute expiration date (CSED).[2] Congress limited this practice as part of the IRS Restructuring and Reform Act of 1998 (RRA 98), which generally ended CSED waivers, other than for extensions entered in connection with installment agreements (IAs).[3] In response to Taxpayer Advocate Directive (TAD) 2010-3, the IRS Small Business/Self-Employed Division (SB/SE) and TAS formed a workgroup to investigate and resolve CSED extensions that exceeded five years.[4]

The IRS has placed almost 82 percent (1,939) of these accounts in currently not collectible (CNC) status or in the collection queue, and has no plan to collect these amounts.[5] A TAS analysis of these accounts reveals that 309 of these taxpayers are deceased.[6] Further, more than half of the taxpayers subject to these CSED extensions owe more than $50,000, of which almost 76 percent is attributable to accrued penalties and interest.[7]

1 IRS, Compliance Data Warehouse (CDW), Integrated Data Retrieval System (IDRS), analysis of IDRS transaction code (TC) 550, definer code (DC) 0 and 1 for Individual Master File (IMF) accounts for tax periods ended on or before December 31, 1998 (April 20, 2013).

2 National Taxpayer Advocate 2006 Annual Report to Congress 428.

3 Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3461, 112 Stat. 685, 764 (1998). The legislation also provided for collection statute extensions in connection with the release of levies after the collection statute expiration date (CSED) expired. However, the IRS has not implemented this provision.

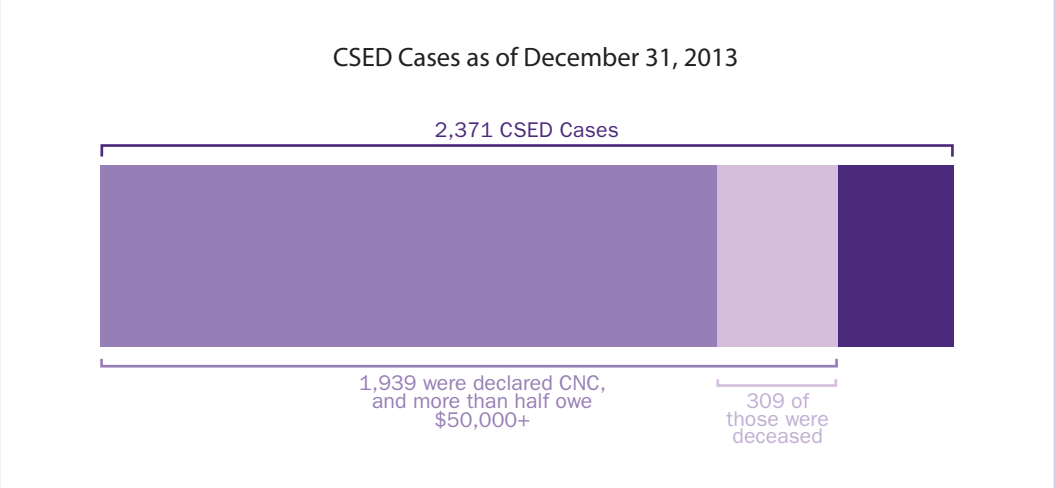
4 Taxpayer Advocate Directive (TAD) 2010-3 and responses to the TAD, *available at*: http://www.irs.gov/Advocate/Taxpayer-Advocate-Directives-and-Related-Documents.

5 IRS CDW, analysis of IDRS TC 550, DC 0 and 1, TC 470, and Status Code 24 (Queue) for Individual Master File (IMF) (April 20, 2013). The IRS deems accounts currently not collectible (CNC) or places them in the collection queue where it does not have the resources to collect or identifies a noncollectible account. *See, e.g.*, Internal Revenue Manual (IRM) 5.11.1.2.2.2(7)(d) (Feb. 3, 2012), IRM 5.19.5.5.8(3) (Sept. 21, 2011), and IRM 5.16.1.1 (May 22, 2012).

6 IRS CDW, analysis of IDRS TC 550, DC 0 and 1, TC 470 for Individual Master File (IMF) (Apr. 20, 2013).

7 IRS CDW, analysis of IDRS TC 550, DC 0 and 1, Tax Module Balances (TMODBAL) by Taxpayer Identification Number (TIN) for the IMF (Apr. 20, 2013).

FIGURE 1.13.1, CSED Cases as of December 31, 2013[8]



The majority of these lengthy CSED cases burden taxpayers, who do not appear able to pay or resolve their debts through collection alternatives. Legal and administrative impediments have unnecessarily complicated the resolution of these accounts. In all but one Annual Report to Congress since 2009, the National Taxpayer Advocate identified accounts with lengthy CSEDs as a most serious problem or provided a status update about the problem. The National Taxpayer Advocate's chief concern is the IRS's failure to cancel these unreasonable CSED extensions that do not comply with current policies. The IRS has already spent over four years trying to fix this problem, and no resolution is in sight. The IRS's lack of urgency with respect to this issue — which involves undoing agreements that in many instances were violations of policy or law — is shocking.

ANALYSIS OF PROBLEM

Background

The IRS generally has ten years to collect a tax liability from a taxpayer.[9] The CSED is the date the IRS must cease taking collection actions on a taxpayer's account. By statute, various conditions suspend the period and extend the CSED.[10]

RRA 98 Changed the Rules for Seeking Collection Statute Waivers.

Before January 1, 2000 (the effective date of section 3461 of RRA 98), the IRS would solicit waivers to extend the CSED to a time when taxpayers could pay their full liabilities or pay in connection with IAs. The IRS initially solicited these waivers on accounts with an open CSED and for periods as long as

8 IRS, Compliance Data Warehouse (CDW), Integrated Data Retrieval System (IDRS), analysis of IDRS transaction code (TC) 550, definer code (DC) 0 and 1 for Individual Master File (IMF) accounts for tax periods ended on or before December 31, 1998 (April 20, 2013).

9 Internal Revenue Code (IRC) § 6502(a).

10 A number of code sections provide that the statute may be suspended by operation of law. *See, e.g.*, IRC § 6330(e) (after a timely request for a Collection Due Process (CDP) hearing); IRC § 6331(i) & (k) (during the pendency of an installment agreement (IA) or offer in compromise (OIC) investigation, or refund suit for a divisible tax; 30 days after the rejection or termination of an IA, or rejection of an OIC; and for any appeals of a rejected IA or OIC, or a terminated IA); IRC § 6503 (during a deficiency proceeding, and for 60 days thereafter; any period for which a taxpayer is outside the United States for six months or longer; any period for which the IRS holds property wrongfully seized until it returns the property; during the pendency of a substitution of value lien discharge proceeding).

10, 20, 30, 40 or even 50 years.[11] Despite adopting the policy on October 30, 1991 of limiting CSED waivers to five years in connection with IAs, the IRS continued soliciting waivers of longer than five years in certain cases until the law changed in 2000.[12] The American Jobs Creation Act of 2004 amended IRC § 6159 to provide for partial payment installment agreements (PPIAs).[13] The IRS responded by limiting its five-year extension policy to PPIAs.[14]

Collection statute extensions concerned Congress in 1998 because the IRS often did not inform taxpayers about their legal rights or consequences of extending statutory periods:

> … The Committee is concerned that in some cases taxpayers have not been fully aware of their rights to refuse to extend the statute of limitations, and have felt that they had no choice but to agree to extend the statute of limitations upon the request of the IRS. Moreover, the Committee believes that the IRS should collect all taxes within 10 years, and that such statute of limitation should not be extended.[15]

As part of RRA 98, Congress amended Internal Revenue Code § 6502(a)(2) to restrict the terms under which the IRS and taxpayers could agree to extend the statutory period for collection beyond ten years. Congress provided that the IRS could collect after the statutory period only if the IRS and the taxpayer agreed to extend the statutory period for collection *in connection with* an original installment agreement or before releasing a levy after the ten-year period.[16] Section 3461(c)(2) of RRA 98, which controls most lengthy CSED accounts, states:

> — If, in any request to extend the period of limitations made on or before December 31, 1999, a taxpayer agreed to extend such period beyond the 10-year period referred to in section 6502(a) of the Internal Revenue Code of 1986, such extension shall expire on the latest of —
>
> (A) the last day of such 10-year period,
>
> (B) December 31, 2002, or
>
> (C) in the case of an extension in connection with an installment agreement, the 90th day after the end of the period of such extension.[17]

Taxpayers use Form 900, *Tax Collection Waiver*, to extend the period for collections on accounts beyond the ten-year statutory period for collection. Counsel has concluded, "A tax collection waiver executed pursuant to IRC § 6502(a)(2) is not a contract [that the parties could agree to amend]. *See Florsheim*

---

11 *See* Internal Revenue Manual (IRM) 53(11)(1) (Oct. 28, 1993) (stating, "The ten year collection period may, at any time prior to its expiration, be extended for any period of time agreed upon by the taxpayer and the district director.").

12 IRM 5331.1(12)(b)2 (Oct. 30, 1991).

13 American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, § 843(a) and (b), 118 Stat. 1600 (Oct. 22, 2004). Prior to 1998, IRS employees sometimes entered into monthly payment agreements that would not fully pay the tax liability over the term of the agreement. In 1998, IRS Counsel concluded that these partial payment agreements were not permitted. In 2004, Congress enacted the AJCA to legally provide for partial payment IAs. H.R. Conf. Rpt. 108-755, at 649-650 (Oct. 7, 2004).

14 IRM 5.14.2.1 (July 12, 2005). The procedure permits waivers of five years plus one year may be added for administrative actions.

15 Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, S. Rept. No. 105-174 at 87 (June 24, 1998).

16 IRC § 6502(a)(2); Treas. Reg. § 301.6502-1(b)(2). Even though the IRS currently has no procedures regarding when seeking an extension of the CSED in connection with a levy release might be appropriate, the statute and regulations provide that the IRS may secure a CSED waiver in connection with a release of a levy where the CSED on the underlying tax liability has expired. The agreement to extend the collection statute must be entered into prior to the levy being released.

17 RRA 98, Pub. L. No. 105-206, § 3461(c)(2), 112 Stat. 685, 764 (1998).

Bros. Drygoods Co. v. United States, 280 U.S. 453. 468 (1930). Rather, it is a voluntary, unilateral waiver of a defense by the taxpayer."[18]

The National Taxpayer Advocate Proposes Legislation and Orders IRS Review and Resolution of Lengthy CSED Accounts.

In 2006, the National Taxpayer Advocate proposed legislation to eliminate the IRS's inventory of over 32,000 accounts affecting approximately 14,000 taxpayers with lengthy CSED extensions.[19] In 2009, the National Taxpayer Advocate recommended that the IRS resolve excessively long CSEDs by writing off accounts with CSEDs greater than the original CSED plus five years (absent other lawful extensions).[20]

On January 20, 2010, the National Taxpayer Advocate issued TAD 2010-3, directing the SB/SE Commissioner to, among other things, provide employees for an SB/SE-TAS workgroup for review, resolution, adjustment, or correction of all accounts with CSEDs extended beyond 15 years after assessment (plus any statutory suspensions).[21] On June 10, 2010, the Deputy Commissioner for Services and Enforcement modified the TAD to require SB/SE (as part of the SB/SE-TAS workgroup, and in coordination with the Office of Chief Counsel) to review these accounts on a case-by-case basis and determine whether alternative resolutions could be reached.

The National Taxpayer Advocate's chief concern is the IRS's failure to cancel these unreasonable CSED extensions that do not comply with current policies. The IRS has already spent over four years trying to fix this problem, and no resolution is in sight.

The Resolution of All Lengthy CSED Accounts Hinges on Accurate Research of Accounts and Remedies that Comport with the Law.

In response to the TAD, the TAS-SB/SE CSED Workgroup investigated CSEDs extended by taxpayers longer than five years. The group initially determined that 4,466 taxpayers held accounts with extensions exceeding policy limits.[22]

The TAS - SB/SE CSED Workgroup Reviews Taxpayer Accounts.

The workgroup is investigating whether it can resolve accounts systemically, rather than case by case.[23] As of December 31, 2013, 2,371 individual taxpayers, who waived the collection statute for more than five years on tax periods before 1999, have open CSEDs.[24] Figure 1.13.2 shows the number of taxpayers by length of the waiver, whether the IRS has placed their accounts in currently not collectible (CNC) status, and the percentage of taxpayers in CNC status.

18 IRS Office of Chief Counsel, Program Manager Technical Advice (PMTA) 2010-10, Memorandum to Director, Collection Policy, Small Business/Self-Employed Division (SB/SE) (Feb. 12, 2010).

19 National Taxpayer Advocate 2006 Annual Report to Congress 428.

20 National Taxpayer Advocate 2009 Annual Report to Congress 227.

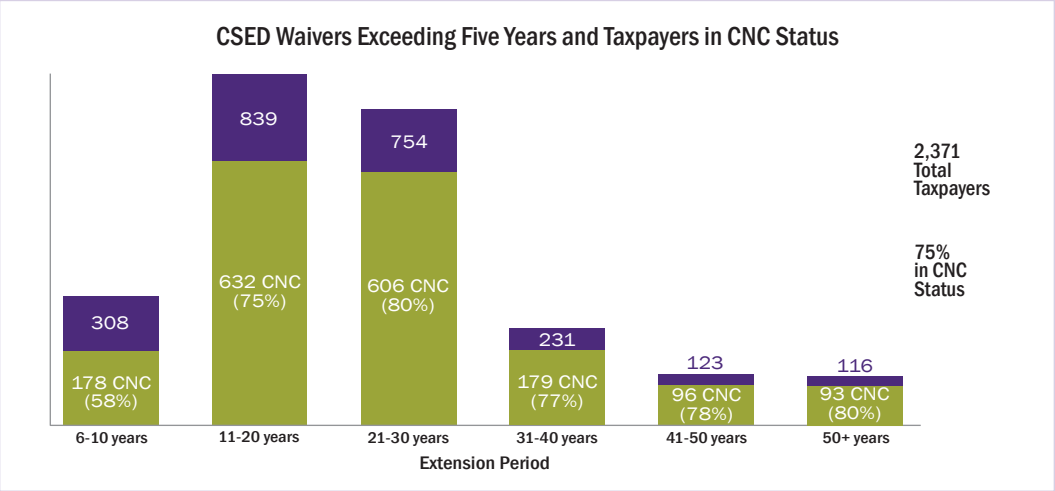
21 National Taxpayer Advocate, Taxpayer Advocate Directive 2010-3 (Jan. 20, 2010).

22 National Taxpayer Advocate 2012 Annual Report to Congress 470.

23 TAS-SB/SE CSED Workgroup, *Memorandum re: Effective Tax Administration Offers In Compromise for Certain Taxpayers Under a Lengthy CSED Extension* (June 21, 2012).

24 *Id*.

FIGURE 1.13.2, CSED Waivers Exceeding Five Years and Taxpayers in CNC Status[25]



SB/SE Research data on these accounts also show:

- 1,628 or almost 69 percent of these taxpayers signed waivers exceeding five years on or after October 30, 1991 in violation of IRS policy in effect at that time.[26]
- Over 87 percent only owe income tax liabilities.[27]
- 295, approximately 12 percent, owe trust fund taxes.[28]
- 2,209, over 93 percent, defaulted on the IA entered in connection with his or her lengthy CSED waiver.[29]
- 117, less than five percent, incurred additional tax liabilities after 1998.[30]

The following chart shows the breakout of taxpayers by active, CNC status (bankruptcy, decedent cases, unable to contact or locate, and economic hardship), and shelved (in the queue or no resources to work) accounts.

25 TAS-SB/SE CSED Workgroup, *Memorandum re: Effective Tax Administration Offers In Compromise for Certain Taxpayers Under a Lengthy CSED Extension* (June 21, 2012).

26 *Id*.

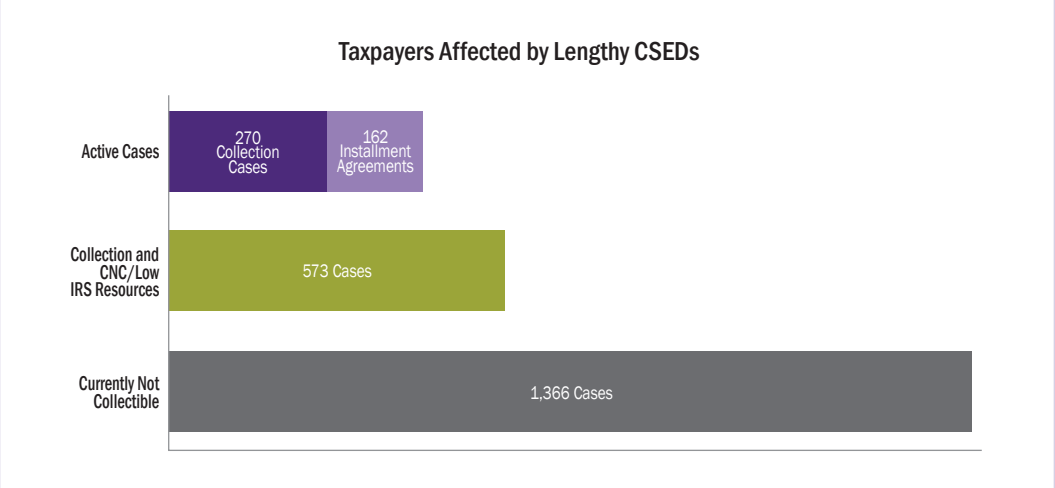
27 *Id*.

28 *Id*. Trust fund taxes refer to taxes collected or withheld under a trust imposed under IRC § 7501. The Trust Fund Recovery Penalty (TFRP) is a penalty that is assessed under IRC § 6672 against the individual or individuals who are responsible for paying the trust fund taxes but willfully did not do so. The amount of the penalty is equal to the amount of the unpaid trust fund taxes.

29 IRS CDW, analysis of IDRS TC 550, DC 0 and 1 for IMF accounts and Masterfile Status code (MF status) (June 25, 2013).

30 IRS CDW, analysis of IDRS TC 550, DC 0 and 1 for IMF accounts (June 25, 2013).

FIGURE 1.13.3, Taxpayers Affected by Lengthy CSEDs[31]



The IRS has not filed or refiled a notice of federal tax lien on almost 14 percent of the taxpayers' tax modules subject to the lengthy CSEDs.[32] The majority of these lengthy CSED cases burden taxpayers, who do not appear able to pay or resolve their debts through collection alternatives, and who would not be subject to collection on these IRS debts under current policy and law.

The IRS's Unacceptable Delay in Resolving These Lengthy CSED Accounts Is Due in Part to Chief Counsel's Concerns About The Commissioner's Authority to Undo These Extensions.

In connection with the TAD, the Office of Chief Counsel issued an opinion addressing whether the Commissioner could revoke, modify, or cancel the taxpayers' waivers for lengthy CSEDs, or whether the Commissioner could abate such liabilities as excessive in amount. Counsel concluded that while the Commissioner lacked the authority to modify or rescind a CSED waiver, the Commissioner could place these accounts into a separate noncollectible status "as to which refund offset and state-income tax levy would also be suspended."[33] However, placing the account in this special separate noncollectible status would not entirely solve the matter.

Liens filed against taxpayers facing lengthy CSEDs would continue to attach to their property and continue to harm these taxpayers by negatively impacting their credit score and economic viability.[34]

31 IRS CDW, analysis of IDRS TC 550, DC 0 and 1 for IMF accounts (June 25, 2013).

32 *Id*.

33 IRS Office of Chief Counsel, Program Manager Technical Advice (PMTA) 2010-10, Memorandum to Director, Collection Policy, Small Business/Self-Employed Division (SB/SE) (Feb. 12, 2010).

34 The Counsel Memo did indicate that the IRS might be able, on a case-by-case basis, to withdraw the lien under the best interest test found in section 6323(j)(1)(D) which would remove the lien from the taxpayer's credit history. On average, a lien filing reduces a taxpayer's credit score by 100 points. The impact of the lien filing is greatest upon the initial filing and diminishes over time. See written response from Vantage Score® (Sept. 17, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 20 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*).

Unpaid tax liens may remain on a taxpayer's credit history, leaving a derogatory mark on the credit history indefinitely.[35]

Counsel further concluded, "The Commissioner's authority under section 6404(c) to abate tax "under uniform rules" when "the administrative and collection costs involved would not warrant collection of the amount due" would not authorize blanket abatements directed by the National Taxpayer Advocate. These abatements are typically made on a case-by-case basis, as the financial situations of taxpayers vary."[36] The National Taxpayer Advocate's position is that the abatement authorization under IRC § 6404(c) contains no explicit exception or prohibition for applying "uniform rules" for abatement to a group or class of taxpayers. Here, we have clearly defined groups of taxpayers with clearly described similar circumstances. Some of these circumstances fit squarely within the 6404(c) abatement language. The language of 6404(c) does not ignore the needs of administrative efficiency — indeed, the statutory language, together with principles of efficient tax administration, clearly contemplates a blanket abatement in these situations.

The majority of these lengthy CSED cases burden taxpayers, who do not appear able to pay or resolve their debts through collection alternatives, and who would not be subject to collection on these IRS debts under current policy and law.

In 2012, IRS Chief Counsel concluded that the IRS can only solicit offers in compromise from these taxpayers if it makes determinations of equity or hardship based on the facts and circumstances of each case.[37] Most recently, the workgroup requested assistance from Counsel to see whether there was a way to resolve these accounts under the existing statutory scheme. Counsel is in the process of writing a legal memo that we hope will provide a way or ways to resolve these cases. The National Taxpayer Advocate, however, is running out of patience.

CONCLUSION

Lengthy CSED accounts are a remnant of the era preceding RRA 98. The IRS continues to burden taxpayers who waived a collection statute for more than five years in connection with an IA. While RRA 98 limited other CSED waivers, the IRS has not yet implemented a plan to resolve lengthy CSED waivers, even though many were solicited in violation of IRS policy. Further, IRS data show little or no collection activity on these accounts. The National Taxpayer Advocate is greatly concerned that the IRS will do nothing and hold these uncollectible debts over taxpayers' heads, rather than resolve all lengthy CSED accounts once and for all as agreed to in response to TAD 2010-3.

35 As a matter of policy, Experian keeps unpaid tax liens on a credit report for 15 years and Equifax for ten years, while Transunion credit reports reflect them indefinitely. Released liens, including those paid off by the taxpayer, are not generally removed from the credit history until seven years from the date of release. *See* The Fair Credit Reporting Act (FCRA), § 605(a)(3), 15 USC 1681c(a)(3); IRC § 6325(a)(1) (lien will be released if the liability is satisfied or becomes unenforceable). However, California requires that all liens, released and open, be removed from credit histories ten years after the filing date. *See* Cal. Civ. Code, § 1785.13(d).

36 IRS Office of Chief Counsel, Program Manager Technical Advice (PMTA) 2010-10, Memorandum to Director, Collection Policy, Small Business/Self Employed Division (SB/SE) (Feb. 12, 2013).

37 *Id.*

RECOMMENDATIONS

The National Taxpayer Advocate offers the following recommendations to finally resolve all lengthy CSED accounts:

1. By April 15, 2014, cease collection of payments on all accounts where the collection period was extended in violation of the IRS 1991 waiver policy.
2. By June 30, 2014, abate all such extended CSED accounts under the authority vested in the Commissioner under the Internal Revenue Code.

MSP #14 COLLECTION DUE PROCESS HEARINGS: Current Procedures Allow Undue Deference to the Collection Function and Do Not Provide the Taxpayer a Fair and Impartial Hearing

RESPONSIBLE OFFICIALS

Kirsten B. Wielobob, Chief, Office of Appeals
Debra Holland, Commissioner, Wage and Investment Division
Karen Schiller, Commissioner, Small Business/ Self-Employed Division

DEFINITION OF PROBLEM

The IRS's current procedures for Collection Due Process (CDP) hearings do not always result in a fair, impartial, and independent review. The IRS Restructuring and Reform Action of 1998 (RRA 98) established a taxpayer's right to an independent review of IRS lien and levy actions by the Office of Appeals, known as a CDP hearing.[1] Unlike other creditors, the IRS can file a lien against or levy a taxpayer's assets without first obtaining a court order. Providing due process rights for collection actions forces the IRS to consider the taxpayer's circumstances before (or immediately after, in the case of lien filing) exercising these powers.[2]

As conducted by the IRS today, CDP hearings do not provide most taxpayers with a meaningful hearing. In many cases, the IRS issues a CDP notice before making any other contact with the taxpayer and before he or she has a chance to meaningfully engage with Collection. As a result, taxpayers may feel pressured into requesting a CDP hearing, and Appeals may receive cases that are not fully developed. When Collection receives a CDP request, it has discretion as to when to send the case to Appeals. In situations where the taxpayer works with Collection and does reach an agreement, Collection will ask the taxpayer to withdraw the CDP request, taking away his or her opportunity for an independent review.

One of the most significant problems with CDP hearings is that Appeals may not give proper attention to a core taxpayer rights aspect of the hearing, namely, the balancing test that requires the Hearing Officer to weigh the need for collection against the taxpayer's interest that the action be no more intrusive than necessary.[3] Moreover, Hearing Officers do not exercise settlement authority used by other Appeals Officers and thus may not fully carry out the balancing test.

1 *See* IRC § 6330(b). *See also* Pub. L. No. 105-206, § 3401. A lien is "a legal right or interest that a creditor has in another's property, lasting usually until a debt or duty that it secures is satisfied." *Black's Law Dictionary* (9th ed. 2009). *See also* IRC § 6321. Levy refers to the IRS's ability to collect amounts owed by taking the property or rights to the property of the taxpayer. *See* IRC § 6331.

2 The taxpayer must file a CDP request within 30 days of receiving the CDP notice. The IRS sends the CDP notice within five days of the filing of the lien or the Notice of Intent to Levy. IRC §§ 6330(b)(1) and 6330(b)(3). In limited circumstances described in IRC § 6330(f) the taxpayer does not have CDP rights until after the levy.

3 "Hearing Officer" describes " a group of employees who deal with taxpayers and resolve disputes. An Appeals hearing officer is any Settlement Officer, Appeals Officer, Appeals Account Resolution Specialist or other employee holding hearings, conferences or who otherwise resolves open case issues in Appeals." IRS, AJAC FAQs, http://appeals.web.irs.gov/about/ajac-faq.htm (updated Sept. 30, 2013).

ANALYSIS OF PROBLEM

RRA 98 established a taxpayer's right to a CDP hearing to give taxpayers who are dealing with the IRS the same protections they have when dealing with other creditors.[4] Congressional testimony explained, "Many people were shocked to learn that a number of the due process protections Americans take for granted in other legal proceedings do not apply to actions involving the IRS."[5] As a result, Congress sought increased protection for taxpayers.[6] The Senate committee report emphasized, "a proposed collection action should not be approved solely because the IRS shows that it has followed appropriate procedures."[7]

CDP hearings have three major elements:

1. To provide an independent review of IRS collection action by an Appeals employee;
2. To verify that Collection has followed any applicable law or administrative procedure; and
3. To ensure "any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[8]

During a CDP hearing, a taxpayer may raise appropriate spousal defenses, challenge the appropriateness of the collection actions, and offer collection alternatives.[9] A taxpayer can challenge the underlying liability if he or she did not receive a statutory notice of deficiency or otherwise have an opportunity to dispute the tax liability.[10]

Of the taxpayers who receive CDP notices, few request CDP hearings. In FY 2012, the IRS issued over 3.6 million CDP notices and received only about 47,500 CDP hearing requests, approximately 1.31 percent of hearings offered.[11] CDP cases represented 37.9 percent of Appeals receipts in 2012 and 35.9 percent through June 30, 2013, the largest single receipt source.[12]

4 S. Rep. No. 105-174, at 68 (1998).

5 144 Cong. Rec. 4,190 (1998).

6 144 Cong. Rec. 4,184 (1998). "Currently there is a woeful lack of protection in this area, particularly during collection activity, where the IRS is the judge and jury, and where some agency employees take a cavalier approach to issuing a notice of lien, levy, or seizure of a taxpayer's home, personal belongings, or business property."

7 S. Rep. No. 105-174, at 68 (1998).

8 IRC § 6330(c).

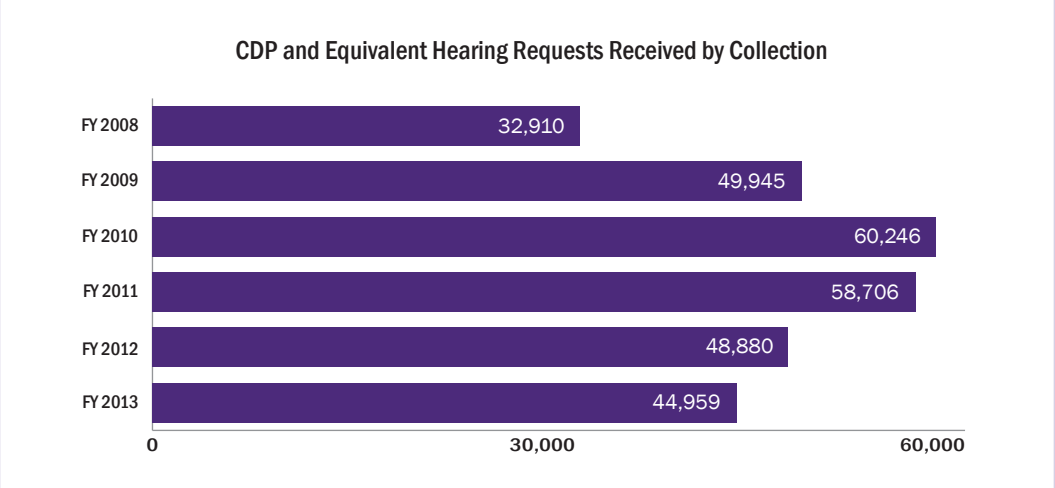
9 IRC § 6330(c)(2)(A).

10 IRC § 6330(c)(2)(B).

11 IRS response to TAS information request (Nov. 15, 2013). Fiscal year is based on when the CDP hearing was requested. In the first half of 2013, the IRS issued over 2.4 million CDP notices, but received only 35,780 CDP requests, approximately 1.48 percent.

12 IRS response to TAS information request (Sept. 17, 2013). Appeals receipts include other issues taxpayers commonly appeal, such as issues in examination. Compare to Examination/TEGE appeals, comprising 31.4 percent in fiscal year (FY) 2012 and 31.4 percent through June 30, 2013.

FIGURE 1.14.1, CDP and Equivalent Hearing (EH) Requests, Fiscal Years 2008–2013[13]



Taxpayers may not have the chance to work with Collection before receiving a CDP notice and may feel forced into a CDP hearing.

The IRS must issue a CDP notice within five days of filing a notice of federal tax lien (NFTL), and at least 30 days before it can levy with respect to the unpaid tax.[14] Although the statute ties the timing of the CDP notice to the NFTL and notice of intent to levy ("NIL"), issuing the CDP notice too early undercuts the entire CDP process.[15] In many cases, Collection employees do not attempt to contact the taxpayer before sending the CDP notice. The Internal Revenue Manual (IRM) requires employees to make reasonable efforts to contact the taxpayer (by visiting, calling, or mailing a notice to the last known address) before issuing the NFTL.[16] However, the IRS undermines this protection by requiring the NFTL filing determination ten days after the initial contact attempt or when the contact was due (before any undeliverable mail would be returned and processed).[17] For levies, there is no requirement that the IRS contact the taxpayer before issuing the NIL, which the IRS can issue as early as ten days after issuing the notice of assessment and demand for payment.[18] Neither the Automated Collection System (ACS) nor Field Collection tracks how often employees contact taxpayers by phone or mail prior to sending CDP notices.[19] Given that ACS employees only spend about two or three percent of their time on outbound calls, it is unlikely ACS contacts most taxpayers before issuing the CDP notice.[20] For Field Collection,

13 TAS Research Individual Master File transaction code 971 action code 275 or 278 (Nov. 17, 2013). Fiscal year is based on when the CDP notice was mailed to the taxpayer, as opposed to the date when the CDP hearing was requested, as used in the text above.

14 IRC §§ 6320(a)(2), 6330(a)(2). In limited situations, the IRS can levy before providing the right to a CDP hearing. IRC § 6330(f). IRC § 6320(a)(2) requires the IRS to issue a notice of the taxpayer's right to a CDP hearing within five days of filing the notice of tax lien.

15 IRC § 6331(d)(2) requires the IRS to provide notice of intent to levy at least 30 days before the day of the levy, except where the collection of tax is in jeopardy.

16 IRM 5.12.2.2(1) (Oct 14, 2013). If the taxpayer does not send in a payment, the IRS must advise the taxpayer of his or her right to appeal under the Collection Appeals Program, which is the only pre-lien administrative appeal process. It is limited to procedural arguments. *See* IRM 5.12.6.4 (2) (Oct. 14, 2013).

17 IRM 5.12.2.3.2(1) (Oct 14, 2013).

18 *See* IRM 5.11.1 (Feb. 3, 2012). The IRS usually issues the Notice of Intent to Levy and Notice of Your Right to a Hearing (L1058) on initial contact with a business taxpayer or combination business/individual taxpayer when a deadline is set for the taxpayer to take specific action. For individual taxpayers, the IRM advises using discretion as to whether to issue the L1058 on initial contact. IRM 5.11.1.2.2 (Dec. 11, 2009).

19 IRS Response to TAS Information Request (Sept. 3, 2013).

20 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 3 (Apr. 28, 2010).

Revenue Officers (ROs) issue the CDP notice at the same time as the initial contact when the RO asks for the financial analysis.[21]

A taxpayer has only 30 days to file a CDP request after receiving a CDP notice, and may feel pressured to request a hearing even if he or she is still putting together documentation and trying to work with Collection.[22] If a taxpayer does not provide the requested information before Collection's deadline, it may deny the taxpayer's position as unsubstantiated and transfer the case file to Appeals without reviewing the documents later provided.[23] In some cases, ROs may perceive the filing of a CDP request as an action solely to delay collection and refer the taxpayer's representative to the Office of Professional Responsibility, despite the fact that filing a CDP request is a reasonable and legal action to take.[24]

Taxpayers may sacrifice their rights if they come to an agreement with Collection after filing the CDP request.

A taxpayer who files a CDP request to preserve the right to a hearing may end up sacrificing this right if he or she reaches an agreement with Collection. If the taxpayer and the IRS come to a proposed settlement, the IRS asks the taxpayer to withdraw the CDP request.[25] While Collection has told TAS that a taxpayer is *not required* to withdraw a CDP request upon reaching a resolution, the IRM states "the RO should solicit a withdrawal of the hearing request."[26] If a taxpayer withdraws a CDP request, the taxpayer loses the opportunity for Appeals to verify independently that the IRS has followed the law and procedures and conduct the balancing test.[27]

The IRS should change these procedures so that Appeals enters into the agreement with the taxpayer, meaning Appeals will still be required to make the CDP determination.[28] When a taxpayer reaches an agreement with Appeals, he or she must sign a form that waives the right to judicial review of Appeals' determination.[29] Under the current system, where a taxpayer signs an agreement with Collection, the result is the worst of both worlds – the taxpayer loses the opportunity for a future Appeals determination that is subject to judicial review, while at the same time giving up the current opportunity for Appeals to review Collection's actions and conduct the balancing test.

---

21 "While the notices sent in the notice stream are sufficient for filing an NFTL, generally when an NFTL has not been previously filed the revenue officer's determination with respect to the filing of the NFTL will be done in conjunction with the initial actual contact or initial attempted contact." While it is preferable to contact the taxpayer in person, the initial contact can also be done by phone or by mailing a notice or letter to the last known address. IRM 5.12.2.2 (Oct. 14, 2013). *See also* IRM 5.1.30.2 (July 8, 2011), 5.1.30.3 (July 8, 2011), 5.1.30.5 (July 8, 2011).

22 IRC § 6330(a)(3); IRC § 6320(a)(3).

23 In some cases, a taxpayer may not receive the NIL or NFTL letter. In FY 2012, 33.9 percent of the NIL letters and 6.5 percent of the NFTL letters were unclaimed, refused, or undeliverable. TAS Research Individual Master File, ratio of taxpayers with transaction code 971 action code 67 or 68 to number of taxpayers with transaction code 971 action code 69. (Nov. 16, 2013). *See* IRM 5.12.6.3.17 (Oct. 14, 2013).

24 The Director of the IRS Office of Professional Responsibility (OPR) has warned practitioners that assisting with a CDP claim involving collection alternatives could lead to practitioner discipline if the taxpayer is not compliant with payment and filing obligations. *See* 137 Tax Notes 742 (Nov. 12, 2012).

25 IRM 5.1.9.3.4 (Feb. 23, 2012).

26 IRS response to TAS information request (Sept. 3, 2013). The regulations provide that withdrawal is allowed but not required. Treas. Reg. 301.6330-1(c), A-C9 provides that when a taxpayer resolves the matter with Collection after filing a CDP request, "the taxpayer *may* withdraw in writing the request that a CDP hearing be conducted by Appeals" (emphasis added). See IRM 5.1.9.3.3 (3) (Feb. 23, 2012).

27 IRM 8.22.5.2.5(5) (Nov. 8, 2013) states, "The Legal and Administrative review is not required when a taxpayer withdraws his/her hearing request," but the IRM is silent as to whether Appeals must conduct the balancing test. The taxpayer also loses the ability to challenge the underlying liability, if allowed in the CDP hearing. *See* IRC § 6330(c)(2)(B).

28 IRC § 6330(c)(3) provides that the CDP determination shall take into consideration: the verification that the law and applicable procedures were followed, any issues raised relating to the unpaid tax or the proposed levy allowed to be raised under IRC § 6330(b)(2), and the balancing test.

29 IRM 8.22.7.1.2 (Nov. 5, 2013). This is similar to what takes place when a taxpayer settles a case in Tax Court and must agree not to appeal the decision.

The process of requesting a hearing raises impartiality concerns.

A taxpayer who requests a CDP hearing may doubt whether the review will be independent because the taxpayer must send the request to Collection, the same office demanding payment.[30] Collection has discretion as to when to send the CDP case to Appeals, and can delay a hearing by not sending the case to Appeals for up to 90 days if it determines the taxpayer is willing to work with Collection.[31] Collection can also send the case immediately if it determines the taxpayer does not want to work with collection or raises frivolous arguments.[32] Thus, the timing of when Appeals receives a case comes with an implication that the taxpayer is a "good taxpayer" willing to work with Collection, or a "bad taxpayer" acting unreasonably. The Appeals Customer Satisfaction Survey reflects the disparity in the time it takes a case to reach Appeals, and found that taxpayers whose cases took 30 days or less to assign to an Appeals Officer were significantly less satisfied overall than those whose cases took longer."[33] Taxpayers may have been dissatisfied because they felt rushed into the Appeals proceedings without the opportunity to have their information and specific facts considered.[34] However, other Appeals customers who were dissatisfied with the amount of time it took to hear from Appeals thought Appeals should schedule an initial conference within 30 days of a request.[35]

Current procedures may prevent taxpayers from effectively challenging the underlying liability.

Some taxpayers may disagree with the underlying liability even though they do not meet the statutory requirements for challenging it.[36] If eligible, taxpayers can raise the liability through other channels.[37] Currently, when a taxpayer raises liability issues such as Innocent Spouse, penalties, or interest abatement, or the taxpayer submits a Doubt as to Liability (DATL) OIC, Appeals assigns the case to an Appeals Officer or Settlement Officer for consideration.[38] If a taxpayer files an amended return or disputes an automated substitute for return (ASFR), the CDP hearing is suspended while

Unlike other creditors, the IRS can file a lien against or levy a taxpayer's assets without first obtaining a court order.

30 *See* IRS Form 12153 (Mar. 2012).

31 During the first three quarters of 2013, the average time from the filing of a CDP request to Appeals receiving the CDP case was 69 days. IRS Response to TAS Information Request (Sept. 5, 2013). *See also* IRM 5.1.9.3.3 (Feb. 23, 2012).

32 See IRM 5.1.9.3.3 (Feb. 23, 2012).

33 Appeals Customer Satisfaction Survey, National Report, Fiscal Year 2012 Results, Time to Hear from Appeals 9. Appeals Customer Satisfaction Survey, National Report, Fiscal Year 2012 Results, Overall Satisfaction by Time from Appeal Request to Case Assignment 15.

34 Two of the strongest drivers of satisfaction for Appeals customers were "Consideration of Information You Presented" and "Application of the Law to the Facts in Your Case." *Id*. at 23.

35 This seemingly contradictory finding may be the result of some Appeals customers experiencing extreme wait times for their conferences to be scheduled. A recent TIGTA report found 58 CDP or Equivalent Hearing cases from a sample of 132 that exceeded the target time of 90 days to resolve or forward to Appeals. Twenty-nine of these cases took more than 180 days to resolve or forward to Appeals. *See* TIGTA, Ref. No. 2013-10-103, *The Office of Appeals Continues to Experience Difficulties in the Handling of Collection Due Process Cases* 7 (Sept. 17, 2013). The sample was taken from 2011 and 2012. *Id*. at 31.

36 The taxpayer can contest a liability during a CDP hearing if he or she did not receive a notice of deficiency, never signed a consent for assessment, and did not have a prior opportunity to dispute the tax liability with Appeals. IRC § 6320(c) and IRC § 6330(c)(2)(B). A taxpayer may not have received a statutory notice of deficiency where the notice was undeliverable and the IRS had the taxpayer's last known address, but the IRS failed to send the notice the taxpayer's last known address.

37 These channels include audit reconsiderations, amended returns, and doubt as to liability (DATL) offer in compromise (OIC). A taxpayer is eligible for audit reconsideration if he or she meets four criteria: the taxpayer must have filed a tax return, the assessment must be unpaid or the IRS has reversed tax credits that the taxpayer is disputing, the taxpayer must identify which adjustments he/she is disputing, and the taxpayer must provide additional information not considered during the original examination. IRM 4.13.1.4 (Oct. 1, 2006). IRC § 7122 provides the authority to enter in OICs, including offers relating only to liability issues.

38 IRM 8.22.8.5.1 (Nov. 8, 2013).

the return is sent to Exam or the ASFR Reconsideration team.[39] As part of the Appeals Judicial Approach and Culture (AJAC) project, Appeals is considering which function should make the initial determination on DATL OICs settled by Appeals.[40] Compliance will determine whether to abate any of the liability, while the CDP hearing itself will remain in Appeals' jurisdiction.[41] These forthcoming changes are positive if they allow Compliance to first consider the DATL offer (subject to the right to an administrative appeal of a rejection) and then allow Appeals to consider other issues as part of the CDP hearing. Unless the appropriate IRS function first resolves the liability issue, Appeals could end up sustaining a levy action even though resolving the liability may extinguish the levy entirely or qualify the taxpayer for a guaranteed or streamlined installment agreement (IA).[42]

Another issue is that taxpayers cannot contest prior-year liabilities in CDP hearings. The regulations refer to a taxpayer's ability to contest liabilities "for any tax period shown on the CDP notice."[43] Appeals does not hear challenges to prior-year liabilities if they are not included on the CDP notice. This does not allow the taxpayer to resolve the collection matter in the most efficient way because most collection alternatives — IAs, OICs, and currently not collectible status — need to cover all years with a liability. One solution to this problem would be for Appeals to suspend the CDP hearing when non-CDP liability issues would be included in collection alternatives covered by the CDP hearing, to allow the taxpayer to resolve these related liability issues with the appropriate IRS function.

Taxpayers face roadblocks to receiving equivalent hearings.

If a taxpayer does not request a CDP hearing within the 30-day period, the taxpayer may still qualify for an equivalent hearing.[44] However, the IRS does not make it simple — the taxpayer will only receive an equivalent hearing if specifically requested.[45] Collection will not automatically process late-filed CDP requests as equivalent hearing requests.[46] Because equivalent hearings generally follow the same procedures as CDP hearings, taxpayers miss an important opportunity for Appeals to conduct the balancing test and review the collection action.[47]

---

39 IRM 8.22.8.7.1.1 (Nov. 8, 2013). The National Taxpayer Advocate recommended a legislative change codifying the audit reconsideration process and providing, *inter alia*, that the Office of Appeals shall not issue a Notice of Determination in said case until such reconsideration and administrative appeal of the underlying liability have been concluded and the results are taken into consideration in making the CDP determination. National Taxpayer Advocate 2005 Annual Report to Congress 463.

40 The AJAC project has the goal of "enhancing internal and external customer perceptions of fair, impartial, and independent Office of Appeals." *See* Memorandum for Appeals Employees, Implementation of the Appeals Judicial Approach and Culture (AJAC) Project, Control No. Ap-08-0713-03 (July 18, 2013).

41 IRS, AJAC FAQS, Offers in Compromise Q6, http://appeals.web.irs.gov/about/ajac-faq.htm#Offers_in_Compromise (updated Nov. 17, 2013).

42 See IRM 5.19.1.5.4 (Oct. 18, 2013).

43 IRC§ 6330(c)(2)(B) allows the taxpayer to raise at the CDP hearing "challenges to the existence or amount of the underlying tax liability for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." Treas. Reg. 301.6330-1(e)(1) provides, "The taxpayer also may raise challenges to the existence or amount of the tax liability specified on the CDP Notice *for any tax period shown on the CDP Notice* if the taxpayer did not receive a statutory notice of deficiency for that tax liability or did not otherwise have an opportunity to dispute that tax liability." (emphasis added).

44 IRM 5.19.8.4.3 (Nov. 1, 2007).

45 A taxpayer can request an equivalent hearing by checking a box on Form 12153, *Request for Collection Due Process or Equivalent Hearing* (which the taxpayer may not have checked because he or she thought the CDP request was timely), by making a written request, or by confirming that he or she wants the untimely CDP hearing request to be treated as an Equivalent Hearing when notified by Collection of an untimely CDP hearing request. The taxpayer must request the hearing within the one year period beginning the day after the date of the CDP levy notice or the day after the end of the five-day period following an NFTL filing. IRM 8.22.4.3 (Mar. 29, 2012).

46 IRM 5.19.8.4.3 (Nov. 1, 2007).

47 IRM 8.22.4.3 (Mar. 29, 2012). The Collection Statute Expiration date is not suspended for an equivalent hearing. The taxpayer cannot receive judicial review of the equivalent hearing, except for innocent spouse issues, abatement of interest issues, and the timeliness of the CDP hearing request. *Id. See* Treas. Reg. 301.6330-1(i).

AJAC procedures are promising, but need further development.

When a taxpayer requests a CDP hearing, Appeals may receive a partial case file or the case may have no development at all.[48] Under the AJAC interim guidance, CDP Hearing Officers have three options for cases that are not fully developed.[49] They can:

- Request information from the taxpayer;
- Issue an Appeals Referral Investigation (ARI) to Collection to secure information;[50] or
- Make a determination based on the information they have.[51]

The AJAC guidance needs further detail to guide Hearing Officers about when to exercise each option. Hearing Officers should only request information from Collection in limited circumstances, which need to be spelled out. For example, if the case file indicates a financial statement was prepared, but it is not in the file, it would be appropriate for the Hearing Officer to issue an ARI. Or, if the taxpayer requests a collection alternative for the first time while the case is in Appeals, an ARI to have Collection review and research is appropriate. However, if the taxpayer has updated financial information to submit, this is squarely in Appeals' jurisdiction, and it should conduct the analysis.[52] The Appeals response to TAS's research request states, "If the taxpayer submits additional information to Appeals that requires further analysis or more complex development, Appeals may issue an Appeals Referral Investigation (ARI) to the originating function as needed." This response raises concerns because Appeals should analyze the additional or supplemental facts as part of its independent review.

Under AJAC procedures, if the taxpayer submits an OIC, the Centralized Offer in Compromise (COIC) unit will review it and share the results with the taxpayer. If COIC's recommendation is anything other than acceptance, Appeals will make the final determination.[53] This approach is positive in that it allows Appeals to retain jurisdiction, ensure the IRS followed proper procedures, and conduct the balancing test.

Concerns remain regarding Appeals' independence from Collection.

Despite the AJAC changes, concerns remain regarding Appeals' independence because it lacks IRM guidance of its own regarding CDP cases.[54] The AJAC interim guidance advises Settlement Officers to use the Collection IRM to:

- Verify whether administrative procedures were followed in issuing the NFTL or NIL;
- Review Collection case actions and decisions; and

48 IRM 8.22.4.6(3) a-g (Mar. 29, 2012). *See also* IRM 5.1.9.3.3 (Feb. 23, 2012).

49 See footnote 45 *supra*.

50 Appeals can use an ARI to request a Collection officer research the taxpayer's assets and income, or evaluate their proposed Collection Alternative. Collection provides this information or analysis to the hearing officer.

51 *See* Memorandum for Appeals Employees, Control No. Ap-08-0713-03, *Implementation of the Appeals Judicial Approach and Culture (AJAC) Project* (July 18, 2013) (revising IRM 8.22.4.2.1). IRM 8.22.4.2.1 was revised on November 5, 2013 and provides only two options in these situations: request the information from the taxpayer or issue an ARI to Collection.

52 "Appeals exercises independent judgment concerning disputed valuations and business decisions made by Collection." IRM 8.23.1.1 (8) (Nov. 20, 2013). "A cadre of Appeals hearing officers will provide the additional review of real property valuations for Appeals." IRM 8.23.3.3.2.5 (Nov. 21, 2013).

53 *See* Memorandum for Appeals Employees, Control No. Ap-08-0713-03, *Implementation of the Appeals Judicial Approach and Culture (AJAC) Project* (July 18, 2013) (revising IRM 8.22.7.10.6.5). IRM 8.22.7.10.6.5 was revised on November 5, 2013 and incorporates this change.

54 Complaints regarding Appeals' lack of independence have been common since Congress created CDP hearings. In 2012, the IRS published Rev. Proc. 2012-18, which prohibits certain communications between Appeals and the IRS function where the case originated (originating function). *See* Rev. Proc. 2012-18, 2012-10 I.R.B. 455.

- Evaluate alternatives to collection action.[55]

While the Collection IRM may be helpful in determining whether Collection followed the proper administrative procedures, Appeals needs its own guidelines for evaluating Collection's actions and decisions. One of the primary components of a CDP hearing is the balancing test, in which Appeals must weigh the IRS's need for efficient collection with the taxpayer's concern that the collection action be no more intrusive than necessary.[56] This balancing test is a fundamental taxpayer right, preventing the government from collecting tax without considering the taxpayer's legitimate interest.[57] It is unique in that Congress has specifically and statutorily required Appeals to weigh the taxpayer's interest against the IRS's need for collection. When Appeals Officers working CDP cases have to use the Collection IRM, which does not provide guidance on the balancing test, they may not provide a truly independent review or give proper attention to the test.

Without receiving an independent hearing from Appeals, taxpayers will continue to face emotional distress and economic hardship without the protections Congress intended.

Another issue is the practice of sustaining Collection's interpretation without independent verification, especially where Collection determines the taxpayer raised frivolous issues or requested a CDP hearing to delay or impede collection.[58] The Collection official can assert in the transmittal document that the taxpayer is making a frivolous argument or one intended to delay collection. If Collection believes the CDP request is frivolous, the taxpayer receives a special Appeals letter, giving him or her 30 days to amend the request.[59] The taxpayer loses the right to a face-to-face hearing if he or she does not amend the request to remove all "frivolous" arguments, including one that reflects a desire to delay.[60]

Appeals does not exercise its settlement authority in CDP cases.

Revenue Procedure 2012-18 and the Appeals IRM make it clear that Appeals has the authority to settle cases.[61] However, Appeals only considers the hazards of litigation in CDP cases in limited situations.[62] Since the advent of CDP in RRA 98, a significant body of law has developed around what constitutes abuse of discretion on the part of the IRS in collection actions. Where case law is unfavorable to the IRS position or practice in a case, Appeals' failure to take these conditions into account may mean that the

55 *See* Memorandum for Appeals Employees, Control No. Ap-08-0713-03 *Implementation of the Appeals Judicial Approach and Culture (AJAC) Project* (July 18, 2013) (revising IRM 8.22.4.2.1).

56 IRC § 6330(c)(3).

57 The National Taxpayer Advocate has recommended that fundamental taxpayer rights, such as the right to be heard and the right to a fair and just tax system, be incorporated into ongoing Collection and Appeals training. National Taxpayer Advocate's Report to the Acting Commissioner, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration* 26-27 (Nov. 4, 2013).

58 *See* IRM 5.19.8.4.7.7 (Sept. 2, 2009). Appeals still receives CDP requests that Collection has deemed to delay or impede collection. Conversely, offers in compromise or installment agreement requests that Collection deems "Solely to Delay" may not go to Appeals. *See* IRM 5.14.3.2 (3)(e) (Jun. 12, 2009); IRM 5.8.3.13.1 (May 14, 2013).

59 "If I do not hear from you or if you submit another issue that is frivolous, or reflects a desire to delay or impede the administration of federal tax laws, I will disregard your hearing request and return your case to the IRS Collection office that referred it to Appeals." Letter 4380 (July 2008).

60 Letter 4380 (July 2008).

61 "Appeals employees remain ultimately responsible for independently evaluating the strengths and weaknesses of the issues in cases assigned to them and making independent judgments concerning the overall strengths and weakness of the cases and the hazards of litigation." Rev. Proc. 2012-18, § 2.02(3)(b). "The judicial attitude is one which reasonably appraises the facts, law, and litigating prospects; uses sound judgment and ability to see both sides of a question; and is objective and impartial. Any approach which contemplates a maximum possible result in favor of the Government or a deficiency in every case is incompatible with a judicial attitude and the Appeals mission." IRM 8.6.4.1.4 (Oct. 26, 2007).

62 "Settlement Officers use hazards of litigation when working Trust Fund Recovery Penalties. Hazards of Litigation are germane to TFRP cases because the determination of the exact amount of the proposed penalty can be tried in court. Collection Due Process cases can be reviewed by the Tax Court, but only for an abuse of discretion, not on the actual case resolution." IRS response to TAS information request (Sept. 5, 2013).

IRS is misapplying the balancing test. If the IRS has a high risk of losing the issue in litigation, then the collection action may not be "no more intrusive than necessary." In its response to TAS's research request regarding the hazards of litigation, Appeals stated, "Collection Due Process cases can be reviewed by the Tax Court, but only for an abuse of discretion, not on the actual case resolution."[63] However, the Tax Court's application of an abuse of discretion standard does not mean that Appeals should not exercise its settlement authority and take the hazards of litigation into account. The rationale for judicial review of collection actions is to provide guidance for when IRS actions constitute abuse of discretion. If the IRS ignores that guidance, it will harm taxpayers.

CONCLUSION

The National Taxpayer Advocate has written about CDP-related issues in numerous Annual Reports to Congress and has offered several legislative recommendations.[64] Without receiving an independent hearing from Appeals, taxpayers will continue to face emotional and economic hardship without the protections Congress intended. Taxpayers have a right to an independent review of collection actions by an impartial Hearing Officer, who must verify that the IRS followed the law and administrative procedures and conduct the balancing test. To make these protections real, the IRS needs to take the recommended actions.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Require Collection to attempt to contact the taxpayer, preferably by phone, before issuing a CDP notice.
2. Direct the taxpayer to send his or her CDP request to Appeals instead of Collection. If this is not done, require Collection to send cases to Appeals immediately upon receipt of the CDP request.
3. Consider untimely CDP requests as requests for an equivalent hearing if they qualify. Notify the taxpayer by letter and attach a list of questions and answers about equivalent hearings.
4. If a taxpayer reaches an agreement with Collection, do not ask the taxpayer to waive the right to a CDP hearing. Require Appeals to retain jurisdiction of the hearing when a taxpayer reaches an agreement with Collection, meaning Appeals and not Collection enters into the agreement with the taxpayer and conducts the other tasks required in CDP hearings.
5. Require Appeals to suspend a CDP hearing when a taxpayer raises a liability issue for a non-CDP year that would be included in collection alternatives covered by the CDP hearing. Allow the taxpayer to resolve these related liability issues with the appropriate IRS function.

63 IRS response to TAS information request (Sept. 5, 2013).

64 See National Taxpayer Advocate 2002 Annual Report to Congress 110-15, 2003 Annual Report to Congress 38-59, 2004 Annual Report to Congress 264-89, 2006 Annual Report to Congress 266–88, 2009 Annual Report to Congress 70-84, 2010 Annual Report to Congress 128-48 (Most Serious Problem: *Inadequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered*); National Taxpayer Advocate 2011 Annual Report to Congress (Most Litigated Issue: *Appeals from Collection Due Process (CDP) Hearings Under Internal Revenue Code Sections 6320 and 6330 619*); National Taxpayer Advocate 2012 Annual Report to Congress 6 (Legislative Recommendation: *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).*

6. Provide further guidance and examples of when the issuance of an Appeals Referral Investigation is appropriate, and limit the use of ARIs to obtaining additional documentation or facts, not analysis.
7. Update the Appeals IRM to provide significant guidance on CDP hearings, including reviewing the collection action, conducting the balancing test, and considering collection alternatives.
8. Require all Appeals Officers, Settlement Officers, and Appeals Account Resolution Specialists to take updated training on conducting the balancing test and applying the hazards of litigation.

MSP #15 EXEMPT ORGANIZATIONS: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status

RESPONSIBLE OFFICIAL

Sunita B. Lough, Commissioner, Tax Exempt & Government Entities Division

DEFNITION OF PROBLEM

The IRS's Exempt Organization (EO) unit receives about 60,000 applications for exempt status each year.[1] In addition, EO receives applications for reinstatement from organizations whose exempt status was automatically revoked. These applications added more than 50,000 cases to EO's workload over the past three years.[2] Already understaffed, EO did not allocate more resources to its Determinations Unit, which processes both initial and reinstatement applications. Its inventory backlog now stands at about 66,000 cases, more than the number of initial applications it usually receives in an entire year, four times the 2010 level, and more than triple the 2011 level.[3] Organizations consulting the "Where is My Exemption Application?" page on IRS.gov are informed that applications requiring review by an EO specialist take a year and a half just to be assigned.[4]

There is no procedure for administrative review of automatic revocations, yet EO uses automated systems that erroneously identify thousands of organizations as no longer exempt.[5] Planned programming changes will not avert future erroneous revocations. By erroneously listing an organization as having lost its tax exempt status, the IRS may cause the organization to lose funding it needs to survive and the effect may be community-wide.

In today's difficult economy and in light of long-term cuts in projected spending known as sequestration, exempt organizations are faced with a gap between an increasing need for their assistance and diminishing

1 *Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990*, Hearing before the H. Comm. on Ways and Means, Subcomm. on Oversight, 112th Cong. 2nd Sess. (July 25, 2012) 2 (testimony of Steven T. Miller, Deputy Commissioner of Services and Enforcement, Internal Revenue Service), *available at* http://waysandmeans.house.gov/UploadedFiles/Miller_Testimony_7.25.pdf (noting that "We consistently receive about 60,000 applications for tax-exempt status each year. Most are requesting status under section 501(c)(3).").

2 Total EO determinations case receipts were 66,038 for fiscal year (FY) 2011; 79,362 for FY 2012; and 79,740 for FY 2013. IRS response to TAS fact check, referencing TE/GE's fourth quarter 2013 Business Performance Review (BPR) (Dec. 16, 2013).

3 TE/GE response to TAS information request (Nov. 12, 2013). FY 2010 open inventory consisted of 15,570 determinations cases. For FY 2011, the level was 20,603 cases. IRS response to TAS fact check, referencing TE/GE's fourth quarter 2013 Business BPR (Dec. 16, 2013). TE/GE's most recent BPR posted on its webpage is for the second quarter of FY 2012. *See* TE/GE BPR FY 2012: Second Quarter (May 23, 2012), *available at* http://tege.web.irs.gov/support/planning/planning.asp.

4 Where Is My Exemption Application?, *available at* http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application (informing tax-pay as of Nov. 14, 2013, that EO was assigning applications it received in May of 2012). The web page was last updated on Sept. 23, 2013. Organizations consulting the more recently updated "Where's My Application?" page on IRS.gov are informed that the IRS might take up to six months after acknowledgthe application to either inform the applicant that the application has been approved or to request additional information. *See Where's My Application, available at* http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Where's-My-Application%3F (last vis-Dec. 17, 2013, showing the page had been updated Dec. 11, 2013). This new webpage was first available around Nov. 1, 2013. See Systemic Advocacy Management System submission 28938. Because six months have not yet elapsed since then, TAS cannot verify the reliability of the six-month estimate.

5 TE/GE estimates it erroneously treated about 9,000 organizations as having had their exempt status automatically revoked. TE/GE response to TAS information request (Nov. 12, 2013).

resources available to meet that need.[6] The single largest category of public charities deliver human services — they "provide networks of direct services to people in need. They feed our hungry, strengthen our communities, shelter our homeless, care for our elderly, and nurture our young."[7] When charities lose funds because they cannot obtain timely recognition of their exempt status, or are erroneously treated as no longer exempt, these vulnerable populations suffer the consequences.

ANALYSIS OF PROBLEM

The single largest category of public charities deliver human services… They feed our hungry, strengthen our communities, shelter our homeless, care for our elderly, and nurture our young.

Background

EO Has Struggled for the Past Decade to Process Its Inventory of Applications for Exempt Status, and Automatic Revocations Made the Problem Worse.

Since 2004, the National Taxpayer Advocate has reported on the increased number of applications for exempt status and the decrease in the number of EO employees who handle them.[8] Three of the past six Annual Reports to Congress identified the delay in processing applications for exempt status as among the Most Serious Problems.[9] EO's workload grew substantially in 2010, when it began notifying organizations their exempt status had been automatically revoked.[10] Many of these organizations applied for reinstatement, and they have done so in increasing numbers. EO, however, had projected a decrease in the number of applications for reinstatement over time. Figure 1.15.1 shows the relationship between EO's projected and actual receipts of reinstatement applications.

6 Marcus Baram, *Filling The Gap: As Government Shrinks, Community Groups Seek Local Solutions*, The Huffington Post (May 2, 2012), *available at* http://www.huffingtonpost.com/2012/05/02/filling-the-gap-crisis-assistance_n_1379761.html; Annie Lowrey, *Government Giving Nonprofits Angst*, The New York Times (Nov. 7, 2013), *available at* http://www.nytimes.com/2013/11/08/giving/government-giving-nonprofits-angst.html?_r=0.

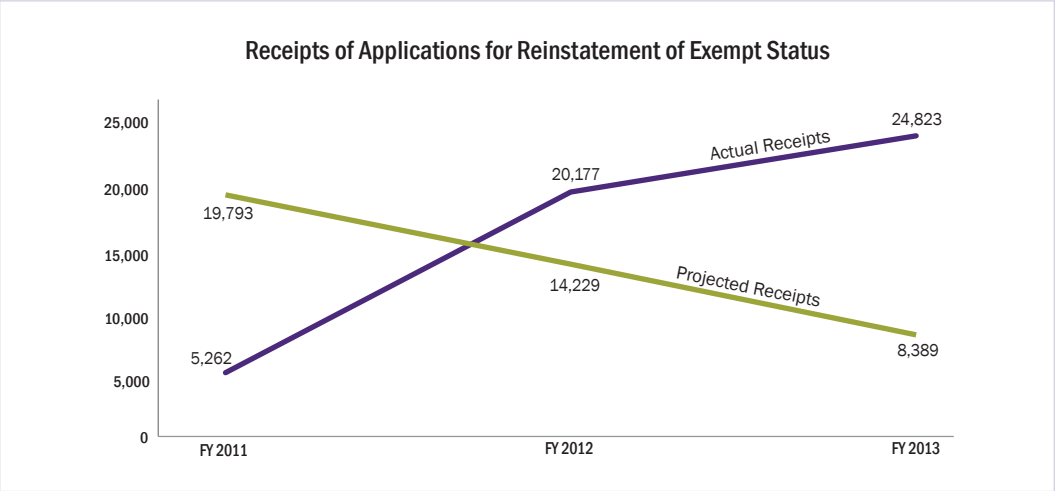
7 Charity Navigator, *available at* http://www.charitynavigator.org/index.cfm?bay=search.categories&categoryid=6; Sarah L. Pettijohn, Urban Institute, *The Nonprofit Sector in Brief 4* (2013), *available* at www.urban.org/UploadedPDF/412923-The-Nonprofit-Sector-in-Brief.pdf, noting that of 335,037 public charities reporting to the IRS in 2011, 116,643 (35 percent) were classified as part of the human services subsector.

8 National Taxpayer Advocate 2004 Annual Report to Congress 193, 203 (Most Serious Problem: *Application and Filing Burdens on Small Tax-Exempt Organizations*).

9 National Taxpayer Advocate 2012 Annual Report to Congress 192 (Most Serious Problem: *Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations*); National Taxpayer Advocate 2011 Annual Report to Congress 442 (Most Serious Problem: *The IRS Makes Reinstatement of an Organization's Exempt Status Following Revocation Unnecessarily Burdensome*); National Taxpayer Advocate 2007 Annual Report to Congress 210 (Most Serious Problem: *Determination Letter Process*).

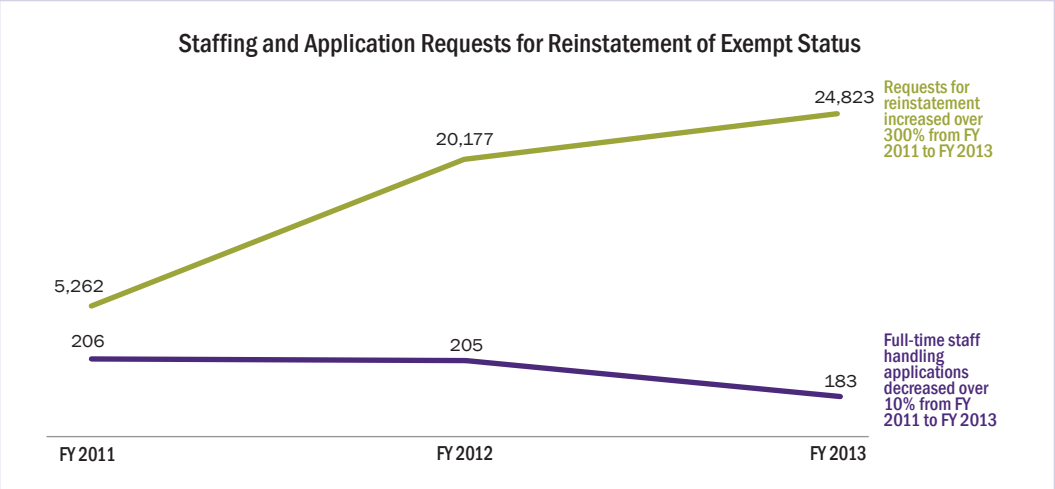
10 Section 1223 of the Pension Protection Act of 2006 (PPA) (Pub. L. No. 109-280, 120 Stat. 780 (2006)) imposed a new annual reporting requirement, Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*, on small exempt organizations and mandated automatic revocation of tax-exempt status of organizations that fail to file required returns or e-Postcards for three consecutive years.

FIGURE 1.15.1, Projected and Actual Receipts of Applications for Reinstatement of Exempt Status, FY 2011–2013[11]



EO and the IRS also ignored TAS's repeated warnings that EO was seriously understaffed to handle the influx of applications, with the result that applications continue to outstrip EO resources, as shown by Figure 1.15.2.[12]

FIGURE 1.15.2, Applications for Reinstatement of Exempt Status and Full-time Cincinnati Staff Handling the Applications FY 2011–2013[13]



11 TE/GE response to TAS information request (Nov. 12, 2013). AWSS Employee Support Services, Payroll/Personnel Systems, HR Reporting Section, Oct 5, 2013, *available at* https://persinfo.web.irs.gov/track/workorg.asp.

12 EO does not assign specific employees to work only on applications for reinstatement. TE/GE response to TAS information request (Nov. 12, 2013).

13 TE/GE response to TAS information request (Nov. 12, 2013) noting that "all Exempt Organizations, Determinations (EOD) and Exempt Organizations, Technical (EOT) employees who work on applications may work on reinstatement requests" and "[t]he approximate number of employees in EOD working applications is 150. The approximate number of employees in EOT working applications is 30." TAS found that as of Oct. 5, 2013, there were 183 full-time Cincinnati Determinations staff. AWSS Employee Support Services, Payroll/Personnel Systems, HR Reporting Section, *available at* https://persinfo.web.irs.gov/track/workorg.asp.

EO's budget as a portion of TE/GE's budget hovered between 35 and 38 percent for FYs 2011-2013 and remained relatively stable in dollar terms, but EO's volume of open inventory (*i.e.*, total unresolved cases) more than tripled.[14] According to the "Where is My Exemption Application?" page on IRS.gov, applications that need development take 18 months to be assigned to a reviewer, up from the nine months cited in last year's Annual Report and the seven months cited in the 2011 Annual Report.[15]

Organizations affected by delays in obtaining recognition of exempt status include those that deliver human services such as food and shelter. Of public charities that report to the IRS, there are more in this category than in any other.[16] Increased need for their assistance coincides with reductions in the amount of government funds to meet the need, especially at the state and local levels. For example, according to a 2012 survey by the U.S. Conference of Mayors:[17]

- Over 80 percent of the survey cities reported an increase in requests for emergency food assistance over the past year and three fourths expect such requests to increase in the future.[18]
- Nearly half of the survey cities expect that resources to provide emergency food assistance will decrease over the next year.[19]
- More than half the survey cities reported an increase in the total number of persons experiencing homelessness and expect the number of homeless families to increase in the future.[20]
- More than half of the survey cities expect resources to provide emergency shelter to decrease over the next year.[21]

The difficulties organizations encounter in obtaining timely recognition of their exempt status directly affects the members of their communities most in need of assistance.

EO Erroneously Notified Thousands of Organizations Their Exempt Status Had Been Revoked. Since the first automatic revocations became effective in 2010, EO has notified about 550,000 organizations they are no longer exempt, with about 9,000 of these notifications being in error.[22] The IRS notes the loss of exempt status on an electronic list of organizations whose exempt status was automatically

14 EO's budget equaled $98,759,800 or 35.6 percent of TE/GE's budget in FY 2011; $100,547,400 or 37.2 percent in FY 2012; and $97,154,000 or 38.1 percent in FY 2013; TE/GE response to TAS information request (Nov. 12, 2013). For FY 2011, the level of open inventory was 20,603 cases compared to the FY 2013 level projected to be 66,000 cases. IRS response to TAS fact check, referencing TE/GE's fourth quarter 2013 Business BPR (Dec. 16, 2013).

15 *See* National Taxpayer Advocate 2012 Annual Report to Congress 196 (Most Serious Problem: *Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations*); National Taxpayer Advocate 2011 Annual Report to Congress 449; Where Is My Exemption Application?, *available at* http://www.irs.gov/Charities-&-Non-Profits/Where-Is-My-Exemption-Application (informing taxpayers that, as of Nov. 14, 2013, EO was assigning applications it received in May of 2012). The web page was last updated on Sept. 23, 2013.

16 Sarah L. Pettijohn, Urban Institute, The Nonprofit Sector in Brief 4 (2013), *available at* www.urban.org/UploadedPDF/412923-The-Nonprofit-Sector-in-Brief.pdf. Of the 335,037 public charities reporting to the IRS in 2011, 116,643 (35 percent) were classified as part of the human services subsector. The next largest category included the 58,568 educational organizations (17.5 percent of the total), followed by the 41,619 health organizations (12.4 percent of the total). All other classifications (arts, culture and humanities; environment and animals; international and foreign affairs; public and social benefit; and religion related) each accounted for less than 12 percent of the total.

17 The U.S. Conference of Mayors, Hunger and Homelessness Survey (Dec. 2012), *available at* http://usmayors.org/publications/.

18 *Id*., at 1-2, reporting that 82 percent of the cities reported an increase in requests for emergency food assistance and three fourths of the survey cities expect requests for emergency food assistance to increase over the next year.

19 *Id*., at 2, reporting that 48 percent expect that resources to provide emergency food assistance will decrease over the next year.

20 *Id*., at 2-3, reporting that 60 percent of the cities reported an increase in homelessness and 60 percent expect the number of homeless families to increase over the next year.

21 *Id,*. at 3, reporting that 58.5 percent of the cities expect resources to provide emergency shelter to decrease over the next year.

22 TE/GE response to TAS information request (Nov. 12, 2013); IRS response to TAS fact check (Dec. 16, 2013).

revoked and removes the organization from the list of organizations to which deductible contributions may be made. An organization will likely immediately suffer the consequences of being taken off the "right" list and placed on the "wrong" list, while it faces potentially lengthy timeframes in the reinstatement process. EO refuses to implement a review procedure that would avert these drastic consequences long enough to allow it to consider the possibility that the revocation might have been erroneous.[23] In the meantime, an organization may become ineligible for grants and may lose donor funding it needs to survive.

As described in last year's Annual Report, after the Treasury Inspector General for Tax Administration found a programming problem existed, EO identified more than 2,270 cases in which an organization was erroneously listed as having had its exempt status revoked, and 300 to 400 additional entities identified themselves as erroneously listed as revoked. The most common reason for the erroneous revocations was that IRS systems did not recognize subordinate organizations as part of a group return when the subordinates and the parent organizations had different accounting periods.[24]

The inventory backlog of applications for exempt status now stands at about 66,000 cases, more than the number of initial applications the IRS usually receives in an entire year, four times the 2010 level, and more than triple the 2011 level.

This year, EO reported to TAS additional programming conditions that caused erroneous revocations. As reported in the National Taxpayer Advocate's Fiscal Year 2014 Objectives Report to Congress, one programming change caused IRS computers to calculate the three-year nonfiling period that triggers automatic revocation only with reference to the date the organization obtained its Employer Identification Number (EIN).[25] An organization obtaining its EIN in 2007, for example, would be treated as having had reporting obligations since 2007, even if the organization commenced operations and obtained recognition of its exempt status only in 2011. Systemic review of filing activity would show three or more consecutive years of nonfiling (2007-2010) and EO would notify the organization that it was no longer exempt. EO does not track the number of organizations it treated as automatically revoked because of this issue.[26]

EO relies on affected organizations to come forward and seek relief, then rectifies an error by restoring the organization's exempt status on its databases and issuing a letter attesting to its exempt status.[27] In an effort to minimize erroneous revocations, EO plans to change its procedures by identifying taxpayers who, in the process of obtaining an EIN, indicate they are nonprofit organizations.[28] The IRS will then send these organizations that do not file returns Notice 259A. The notice does not actually remind (or inform)

23 *See* National Taxpayer Advocate 2012 Annual Report to Congress 192, 202 (IRS Response: Most Serious Problem: *Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations*).

24 *Id.* at 199.

25 National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 33 (June 30, 2013). An EIN is a nine-digit number assigned by the IRS to sole proprietors, corporations, partnerships, estates, trusts, and other entities for tax filing and reporting purposes. An organization requests an EIN by submitting IRS Form SS-4, *Application for Employer Identification Number (EIN)*. The form does not require that the organization already be operational. For example, the applicant may select "banking purpose" as the reason for applying for the EIN. Thus, a new organization might obtain an EIN, set up a business bank account, and then use a check or credit card from the business bank account to pay the incorporation fee imposed by the state in which the organization is created. The EIN application asks what type of entity the applicant is, and contains a box for "other nonprofit organization."

26 TE/GE response to TAS information request (Nov. 12, 2013).

27 TE/GE response to TAS information request (Nov. 12, 2013).

28 *Id*. This capability is expected to be available beginning in January of 2014.

When charities lose funds because they cannot obtain timely recognition of their exempt status, or are erroneously treated as no longer exempt, these vulnerable populations suffer the consequences.

the organization of its filing obligation, but is captioned simply "You didn't file a Form 990/990-EZ or Form 990-N." The recipient is told that if it did not file, it should respond to the letter, and EO believes that this may prompt organizations that do not have a filing requirement to contact the IRS.[29] However, the portion of the notice "If We Don't Hear From You" begins, "[b]ecause you have tax-exempt status, you must file Form 990/990-EZ or Form 990-N." An organization that does not (yet) have exempt status would likely conclude that the notice simply doesn't apply to it. Nothing in the notice or any other IRS communication alerts the taxpayer that as far as the IRS is concerned, the three-year nonfiling period for automatic revocations has begun.

EO's decision to continue to measure the three-year nonfiling period with reference to issuance of the EIN is essentially a business decision. EO reasons that because an organization generally has an annual filing requirement from the time it forms and generally obtains an EIN in conjunction with its legal formation, "the EIN establishment date is an appropriate, and the best available, metric from which to begin looking for filings."[30] We agree that this may be an accurate description of how events generally unfold, and we recognize the convenience of using the EIN establishment date as a point of reference. However, the National Taxpayer Advocate takes issue with the imposition of this general rule because it is coupled with EO's refusal to provide administrative review of automatic revocations. By computing the three-year nonfiling period with reference to the EIN date, EO is perpetuating erroneous revocations. Some taxpayers may obtain EINs without actually forming a legal entity or conducting any activity. These taxpayers would not, as a matter of law, have a filing obligation. Other taxpayers, as generic organizations, may obtain EINs, have no filing requirements, and only later become nonprofit organizations, yet the nonfiling period would start on the date the EIN was obtained. Because the best available metric also ensures continued error, EO should allow administrative review of automatic revocations that result from this business decision.

A related procedure unfairly penalizes organizations that do file for exempt status as soon as they obtain their EINs, namely EO's inclusion in the three-year nonfiling period the time an e-Postcard filer was waiting for EO to process its application for exempt status. It is impossible to submit an e-Postcard in that period without assistance from the IRS.[31] TAS's position, with which the IRS has not agreed, is that it is unfair to "count" any failure to file during this period as one of the three periods that triggers automatic revocation, when the Internal Revenue Code *requires* electronic filing of the postcard and the IRS has designed a system that makes it physically impossible for the EO to make such an e-filing on its own. EO expects to partially address this problem with the same change in its procedures described above. Taxpayers that indicate on their applications for an EIN that they are nonprofit organizations will be

29 TE/GE response to TAS information request (Nov. 12, 2013).

30 *Id*.

31 One of the Frequently Asked Questions about exempt organizations' annual filing requirements is "Does an organization whose gross receipts are normally $25,000* or less have to file the *e-Postcard* if its application for tax exemption is pending?" The answer is "Yes, but to do so an officer of the organization must first call Customer Account Services at 1-877-829-5500 (a toll-free number) and ask that the organization be set up to allow filing of the *e-Postcard*." Exempt Organizations Annual Reporting Requirements — Annual Electronic Notice (Form 990-N): Frequently Asked Questions and Answers, *available at* http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Annual-Reporting-Requirements-Annual-Electronic-Notice-(Form-990-N):-Organization-With-Application-Pending-Must-File. Taxpayers who call the number cited above can expect to wait 17 minutes to speak to an IRS employee. The level of service (the percentage of callers requesting a customer service representative who received assistance) is 68.58 percent. TE/GE response to TAS information request (Nov. 12, 2013).

able to file a return or e-Postcard without assistance from the IRS.[32] This solution will not help taxpayers whose EIN applications do not show they are nonprofits. As noted above, it also does not help taxpayers who, although they have an EIN, have not commenced operations or do not respond to the IRS's notice because they do not believe it applies to them.

A separate programming change affected reinstated organizations. IRS databases did not show that organizations whose exempt status had been reinstated had a new three-year automatic revocation period. This caused the IRS to revoke exempt status a second time shortly after granting reinstatement.[33] The IRS does not know how many organizations it treated as automatically revoked because of this change.[34] While the IRS has resolved the problem for many of these organizations, it does not know how many it may have overlooked.[35] EO requested programming changes that will essentially suspend the three-year nonfiling period while the organization's exempt status remains automatically revoked. If approved, the changes will be implemented in January of 2015.[36] As the National Taxpayer Advocate has repeatedly pointed out, administrative review of all *proposed* automatic revocations (rather than the current ad hoc and nonpublic approach) would likely have averted many errors.[37]

CONCLUSION

EO's inventory backlog, which now exceeds the number of initial applications it usually receives in an entire year, burdens taxpayers who must wait for 18 months for their applications to be assigned to an analyst. Thousands of organizations were forced to cope with EO's troubled inventory management only because EO erroneously treated them as having had their exempt status automatically revoked and they were required to apply for reinstatement. EO is aware that measuring the three-year nonfiling period with reference to the EIN date causes erroneous revocations, yet it intends to retain that practice. It does not adequately inform organizations how the practice may affect them or provide organizations any way to seek administrative review of automatic revocations.

32 TE/GE response to TAS information request (Nov. 12, 2013). In fact, as described above, the IRS will issue these taxpayers notice CP 259A to notify them they did not file a return.

33 Upon learning that EO programming was causing erroneous revocations, TAS issued guidance to its employees explaining how to identify and advocate for taxpayers who come to TAS with these problems.

34 TE/GE response to TAS information request (Nov. 12, 2013).

35 *Id*.

36 *Id*.

37 National Taxpayer Advocate 2012 Annual Report to Congress 192 (Most Serious Problem: *Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations*); National Taxpayer Advocate 2011 Annual Report to Congress 442 (Most Serious Problem: *The IRS Makes Reinstatement of an Organization's Exempt Status Following Revocation Unnecessarily Burdensome*); National Taxpayer Advocate 2011 Annual Report to Congress 562 (Legislative Recommendation: *Provide Administrative Review of Automatic Revocations of Exempt Status, Develop a Form 1023-EZ, and Reduce Costs to Taxpayers and the IRS by Implementing Cyber Assistant*).

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Issue a letter informing the organization when the IRS proposes to treat it as having had its exempt status automatically revoked and providing an opportunity to correct the condition that caused the proposed automatic revocation within 30 days. The letter should specify the availability of administrative review for organizations raising concerns that the IRS is proceeding in error.
2. When notifying organizations that they did not submit a required return or e-Postcard, inform them that EO calculates the three-year nonfiling period using the date the organization obtained its EIN. Advise them to contact EO if its use of the EIN date may result in an erroneous revocation.
3. Do not include in the three-year nonfiling period for purposes of automatic revocations any period for which an organization could not submit an e-Postcard without contacting the IRS.

MSP #16 REVENUE PROTECTION: Ongoing Problems with IRS Refund Fraud Programs Harm Taxpayers by Delaying Valid Refunds

RESPONSIBLE OFFICIALS

Jodi Patterson, Director, Return Integrity and Correspondence Services
Mary Howard, Director, Privacy, Governmental Liaison and Disclosure
Debra Holland, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Return integrity programs are designed to detect and prevent civil fraud in tax returns before the IRS issues refunds to taxpayers, as part of the overall revenue protection strategy. The National Taxpayer Advocate identified problems with these programs as early as 2005. However, despite improvements, issues within the return integrity strategies persist and continue to harm taxpayers.[1]

- The IRS eliminated the Pre-Refund Program Executive Steering Committee (ESC) at the end of fiscal year (FY) 2012. This left no overarching governance of the design or implementation of revenue protection strategies or filters to detect fraud, and inhibited an integrated approach, resulting in potentially duplicative or over-inclusive filters.
- Filters delayed 308,868 refunds due to "false positive" signs of fraudulent activity in filing season 2013.[2]
- If certain letters informing taxpayers of the status of refunds caught in filters are returned as undeliverable, the IRS destroys them, and the taxpayers may never learn the status of their cases or receive their refunds.[3]
- Many taxpayers caught in the Automated Questionable Credit (AQC) program do not receive letters informing them of the status of their accounts and what to do next.[4]
- Taxpayers caught in the bank/external leads program only received letters informing them that their financial institutions could not process their direct-deposit refunds from the IRS and to allow an additional ten weeks to receive them in about 12 percent of cases.[5]

1 See National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2005 Annual Report to Congress vol. 2 (*Criminal Investigation Refund Freeze Study*).

2 IRS Return Integrity & Correspondence Services (RICS), Update of the Taxpayer Protection Program (TPP) (Oct. 31, 2013); IRS Return Integrity & Correspondence Services (RICS), Update of the Taxpayer Protection Unit (TPU) (Oct. 31, 2012).

3 IRM Exhibit 3.13.62-55 (May 10, 2013) and IRM 25.25.5.5 (Oct. 1, 2013). The letters classified as "just destroy" are the CP05 (*We're holding your refund until we finish reviewing your tax return*), CP05A (*We need more information to determine whether you're due a refund*), 4115C (*Information Regarding Your Refund*), and 4464C (*Questionable Refund 3rd Party Notification*).

4 IRS response to TAS research request (Oct. 15, 2013). As of October 15, 2013 RICS had issued 82,109 4800C letters and has 111,670 cases in inventory.

5 Refund Fraud & ID Theft Global Report, July 2013; CP 53A, A *Message About Your Request*, for an Electronic Deposit Refund, SNIP CP53A data as of cycle 201344. Through September 30, 2013, the Refund Fraud & ID Theft Global Report reports bank/external leads affecting 171,189 accounts, but the IRS sent only 20,409 letters to taxpayers.

- TAS receipts of Integrity Verification and Operation (IVO) cases have increased over 45 percent for the year to date from FY 2012 to FY 2013.[6]
- In about 80 percent of cases closed in FY 2013, taxpayers who contacted TAS about delayed refunds flagged by the Electronic Fraud Detection System (EFDS) received full or partial relief from the IRS.[7]
- The IRS's failure to implement the new Return Review Program (RRP) on schedule could lead to a crash of EFDS until the aged system could be repaired, which would force the IRS to decide whether to stop issuing refunds in the event of crash, or issue billions of dollars in potentially fraudulent refunds without screening.[8]

The continued failure of the IRS to address problems in return integrity programs burdens taxpayers who filed legitimate returns, but have been wrongly ensnared in a myriad of filters from various units of the IRS.[9] The failure of these units to coordinate may result in duplicate, over-inclusive, and unnecessary filters that are not routinely reviewed for accuracy or continued need. With the elimination of the return integrity steering committee, problems associated with fraud detection filters will not be discussed at a servicewide level and may create additional burden.

ANALYSIS OF PROBLEM

Background

The return integrity process is complex and multifaceted. A tax return must travel a long path with many potential roadblocks before the IRS accepts it as filed. The main goal of IVO is to stop fraudulent refunds before they are issued by identifying potentially false returns, usually through wages or withholding reported on the returns. The IRS does this primarily with the Electronic Fraud Detection System, which was built in the 1990s. EFDS runs all individual tax returns through various filters to identify characteristics that may indicate a high risk of fraud.[10]

Once EFDS completes the initial screening and flags a return as having a high likelihood of fraud, the IRS freezes the taxpayer's refund for 11 weeks so IVO can attempt to verify wages and withholding. The IRS sends a letter to the taxpayer explaining that income, withholding, or tax credits are being reviewed and the refund is being held pending this review.[11]

6 Data obtained from Business Performance Management System (BPMS) (Oct. 1, 2012; Oct. 1, 2013). IVO is an IRS unit within the Wage and Investment (W&I) operating division, the purpose of which is to support civil fraud detection and prevention. TAS received 18,012 cases in FY 2012 and 26,136 cases in FY 2013.

7 Data obtained from BPMS (Oct. 1, 2013).

8 Privacy Impact Assessment (PIA) 250 (Oct. 2, 2012), *available at*: http://www.irs.gov/pub/irs-utl/RRP_TS_pia.pdf. A PIA is a process for examining the risks and ramifications of using information technology to collect, maintain and disseminate information in identifiable form about members of the public and agency employees.

9 Filters are created and implemented by at least three distinct IRS units: Criminal Investigation (CI); Privacy, Governmental Liaison and Disclosure (PGLD); and RICS.

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

11 Notice CP 05, *Information Regarding Your Refund*.

One way the IRS attempts to verify information during this period is to compare it with the Information Returns Master File (IRMF). The IRMF is populated with third-party reporting data such as wage and withholding reported on Form W-2, *Wage and Tax Statement*, and most Forms 1099, *U.S. Information Return*.[12] If the return information cannot be automatically verified through the IRMF database, the next step is manual verification. IVO employees will attempt to contact the employers listed on the return to verify the wages and withholdings reported.[13] If the employer verifies the information and IVO is satisfied that the return is valid, the IRS will release the refund.

If certain letters informing taxpayers of the status of refunds caught in filters are returned as undeliverable, the IRS destroys them, and the taxpayers may never learn the status of their cases or receive their refunds.

The IRS formed an Information Returns Acceleration team in 2012 to develop a way for the IRS to obtain W-2 information from the Social Security Administration (SSA) earlier in the processing season to verify wages claimed on returns with information reported by payors. The team also continued to utilize the Disc program, where multiple major employers submit a copy of W-2 data directly to the IRS by mid-March to allow the IRS to match potentially fraudulent information returns to the employer database. Both programs are a step in the right direction by allowing the IRS to verify income and withholding information before releasing a refund.

If IVO cannot verify the return information through IRMF or employer contact, the IRS sends a letter to the taxpayer requesting documentation to substantiate the information.[14] Finally, if IVO cannot verify the return information before the 11-week hold expires, the IRS will make the hold permanent.[15]

A taxpayer caught in a variety of filters may believe he or she has been audited multiple times.

- A return could possess certain characteristics of identity theft and be stopped by the Taxpayer Protection Program (TPP) until the taxpayer verifies that he or she is not an identity thief;[16]
- The same return could then be selected for a pre-refund audit of a claimed Earned Income Tax Credit (EITC); or
- A return can be selected for income and withholding verification, and then also be audited.

12 Under present law, issuers who file these forms electronically have until March 31 to file them with the government. Issuers send Forms 1099 directly to the IRS and Forms W-2 directly to the Social Security Administration (SSA), which in turn sends information extracted from the forms to the IRS each week, starting in late March. Internal Revenue Code (IRC) §§ 6051(a), 6049(a), 6042(a); *see IRS Instructions for Forms W-2 and W-3, Wage and Tax Statement and Transmittal of Wage and Tax Statements*; Social Security Administration, *Employer W-2 Filing Instructions & Information, available at* http://www.ssa.gov/employer/gen.htm (last visited Oct. 24, 2012). For a more detailed discussion of third- party information reporting and its uses, see National Taxpayer Advocate 2012 Annual Report to Congress (Status Update: *The Preservation of Fundamental Taxpayer Rights Is Critical as the IRS Develops a Real-Time Tax System*).

13 IRM 21.9.1.8(1) (May 4, 2012). The IRS employs several methods to contact employers for verification of wages, adhering to the employer preference if one exists. Letters are sent annually to certain large employers, requesting them to provide wage information on a computer disc. Requests for verification are automatically generated by fax; phone calls are made based on employer preference.

14 IRM 21.9.1.8(1) (May 4, 2012). Letter 4115 requests income documentation from the taxpayer/employee (*e.g.*, copies of checks, bank statements, pay statements, check stubs, and employer letters).

15 Email from AMTAP analyst (Sept. 28, 2011).

16 IRM 21.9.1.14, *Taxpayer Protection Program* (June 4, 2013). For a full discussion of the National Taxpayer Advocate's concerns about identity theft, see Most Serious Problem: *The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers, supra*.

The lack of integration of IRS filters can create multiple delays in releasing the refund and significantly increase taxpayer burdens and frustration with the IRS.

The National Taxpayer Advocate Continues to Identify Return Integrity Programs as a Most Serious Problem.

Return integrity programs first made the National Taxpayer Advocate's list of the most serious problems facing taxpayers in 2005 and were discussed in a corresponding research study.[17] The National Taxpayer Advocate has recommended many improvements to limit the burden these programs cause for taxpayers seeking legitimate refunds, while still protecting the IRS's very valid need to reduce and prevent fraud. While the IRS has altered return integrity programs and strategies, it has failed to implement many of these recommendations.[18]

TAS monitors the IRS's progress on all recommendations in the National Taxpayer Advocate's Annual Reports to Congress, documenting whether the IRS agreed to take action and what it has done. In the three reports where various return integrity programs were cited as most serious problems facing taxpayers, the National Taxpayer Advocate made 21 recommendations to improve the programs.[19] The IRS agreed to fully or partially implement nine of the 14 recommendations in the 2011 and 2012 Annual Reports and declined to accept five others.[20]

The National Taxpayer Advocate Disagrees with the Elimination of the Pre-Refund Program Executive Steering Committee.

The IRS eliminated the Pre-Refund Program Executive Steering Committee at the end of FY 2012. This left the IRS with no overarching governance of the design or implementation of revenue protection strategies or filters and inhibited an integrated approach, resulting in potentially duplicative or over-inclusive filters. The committee provided a forum where decision makers from various parts of the IRS could not only inform other areas of new programs, but also allowed the parties to raise concerns. It provided the IRS, including TAS, a forum to work as one to identify and prevent fraud. Dismantling the ESC was a step in the wrong direction. By not addressing fraud globally and in a collaborative manner, the IRS is missing opportunities to share information and prevent innocent taxpayers from being caught in fraud filters.

---

17 See National Taxpayer Advocate 2005 Annual Report to Congress (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2005 Annual Report to Congress vol. 2 (Criminal Investigation Refund Freeze Study).

18 See National Taxpayer Advocate 2005 Annual Report to Congress (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*); and National Taxpayer Advocate 2012 Annual Report to Congress (Most Serious Problem: *Despite Some Improvements, the IRS Continues to Harm Taxpayers by Unreasonably Delaying the Processing of Valid Refund Claims That Happen to Trigger Systemic Filters*).

19 See National Taxpayer Advocate 2005 Annual Report to Congress (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*); and National Taxpayer Advocate 2012 Annual Report to Congress (Most Serious Problem: *Despite Some Improvements, the IRS Continues to Harm Taxpayers by Unreasonably Delaying the Processing of Valid Refund Claims That Happen to Trigger Systemic Filters*).

20 Annual Report to Congress 2011 Report Card, *available at* http://www.irs.gov/Advocate/Annual-Report-to-Congress-Report-Cards. The seven recommendations made in the 2005 Annual Report to Congress were not reported and tracked in the same manner as the TAS tracking system was not implemented until 2007. The IRS now responds in a standardized manner to Annual Report to Congress recommendations. Therefore, only information on the 14 recommendations in the 2011 and 2012 Annual Reports to Congress is available. (The 2012 Report Card is not finalized, will provide link and potentially update numbers when it is available.)

Taxpayers are Harmed by Various Uncoordinated Return Integrity Strategies.[21]

The Automated Questionable Credit (AQC) program may be confusing to taxpayers.

In November 2011, RICS developed and implemented a streamlined statutory notice of deficiency pilot program — the AQC. AQC expanded the IRS's use of automation to prevent improper refunds of questionable withholding and refundable credits.[22] TAS identified and elevated areas of concern, including the possible expansion of math error authority. Significant concerns included a statement in the initial AQC letter to taxpayers that the inquiry is not an audit and the IRS may examine the return again later, leaving the taxpayer with little certainty.[23]

As of October, 2013 RICS had issued over 80,000 4800C letters but has nearly 112,000 cases in inventory received through AQC.[24] TAS reviewed 50 of these cases from TAS inventory; of those, only 16 taxpayers received the 4800C letter informing them of the actions proposed for their accounts and the next steps the taxpayers needed to take.[25]

External Leads Program burdens taxpayers

In 2011, RICS implemented the External Leads Program, which is responsible for receiving and processing informational leads and funds returned by partner financial institutions and various other sources because the funds were deemed questionable. External leads may involve Treasury checks, direct deposits/Automated Clearing House, refund anticipation loans or checks, and pre-paid debit cards. The program receives leads from over 130 external sources as well as internal leads from throughout the IRS.[26]

Within approximately 15 business days of receiving an external lead, RICS employees begin their research to determine the validity of the refund and will advise the financial institution to return the funds if it cannot determine the refund was valid.[27] The RICS employee is not required to notate the taxpayer's account to show the interception of the refund, and only in limited circumstances must notify the taxpayer before the financial institution returns the funds to the IRS.[28] Consequently, if the taxpayer contacts the IRS about his or her refund, a Customer Service Representative (CSR) cannot identify RICS involvement by reviewing the main tax account database or provide any guidance on what the IRS is doing. In most instances, the CSR refers the taxpayer back to the financial institution, even though it was the IRS that decided the funds must be returned. Additionally, financial institutions are advised to inform their account holders that:

> Since it takes several weeks for funds to be processed through accounting, [IRS] phone assistors may not have information regarding the returns. Once appropriate research has been conducted, taxpayers should receive further correspondence from the IRS in most cases.

---

21 For a discussion of the National Taxpayer Advocate's concerns regarding identity theft fraud programs, see Most Serious Problem: *The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers, supra*.

22 TAS, Business Performance Review First Quarter FY 2012.

23 IRS, 4800C, *Questionable Credit 30 Day Contact Letter*.

24 IRS response to TAS research request (Oct. 15, 2013). As of October 15, 2013 RICS had issued 82,109 4800C letters and has 111,670 cases in inventory.

25 TAMIS data, June 12, 2013.

26 Publication 5033, *External Leads Guidelines* (Feb. 2013).

27 *Id*.

28 IRM 25.25.8.2 (Oct. 29, 2013). A notation on the account could be made in Integrated Data Retrieval System (IDRS), the IRS system that allows employees to see activity on taxpayers' accounts, to inform employees of the status of a refund intercepted through the external leads program.

> When receiving inquiries, account holders can be advised that funds have been returned to the IRS; however, it takes 6-8 weeks before account information is readily available. There is not a specific IRS phone line for these inquiries.[29]

Through September 30, 2013, the Refund Fraud & ID Theft Global Report reports bank/external leads affecting 171,189 accounts, resulting in $441,834,298 in stopped refunds.[30] However, the IRS sent only 19,985 letters to taxpayers to tell them that their financial institutions could not process their direct-deposit refunds and to allow an additional ten weeks.[31] RICS also had to alert CSRs to stop referring taxpayers back to their financial institutions.[32]

Undelivered mail procedures may mean taxpayers never learn about refund delays.

When corresponding with a taxpayer, the IRS uses the "address of record," which is generally the address given on the taxpayer's last return.[33] When the IRS sends a notice or document to a "last known address," it is legally effective even if the taxpayer never receives it.[34] The IRS issues several important refund status notices following the last known address rule.[35] If a preparer makes a mistake in entering the address, or the taxpayer moves without leaving a forwarding address, the IRS will destroy the undelivered letters upon their return. This means the taxpayer never learns that his or her return is under review and has no chance to prove the wages and withholding are valid.[36]

Often, however, the IRS already has the correct address in its records and could resolve the issue with a simple review. For example, if a preparer makes a transposition error on the house number, the notice will be returned as undeliverable. However, the taxpayer may have filed from the same address for several years, so by checking the address history the IRS could easily correct the address and resend the notice, thus providing the taxpayer an opportunity to provide supporting documentation. By reclassifying these letters so employees would conduct further research when they come back as undeliverable, the IRS could direct them to the proper addresses.[37]

---

29 Publication 5033, External Leads Guidelines, Rev. 02-2013.

30 IRS, *Refund Fraud & ID Theft Global Report* (Sept. 2013).

31 CP 53A, A Message About Your Request for an Electronic Deposit Refund, SNIP Notice Volume through Oct. 5, 2013 (Cycle 40).

32 Servicewide Electronic Research Program (SERP) Alert 13A0407, *Direct Deposit Reject Calls Related to Reason Code* 17 (June 27, 2013).

33 IRS policy requires the taxpayer to provide "clear and concise" notice of any change of address during telephone calls with the IRS, in correspondence submitted to the IRS, or through a change of address filed with the U.S. Postal Service (USPS) and transmitted to the IRS via the National Change of Address (NCOA) system. Treas. Reg. § 301.6212-2: Definition of Last Known Address; Rev. Proc. 2010-16.

34 Treas. Reg. § 301.6212-2; Rev. Proc. 2010-16.

35 Notices classified as "just destroy" informing taxpayers of the status of their refunds caught in fraud filters include CP05 (*We're holding your refund until we finish reviewing your tax return*), CP05A (*We need more information to determine whether you're due a refund*), 4115C (*Information Regarding Your Refund*), and 4464C (*Questionable Refund 3rd Party Notification*).

36 IRM 3.13.62-55 (May 10, 2013); IRM 25.25.5.5 (Oct. 1, 2013). The letters classified as just destroy are the CP05 (*We're holding your refund until we finish reviewing your tax return*), CP05A (*We need more information to determine whether you're due a refund*), 4115C (*Information Regarding Your Refund*), and 4464C (*Questionable Refund 3rd Party Notification*).

37 For a full discussion of the National Taxpayer Advocate's concerns regarding undelivered mail, see National Taxpayer Advocate 2012 Annual Report to Congress (Status Update: *Underfunding IRS Initiatives to Modernize Its Taxpayer Address Correspondence Systems Undermines Taxpayers' Statutory Rights and Impedes Efficient Resource Allocation*) and National Taxpayer Advocate 2010 Annual Report to Congress (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*). One of the National Taxpayer Advocate's primary recommendations to address the problems created by undelivered mail is for the IRS to create a single unit responsible for processing all undelivered mail, including searches for a better taxpayer address. This would provide an IRS-wide solution and strategy to address undelivered mail.

Delays in implementation of the Return Review Program may result in harm to the government and taxpayers.

The Electronic Fraud Detection System is the IRS's primary frontline system for detecting fraudulent returns. Although it assisted the IRS in successfully preventing the release of over $18 billion in fraudulent refunds,[38] the Treasury Inspector General for Tax Administration (TIGTA) has estimated the IRS still may have paid $5.2 billion in potentially fraudulent tax refunds on 1.5 million returns in tax year 2010.[39] The IRS has declared EFDS "too risky to maintain, upgrade, or operate beyond 2014."[40]

TAS has identified multiple instances where the case was lost in transit, thus imposing severe burden on the taxpayer and significantly delaying resolution.

In 2009, the IRS began developing the Return Review Program (RRP) to replace EFDS; Congress approved $54 million for IRS Information Technology (IT) to establish the RRP. RRP is expected to enhance revenue by $28.8 million per year when fully implemented, and its estimated five-year rate of return is 15,800 percent. More simply put, the IRS estimates it will recoup over $15,000 for every dollar spent.[41] RRP also will automate a variety of tasks, many of them manual, that employees now perform. For example, today when a case is referred for an audit, employees enter data on a spreadsheet, which is then transferred to headquarters personnel who open and assign the case. TAS has identified multiple instances where the case was lost in transit, thus imposing severe burden on the taxpayer and significantly delaying resolution.

Despite estimated high levels of return, significant monetary investment, and a huge resource investment in teams and development of system requirements, the IRS is now forced to consider non-deployment or a limited deployment of RRP. On January 15, 2013, IT reported it did not have enough resources to bring RRP online by the January 1, 2015 deadline.[42]

Not deploying the RRP as intended could impose significant harm and cost on both the IRS and the public. A failure of the EFDS system, which according to a 2010 IRS statement is becoming increasingly likely, would force the IRS to decide whether to stop issuing refunds until the system could be repaired, or issue billions of dollars in potentially fraudulent refunds without screening.[43] In addition, as EFDS becomes harder to update and maintain, it could erroneously stop an increasing number of valid refunds. The lack of automation to handle administrative adjustments and actions is straining the IRS's limited resources as fraud and identity theft grow and staffing declines.

38 IRS, *W&I Business Performance Review* (Nov. 14, 2012).

39 TIGTA, Ref. No. 2013-40-015, *Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable* (Jan. 31 2013).

40 Privacy Impact Assessment (PIA) 250 (Oct. 2, 2012). http://www.irs.gov/pub/irs-utl/RRP_TS_pia.pdf. A PIA is a process for examining the risks and ramifications of using information technology to collect, maintain and disseminate information in identifiable form about members of the public and agency employees.

41 Wage & Investment Division Summary of Proposed FY 2013 Budget Initiatives (as of Feb. 1, 2011).

42 Email from Supervisory Tax Analyst, Wage & Investment, Business Modernization dated Jan. 15, 2013.

43 Privacy Impact Assessment (PIA) 250 (Oct. 2, 2012). http://www.irs.gov/pub/irs-utl/RRP_TS_pia.pdf.

Service to Taxpayers Ensnared by Filters Continues to Decline.

Over the last three years, TAS has seen a significant increase in wage verification cases. In FY 2011, TAS received just over 21,000 such cases; in FY 2013 the number rose to more than 26,000.[44] Cases involving taxpayers facing an economic burden increased 111 percent during that time.[45] This increase shows that although the wage verification unit tries to get innocent taxpayers out of the process as fast as possible, it still holds up many refunds when a filter inadvertently catches a valid return.

The number of taxpayers who came to TAS seeking and received the release of IVO refund holds shows the IRS continues to impose significant delays on innocent taxpayers. The percentage of taxpayers who received full or partial relief after contacting TAS, has increased from 75 percent in FY 2012 to 80 percent in FY 2013.[46]

According to the IRS, the Taxpayer Protection Program (TPP) stopped 1,039,000 refunds with a false positive rate of 29.7 percent in FY 2013, compared to 402,000 refunds stopped in FY 2012 with a false positive rate of 17.7 percent.[47] The significant growth in refunds stopped correlates to an increase in the number of filters the TPP uses, from 11 in FY 2012 to more than 80 in the FY 2013 filing season.[48] The increase in innocent taxpayers being caught in the filters has significantly taxed the TPP's ability to respond to taxpayer inquiries. Overall, fewer than six of ten calls to the TPP reached a live assistor for help, and only after waiting an average of almost 21 minutes.[49]

CONCLUSION

The National Taxpayer Advocate recognizes the need for return integrity strategies and the importance of automated filters to screen returns for potential fraud. However, automated screens will never achieve perfection. The IRS must remain cognizant of the taxpayers who are innocently caught by these screens and work diligently to timely resolve their cases and adjust filters. Dismantling the Pre-Refund Executive Steering Committee was a step in the wrong direction, contravening IRS efforts to work globally to address screening returns, and eliminating the opportunity for separate IRS functions, including TAS, to work together. This action further handicaps the development and refining of filters, thereby not only jeopardizing revenue but also the legitimate taxpayers whose returns are dragged into this process.

---

44 Data obtained from BPMS, Oct. 1, 2011; Oct. 1, 2013. TAS received 21,286 cases in FY 2011 and 26,136 in FY 2013.

45 *Id*. Economic burden cases increased 111.2 percent from FY 2011 to FY 2013.

46 Data obtained from BPMS, Oct. 1, 2012; Oct. 1, 2013.

47 IRS Return Integrity & Correspondence Services, *Update of the Taxpayer Protection Program (TPP)* (Oct. 31, 2013); *Update of the Taxpayer Protection Unit (TPU)* (Oct. 15, 2012).

48 TIGTA, Ref. No. 2013-40-083, *Income, and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds* (Aug. 7, 2013).

49 Joint Operations Communications (JOC) Executive Level, Taxpayer Protection Program (TPP) performance report (Sept. 28, 2013).

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Reinstate the Pre-refund Executive Steering Committee or form a new, similar committee with TAS as a charter voting member.
2. Perform regular global reviews and updates of all return integrity filters.
3. Introduce a computer code to indicate that a refund is under investigation through the bank leads program.
4. Reclassify the letters intended to inform taxpayers of the status of a refund caught by filters from "just destroy" to "perform further research" when they are returned as undeliverable.

MSP #17 ACCURACY RELATED PENALTIES: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Still Assesses Penalties Automatically

RESPONSIBLE OFFICIALS

Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

In 2012, in a reversal of prior advice, the IRS Office of Chief Counsel determined that the IRS was not authorized to impose an accuracy-related penalty under Internal Revenue Code (IRC) § 6662 against taxpayers for claiming refundable credits that it had frozen (*i.e.*, not actually paid or credited to the account).[1] Yet, the IRS declined to identify and abate (or refund) more than $40 million in penalties that it imposed against more than 46,000 taxpayers prior to changing its position.[2] The IRS's failure to expend the resources needed to remove these improper and inapplicable penalties signals disrespect for the law and a disregard for taxpayer rights, which in turn, is likely to reduce voluntary tax compliance.[3]

The IRS's decision not to abate inapplicable penalties illustrates its resource-driven approach to them. As described in prior reports, the IRS continues to propose penalties automatically when they might apply — before performing a careful analysis of the relevant facts and circumstances — and then burdens taxpayers by requiring them to prove the penalties do not apply.[4] For example, in fiscal year (FY) 2012 the IRS sent over 93,000 (CP 2000) letters as part of its matching program, which proposed nearly $100 million in accuracy-related penalties without first contacting the taxpayers to determine the reason for the apparent mismatch.[5] Thus, contrary to congressional intent, the IRS automatically *assumes* the taxpayer acted negligently and places the burden on the taxpayer to prove otherwise.[6]

In particular, this automated approach imposes a disproportionate burden on unsophisticated taxpayers who have difficulty communicating with the IRS or do not understand the relevant facts and legal rules. The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

1 Program Manager Technical Advice (PMTA) 2012-16 (May 30, 2012) (concluding that the claim for a refund that is frozen by the IRS does not give rise to an underpayment, as defined in IRC § 6664, to which an accuracy-related penalty could apply).

2 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013).

3 Research suggests that sole proprietors who believe the government, the IRS, and the tax laws are fair are more likely to comply. *See* National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-28. *Accord* National Taxpayer Advocate 2013 Annual Report to Congress, vol. 2, *infra (Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?)*; IRM 20.1.1.1.3(4) (Dec. 11, 2009) ("A wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.").

4 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 275; National Taxpayer Advocate 2010 Annual Report to Congress 198; Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers From Claiming EITC*, *infra/supra*.

5 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013) (excluding taxpayers who first received CP 2501, which the IRS sometimes uses to inquire about an apparent discrepancy). Moreover, the IRS abated about 20 percent of the tax it assesses through AUR in FY 2012. IRS Compliance Data Warehouse, Individual Master File (Dec. 17, 2013).

6 *See* H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.) (directing the IRS to "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.").

The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

ANALYSIS OF PROBLEM

A refundable credit claim can give rise to an "underpayment" triggering an accuracy-related penalty, according to the IRS.

A taxpayer who submits a return that is not accurate (*i.e.*, reflects an "underpayment") may be subject to an accuracy-related penalty under IRC § 6662. For example, the penalty may apply if the error is "substantial" or if the IRS determines the taxpayer was negligent. Generally, an "underpayment" is W - (X+Y-Z) where:

- W = the correct amount of tax required to be shown on the return;
- X = the tax reported (actually shown) on the return;
- Y = the amount not shown, but previously assessed (or collected without assessment); and
- Z = certain rebates.[7]

It has long been unclear whether or how refundable credits, such as the Earned Income Tax Credit (EITC), the First-Time Homebuyer Credit, (FTHBC), the Additional Child Tax Credit (ACTC), and the Economic Stimulus Payment (ESP) are included in this computation, or how the analysis changes if the IRS has refunded, credited, or frozen these credits.[8] However, the IRS has taken the position that a refundable credit claim can produce an underpayment, and if the underpayment is attributable to a substantial understatement or negligence, the IRC § 6662 penalty applies.[9] In general, the IRS believes these claims reduce the amount shown on the taxpayer's return (X, above).[10] Thus, it continues to impose substantial understatement penalties against taxpayers who make improper credit claims (provided they are not frozen, as discussed below).

7 IRC § 6664(a)(1)-(2); Treas. Reg. § 1.6664-2(a)(1)-(2).

8 *See, e.g.*, TAM 2841039058 (Mar. 21, 1998) (acknowledging disagreements between Examination and Counsel); SCA 200113028 (Feb. 26, 2001) (concluding penalty is applicable on frozen EITC refunds, but acknowledging a contrary conclusion in prior advice); *Akhter v. Comm'r*, T.C. Summ. Op. 2001-20 (concluding frozen refund claims could not give rise to underpayments); *Solomon v. Comm'r*, Summ. Op. 2008-95 (same); CCA 200851079 (Dec. 19, 2008) ("The court [in *Solomon*] seems to have gotten it wrong"); PMTA 2010-01 (Nov. 20, 2009) (the regulations "do not specifically address how to factor the FTHBC into the formula for calculating an underpayment"); PMTA 2011-03 (Aug. 27, 2010) (addressing confusion); PMTA 2012-16 (May 30, 2012) ("We have reconsidered our advice…"). *See also* Carlton Smith, *IRS Wrongly Ignores the 20 Percent Excessive Refund Penalty*, 2013 TNT 39-10 (Feb. 27, 2013) (discussing longstanding uncertainty).

9 *See, e.g.*, TAM 2841039058 (Mar. 21, 1998); SCA 200113028 (Feb. 26, 2001); CCA 200851079 (Dec. 19, 2008); PMTA 2011-03 (Aug. 27, 2010); PMTA 2012-16 (May 30, 2012). For individuals, a "substantial understatement" penalty may apply if an understatement exceeds the greater of $5,000 or ten percent of the tax required to be shown on the return. *See* IRC § 6662(d)(1)(A)(i)-(ii). Understatements generally must be reduced by any portion attributable to (1) an item for which the taxpayer had substantial authority; or (2) any item for which the taxpayer adequately disclosed the relevant facts affecting the item's tax treatment, provided the taxpayer had a reasonable basis for such treatment. IRC § 6662(d)(2)(B).

10 PMTA 2012-16 (May 30, 2012). The Tax Court recently agreed, in part, with the IRS, holding that for purposes of computing the IRC § 6662 penalty a refundable credit claim reduces the amount shown on the taxpayer's return. *See Rand v. Comm'r*, 141 T.C. No. 12 (2013) [hereinafter *Rand*]. However, it disagreed with the IRS's computation of the penalty, holding that the claim could not reduce the amount shown below zero. *Id*.

In 2012, the Office of Chief Counsel determined it was not appropriate to impose the accuracy-related penalty for "frozen" refundable credit claims.

On May 30, 2012, the IRS Office of Chief Counsel changed its position, as advocated by TAS.[11] It concluded that when a taxpayer claimed a refundable tax credit that the IRS had frozen, there could be no underpayment of tax, and consequently the IRC § 6662 penalty was not applicable. Counsel reasoned that a frozen refundable credit is an amount "assessed or collected without assessment" (Y, above). Thus, if the only error on a return is a frozen refundable credit claim, which is treated as collected, there is no "underpayment" (*i.e.*, X and Y cancel each other out). Without an underpayment, the accuracy-related penalty (including the substantial understatement penalty) does not apply.[12]

The IRS abated some improper penalties, but not others.

The IRS continued imposing substantial understatement penalties on frozen refund claims for about ten months after receiving the May 30, 2012 guidance. Following additional advocacy by TAS, the IRS identified and abated the penalties imposed on frozen refunds between June 1, 2012 and March 31, 2013, as shown in the following table.

TABLE 1.17.1, Substantial Understatement Penalty Abatements on Frozen Credit Refund Claims[13]

Type of Work	Total Cases	Total Abatements
EITC	99,303	$131,450,817
Discretionary	9,471	11,395,629
Total	**108,774**	**$142,846,446**

However, the IRS has not identified and abated (or refunded) penalties imposed on other similarly-situated taxpayers before June 1, 2012.[14] For example, the IRS has failed to remove over 46,000 penalties totaling more than $40 million that it imposed in the two and a half years between the issuance of the first Counsel opinion (November 20, 2009) (which Counsel has implicitly acknowledged was incorrect) and the most recent Counsel opinion (May 30, 2012).[15] Moreover, it is still trying to collect over $20 million in accuracy related penalties improperly assessed against more than 23,000 taxpayers.[16]

11 After TAS questioned the position taken by Counsel in PMTA 2010-01 (Nov. 20, 2009) and PMTA 2011-03 (Aug. 27, 2010), the Office of Chief Counsel revised this advice. See PMTA 2012-16 (May 30, 2012).

12 This change does not affect the IRS's position that it may assert the accuracy-related penalty (including the substantial understatement penalty) for refundable credit claims that it has not frozen. While the court's holding in *Rand* confirms that refundable credit claims can trigger an accuracy-related penalty, its analysis suggests the penalty would only apply to the portion of the credit(s) used to reduce the tax otherwise due.

13 IRS response to TAS information request (May 10, 2013) (reflecting abatements from June 1, 2012 to March 31, 2013).

14 The IRS's only explanation is that IRS Office of Chief Counsel advised, in an unpublished email, that the IRS is not required to abate these penalties. Email from Attorney, IRS Office of Associate Chief Counsel (P&A) to Senior Analyst, SBSE Campus Compliance Services, Exam Policy (Sept. 12, 2012). According to the IRS, however, it is working to estimate the volume of cases involving similarly situated taxpayers. IRS response to TAS information request (Nov. 20, 2013).

15 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013).

16 *Id*.

In other contexts, the IRS has failed to minimize taxpayer burden by proposing penalties automatically, before making more than a *de minimis* effort to determine if they apply.

The IRS's administration of penalties sometimes prioritizes automation and efficiency rather than accuracy and fairness. For example, before it can be sure if a penalty for negligence applies, the IRS needs to determine if the taxpayer was actually negligent or if an error was due to reasonable cause and not willful neglect.[17] As shown in the following table, however, the IRS may use different levels of effort to communicate with taxpayers and ascertain the reason for an apparent discrepancy before proposing a penalty, depending on the type of examination or matching program.

TABLE 1.17.2, Procedures for Proposing Accuracy-Related Penalties by Program

Program	Significant address research? [18]	Common letter to propose penalty	Examiner's contact information on letter? [19]	Examiner discusses reason(s) for the discrepancy before penalty asserted? [20]	Penalty assessed if taxpayer not located? [21]
Field Exam	Yes	Letter 950 [22]	Yes	Yes	Not usually
Office Exam	Yes	Letter 915 [23]	Yes	Yes	Not usually
Corr. Exam	No	Letter 525 [24]	No	No	Yes
Automated Underreporter	No	Letter CP 2000 [25]	No	No	Yes

If a mismatch occurs with respect to the same item of income reported by a third party but not reported on the return in more than one year, the IRS's Correspondence Examination and Automated Underreporter (AUR) functions automatically propose a negligence penalty.[26] AUR often does so in the

17 IRC §§ 6662, 6664(c)(1); Treas. Reg. § 1.6664-4(b)(1).

18 *Compare* IRM 4.10.2.7.2 (Apr. 2, 2010) (describing how field and office exam employees may use asset locator services, postal traces, credit reports, internet searches, IDRS searches, third party contacts, research of related TINs, and personal visits to locate the taxpayer) *with* IRM 4.19.13.13 (Jan. 1, 2013) (discussing how corr. exam employees research addresses using IRDRs); IRM 4.19.3.19.2 (Sept.1, 2013) (discussing AUR's review of other correspondence to find an updated address); IRM 4.19.3.20.11.2 (Sept. 1, 2013) (discussing AUR default procedures, which do not include additional address research).

19 *See* IRM 4.10.1.5.3.2(4) (May 14, 1999) ([For field and office exams] "[A]ll correspondence must contain an employee name, contact telephone number, employee identification number, and signature"). While corr. exam and AUR letters include a general number, an examiner may not be assigned to a case in corr. exam or AUR unless the IRS receives a response to its computer-generated letters. *See, e.g.*, IRM 4.19.20.1(1) (Jan. 1, 2013). Accordingly, the IRS cannot list the examiner's name or number.

20 For field and office exams, employees are required to communicate with the taxpayer before asserting penalties. *See* IRM 4.10.6.3.5 (May 14, 1999) ("To ensure the proper consideration and appropriate application of penalties, it is very important to solicit the taxpayer's explanation for adjustments"); IRM 4.10.6.4(3) (May 14, 1999) ("The assertion of penalties, including alternative positions, should be discussed with the taxpayer and/or representative prior to issuing an examination report"). These requirements do not apply in corr. exam or AUR. *See, e.g.*, IRM 4.19.13.5.3 (Jan. 1, 2013) ("[when documenting penalties on a lead sheet] the taxpayer's position must be addressed [only] if the taxpayer responds to the Exam report and addresses the underpayment in the response.").

21 *Compare* IRM 4.10.2.7.2.7 (Apr. 2, 2010) (for field and office exams a penalty is not assessed unless non-assessment would undermine compliance) *with* IRM 20.1.5.7.1(5)(a) (Jan. 24, 2012) (indicating corr. exam will assert the negligence penalty even if a taxpayer is not located); IRM 20.1.5.3.1(2) (Jan. 24, 2012) (discussing how AUR may automatically assert negligence or substantial understatement penalties when a taxpayer does not respond); IRM 4.19.3.16.5 (Sept. 1, 2012) (same for substantial understatement); IRM 4.19.3.16.6 (Sept. 1, 2008) (same for negligence/disregard).

22 IRM 4.10.8.11 (Aug. 11, 2006).

23 *Id*.

24 IRM 4.19.10.1.6 (Feb., 24, 2011).

25 IRM 4.19.3.1 (Sept. 1, 2012).

26 *See, e.g.*, IRM 4.119.4.18.1.4 (Oct. 1, 2012) (BMF AUR); IRM 4.19.3.16.6 (Sept. 1, 2008) (IMF AUR); IRM 20.1.5.7.1(5)(a) (Jan. 24, 2012) (indicating that corr. exam should assert negligence based on a mismatch in a single year if the taxpayer does not respond).

The IRS's general approach to accuracy-related penalties burdens taxpayers by requiring them to prove the penalties are inapplicable.

first letter it sends to the taxpayer that identifies a deficiency (*i.e.*, the CP 2000).[27] The IRS issued 4.5 million CP 2000s in FY 2012.[28] Over 93,000 of these letters proposed nearly $100 million in accuracy-related penalties before the IRS inquired about the discrepancy or called the taxpayer.[29]

The IRS's automatic penalty assessment procedures, which do not even require IRS employees to make outgoing calls (unless the taxpayer responds to a letter)[30] to determine whether the taxpayer was negligent or had "reasonable cause," ignore direction from Congress that the IRS should "make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later."[31] Other stakeholders have expressed similar concerns.[32] Penalties that the IRS automatically proposes do not take the taxpayer's effort to comply into account — at least not before being proposed. The latest research also suggests that administering penalties in this way may reduce long-term voluntary compliance by those who are subject to them.[33]

The IRS's general approach to accuracy-related penalties burdens taxpayers by requiring them to prove the penalties are inapplicable.[34] This approach violates taxpayer rights and imposes a disproportionate burden on unsophisticated taxpayers who have difficulty communicating with the IRS or do not understand the relevant facts and legal rules — precisely the taxpayers that Congress intends to benefit with many refundable credits, such as the FTHBC.[35]

The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

Notwithstanding the IRS's practice of imposing a substantial understatement penalty on those claiming refundable credits, the Treasury Department requested and received legislation in 2007 to impose a new

27 In some cases, AUR sends a CP 2501, which asks about the discrepancy before sending the CP 2000. IRM 4.19.3.6 (Sept. 1, 2010).

28 IRS Data Book, *Table 14, Information Reporting Program* (FY 2012), http://www.irs.gov/uac/SOI-Tax-Stats-Information-Reporting-Program-IRS-Data-Book-Table-14.

29 IRS Compliance Data Warehouse, Individual Master File (Nov. 26, 2013). This figure omits the accuracy-related penalties assessed in FY 2012 as a result of AUR cases opened in earlier periods. It also omits taxpayers who received a CP 2000 only after receiving a letter (CP 2501) inquiring about the reason for the discrepancy.

30 Exam generally sends Letter 566 to ask for documentation before sending Letter 525 to propose a deficiency and penalty. IRM 4.19.10.4.10.1 (Jan. 1, 2013). However, even Exam will only try to call the taxpayer if it receives a response. *See* IRM 4.19.13.11 (Jan. 1, 2013).

31 H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.). *See also* IRC § 6751(b)(1) (generally requiring penalties to be personally approved by a supervisor before assessment unless automatically calculated through electronic means).

32 American Institute of Certified Public Accountants (AICPA), *Report on Civil Tax Penalties: The Need for Reform* (Aug. 28, 2009) ("[I]ncreasingly, penalties are assessed using automated processes … without the benefit of pre-assessment rights to pursue reasonable cause and other defenses. In many instances, taxpayers pay penalties even if they are unwarranted because it is so difficult and costly to challenge a penalty once it is assessed."). American Bar Association (ABA) Tax Section, *Comments Concerning Possible Changes to Penalty Provisions of the Internal Revenue Code* (1999) ("Automatic assertion, followed by abatement, is far less satisfactory than assertion after inquiry, because taxpayers resent being penalized first and then having to prove compliance, and because many penalties that are asserted and paid probably should never have been assessed."). *See also* IRM 20.1.1.2.2(1)(b) (Nov. 25, 2011) ("[E]rroneous penalty assessments and incorrect calculations confuse taxpayers and misrepresent the overall competency of the IRS.").

33 National Taxpayer Advocate 2013 Annual Report to Congress, vol. 2 *infra*, *(Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?)*.

34 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 275; National Taxpayer Advocate 2010 Annual Report to Congress 198; Most Serious Problem: *The IRS Inappropriately Bans Many Taxpayers from Claiming EITC*, *infra/supra*.

35 For a discussion of taxpayer rights, including the rights to be informed, heard, and pay no more than the correct amount of tax see, *e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 493-518.

penalty for excessive claims for credit or refund under IRC § 6676.[36] It applies to claims (other than those involving the EITC) to which the penalty under IRC § 6662 does not apply.[37]

The National Taxpayer Advocate is concerned that the IRS may similarly apply the new penalty under IRC § 6676 any time a claim for a refundable credit trips whatever "filters" the IRS has established, even if the IRS freezes the claim and does not make a payment to the taxpayer.[38] Because this new penalty contains no reasonable cause exception, such an approach would turn many refundable credits into traps for the unwary.

CONCLUSION

The IRS has improperly assessed accuracy related penalties, has refused to abate them on assessments made prior to June 1, 2012, and continues to assess them automatically without properly determining that they actually apply. The National Taxpayer Advocate is concerned the IRS may take the same automated approach to the new penalty under IRC § 6676, which applies to excessive claims for credit or refund.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Identify and abate (or refund) all accuracy-related penalties on frozen refundable credit claims for all open years.[39]
2. If a court determines that accuracy-related penalties do not apply to refundable credit claims that the IRS has paid, and the IRS does not appeal, then identify and abate (or refund) all such penalties on open years.[40]
3. In the meantime, the IRS should direct attorneys handling refundable credit cases involving IRC § 6662 penalties to notify the court and opposing counsel (or *pro se* petitioner) if the IRS is pursuing a larger penalty than would apply under the Tax Court's recent analysis in *Rand*.
4. Avoid proposing the new penalty under IRC § 6676 automatically (*i.e.*, before contacting the taxpayer, considering the facts, and determining that it actually applies).
5. Work with the Treasury Department to seek an amendment to IRC § 6676 to provide a reasonable cause exception, as previously recommended by the National Taxpayer Advocate.

36 For a discussion of the Treasury's request and recommendations to improve this new penalty, see National Taxpayer Advocate 2010 Annual Report to Congress 544-47.

37 IRC § 6676(d).

38 For a discussion of the problems with pre-refund filters, see, *e.g.*, National Taxpayer Advocate 2011 Annual Report to Congress 15-27; National Taxpayer Advocate 2011 Annual Report to Congress 28-47.

39 PMTA 2012-16 (May 30, 2012). The IRS may abate penalties erroneously assessed if it has not collected them. IRC § 6404. Similarly, the IRS may refund any penalties the taxpayer already paid if the period of limitations for filing a claim for refund remains open. IRC § 6511.

40 If the IRS decides to follow *Rand*, it should abate accuracy-related penalties applied to refundable credits (even if not frozen) to the extent the IRS treated them as reducing the tax shown as due below zero.

MSP #18 ONLINE SERVICES: The IRS's Sudden Discontinuance of the Disclosure Authorization and Electronic Account Resolution Applications Left Practitioners Without Adequate Alternatives

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage and Investment Operating Division
Rajive Mathur, Director, Office of Online Services

DEFINITION OF PROBLEM

The IRS offers practitioners the option to interact electronically through an e-Services suite of web-based products. In early 2013, the IRS decided to retire the Disclosure Authorization (DA) and Electronic Account Resolution (EAR) applications in e-Services without discussing the matter with the practitioner community beforehand. DA enabled practitioners to electronically submit Form 2848, *Power of Attorney and Declaration of Representative*, and Form 8821, *Tax Information Authorization*. DA processed approximately one-tenth of all disclosure authorizations (over 372,000 authorizations) submitted to the IRS in fiscal year (FY) 2013.[1] The EAR application enabled practitioners to interact with the IRS electronically on a client's account-related issues. EAR competed more than 31,000 transactions in FY 2013.[2]

The IRS cited two reasons for discontinuing the programs: low usage and increased operating costs.[3] The National Taxpayer Advocate is concerned that, in making this decision, the IRS failed to take the following actions:

- **Base the Decision on a Strategic Plan to Promote and Develop e-Services.** The IRS failed to make the decision pursuant to an overarching strategic plan to expand e-service options to all tax partners. For example, it did not attempt to reevaluate and modify its marketing strategy for the two applications to increase usage and lower the cost per transaction. The IRS also failed to consider the additional long-term costs of practitioners' migration away from the online services to paper and phone-based systems.[4]
- **Provide an Electronic Alternative.** The IRS failed to take concrete steps to replace the programs with less costly alternative applications despite the clear demand for more electronic services by the practitioner community and the IRS's own strategic objective of expanding e-services to its tax partners.[5]

1 On September 2, 2013, the IRS retired the DA & EAR systems. Wage and Investment division (W&I) response to information request (Oct. 31, 2013). The amount of transactions in FY 2013 (372,681 through the week ending Sept. 7, 2013) was a slight increase over the 332,198 in FY 2012 and 282,987 in FY 2011. Ten percent is an understatement as the Centralized Authorization File (CAF) numbers include revocations of authorizations and other forms not processed through DA.

2 W&I response to TAS information request (Oct. 31, 2013). The number of transactions in FY 2013 (31,338 through the week ending Sept. 7, 2013) was a slight decrease from the 33,677 in FY 2012 (but a slight increase over the 30,457 in FY 2011).

3 *Id*.

4 *Id*.

5 IRS Strategic Plan 2009-2013 at 16.

- **Consult with Stakeholders Beforehand.** The IRS did not engage its stakeholders before making the final decision to retire the applications. Had the IRS done so, it might have recognized that growth potential warranted the investment in redesign and continuation of these two services.
- **Pay Due Consideration to the Increased Burden on Practitioners and Taxpayers.** Once the IRS retired the programs, practitioners who used DA reverted back to either mailing or faxing their disclosure authorization forms to the Centralized Authorization File (CAF), which has experienced increasing processing times and issues, in part, due to its outdated systems.[6] In addition, those who used EAR must now contact the IRS through the Practitioner Priority Service (PPS), which has experienced decreasing customer service representative (CSR) levels of service and increasing wait times since fiscal year (FY) 2010.[7]

ANALYSIS OF PROBLEM

Background

The IRS has a strategic goal to provide more electronic services to its partners.[8] The vehicle for providing such online tools to tax professionals is "e-services," a suite of web-based products that allow tax professionals and payors to conduct business with the IRS electronically. Disclosure Authorization (DA) and Electronic Account Resolution (EAR) were two applications offered in IRS e-Services. DA allowed registered users to create, view, and modify Forms 2848, *Power of Attorney and Declaration of Representative*, and 8821, *Tax Information Authorization* (collectively referred to as disclosure authorizations herein).[9] For example, when clients receive notices from the IRS, in order for their tax professionals to understand and address the notices, they file an authorization (such as Form 2848 or Form 8821) to contact the IRS on behalf of their clients. Using e-Services, tax professionals could instantaneously file an authorization through DA. The benefits of DA included quick processing and immediate acknowledgement of submissions, which are vital to stop levy actions and notices of deficiency.

Once a disclosure authorization was processed, the professional could later request clarification of the notice through EAR. EAR allowed tax professionals to expedite resolution of clients' account problems by electronically sending and receiving related inquiries. This meant practitioners could:

- Instantly inquire about client refunds;
- Request account changes;
- Establish installment agreements for clients to pay taxes; and
- Submit other inquiries—all without long wait times or faxing authorizations during a call to the IRS.

6 National Taxpayer Advocate 2012 Annual Report to Congress 281-301 (Most Serious Problem: *IRS Processing Flaws and Service Delays Continue to Undermine Fundamental Taxpayer Rights to Representation*); National Taxpayer Advocate 2010 Annual Report to Congress 171-186 (Most Serious Problem: *Persistent Breakdown in Power of Attorney Processes Undermine Fundamental Taxpayer Rights*); National Taxpayer Advocate 2009 Annual Report to Congress 256-271 (Most Serious Problem: *IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need*).

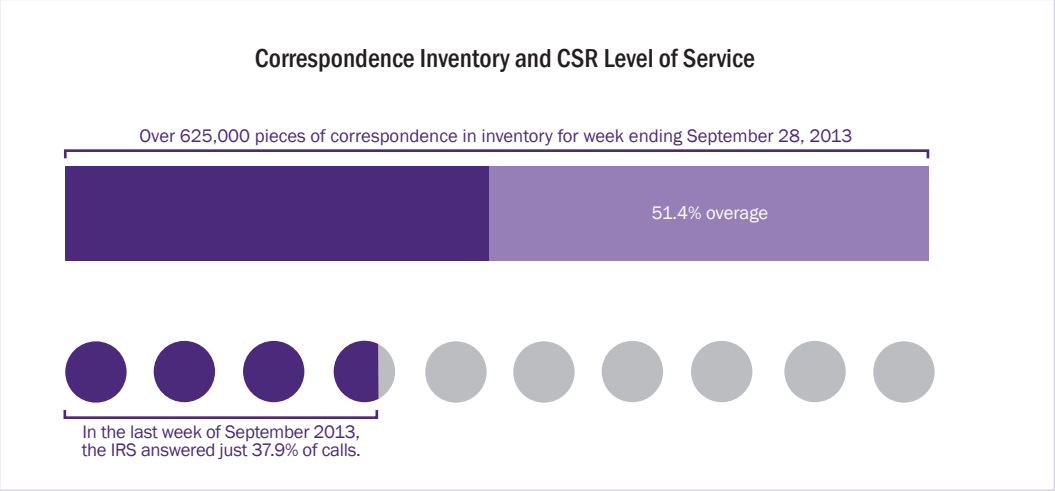
7 Internal Revenue Service Oversight Board Annual Report 2012 at 23. Monthly CSR level of service (LOS) rates varied but declined overall in FY 2013. Rates also declined for full FYs 2010 through 2012, but there was a slight increase in level of service in FY 2013 (when compared to 2012, but 2013 CSR LOS is less than 2010 levels) overall. Enterprise Snapshot Reports (Sep. 28, 2013). IRS, Joint Operations Center, Executive Level Summary Reports (Nov. 25, 2013).

8 IRS Strategic Plan 2009-2013 at 16.

9 W&I Operating Division Business Performance Review (BPR), FY 2013: First Quarter 7 (Mar. 2013).

The IRS responded to the EAR inquiry to a secure electronic mailbox within three business days, which is significantly less time than it would take to receive a response by mailing correspondence to the IRS. In fact, at the end of September 2013 the IRS had over 625,000 pieces of correspondence in inventory, of which more than half were considered overage.[10] For taxpayers and representatives who attempted to talk to a customer service representative on the IRS Customer Account Services telephone lines, the IRS reported a level of service of less than 40 percent during the last week of FY 2013, which means for this week the IRS did not answer more than six out of every ten calls.[11]

FIGURE 1.18.1, Correspondence Inventory and CSR Level of Service for Week Ending September 28, 2013



In March 2013, the IRS decided to retire the DA and EAR applications effective August 11, 2013.[12] This date was subsequently postponed to September 2, 2013, to coincide with the migration to a new web portal.[13] The IRS cited low usage and costs as reasons to retire the applications.[14]

The IRS's Decision to Retire the Two Applications Based on Increased Costs and Low Usage Does Not Comport with its Strategic Plan to Promote and Develop e-Services.

The IRS Strategic Plan in place at the time of the decision to terminate the programs has as its first goal to "[i]mprove service to make voluntary compliance easier." To achieve this goal, Objective Four provides that it will "[s]trengthen partnership with tax practitioners, tax preparers, and other third parties in order

10 IRS, Joint Operations Center, *Accounts Management Information Report (AMIR) National Summary* (week ending Sept. 28, 2013). The IRS had 626,451 pieces of correspondence in inventory of which 51.4 percent were considered overage. The definition of overage varies by topic but it is generally over 45 days old.

11 IRS, Joint Operations Center, Executive Level Summary Reports (week ending Sept. 28, 2013). For this week, IRS reported a 37.9 percent CSR LOS. IRS now refers to Customer Account Services telephone lines as Accounts Management (AM) telephone lines. This is a compilation of 27 lines (AM is a sum of 27 (1040, 4933, 1954, 0115, 8374, 0922, 0582, 5227, 1778, 9887, 9982, 2942, 4184, 7388, 0452, 0352, 7451, 9946, 5215, 3536, 2050, 4778, 4259, 8482, 8775, 5500 and 4490).

12 W&I Operating Division BPR, FY 2013: First Quarter 7 (Mar. 2013).

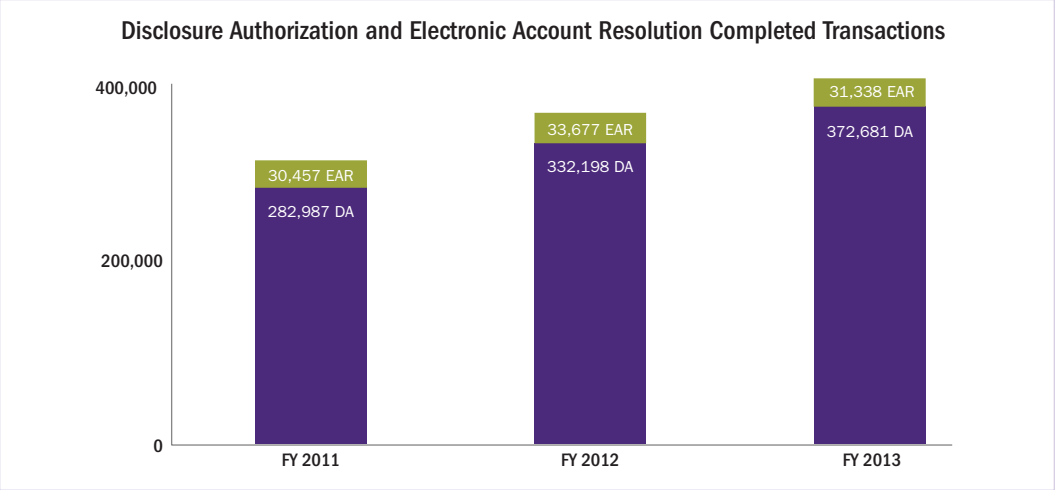
13 W&I response to TAS information request (Oct. 31, 2013). A portal is a critical interface between the IRS and the public. It is a point of entry to a network system that includes a search engine or collection of links to other sites arranged by topic. The IRS's Internet portal provides the infrastructure that allows users (IRS employees and taxpayers) to have Web-based access to IRS information and file tax returns electronically.

14 *Id*.

to ensure effective tax administration." Among the many ways the IRS will increase the quality of service to tax partners, the strategic plan clearly states that the IRS will "expand e-service options."[15] In addition, the second objective under the Plan's Strategic Foundation to "[i]nvest for high performance" provides that the IRS should "[b]uild and deploy advanced information technology systems, processes, and tools to improve IRS efficiency and productivity" and provides as its fourth strategy thereunder to "[e]xpand online tools and services."[16] Therefore, by discontinuing two applications within e-Services without offering improved electronic alternatives, the IRS appears to have failed several objectives and strategies of its own Strategic Plan.

Before retirement, the DA system processed approximately 300,000 disclosure authorizations annually, with usage increasing steadily over the past three years. EAR experienced lower usage numbers with over 31,000 transactions completed in FY 2013, which is consistent with the previous two fiscal years. The chart below shows the transactions completed in DA and EAR.[17]

FIGURE 1.18.2, DA & EAR Completed Transactions — FY 2011–2013[18]



The Centralized Authorization File units in Accounts Management received the larger portion of the disclosure authorizations (approximately 3.4 million annually).[19] Consequently, roughly ten percent of the authorizations were transmitted through DA.[20] The chart below illustrates authorizations received by the CAF unit for FY 2011 through 2013.

15 IRS Strategic Plan 2009–2013 at 16.

16 *Id*.

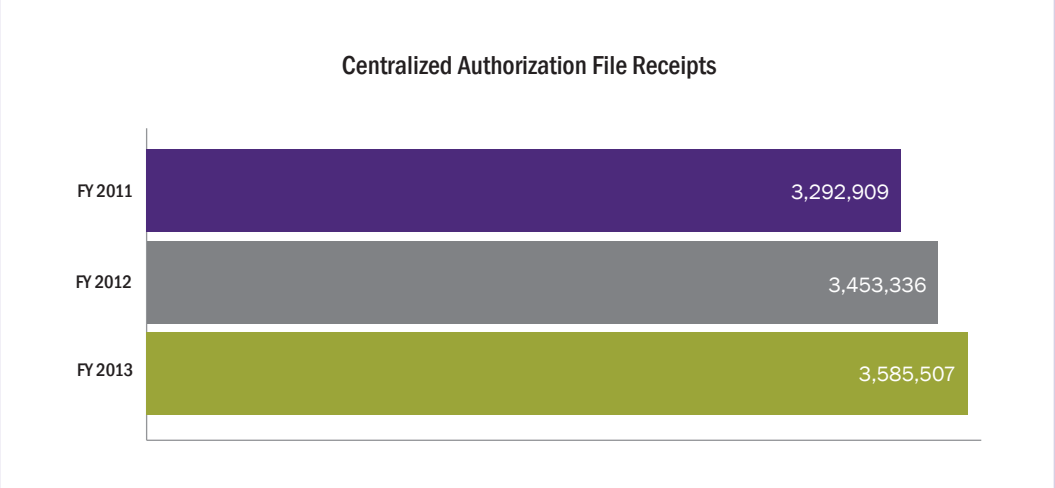
17 EAR completed 31,338 transactions in FY 2013, 33,677 transactions in FY 2012 and 30,457 in FY 2011. W&I response to TAS information request (Oct. 31, 2013).

18 The IRS retired the DA & EAR systems Sept. 2, 2013, thus the data reflects transactions completed through the week ending Sept. 7, 2013. *Id*.

19 W&I response to TAS information request (Oct. 31, 2013, and Dec. 18, 2013). DA processed 282,987 transactions in FY 2011, 332,198 in FY 2012 and 372, 681 in FY 2013. CAF had 3,292,909 receipts in FY 2011, 3,453,336 in FY 2012 and 3,585,507 in FY 2013. W&I Operating Division BPR, FY 2013: First Quarter 7 (Mar. 2013).

20 The CAF data reflects receipts while the DA data reflects transactions completed. Ten percent is a conservative estimate and likely an understatement as the CAF numbers include revocations of authorizations and other forms not processed through DA.

FIGURE 1.18.3, CAF RECEIPTS FY 2011–2013[21]



While the IRS promoted these e-service applications through various media over the years, it did not attempt to modify its marketing plan once low usage became a concern and possible basis for termination. Rather than attempting to increase use, the IRS decided to decrease it to zero.[22]

In addition to low usage, the IRS has cited costs as a main reason for discontinuing these applications. The IRS retired the applications upon the launch of a new web portal that is considered more modern, with increased flexibility and security. Facing a limited budget, the IRS could not afford to redesign the two e-services applications to transition them to the new portal.[23]

The IRS's final decision to terminate the programs runs counter to the goals of the Strategic Plan. Cost is an important program redesign objective, but in itself is insufficient without factoring in the objectives of time reduction and the measure of output quality. In fact, due to its budget restrictions, the IRS appears to have targeted "low hanging fruit" to suit its short-term fiscal needs without considering the long-term costs of paper and phone-based systems to replace the two applications.[24] In addition, the IRS made no effort to modify its current marketing strategy to increase usage and thereby lower the cost per transaction.[25] Finally, in this case, technology was viewed solely as a cost issue as opposed to a way of reshaping and improving business processes and eliminating expensive downstream rework.

The IRS also failed to give due consideration to the long-term impact on its tax partners. When the IRS suddenly terminates an online self-service tool geared toward the tax practitioner community, it does not instill an atmosphere of trust. Practitioners may be wary and unwilling to invest resources in future IRS

21 W&I response to TAS information request (Oct. 31, 2013).

22 The IRS promoted the programs at the Tax Forums, in seminars to practitioner groups, and on PPS. However, it did not modify its marketing plan to increase usage before termination. *Id*.

23 *Id*.

24 *Id*.

25 In a response to a 2009 Annual Report Recommendation 5-1, the IRS recently stated, "The IRS has already completed a short term research study and identified several quick-hits pertaining to existing electronic services that offer opportunities to enhance our e-services portfolio. Longer-term internet strategy key initiatives are underway for completion March 15, 2014." OLS response and request to close 2009 Annual Report to Congress Recommendation 5-1 (Sept. 13, 2013).

products and change their practices accordingly if they have no assurance that the IRS will support the product in the future.

The IRS Did Not Consider Replacement Electronic Applications Before Terminating the Applications

The IRS has said it intends to replace DA with a more cost-effective automated system that will save time with more user-friendly features.[26] However, it has not provided any concrete plans to roll out a comparable electronic alternative. The IRS Office of Online Services told TAS that it has an unfunded and yet-to-be prioritized work request to replace DA as a web-based stand-alone product.[27] In addition, we have recently learned the IRS will begin a limited pilot to use eFax for the storage and receipt of incoming powers of attorney in 2014.[28] While not as efficient as DA, we believe eFax could be a non-paper alternative with some of the benefits of electronic transmission.

The IRS's final decision to terminate the programs does not display any strategic forethought and runs contrary to the goals of the IRS Strategic Plan.

Any new online application will have significant start-up costs, but the IRS must factor into its cost analysis the long-term savings of eliminating the need for manual processing. Once a new application is proven to operate effectively, the IRS could even phase in a mandate of its use for practitioners governed by Circular 230, *Regulations Governing Practice before the Internal Revenue Service.*

The IRS Retired the Applications Without Soliciting Stakeholder Comments Beforehand or Adequately Addressing Practitioners' Needs

The IRS made the final decision to terminate the two applications without soliciting comments from its stakeholders beforehand. Almost immediately after the IRS announced the decision on its website, there was outcry from the practitioner community, many of whom contacted the Taxpayer Advocate Service to voice their significant concerns.[29] Practitioners were outraged that they were never consulted before the announcement, and nearly 4,000 of them signed a petition urging the IRS to reverse its decision.[30] By not consulting practitioners in advance, the IRS deprived itself of advice on how to improve the two programs or even market them to increase usage. Thus, at least in this instance, the IRS designed its e-services in a vacuum.

Many practitioner groups have voiced concern that the applications had low usage because the practitioners were not adequately informed of their availability, and have even offered to assist the IRS in raising awareness.[31] While the IRS may cite low past usage of the products, the public outcry alone demonstrates there is great potential demand for the services. Had the IRS consulted with those stakeholder groups

26 W&I response to TAS information request (Oct. 31, 2013).

27 *Id*.

28 William Hoffman, *Werfel Warns of Service Cuts from Further IRS Budget Reductions, Tax Notes Today* (Nov. 21, 2013).

29 Kristin Esposito, *IRS E-Services: Can They Come Back Better Than Before?* AICPA Insights (Aug. 5, 2013); Jeff Stimpson, *Thousands of Practitioners Protest End of e-Services Tools*, Accounting Today (July 19, 2013).

30 Jeff Stimpson, *Thousands of Practitioners Protest End of e-Services Tools*, Accounting Today (July 19, 2013).

31 Joint Letter from National Association of Enrolled Agents, National Society of Accountants, and National Association of Tax Professionals to Acting IRS Commissioner (June 21, 2013), *available at* http://www.naea.org/advocacy/comments-letters/irs-retiring-da-ar-e-services; Letter from Florida Institute of Certified Public Accountants to Acting Commissioner (July 15, 2013), *available at* http://www.ficpa.org/Content/News/NewsFlash/July-25-2013.aspx.

prior to making its decision, it might have recognized the growth potential warranted the investment in redesign and continuation of these two services.

To many practitioners, the sudden and unexpected announcement appeared inconsistent with previous IRS communications encouraging practitioners to use e-Services — and even mandating that they e-file their clients' returns. Until this point, there was a perceived momentum on the part of the IRS to implement electronic solutions. Thus, the announcement came as a complete surprise to the practitioner community.[32]

When the IRS Oversight Board conducted discussion groups with practitioners at the 2012 Nationwide Tax Forums, one of the ten main themes that emerged in those discussions was the practitioner demand for electronic tools to interact with the IRS.[33] Moreover, the IRS Electronic Tax Administration Advisory Committee (ETAAC) criticized the decision by stating, "removing online tools and reverting to a paper submission process is counter-productive.[34]

The National Taxpayer Advocate understands that the IRS has a limited budget for online services and must prioritize applications based on costs, usage, and impact. However, we believe the IRS should have engaged the stakeholder community and the National Taxpayer Advocate before making a final decision. As noted above, once the IRS announced the planned retirement, the practitioner community immediately raised its concerns; thus it is very likely that the practitioner community would have been responsive to the IRS in providing pre-decisional comments.

The IRS Decision Has Increased the Burden on Tax Practitioners and Their Taxpayer Clients.

In retiring the applications, the IRS acknowledged the customer impact to practitioners who used DA but now must go back to submitting paper POA and authorization forms by fax or regular mail. This change will significantly increase turnaround time from almost immediate processing with the online program to approximately five days of processing through the CAF.[35] To handle the increased workload, the IRS increased CAF staffing from nearly 220 full-time equivaents (FTEs) during FY 2012 to over 230 in FY 2013 with a goal of maintaining the level of service of five days or less going forward.[36] However, the IRS also has acknowledged, "current budget cuts will impact their dedicated resources to this program and they are working to determine the impact on processing time."[37]

The National Taxpayer Advocate is concerned that the IRS believes it has adequately addressed practitioner needs by directing Forms 2848 and 8821 away from an effective online system, which gained increasing acceptance from the practitioner community, toward a paper-based system with a poor track

32 Jim Buttonow, *Eight Ways to Improve IRS e-Services*, AICPA Tax Insider (July 11, 2013).

33 IRS Oversight Board Annual Report 2012 at 6, 33.

34 Electronic Tax Administration Advisory Committee, 2012 Annual Report to Congress 38 (June 3, 2012). ETAAC is an advisory committee pursuant to Federal Advisory Committee Act and established under the IRS Restructuring and Reform Act of 1998 (RRA 98) with the primary duty to provide input to the IRS on its strategic plan for electronic tax administration.

35 W&I response to TAS information request (Oct. 31, 2013). *See also* e-Services for Low Income Taxpayer Clinics (Nov. 13, 2013), *available at* http://www.irs.gov/Advocate/e-Services-for-Low-Income-Taxpayer-Clinics.

36 W&I Operating Division BPR, FY 2013: First Quarter 7 (Mar. 2013); W&I response to TAS information request (Oct. 31, 2013) shows a staffing increase from 218 in FY 2012 to 232 in FY 2013.

37 W&I response to TAS information request (Oct. 31, 2013); W&I Operating Division BPR, FY 2013: First Quarter 7 (Mar. 2013).

record, increased overall processing times, and a lack of acknowledgement upon receipt of submissions. Practitioners have also voiced similar concerns that they will be forced to revert to inefficient, old-fashioned methods.[38]

In the 2009, 2010, and 2012 Annual Reports, we have written about the problems experienced with processing authorization requests through the CAF unit. Specifically, the ineffective and outdated high-speed fax machines used by the CAF have failed to transmit all pages, break down frequently, and sometimes do not even receive authorizations. In addition, the unit has misplaced or failed to record authorizations. Practitioners do not receive an acknowledgement upon submission and many actually submit authorizations in duplicate to ensure receipt, which only creates a greater backlog.[39] Moreover, for authorization requests it actually works, the CAF has experienced long processing times in the past.[40] The IRS has stated that it has a goal to maintain processing times of five days or less, but this still increases the risk that taxpayers will not receive the benefit of representation during critical periods, such as levy actions.[41] Furthermore, the longer processing times increase the likelihood that the practitioner will contact the IRS several times, which only increases costs to the IRS.[42] Any additional time the practitioner spends submitting disclosure authorization is a cost of representation likely passed on to the client.

Practitioners who used EAR for assistance with client account issues must now call the PPS, which experienced a steady decline in service between FY 2010 and FY 2012. For example, in FY 2010, the CSR level of service was 80 percent, with a decrease to 78 percent in FY 2011 and 73 percent in FY 2012. The CSR level of service slightly increased to 75 percent in FY 2013, but the average wait time to receive an answer nearly doubled from over 10 minutes in FY 2010 to nearly 20 minutes in FY 2013.[43] The graphic below shows the fluctuation in the wait times as well as level of service on PPS during each month of FY 2013:

38 Letter from Florida Institute of Certified Public Accountants to Acting Commissioner (July 15, 2013); Joint Letter from National Association of Enrolled Agents, National Society of Accountants, and National Association of Tax Professionals to Principal Deputy Commissioner Daniel Werfel (June 21, 2013).

39 National Taxpayer Advocate 2012 Annual Report to Congress 281-301 (Most Serious Problem: *IRS Processing Flaws and Service Delays Continue to Undermine Fundamental Taxpayer Rights to Representation*); National Taxpayer Advocate 2010 Annual Report to Congress 171-186 (Most Serious Problem: *Persistent Breakdown in Power of Attorney Processes Undermine Fundamental Taxpayer Rights*); National Taxpayer Advocate 2009 Annual Report to Congress 256-271 (Most Serious Problem: *IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need*). Disclosure Authorization issues a real-time acknowledgement of accepted submissions. *See* http://www.irs.gov/Advocate/e-Services-for-Low-Income-Taxpayer-Clinics (last visited Dec. 11, 2013).

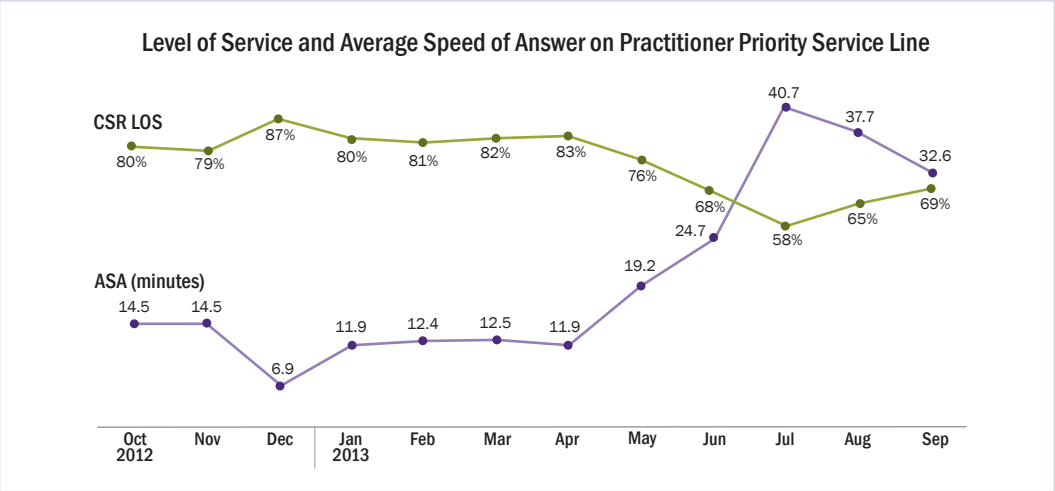
40 National Taxpayer Advocate 2012 Annual Report to Congress 281-301 (Most Serious Problem: *IRS Processing Flaws and Service Delays Continue to Undermine Fundamental Taxpayer Rights to Representation*); National Taxpayer Advocate 2010 Annual Report to Congress 171-186 (Most Serious Problem: *Persistent Breakdown in Power of Attorney Processes Undermine Fundamental Taxpayer Rights*).

41 W&I response to TAS information request (Oct. 31, 2013). The IRS states "In 2013 Accounts Management CAF processing was consistently 5 days or less."

42 *Id*. Authorizations input via e-Services Disclosure Authorization (DA) were immediately loaded to the Centralized Authorization File (CAF).

43 Internal Revenue Service Oversight Board Annual Report 2012 at 23; IRS Joint Operations Center, Snapshot Product Line Detail Reports (Sept. 30, 2011, Sept. 30, 2012, Sept. 30, 2013). The CSR LOS for the PPS was 79.8 percent for FY 2010, 78.3 percent for FY 2011, 73.4 percent for FY 2012, and 75.0 percent for FY 2013.

FIGURE 1.18.4, FY 2013 Monthly CSR Level of Service and Average Speed of Answer on PPS[44]



CONCLUSION

The IRS discontinued the DA and EAR applications undermining its strategic plan to expand e-service options to all tax partners. The decision was made without first consulting the practitioner community. Requiring practitioners to revert to paper and phone-based systems, which have had declining service in recent years, sends a message to the community that the IRS is unresponsive to practitioners' needs in favor of its own short-term budgetary needs. In addition, taxpayers will pay the ultimate price when their disclosure authorizations are not processed timely.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Consult with and solicit comments from impacted stakeholders, *i.e.,* the practitioner community, before deciding whether to retire applications.
2. Establish a strategic plan to identify, develop, and promote viable electronic alternatives to discontinued applications prior to discontinuance.
3. For online practitioner applications experiencing low usage, solicit comments from the users on how to improve the applications to boost usage to acceptable levels.
4. Solicit suggestions from practitioners on marketing strategies and potentially develop a joint marketing initiative, leveraging stakeholders' ability to communicate with their members.
5. Evaluate potential electronic alternatives to the retired e-services applications.

44 IRS Joint Operations Center, Snapshot Product Line Detail Reports (Sept. 30, 2011, Sept. 30, 2012, Sept. 30, 2013). Average speed of answer was 10.5 minutes in FY 2010 compared to 19.7 minutes in FY 2013.

MSP #19 IRS WORKER CLASSIFICATION PROGRAM: Current Procedures Cause Delays and Hardship for Businesses and Workers by Failing to Provide Determinations Timely and Not Affording Independent Review of Adverse Decisions

RESPONSIBLE OFFICIALS

Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The delay in classification of workers as employees or independent contractors by the IRS's SS-8 Unit has significant tax consequences for businesses and individuals. The classification impacts employment tax liabilities, income tax withholding obligations, information reporting, the allowance of expenses that may be derived from a "trade or business," and eligibility for employee benefit or pension plans.[1] The enactment of the Affordable Care Act magnifies the tax consequences of worker classification. The National Taxpayer Advocate has previously recommended that the IRS simplify its worker classification criteria, and has offered legislative and administrative remedies to alleviate the burden on applicants. These proposals include the development of a free online self-help tool that would give employers a preliminary determination of employment status based on their responses to specific questions.[2]

As of fiscal year (FY) 2013, 81 percent of cases in the IRS SS-8 Worker classification program are "overage."[3] This means that applicants must wait an average of a year before receiving a determination.[4]

The National Taxpayer Advocate has several additional concerns. First, the SS-8 Program uses new Internal Revenue Manual (IRM) guidance that results in premature rejection of legitimate applications without giving applicants an opportunity to respond and cure minor defects. Second, applicants who receive adverse determinations from this unit do not automatically receive administrative appeal options.

1 Internal Revenue Code (IRC) §§ 162, 401, 411.

2 *See* National Taxpayer Advocate 2012 Annual Report to Congress 19-20; National Taxpayer Advocate 2010 Annual Report to Congress 371; National Taxpayer Advocate 2008 Annual Report to Congress 375-90.

3 Treasury Inspector General for Tax Administration (TIGTA), Ref No. 2013-30-058, *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings* (June 14, 2013); IRS Response to TAS Research Request (Nov. 20, 2013).

4 Minutes of the Meeting of the SS-8 Worker Classification Advocacy Project Team, Jan. 16, 2013.

ANALYSIS OF PROBLEM

Background

Delay in classification of workers as employees or independent contractors has serious tax consequences.

Proper worker classification, whether as an employee or independent contractor, is critical to both businesses and workers. Generally, if a worker is misclassified as an independent contractor by a firm that is paying for services and the IRS reclassifies the worker as an employee, he or she is responsible for federal income tax and an employee's share of Federal Insurance Contributions Act (FICA) tax on the income.[5] If that reclassified worker already paid self-employment tax, he or she may be eligible for a refund. The related firm is responsible for federal income tax withholding, Federal Unemployment Tax Act (FUTA), and Social Security and Medicare taxes on the earnings unless special rates apply.[6] Specifically, the following employment taxes are at issue in an SS-8 determination:

- Federal income tax withholding at source of wages as provided by Internal Revenue Code (IRC) § 3402;
- FICA tax as provided by IRC § 3101; and
- FUTA tax as provided by IRC § 3301.

A business that has treated a worker's income incorrectly, or has been notified by the IRS that its worker's employment status has been reclassified, may have to file or adjust the related employment tax return(s) to pay the appropriate amount.[7]

Proper worker classification, whether as an employee or independent contractor, is critical to both businesses and workers.

A delay in worker classification decision impacts workers and businesses adversely, as any delinquent income and employment taxes are subject to penalties and interest. In some situations, a delayed determination may cause workers to lose refunds of overpaid self-employment taxes if the refund statute of limitations has expired. The filing of a Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, does not prevent the expiration of the time in which a refund must be claimed.[8] Many other benefits and determinations hinge on whether a worker is considered an employee or an independent contractor.[9]

Congress Has Passed Legislation to Address Ambiguities in Worker Classification but Additional Action Should be Taken.

The basis for determining the status of a worker as an independent contractor or employee had primarily rested on a common-law test of 20 factors that enumerated the degree of control that a person engaging

5 IRC §§ 3401, 3012(a), as amended by the Social Security Protection Act of 2004, Pub. L. No. 108-203.

6 IRC §3406(a)(1).

7 *See, e.g.*, Publication 4341, 20 (Rev. 01/2010).

8 In general, the statute of limitations period for credits or refunds is governed under IRC § 6511, which states such claims must be filed within three years from the time a return is deemed to be filed or two years from the time the tax was paid, whichever is later.

9 For example, IRC § 404(d) which limits deductions for deferred compensation paid to independent contractors; Section 531, The Deficit Reduction Act of 1984, Pub. L. No. 98-369, (addressing employee fringe benefits), IRC §401, *supra*.

the services of another had on the work, detail, and means by which the work was performed.[10] Congress addressed employment status by enacting Section 530 of the Revenue Act of 1978.[11] This section prohibits the IRS from reclassifying independent contractors as employees provided the payor consistently treated the payee as a contractor in good faith. It also barred the IRS from issuing guidance on the employment status of individuals.[12]

Congress' objective was to *temporarily* relieve businesses of uncertainties and provide a "safe harbor" if payors reasonably relied on past audit practices, published rulings, or judicial precedents, recognized practices in an industry, or long-standing treatment by the payors with regard to employment taxes.[13] However, the "temporary" relief was extended and then made permanent by the 1982 Tax Equity and Fiscal Responsibility Act.[14]

The National Taxpayer Advocate has previously recommended that Congress repeal § 530 and replace it with safe harbors applicable to employment and income tax determinations.[15] Repeal would also remove restrictions on IRS guidance.[16]

The Form SS-8 Process Can Require Lengthy Fact Gathering, Investigation, and Application of Law.

A worker or business may file Form SS-8 to receive a determination from the IRS as to whether the person in question is an employee or independent contractor.[17] The four-page, five-part form requires the submitter to answer numerous questions and provide a detailed explanation of the work relationship between the business and the worker. The SS-8 Unit screens the forms and returns them to the submitters if they are incomplete.[18] Once a form is complete and accepted for processing, the SS-8 technician will send a letter to the business, if the worker was the submitter, and ask the business to complete Form SS-8, because the determination of employment status affects both parties.[19] The technician may ask for additional information from the submitter, other involved parties, or third parties to help clarify the work relationship.

---

10 *See* Rev. Rul. 87-41, 1987 C.B. 296.

11 Section 530, Revenue Act of 1978, P.L. 95-600 (Nov. 6, 1978), as amended.

12 Section 530(b), Revenue Act of 1978, Pub. L. No. 95-600 (Nov. 6, 1978), as amended.

13 S. Rep. 95-1263 (Oct. 1, 1978).

14 Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 269(c).

15 *See* National Taxpayer Advocate 2012 Annual Report to Congress 19-20; National Taxpayer Advocate 2010 Annual Report to Congress 371; National Taxpayer Advocate 2008 Annual Report to Congress 375-90.

16 Congress expressed a concern that the IRS's increased enforcement of employment tax classifications could result in a heavy liability for employers: "If the IRS prevailed on a [worker] reclassification, the [business] became liable for employment taxes — withholding, Social Security, and unemployment — which neither had been withheld nor paid to the Treasury... many [businesses] lack [information that could offset the liabilities] about their workers and cannot benefit…" (S. Rep. 95-1263 (Oct. 1, 1978, *supra*)). In addition, businesses have expressed concern to TAS that any IRS-issued guidance would weigh heavily towards a determination that there is an employer-employee relationship. The online tool proposed by the National Taxpayer Advocate would provide an objective system that would be impartial to workers and employers based on their accurate responses to questions.

17 A Form SS-8 determination may be requested only to resolve federal tax matters. The Form SS-8 is filed according to the firm's location. In general, forms from western states are sent to Holtsville, NY and those from the East are sent to Newport, VT.

18 IRM 7.50.1.3.1 (Oct. 3, 2013). New Form SS-8 Receipts: First Read Screening Process.

19 The language specified by IRM Exhibit 7.50.1-17 (Oct. 3, 2013) assumes that the worker is the applicant; however, it instructs the SS-8 technical employee to send a letter "to the other party involved with the SS-8 determination" when preparing a full determination case for assignment. IRM Exhibit 7.50.1-17 (10-03-2013).

The technician reviews the facts, applies the law, and makes a determination. The determination is generally made under a facts-and-circumstances analysis that seeks to ascertain whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also the circumstances under which it is performed. In Rev. Rul. 87-41, the IRS enumerated 20 factors for determining whether an employer-employee relationship exists.[20] The importance of each factor varies depending on the occupation and the factual context in which the services are performed.[21]

A determination issued in response to a Form SS-8 request is binding to the IRS and applies only to the business and the worker to which it is addressed. If only one worker provided information about a work relationship, but the facts are not materially different for other workers in the same class, the SS-8 Unit may apply a written determination to those workers.[22]

A worker or business that disagrees with a determination may request a reconsideration if additional information is provided. However, the same group considers the reconsideration and almost all of the original determinations are upheld.[23] Under current procedures, no administrative appeal rights are allowed.

The IRS's last comprehensive estimate of the number of workers improperly classified was for tax year (TY) 1984. At that time, it found that 15 percent of employers misclassified 3.4 million workers as independent contractors. This resulted in an estimated total tax loss of $1.6 billion in Social Security taxes, Medicare taxes, federal unemployment taxes, and federal income taxes (for 1984).[24] The IRS has included a worker classification study in its ongoing National Research Program (NRP), but results will not be available until 2015.[25]

The SS-8 Unit Has a Backlog of Inventory.

In fiscal year 2013, the SS-8 program received 3,982 requests for determination filed by workers and 128 by employers.[26] The unit had a total inventory of approximately 11,545 cases of which 9,387 — more than 81 percent — were considered "overage," having been in process for 180 days or more. As the following chart shows, although the volume of overage cases has fluctuated over the last three years, the overall trend is worsening.

---

20 *See* Rev. Rul. 87-41, 1987 C.B. 296.

21 If the business fails to complete and return the form to the SS-8 Unit, the technician will base the determination solely on the information in the worker's Form SS-8. If both parties complete Form SS-8, the technician mails the determination letter to the business and a copy with a cover letter to the worker, regardless of which party is the requester.

22 IRM 7.50.1.5.2 (Rev. Oct. 3, 2013).

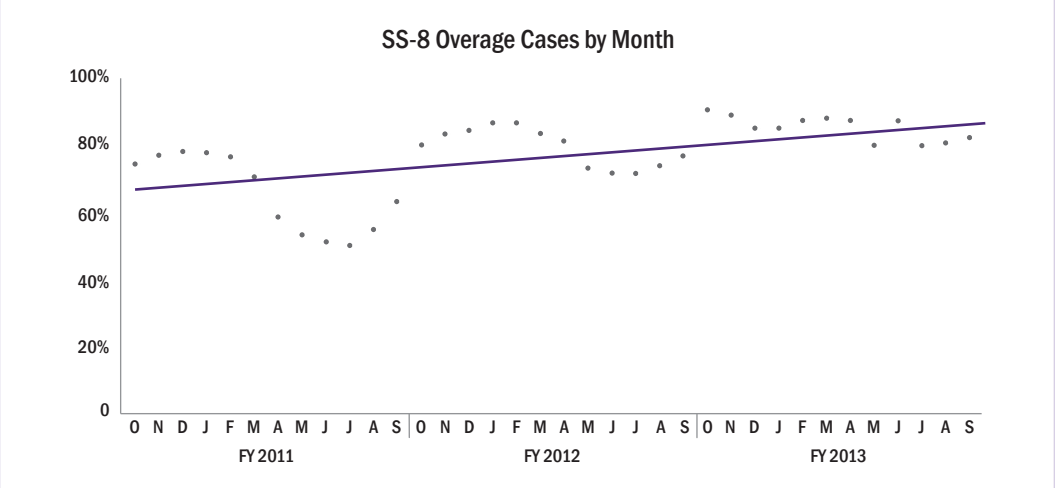
23 In FY 2011 318 reconsideration requests were received and one resulted in reversal. In FY 2012 119 reconsideration requests were received and three resulted in reversal. In FY 2013 196 reconsideration requests were received and four resulted in reversal. IRS response to research request (Nov. 20, 2013). There are no provisions in the IRM for quality or managerial review. (*See* IRM 7.50.1.5.10.1 (Oct. 3, 2013)).

24 Beier, Ken. "Strategic Initiative on Withholding Noncompliance (SVC-1), Employer Survey, Report of Findings." Unpublished: Department of the Treasury, Internal Revenue Service, June 1989. Beier, Ken. "Strategic Initiative on Withholding Noncompliance (SVC-1), Misclassified Employee Survey, Report of Findings." Unpublished: Department of the Treasury, Internal Revenue Service, September 1989. TIGTA, Ref No. 2013-30-058, *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings* (June 14, 2013).

25 The NRP is a comprehensive, statistical effort by the IRS to measure compliance for different types of taxes and various sets of taxpayers. (IRM 4.22.1.3 (Apr. 25, 2008)). The scope of the NRP includes worker classification issues. (IRM 4.22.10.3.3 (Oct. 1, 2011)). An examiner must review Form 1099s issued to individuals, determine that the classification of employees was correct and, if adjustments are proposed, determine if the taxpayer qualifies for Section 530 relief or if settlement programs apply, as part of the NRP's required analysis of Form 1099. (IRM 4.22.10.5.1 (Oct. 1, 2011)).

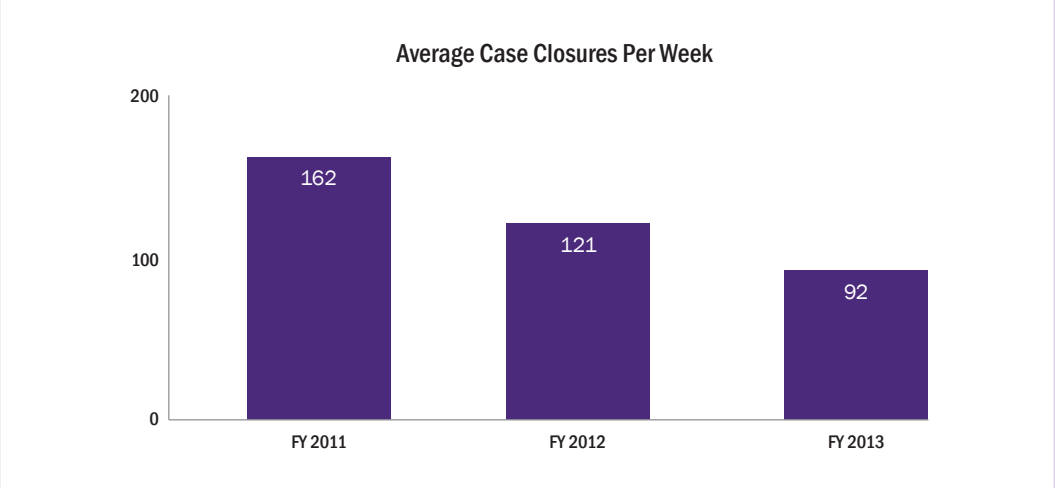
26 IRS response to TAS research request (Nov. 20, 2013).

FIGURE 1.19.1, SS-8 Overage Cases By Month[27]



The IRS has claimed that its large inventory was partially due to the SS-8 Unit's previous policy of accepting all forms filed.[28] The program's managers have since instituted "first read screening" procedures for new receipts — outlined above — to reduce incomplete filings. Despite these new procedures, the average case closures continue to decline.

FIGURE 1.19.2, AVERAGE WEEKLY CLOSURES[29]



27 IRS response to TAS research request (Nov. 20, 2013).

28 TAS call with IRS Operating Division (Jul. 19, 2013).

29 IRS response to TAS research request (Nov. 20, 2013).

IRS Procedures Direct Employees to Reject Legitimate Applications Without Substantive Applicant Contact.

In accordance with its new IRM, the SS-8 Unit's clerical staff screens new Form SS-8 receipts to ensure the documents are complete, accurate, and meet criteria.[30] Until recently, the examiners have been working without formal guidance, but the standards in the new IRM (which encompasses the "first screening process") for rejecting cases are skewed. For example, the Unit can reject cases if the forms are incomplete or have missing information. The Form SS-8 instructions state all questions must be answered or state "Unknown" or "Does not apply."[31]

Some questions are necessary to make a determination as they shed light on the level of control by the business over the worker. However, other questions could be left unanswered. The SS-8 Unit is currently returning many forms as incomplete even though taxpayers, in most cases, will come back with the needed information. The IRS has allowed taxpayers to "cure" incomplete submissions in other areas, including the Collection offer in compromise program. The National Taxpayer Advocate described the hardships faced by taxpayers whose offers were rejected by the IRS during initial screening before they were considered for investigative review.[32] Collection employees are now guided to call taxpayers, before sending correspondence or rejecting an offer, and solicit any missing or incomplete information.[33] A similar approach could be beneficial in this instance; rather than rejecting incomplete SS-8 filings and increasing future receipts, simply picking up the phone and calling the taxpayer to request additional information could move a case forward with little burden to either party.

As shown below, a substantial number of Form SS-8 submissions have been returned to the submitters since the institution of first read screening procedures.[34] In fact, as technicians work through the backlog of unprocessed forms, they are now returning almost as many submissions as they are receiving.

FIGURE 1.19.3, SS-8 Submissions and Returns[35]

Form SS-8 Submissions	Fiscal 2011	Fiscal 2012	Fiscal 2013
Filed by workers.	9,198	5,392	3,982
Filed by firms	645	264	128
Returned	0	3,104	3,905

Currently, the SS-8 Unit immediately closes cases under a counter-productive standard based on "the adequacy of information provided," rather than keeping them open and notifying submitters of deficiencies. The Unit sends the submitter an information courtesy letter advising that it could not process the request for a determination since the form was incomplete or missing documentation.[36] If the submitter subsequently submits a completed form, the Unit opens a new case and starts aging the case at that time. This

30 IRM 7.50.1.3.1 (Oct. 3, 2013).

31 Form SS-8 (Rev. Aug. 2011) *Disclosure of Information, Parts I–IV*: "If you cannot answer a question, enter "Unknown" or "Does not apply."

32 National Taxpayer Advocate 2007 Annual Report to Congress 380.

33 IRM 5.8.4.7 (May 10, 2013).

34 IRS response to TAS research request (Nov. 20, 2013).

35 Id.

36 IRS Courtesy Information Letter 4949.

allows the Unit to return substantial numbers of forms and delete them from its open inventory. Due to the importance of a determination, the Unit should give the submitter at least 30 days to cure the defects and submit a completed Form SS-8, rather than rejecting it out of hand. In some cases, an outbound call from the SS-8 unit to the submitter could cure any perceived defects in the submission and quickly resolve the case for both the applicant and the IRS, as opposed to statistical gamesmanship.

A delay in a worker classification decision impacts workers and businesses adversely, as any delinquent income and employment taxes are subject to penalties and interest.

The IRS can address the backlog by providing a self-help tool for businesses to receive classification determinations. The United Kingdom provides a free, web-based, non-binding "indication of employment status" to requestors through an online tool called Electronic Status Indicator (ESI).[37] A similar tool would benefit U.S. taxpayers and the government.[38] Unless facts and circumstances have materially changed, workers and employers could rely on an online determination without submitting a Form SS-8.

The current SS-8 program is a paper-based system in which forms must be mailed to the IRS — faxed, photocopied, or electronic versions forms are not accepted for initial determinations.[39] An online system that would prevent requestors from submitting forms with missing data could help applicants by minimizing delays in the application cycle and the IRS by avoiding complications and downstream costs associated with resubmitted forms.

Applicants Who Receive Adverse Determinations from the SS-8 Unit Lack Independent Administrative Appeal Options.

Applicants whose cases are in the SS-8 Unit have no option for an independent review if they receive an adverse determination. Instead, any disagreement is referred back to the unit, with no safeguards to ensure that the reviewer is independent of the group that made the original decision.[40] While the statute does not expressly provide appeal rights, nothing prevents the IRS from providing appeal rights to workers or businesses as to a status determination, even where there is no examination of a federal return. As noted above, the SS-8 Unit upholds almost all of its original determinations, which raises concerns about the impartiality of those reviews. An incorrect decision by the IRS has significant consequences to the income and employment tax liabilities of the affected parties. The IRS should provide applicants the right to an independent, administrative appeals review of adverse determinations.

37 HM Revenue & Customs http://www.hmrc.gov.uk/calcs/esi.htm (last visited Nov. 3, 2013). According to the site, "The ESI tool is helpful for anyone who takes on workers, such as employers and contractors. (The tool refers to anyone in this position as an engager.) Individual workers can also use the tool to check their employment status. The tool cannot, however, be used to check the employment status of some workers: company directors and other individuals who hold office, agency workers, [or] anyone providing services through an intermediary…"

38 National Taxpayer Advocate 2008 Annual Report to Congress, 376.

39 Form SS-8 (Rev. Aug. 2011).

40 IRM 7.50.1.5.10 (Oct. 3, 2013); IRM 8.7.16.1 (Oct. 1, 2012).

CONCLUSION

The National Taxpayer Advocate remains concerned that Congress and the IRS have not acted on previous recommendations in this area. The inventory backlog in the SS-8 unit means that businesses and applicants incur substantial tax consequences as they wait for classifications, and applications may be rejected in a narrow and rote screening process, leading to even more delays. The IRS has yet to provide online tools that applicants can rely on to determine their worker classification status and that would reduce SS-8 submissions. Further, businesses and workers alike are denied their full administrative appeal rights.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Adopt the National Taxpayer Advocate's previous recommendation to develop an electronic self-help tool for employers or workers to determine employment status.[41]
2. Allow applicants the right to an independent administrative appeals review of adverse determinations by the SS-8 unit.
3. Increase staffing to address the existing backlog and prevent future accumulation of worker classification requests.
4. Provide applicants an opportunity to cure perceived deficiencies in their initial filings rather than rejecting the applications outright through an initial screening process.

41 National Taxpayer Advocate 2012 Annual Report to Congress 19-20.

MSP #20 INTERNATIONAL TAXPAYER SERVICE: The IRS is Taking Important Steps to Improve International Taxpayer Service Initiatives, but Sustained Effort will be Required to Maintain Recent Gains

RESPONSIBLE OFFICIALS

Heather C. Maloy, Commissioner, Large Business & International Division
Debra Holland, Commissioner, Wage and Investment Division
Sarah Hall Ingram, Director, Affordable Care Act Implementation

DEFINITION OF PROBLEM

In 2008, when the National Taxpayer Advocate first described the difficulties international taxpayers face in complying with their U.S. tax obligations, about five million U.S. citizens were living abroad. This compared to just over four million in 1999, a 22 percent increase in a nine-year period.[1] By 2013, the number of U.S. citizens overseas had jumped to 7.6 million — an additional increase of more than 50 percent in just five years.[2] The National Taxpayer Advocate continues to describe the challenges the Foreign Account Tax Compliance Act (FATCA) and Report of Foreign Bank and Financial Accounts (FBAR) regimes pose for international taxpayers.[3] Adding to their compliance obligations, beginning in 2014, U.S. taxpayers living abroad will face unique challenges in complying with their obligations under the Affordable Care Act (ACA).[4]

The National Taxpayer Advocate has continued to call attention to the service needs of international taxpayers, and the IRS has taken important steps to address some immediate concerns.[5] However, the IRS has not yet undertaken the long-term commitment necessary to meet the needs of this important, fast-growing group of taxpayers.

International taxpayers who do not find the online services they need may call the international call site, a *toll* number. The call site answered approximately 330,000 calls in fiscal year (FY) 2012. Callers, some

1 National Taxpayer Advocate 2008 Annual Report to Congress 141 (Most Serious Problem: *Access to the IRS by Taxpayers Located Outside of the U.S*); United Nations Secretariat Department of Economic and Social Affairs, Statistics Division, *Estimation of emigration from the United States using international data sources* 4 (Nov. 2006) *available at* http://unstats.un.org/unsd/Demographic/meetings/egm/migrationegm06/DOC%2019%20ILO.pdf#page=4, estimating that 4.1 million US citizens lived abroad in 1999.

2 U.S. Dept. of State Bureau of Consular Affairs, *Who We Are and What We Do: Consular Affairs by the Numbers, available at* http://travel.state.gov/pdf/ca_fact_sheet.pdf, estimating that 7.6 million U.S. citizens live abroad (May 2013 update).

3 See Most Serious Problem (Reporting Requirements: *The Foreign Account Tax Compliance Act has the Potential to be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights*) and Most Serious Problem (*The IRS Offshore Voluntary Disclosure Program Disproportionately Burdens Those who Made Honest Mistakes*), *supra*.

4 The Patient Protection and Affordable Care Act of 2010 (ACA), Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010). For a more complete discussion of IRS outreach and education about the ACA see Most Serious Problem: *Affordable Care Act: The IRS Communication and Implementation Strategy Needs Improvement, supra*.

5 National Taxpayer Advocate 2012 Annual Report to Congress 262 (Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*); National Taxpayer Advocate 2011 Annual Report to Congress 129-272, which included six serious problems international taxpayers face in understanding and meeting their U.S. tax obligations.

of whom were phoning from overseas, waited ten minutes on average to speak to an assistor.[6] More than a quarter of the time, the caller did not succeed in speaking to an assistor at all.[7] International taxpayers may find information online about how to meet their filing obligations, and especially seek information about how to obtain an Individual Taxpayer Identification Number (ITIN), but they still cannot electronically file Form W-7, *Application for IRS Individual Taxpayer Identification Number* or Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

ANALYSIS OF PROBLEM

Background

More U.S. Citizens Live Abroad and a Greater Proportion are Renouncing their Citizenship.

U.S. citizens or resident aliens are subject to tax on their worldwide incomes.[8] They have the same general tax reporting requirements whether they reside in the United States or abroad, an obligation that at one time could have been viewed as "nontrivial but not onerous."[9] However, as the National Taxpayer Advocate noted, the tax requirements have become so confusing and the compliance burden so great that some taxpayers give up their U.S. citizenship.[10] As Figure 1.20.1 shows, since 1999, the number of U.S. citizens living abroad has increased 85 percent while the number of annual expatriations has skyrocketed nearly 500 percent. Perhaps because renouncing citizenship "may be easier than staying in compliance with U.S. tax laws that can be onerous for citizens of other countries," expatriations are expected to continue to increase, with an expected 2013 level at least 33 percent more than the previous high in 2011.[11]

6 As discussed below, there were 304,866 unique visitors in fiscal year 2013 to the IRS.gov landing page for international taxpayers. Taxpayers spoke to an assistor at the international call site 332,246 times in FY 2012. IRS Snapshot Report run Nov. 14, 2013. According to one IRS survey, 60 percent of international taxpayers who filed a return and called the IRS (67 out of 112) stated that they personally paid for the international phone call. Wage and Investment Research & Analysis (WIRA): 2012 *Taxpayer Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors* 47 (Aug. 2012).

7 The Customer Service Representative (CSR) level of service at the international call site was 72 percent, meaning 28 percent of calls went unanswered.

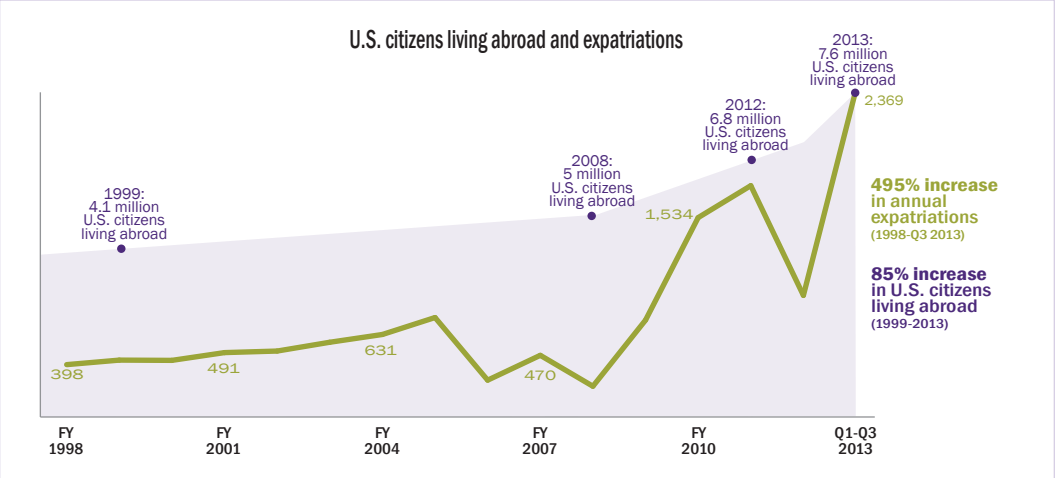
8 IRC § 61.

9 Peter J. Spiro, *The (Dwindling) Rights and Obligations of Citizenship*, 21 William and Mary Bill of Rights Journal 899 at 920 (Mar. 2013).

10 National Taxpayer Advocate 2012 Annual Report to Congress 262 (Most Serious Problem: *Challenges Persist for international Taxpayers as the IRS Moves Slowly to Address Their Needs*); National Taxpayer Advocate 2011 Annual Report to Congress 151 (Most Serious Problem: Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting their Specific Needs and Preferences).

11 Laura Saunders, *More Taxpayers Are Abandoning the U.S. Year's Tally for Expatriations Sets Record; Increase Comes Amid Tax Crackdown on Offshore Assets*, The Wall Street Journal (Nov. 13, 2013) *available at* http://online.wsj.com/news/articles/SB10001424052702304243904579195923107439130. See also William Douglas, *Tax Law is Putting a Strain on Expatriates: Record Number Are Ditching U.S. Passports Out of Frustration, Fear*, The Washington Post (Nov. 20, 2013) A24.

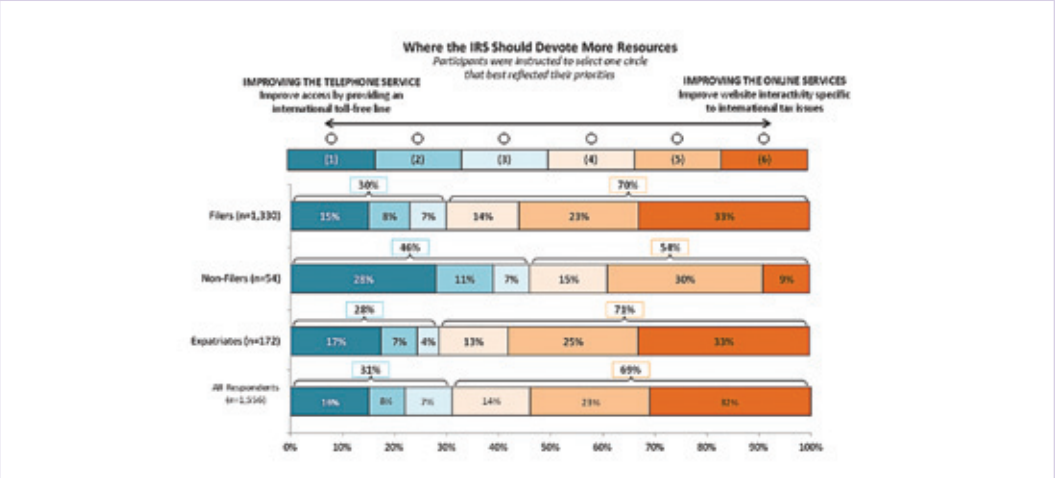
FIGURE 1.20.1, U.S. Expatriations Since 1998[12]



The IRS Focuses on Improving IRS.gov, but Telephone Communication Remains Essential for Many International Taxpayers.

In the past few years, the IRS has published research studies that explore the needs and preferences of international taxpayers.[13] As Figure 1.20.2 shows, while taxpayer preferences may best be described as falling on a continuum, most respondents to an IRS survey indicated that the IRS should devote resources to improving online services rather than to improving telephone services.[14] However, a significant minority preferred improvements to telephone service by providing an international toll-free line.

FIGURE 1.20.2, Preferences of Filers, Non-filers, and Expatriates[15]



Source: 2011 Survey of Individuals Living Abroad: Top Line Report. ICF Macro, September 16, 2011.

12 See Most Serious Problem: *Reporting Requirements: The Foreign Account Tax Compliance Act has the Potential to be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights*, *infra/supra* for further discussion of this trend.

13 *See, e.g.*, WIRA: 2012 Taxpayer *Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors* (Aug. 2012); *WIRA: Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010).

14 WIRA: 2012 Taxpayer *Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors* 60 (Aug. 2012).

15 *Id*. at 44.

The IRS report concludes, "[i]n light of recent budget cuts, tight resources, and an increased workload, the IRS must labor to improve voluntary compliance with international tax provisions and reduce the tax gap attributable to international transactions. This effort will require a strategic balance of both service and enforcement initiatives grounded in targeted, relevant outreach and the effective use of technology."[16] As part of this effort, the IRS's Office of Online Services (OLS) adopted a five-year strategy to provide taxpayers a range of online service options.[17] However, many of these services are not yet available. In the meantime, international taxpayers can obtain information or assistance with their individual accounts by calling the international call site, and they are doing so with increasing frequency, but the service they receive there is worsening.

… as the National Taxpayer Advocate noted, tax requirements have become so confusing and the compliance burden so great that some taxpayers give up their U.S. citizenship.

IRS.gov has a "Contact My Local Office Internationally" page that provides a telephone number (not toll-free) to the international call site, which taxpayers used to speak with an IRS employee about 330,000 times in FY 2012.[18] The customer service representative (CSR) level of service decreased from 78 percent in FY 2011 to 72 percent in FY 2012.[19]

The IRS's lack of online services forces taxpayers to call from overseas. This system may not accommodate their preferences, and is not the best use of IRS resources.[20]

At least one IRS Tax Attaché office uses the Department of State's voice-over-Internet- protocol (VoIP) system at the U.S. Embassy where it is located to reach taxpayers by telephone.[21] The service permits an unlimited number of international outbound calls for the same low rate.[22] If call forwarding were also part of the service, a taxpayer could dial the number listed in a local telephone directory as the IRS taxpayer service line and reach an IRS assistor in the U.S. - without paying international call rates.

The IRS is Planning Significant Improvements to its Communications Capabilities that will Benefit International Taxpayers and is Undertaking Further Research About Their Filing Compliance but Needs to Prioritize Developing Online Services for These Taxpayers.

The IRS is launching a pilot program in which taxpayers will be able to securely exchange messages and documents with IRS employees through a secure messaging portal (SMP). Taxpayers who register for the service will receive system-generated notifications by email or SMS text notifying them they received a message on the SMP. The notification will not contain any personally identifiable information.

16 WIRA: 2012 Taxpayer *Experience of Individuals Living Abroad: Service Awareness, Use, Preferences, and Filing Behaviors* 11 (Aug. 2012).

17 See National Taxpayer Advocate 2012 Annual Report to Congress 252 (Most Serious Problem: *The IRS is Striving to Meet Taxpayers' Increasing Demand for Online Services, Yet More Needs to be Done*)

18 Taxpayers called this number and spoke with an assistor 332,246 times in FY 2012. IRS Snapshot Report (report run Nov. 14, 2013).

19 *Id*. We do not show data for FY 2013 because the numbers are not compatible with earlier years due to a change in the report structure.

20 See National Taxpayer Advocate 2012 Annual Report to Congress 151 (Most Serious Problem: *The IRS is Striving to Meet Taxpayers' Increasing Demand for Online Services, Yet More Needs to be Done*), noting that "[w]hile such [online service] projects 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."

21 National Taxpayer Advocate Nov. 15, 2013 in-person meeting and Nov. 26 and 27, 2013 telephone conversations between TAS Attorney Advisor and IRS Deputy Tax Attaché, United Kingdom.

22 Nov. 26, 2013 conversation with IRS Deputy Tax Attaché, United Kingdom, describing the applicable Vonage subscription. Vonage rates generally are *available at* http://vonage-promotions.com/?s=100&k=187&gclid=CM6T7-P_lLsCFTNp7AodlWoAUw. The IRS cannot confirm the cost of the service, but it appears that it would be approximately $30 per month.

Upon logging in through the SMP authentication page, the taxpayer will be able to read and respond to correspondence with the IRS, attach documents to messages to the IRS, and download attachments in messages from the IRS. Future pilot phases will include live chat, "click to call," screen sharing, and online video meetings.[23] One initiative tailored to taxpayers living abroad is a pilot project to offer Virtual Volunteer Income Tax Assistance (VITA). The pilot is scheduled to begin with the 2014 filing season at two sites, in Warsaw, Poland and Beijing, China. Another planned pilot that is not yet underway will provide virtual service and tax workshops in Virtual Town Hall meetings overseas.[24] The National Taxpayer Advocate applauds these efforts, and urges the IRS to include include international taxpayers in the earliest phases of the various online service pilots.

The IRS has also contracted with an independent consultant to survey 4,000 individuals residing abroad who the IRS believes have U.S. filing requirement and did not file a return.[25] The survey, to be conducted by mail and online, will "focus on why some individuals living abroad do not file a tax return, their awareness of certain tax provisions and forms specific to International Taxpayers, and how the IRS can encourage voluntary compliance among this population."[26] The IRS previously described such a survey, and while the National Taxpayer Advocate generally supports the initiative, she is concerned that the IRS is proceeding without vetting it with stakeholders, including TAS.[27]

The IRS's lack of online services forces taxpayers to call from overseas. This system may not accommodate their preferences, and is not the best use of IRS resources.

International Taxpayers Cannot Call the IRS for Some Important Services They Need and Do Not Have Access to Those Services Online.

The IRS website, with a new version (or "content management system") as of August 31, 2012, has a page for international taxpayers, but the IRS.gov homepage does not link directly to it. A user can select information for individual taxpayers from an obscure dropdown menu on the homepage and from there access the international taxpayer landing page.[28] Alternatively, from the homepage, a user can type in a search term such as "international" that opens the international taxpayer landing page. Google Analytics data, available since the launch of the new IRS.gov on August 31, 2012, shows the individual international taxpayer landing page was viewed approximately 450,000 times by about 300,000 unique visitors in FY 2013.[29] The five most frequently visited IRS web pages that pertain

23 LB&I response to TAS information request (Oct. 28, 2013).

24 W&I response to TAS information request (Oct. 28, 2013).

25 *Id*. These presumed non-filers will be identified using the IRS Compliance Data Warehouse non-filer database and U.S. Department of State passport data.

26 *Id*.

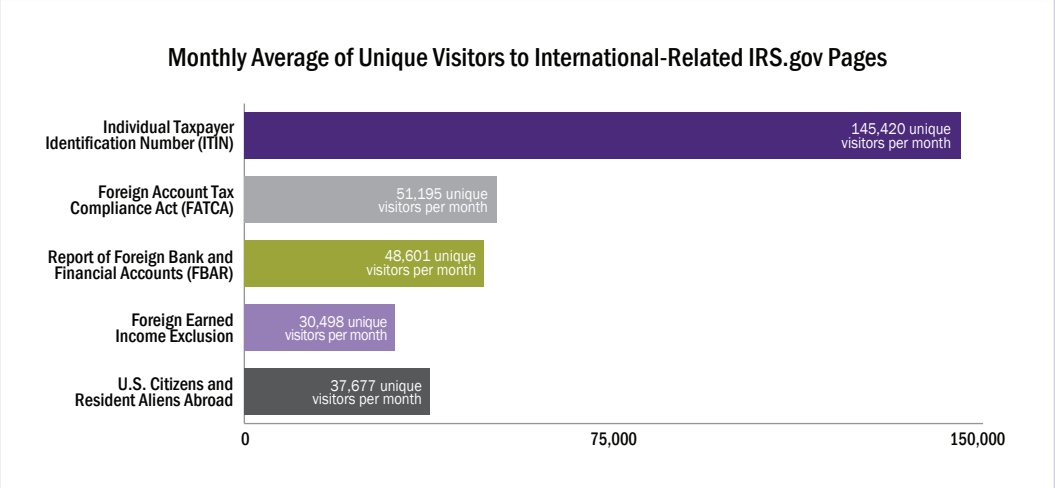
27 National Taxpayer Advocate 2012 Annual Report to Congress 262, 271 (Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*). The IRS indicates that "fielding for this survey is expected to begin in early January 2014 and concluded in March 2014." W&I response to TAS information request (Oct. 28, 2013).

28 The international taxpayer landing page is at http://www.irs.gov/Individuals/International-Taxpayers. Before the migration to the new Content Management System, the International Taxpayer content resided in the Businesses channel of IRS.gov rather than with the Individual channel.

29 The IRS uses Google Analytics to obtain metrics about IRS.gov webpage usage. Data includes the number of page views, the number of unique visitors, bounce rates, average time on pages, the number of exits, and average visit duration. There were 447,074 page views of the landing page, by 304,866 unique visitors during FY 2013. Large Business & International Division (LB&I) response to TAS information request (Nov. 18, 2013). Google Search Analytics also powers the new Content Management search engine on IRS.gov, allowing users to obtain more efficient search results.

to international taxpayers (other than the international taxpayer landing page) are shown in Figure 1.20.3 below.[30]

FIGURE 1.20.3, Monthly Average of Unique Visitors to International-Related IRS.gov Pages



Keeping in mind that "international taxpayers may best be served through investment and improvements in IRS.gov and online services," the IRS's Large Business & International Division considered Form W-7, the ITIN application, a candidate for electronic filing.[31] The Google Analytics data that has since become available confirms taxpayers' overwhelming interest in information about ITINs relative to other international topics. Nevertheless, LB&I no longer supports electronic filing of Form W-7 and taxpayers still cannot file it electronically.[32]

30 LB&I response to TAS information request (Oct. 28, 2013). The IRS individual international page invites users to search TaxMap, an IRS-developed tax law discovery tool that refers taxpayers to information available on IRS.gov. TaxMap is *available at* http://taxmap.ntis.gov/taxmap. Approximately 13,000 unique visitors selected among the more than 200 topics in the TaxMap international index, but the IRS does not have data on which topics are visited most often. The TaxMap international index is hosted by another government agency, the National Technical Information Service (NTIS). The software NTIS uses is not configured to capture the frequency with which taxpayers select various index topics. However, the top five countries from which visitors accessed TaxMap, and the respective number of unique visitors in a recent six-month period were:

United States – 155,903 visitors; China – 5,937 visitors; Canada – 3,413 visitors; United Kingdom – 2,974 visitors; and Germany – 1,852 visitors. LB&I response to TAS information request (Oct. 28, 2013). The data is for the period March 22, 2013 to September 16, 2013 and was created through reverse domain name system lookups of the Internet protocol addresses of TaxMap visitors.

31 2012 WIRA Research Study; WIRA, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* 43, 60 (Feb. 2010).See National Taxpayer Advocate 2012 Annual Report to Congress 262, 274 (IRS Response, Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*).

32 The IRS advised that "The IRS does not plan to pursue electronic filing of the ITIN application. Form W-7, Application for IRS Individual Taxpayer Identification Number (ITIN),is not a candidate form for electronic filing for the following reasons: 1. Modernized e-File (MeF) is unable to accept both the W-7 and associated tax return(s) in the same transaction. Taxpayers are required to include their original, valid tax return(s) for which the ITIN is needed. [We note that this requirement is subject to a few exceptions. Nonresident aliens claiming the benefits of a tax treaty and persons with income, payments, or transactions subject to third party reporting or withholding may apply for an ITIN separately from filing a tax return. *See* Instructions for Form W-7 (Aug. 2013).] 2. MeF requires a valid Taxpayer Identification Number (TIN) at the time the return is submitted for processing. The tax returns submitted with the W-7 applications do not have a TIN when the return is submitted to IRS. 3. Taxpayers must also submit documentation that supports the information provided on the Form W-7. The applicant can submit original documents or certified copies from the issuing agency.

[We note that certain applicants are exempt from the requirement to submit original documents: spouses and dependents of military taxpayers; students who are part of the Student and Exchange Visitor Program (SEVP); and nonresident aliens claiming tax treaty benefits.] Attaching a pdf version of the supporting documentation will not allow IRS to authenticate the documents per IRM 3.21.263." TAS SharePoint (tracking annual report to Congress recommendations), 2012 Rec. 15-4.

LB&I did request inclusion of Form 1040NR, *U.S. Nonresident Alien Income Tax Return,* in the 2015 release of the IRS's Modernized E-file platform, which would permit taxpayers to file the return electronically. The IRS Submission Processing Executive Steering Committee declined to do so due to "other priorities and resource constraints."[33] However, as the National Taxpayer Advocate urged, the IRS now includes Form 8938, *Statement of Specified Foreign Financial Assets*, among those that can be submitted electronically.[34]

The IRS Still Maintains Only Four Foreign Tax Attaché Offices for Interaction with International Taxpayers.

The "How to Contact the IRS" webpage provides the contact information for four embassies or consulates where the IRS has tax attachés and for the local Puerto Rico office. Taxpayers contacted their foreign attaché offices 26,205 times in FY 2013, by way of:

- 6,929 in-person contacts (walk-in or by appointment);
- 10,546 telephone contacts; and
- 8,730 correspondence contacts (by letter, fax, or email).[35]

The four tax attaché offices held outreach events as follows:[36]

	Beijing	Frankfurt	London	Paris	Total
FY 2011	12	2	6	7	27
FY 2012	17	3	6	7	33
FY 2013	10	3	17	6	36

The topics of these outreach events and tax workshops, at which the number of attendees ranged from 20 to 200, included:

- Filing requirements for taxpayers living abroad;
- Foreign earned income exclusion;
- Foreign tax credit;
- Treaty-related issues; and
- ITIN, FBAR, FATCA, and other topics of interest for international taxpayers.[37]

Despite the growth of the U.S. population overseas and repeated urging by the National Taxpayer Advocate, the IRS has not increased the number of attachés and has no plans to do so.[38]

33 LB&I response to TAS information request (Oct. 28, 2013).

34 See National Taxpayer Advocate 2012 Annual Report to Congress 262, 280 (Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*)

35 LB&I response to TAS information request (Oct. 28, 2013).

36 *Id*.

37 LB&I response to TAS information request (Oct. 28, 2013).

38 See National Taxpayer Advocate 2011 Annual Report to Congress 151,157 (Most Serious Problem: Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences) for a description of the IRS attaché post expansion analysis, in which it identified nine countries as candidates for post expansion. The study abruptly ended due to "budgetary and other considerations." The IRS has no plans to increase the number of foreign tax attaché posts. LB&I response to TAS information request (Oct. 28, 2013).

The Individual Taxpayer Assistance Team is a Promising Development, but Needs to be Made Permanent.

In June 2012, LB&I, the Wage & Investment Division (W&I), and TAS created the International Individual Taxpayer Assistance Team (IITA) to develop international taxpayer service initiatives.[39] The IRS Office of Online Services (OLS) joined the group in August of 2012. The team has been instrumental in updating and streamlining various IRS webpages for international taxpayers, identifying areas and issues of most concern to them and working with TaxMap. The National Taxpayer Advocate has recommended that the IRS make IITA permanent, with a formal charter.[40] She has further recommended that IITA be required to provide periodic written reports and formal recommendations to Business Operating Division (BOD) executives through the existing Services Committee, and the IRS has agreed to consider the proposal. Once IITA is a permanent, accountable group, it can engage in long-term planning, and the IRS can measure its effectiveness. LB&I has appointed a permanent full-time program manager for IITA, an important first step, but there are no other full-time employees dedicated to IITA.[41] IITA continues to function through "cross functional ad hoc teams" — exactly the approach the National Taxpayer Advocate would prefer to avoid, in favor of a more holistic approach.[42]

International Taxpayers Face Unique Challenges under the Affordable Care Act.

The Affordable Care Act of 2010 generally requires "applicable individuals" to have minimal essential health coverage (MEC) beginning in 2014 or pay a penalty.[43] U.S. citizens abroad who are subject to the requirement will be treated as having MEC under circumstances described in the statute (for example, if they are eligible for the foreign earned income exclusion).[44] In addition, according to the Department of Labor, U.S. citizens living abroad who do not meet the statutory requirements may still be considered as having MEC if they are covered by an "expatriate health plan."[45] However, Treasury regulations do not reflect this rule and important details about how U.S. taxpayers living abroad can meet their obligations under the ACA remain undeveloped.[46] The IRS has posted only two FAQs about how ACA applies to

39 For a complete discussion of the steps the IRS has taken to provide better service to international taxpayers, see National Taxpayer Advocate 2012 Annual Report to Congress 262, 265 (Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*).

40 National Taxpayer Advocate 2012 Annual Report to Congress 262, 280 (Most Serious Problem: *Challenges Persist for International Taxpayers as the IRS Moves Slowly to Address Their Needs*).

41 LB&I response to TAS information request (Oct. 28, 2013).

42 Nov. 4, 2013 email from IITA program manager to TAS Senior Technical Advisor.

43 The Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010). An "applicable individual" does not include "an individual for any month if for the month the individual is not a citizen or national of the United States or an alien lawfully present in the United States." *See* IRC § 5000A(a), (b), (d), and (f).

44 IRC § 5000A(f)(4) provides: "Individuals residing outside United States or residents of territories. — Any applicable individual shall be treated as having minimum essential coverage for any month — (A) if such month occurs during any period described in subparagraph (A) or (B) of section 911(d)(1) which is applicable to the individual, or (B) if such individual is a bona fide resident of any possession of the United States (as determined under section 937(a) for such month."

45 An expatriate health plan for purposes of certain transitional relief is "an insured group health plan with respect to which enrollment is limited to primary insureds who reside outside of their home country for at least six months of the plan year and any covered dependents, and its associated group health insurance coverage." U.S. Dep't. of Labor, *FAQs about the Affordable Care Act Implementation Part XII* (March 8, 2013), *available at* http://www.dol.gov/ebsa/faqs/faq-aca13.html.

46 Letter from the American Benefits Council to the U.S. Dep't. Of Labor (May 8, 2013) *available at* http://www.americanbenefitscouncil.org/index.cfm.

U.S. citizens residing abroad, neither of which sheds any additional light on this issue.[47] The international taxpayer landing page does not contain a direct link to these FAQs.

CONCLUSION

The population of U.S. international taxpayers is growing rapidly, and is subject to increasingly burdensome tax compliance obligations. The IRS emphasizes service to these taxpayers via IRS.gov pages, but taxpayers increasingly call the IRS for information and matters relating to their accounts even if they have to pay for the call and even though they would prefer online services. At the same time, important online services continue to be unavailable. The IRS is making incremental progress with developing the International Individual Taxpayer Assistance Team, but needs to do more.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Make the IITA a permanent initiative with reporting responsibilities.
2. Develop and implement free electronic filing of Forms 1040NR and W-7.
3. Prioritize the delivery of online services to the overseas population of international taxpayers, given their special circumstances and communication barriers, by including them in the first group of pilot projects the IRS launches.
4. Improve the CSR level of service for international taxpayers who call the international call site.
5. Explore the use of voice-over-Internet-protocol and other alternative methods of telephone services that will allow the IRS to contact taxpayers, and taxpayers to contact the IRS, without paying international call rates.
6. Open more foreign tax attaché offices, and locate a Local Taxpayer Advocate at each site.
7. Develop dedicated FAQs that ultimately become formal published guidance about how U.S. citizens abroad who are subject to the reporting requirements of the Affordable Care Act (ACA) can meet their obligations, and provide links to this guidance on the ACA webpage from the international taxpayer webpage.

47 The FAQs appear at http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision and include answers to: 12. Are US citizens living abroad subject to the individual shared responsibility provision? 13. Are residents of the territories subject to the individual shared responsibility provision? ACA Implementation response to TAS information request (Nov. 1, 2013).

MSP #21 INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS: ITIN Application Procedures Burden Taxpayers and Create a Barrier to Return Filing

RESPONSIBLE OFFICIAL

Debra Holland, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

In late 2012, in response to a Treasury Inspector General for Tax Administration (TIGTA) report, the IRS announced permanent changes to its Individual Taxpayer Identification Number (ITIN) application procedures. Under the new procedures, primary and secondary applicants may use a certifying acceptance agent (CAA) to certify their supporting documents and submit copies rather than originals to the IRS. However, persons applying for an ITIN for a dependent still must mail original documents or copies certified by the issuing agency to the IRS, unless the dependent has the documents certified at an IRS Taxpayer Assistance Center (TAC) or a U.S. tax attaché's office.

The new procedures are one reason ITIN applications filed with returns during calendar year 2013 plunged 48.4 percent from the 2010-2012 baseline.[1] During the same time, the percentage of rejected applications has soared to 50.2 percent.[2] Without an ITIN, taxpayers ineligible for a Social Security number (SSN) cannot meet their tax return filing obligations or claim the personal exemptions for spouses and children and the tax credits and refunds to which they are legally entitled. Taxpayers also need ITINs to participate in the global economy by having the proper amount of taxes withheld, claiming tax treaty benefits, and complying with reporting laws such as the Foreign Account Tax Compliance Act (FATCA).[3]

A fundamental problem with the IRS's ITIN application procedures is that they exacerbate the issues identified by TIGTA instead of mitigating them, including:

- The lack of appropriate employee training and sufficient time to review ITIN applications, made worse by the new CAA limitations;
- The inability of CAAs, who often have specialized knowledge of identification documents used in certain communities and regions, to assist the IRS in identifying fraud because they cannot certify dependent documents; and
- The continued requirement to submit ITIN applications with a paper tax return during the filing season, which burdens taxpayers and the IRS, and squanders opportunities to detect fraud.

1 IRS, ITIN Production Reports (Oct. 30, 2010, Oct. 29, 2011, Oct. 27, 2012, and Oct. 26, 2013). Totals are year-to-date from January 1 through the date of each report.

2 *Id.*

3 See Most Serious Problem: *Reporting Requirements: The Foreign Account Tax Compliance Act has the Potential to be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights, infra*.

A second major problem is that with the ITIN unit's increased focus on fraud and enforcement, it has given taxpayer service short shrift. Issues related to this approach include:

- Long wait times for applications to be processed, lost mail, and inadequate customer service and assistance at TACs;
- Barriers to resolving suspended or rejected applications, and the inability to speak with an IRS employee and learn the reason for a suspension or a rejection;
- New CAA procedures that discourage participation in the program and fail to provide appropriate training to CAAs; and
- Procedures for retiring old or inactive ITINs that may harm taxpayers and deprive them of their rights.

ANALYSIS OF PROBLEM

Background

The National Taxpayer Advocate has drawn attention to issues with the ITIN application process for many years.[4] In 2003, the National Taxpayer Advocate reported the IRS did not have adequate staffing to process ITIN applications and tax returns during the filing season.[5] She also identified processing delays, inadequate phone assistance, and the seemingly arbitrary acceptance or rejection of applications. Many of these problems still burden applicants a decade later. In July of 2012, TIGTA reported the ITIN application process was "so deficient that there is no assurance that ITINs are not being assigned to individuals submitting questionable applications."[6] While not minimizing compliance concerns, the National Taxpayer Advocate disagreed with some of TIGTA's conclusions about the amount of fraud associated with ITINs,[7] as well as recommendations such as requiring only original or certified copies of documents and discontinuing the CAA program.[8]

Overview of New Procedures

In response to the TIGTA report, the IRS made wholesale interim changes to the ITIN program in June 2012, many of which were made permanent in November 2012 revisions.[9] Under the new procedures, taxpayers (subject to a few exceptions) must send to the IRS original documents or copies certified by the issuing agency to support their ITIN applications unless they:

1. Use a CAA;
2. Apply at a Taxpayer Assistance Center; or

4 *See* National Taxpayer Advocate 2003 Annual Report to Congress 60-86; National Taxpayer Advocate 2004 Annual Report to Congress 143-162; National Taxpayer Advocate 2008 Annual Report to Congress 126-140; National Taxpayer Advocate 2010 Annual Report to Congress 319-338; National Taxpayer Advocate 2012 Annual Report to Congress 154-79.

5 National Taxpayer Advocate 2003 Annual Report to Congress 60-86.

6 TIGTA, Ref. No, 2012-42-081, Substantial Changes Are Needed to the Individual Taxpayer Identification Number Program to Detect Fraudulent Applications (July 16, 2012) (hereinafter TIGTA report).

7 *See* National Taxpayer Advocate 2012 Annual Report to Congress 157 (finding that the complexity of the requirements for claiming the Child Tax Credit or Additional Child tax credit lead to widespread erroneous claims or omissions that cannot be attributable solely to fraud, as the TIGTA reports imply).

8 *Id.* at 159; TIGTA Report.

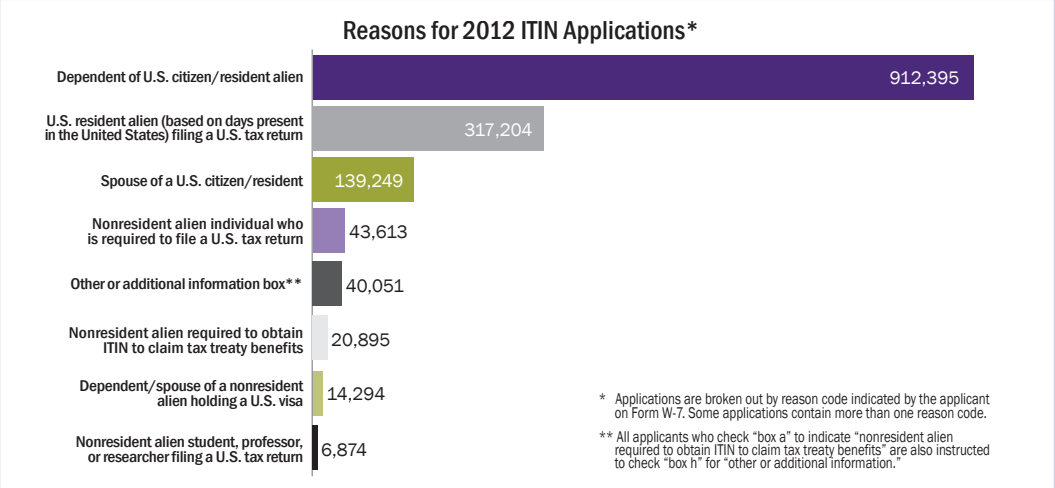
9 *See* IRS, IRS Strengthens ITIN Application Requirements; Interim Changes Will Protect the Integrity of the ITIN Process, IR 2012-62 (June 22, 2012); IRS, IRS Strengthens Integrity of ITIN System; Revised Application Procedures in Effect for Upcoming Filing Season, IR 2012-98 (Nov. 29, 2012).

3. Apply at a U.S. tax attaché office.

Only primary and secondary applicants can use a CAA to certify their supporting documentation.[10] All applicants, including dependents, can apply at a TAC, but TACs will only certify passports and national ID cards.[11] Applicants living overseas can also apply at one of four U.S. tax attaché offices, which will certify all 13 approved types of documentation.[12] The new original document requirement exempts military spouses and dependents, students who are part of the Student and Exchange Visitor Program (SEVP),[13] and nonresident aliens claiming tax treaty benefits.

The revised procedures left in place the requirement that absent certain exceptions, an applicant must submit the application with a paper federal tax return during the filing season, to prove the taxpayer has a valid filing requirement. Nonresident aliens claiming the benefits of a tax treaty and persons with income, payments, or transactions subject to third-party reporting or withholding may apply for an ITIN separately from filing a tax return.[14] However, these applicants make up a minority of ITIN filers.

FIGURE 1.21.1, Calendar Year 2012 ITIN Applications by Reason Code[15]



10 To send in copies of the documents instead of originals or certified copies, CAAs must conduct an in-person interview or a live video electronic interview with the applicant. *See* IRM 3.21.263.3.2 (Jan. 2, 2013).

11 The IRS increased the number of TACs certifying ITIN applications to 100 during the end of the 2013 filing season but has not committed expanding this program to more TACs in 2014. http://www.irs.gov/uac/TAC-Locations-Where-In-Person-Document-Verification-is-Provided (last updated June 3, 2013). IRS response to TAS information request (Nov. 7, 2013).

12 The attachés are based in Beijing, Frankfurt, London, and Paris. *See* 2013 ITIN Updated Procedures Frequently Asked Questions, http://www.irs.gov/Individuals/2013-ITIN-Updated-Procedures-Frequently-Asked-Questions (last updated Sept. 13, 2013).

13 The Taxpayer Advocate Service was instrumental in bringing about this exception for SEVP students. TAS held multiple conference calls and meetings with stakeholders during 2012 and advocated for revised procedures for students.

14 *See* Instructions for Form W-7 (Aug. 2013).

15 TAS Research, Compliance Data Warehouse, Entity Application Programs, Form_W7 table, data drawn November 19, 2013. The reason code for dependents is derived from the W-7 application itself that lumps dependents of U.S. Citizens and resident aliens (for tax purposes) together.

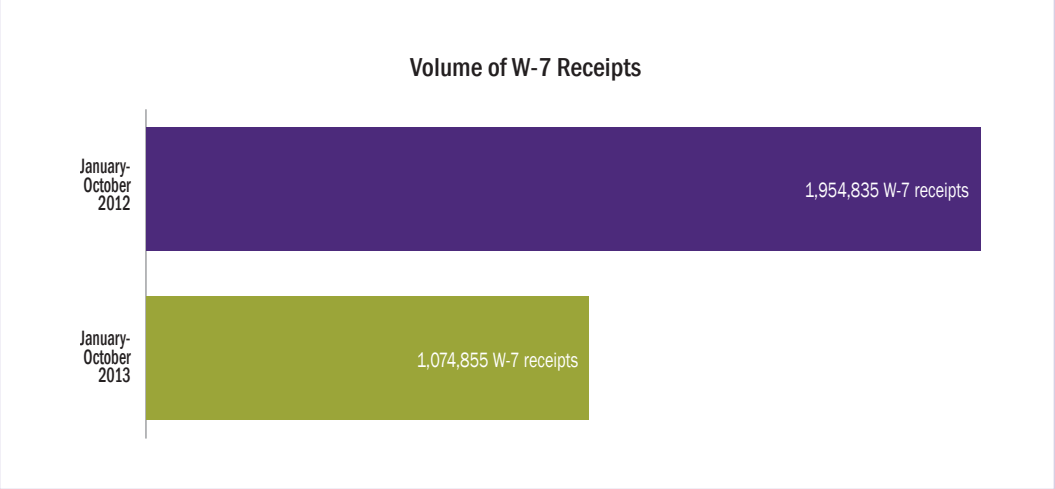
The National Taxpayer Advocate, Low Income Taxpayer Clinics (LITCs), and outside stakeholders warned the IRS about the negative consequences of the interim procedures, and of retaining the rule that an applicant must apply with a tax return during filing season, which include the following:[16]

- Taxpayers may forgo filing a joint return and claiming any exemptions, or file with an incorrect filing status because their spouses and dependents cannot obtain ITINs before the return filing date. Thus, they may pay more than they owe.
- Some affected taxpayers may stop filing returns altogether due to the difficulty of obtaining an ITIN.
- Taxpayers will experience hardship from not having their original documents for an extended period (often many months), risking fines and incarceration in some locations, and facing the costs of obtaining duplicates if lost.

Current and Future Volumes of ITIN Applications

From January 1 through October 27, 2012 the IRS received nearly two million ITIN applications.[17] During the same period in 2013, having projected receipts of over 1.8 million, the IRS received just over one million as shown below.[18]

FIGURE 1.21.2, Volume of W-7 Receipts, 2012 and 2013



While a decline in unauthorized immigration may have contributed to the decrease, recent data suggests that unauthorized immigration has actually increased since 2009.[19] In addition, while economic activity slowed during the global downturn, it has picked up again and applicants need ITINs for purposes of

16 *See* National Taxpayer Advocate 2012 Annual Report to Congress 159-63.

17 ITIN Comparative Report (Oct. 26, 2013). There were 1,954,836 W-7 receipts, 1,241,031 ITINs assigned, and 720,771 applications rejected from January through October, 2012.

18 *Id*. The IRS projected receipts of 1,820,782 for October 26, 2013. There were only 1,074,855 W-7 receipts, the IRS assigned 550,840 ITINs, and rejected 538,544 applications from January through October 2013. The term projected receipts is synonymous with the IRS term "scheduled receipts."

19 *See* Pew Research Hispanic Trends Project, *Population Decline of Unauthorized Immigrants Stalls, May Have Reversed* (Sept. 23, 2013), *available at* http://www.pewhispanic.org/2013/09/23/population-decline-of-unauthorized-immigrants-stalls-may-have-reversed/. The estimated number of unauthorized immigrants peaked at 12.2 million in 2007, fell to 11.3 million in 2009, but has been increasing since to 11.7 million in 2012. *Id*.

withholding or claiming tax treaty benefits.[20] One plausible explanation for the decrease in applications is the chilling effect of the new procedures.[21] LITCs reported to TAS that in 2013, people chose not to apply for ITINs due to the burden of giving up original documents.[22]

The burden associated with the IRS's new procedures will only be exacerbated by any upcoming immigration reform. In 2013, the Senate passed the Border Security, Economic Opportunity, and Immigration Modernization Act.[23] Under section 2101 of this bill, persons cannot apply for registered provisional status until they have satisfied "any applicable Federal tax liability," which includes any income taxes assessed under IRC § 6203.

Having satisfied an assessed tax liability would usually mean a taxpayer has already filed a return with an ITIN. However, the legislation also requires applicants to meet an employment or education requirement, and one method for meeting this is to provide proof of income. Thus, there may be an upsurge in ITIN applicants who need to file past returns. The Senate bill is estimated to result in a net increase of 9.6 million people residing in the United States by 2023.[24] When asked if it considers how immigration patterns affect ITIN applications, and how it will manage an increase in applications due to reform, the IRS provided no details about these issues or whether it has done any planning.[25]

ITIN Applicant Characteristics

ITIN filers, on average, report low adjusted gross income (AGI), with most of it coming from wages. They also claim lower refunds and lower child tax credits, but higher additional child tax credits, as shown in Figure 1.21.3.[26]

FIGURE 1.21.3, Income and Credits of ITIN and Non-ITIN Filers – Tax Year 2010, Processing Year 2011*

	Average For ITIN Filers	Average for Non-ITIN Filers
Adjusted Gross Income	$ 32,616	$ 59,984
Wage Income	$ 33,584	$ 50,376
Refund Amount	$ 2,824	$ 3,516
Child Tax Credit	$ 878	$ 1,227
Additional Child Tax Credit	$ 1,944	$ 1,236

* Average amount is calculated for returns where the line item is greater than zero.

ITIN filers possess a lower proportion of single filers than the overall population, claim more dependents, and as a group are younger.

20 In 2012, almost 21,000 people applied for an ITIN to claim tax treaty benefits, as shown by checking box "a" on Form W-7. TAS Research, Compliance Data Warehouse, Entity Application Programs, Form_W7 table, data drawn November 19, 2013.

21 *See* IRS response to TAS information request (Nov. 7, 2013) ("Recent implemented changes to the ITIN program, including more rigid documentation requirements, may have contributed to the recent decrease in applications received and the number of applications rejected and suspended. Another factor may be a change to the population that applies for ITINs.").

22 TAS conference call with Low Income Taxpayer Clinics (May 23, 2013).

23 S.B. 744, 113th Cong. (2013).

24 CBO, Letter to Patrick Leahy, Chairman, Committee on Judiciary 1 (July 3, 2013), *available at* http://www.cbo.gov/publication/44397.

25 The IRS's response states: "The IRS will take the necessary steps to administer any tax related requirements of legislation if and when a new law is enacted." IRS response to TAS information request (Nov. 7, 2013).

26 IRS, Wage and Investment Research and Analysis (WIRA) ITIN Preliminary Findings and Recommendations (July 13, 2012).

FIGURE 1.21.4, DEMOGRAPHICS OF ITIN FILERS – TAX YEAR 2010, PROCESSING YEAR 2011*

Filing Status	ITIN Filers	Non-ITIN Filers
Single	20%	46%
Married Filing Joint	41%	38%
Married Filing Separate	4%	2%
Head of Household	35%	15%

Dependent Count	ITIN Filers	Non-ITIN Filers
0	18%	64%
1	14%	17%
2	23%	13%
3	23%	5%
4+	22%	2%

Age Category (Primary Taxpayer)	ITIN Filers	Non-ITIN Filers
0-18	0%	1%
19-25	11%	13%
26-35	35%	19%
36-45	30%	17%
46-55	15%	19%
56-65	6%	15%
66+	3%	15%

* Numbers may not total due to rounding.

For Tax Year 2011, ITIN filers reported $8.4 billion in total tax liability.[27]

The New Procedures Are Not Tailored to Address Fraud.

According to the TIGTA report, major issues with the IRS's processing of ITIN applications include:

- The environment created by management, including short processing timeframes, discourages employees from detecting fraudulent applications.
- Employee training on questionable documents is inadequate.
- The processes do not verify applicants' identity and foreign status.
- IRS management eliminated steps to identify questionable application patterns and schemes, including using application data such as duplicate mailing addresses as an indication of fraud.[28]

If one of the primary problems is that IRS employees are not sufficiently trained or given adequate time to process ITIN applications, the IRS's decision to only allow primary and secondary applicants to use CAAs only worsens this problem. Under the new procedures, the ITIN unit will likely receive more applications

27 *See* IRS response to TAS information request (Nov. 7, 2013), Individual Taxpayer Identification Number (ITIN) Usage Analysis: Tax Year (TY) 2010 to 2012.

28 *See* TIGTA Report.

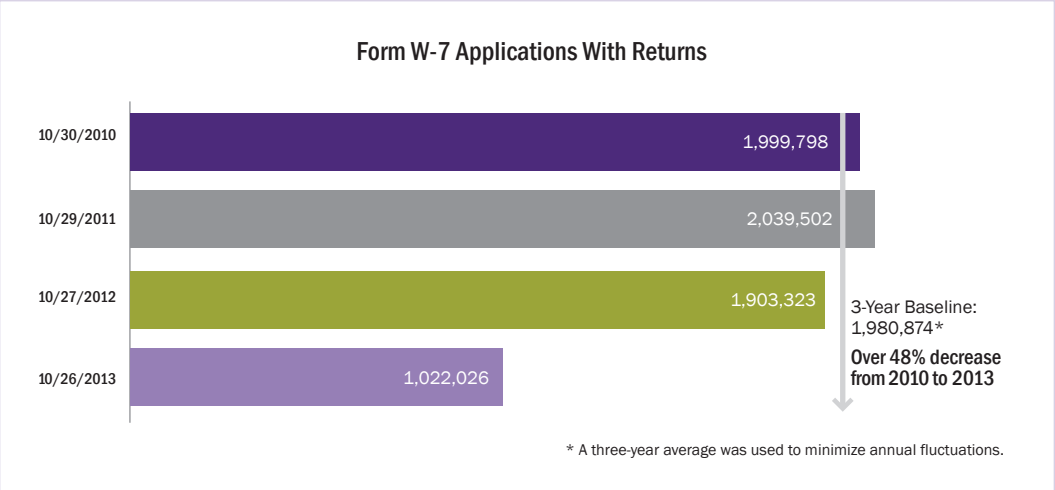
that have not been certified by a CAA, requiring greater scrutiny and more time to review. The reduction in the CAA program also does not help resolve problems with verifying identity and foreign status. CAAs are embedded in the communities they serve, and often their clientele consists largely of people from a few specific countries. Unlike IRS employees, who must be able to review identity documents from hundreds of countries, CAAs often have specific knowledge of a country's or region's documentation, putting them in a better position to verify identity and foreign status and identify fraud.

Some affected taxpayers may stop filing returns altogether due to the difficulty of obtaining an ITIN.

The TIGTA report includes a detailed section about how many ITINs and associated refunds were sent to a single address, implying that these ITIN applications were fraudulent.[29] During the 2013 filing season, the IRS instructed employees to "correct" the taxpayer's mailing address listed on the application (Form W-7) if the address belonged to a CAA.[30] This policy harmed applicants who may not have had long-term addresses where they could receive official documents. Based on the theory that a large number of documents sent to a single address is an indicator of fraud, the IRS made changes that burden taxpayers without actually addressing any proven fraud in the context of ITINs. TAS is pleased that the IRS has since accepted its recommendation to remove this instruction from the IRM and allow applicants to use a CAA's address to receive original documents.[31]

The IRS also changed its employee training to address the TIGTA comments about an environment that leaned towards accepting applications. However, it appears the pendulum may have swung too far in the opposite direction. Through October 2013, the number of W-7 applications with filed returns has plummeted 48.4 percent from the previous three-year baseline as shown below.

FIGURE 1.21.5, 2013 Form W-7 Applications with Returns Plunged 48.4 Percent from the 2010–2012 Baseline[32]



29 *See* TIGTA Report at 17.

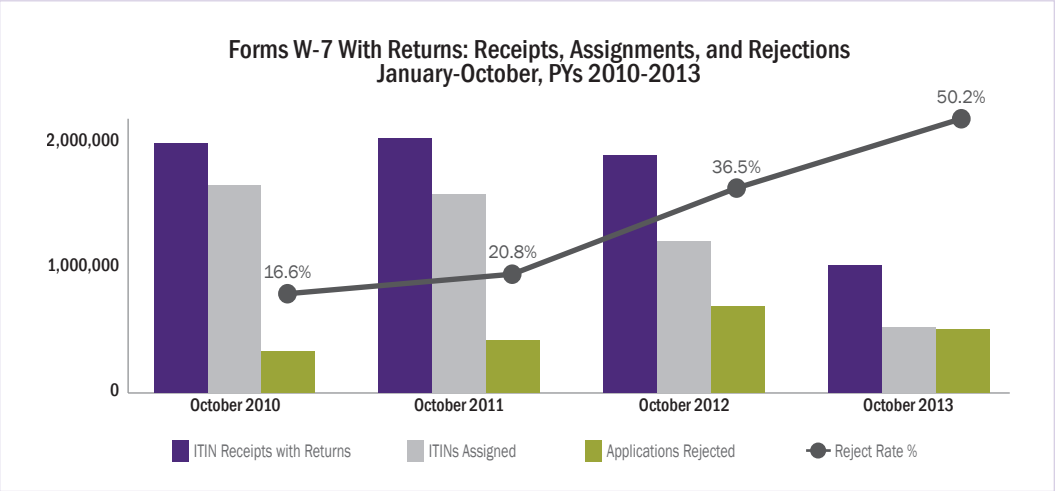
30 This address is used to return original documents to the applicant. "If the address on line 2 is the business address of the CAA, edit the taxpayer's address from the tax return to the Form W-7." IRM 3.21.263.5.3.5.5 (Jan. 1, 2013).

31 *See* TAS IMD Review Comments, IRM 3.21.263, SAMS 27612 (July 25, 2013). *See also* Interim Procedural Update 13U1417, IRM 3.21.263.5.3.5.5(2) (Sept. 3, 2013). Stakeholders also advocated for this change. IRS conference call with practitioners (Aug. 16, 2013).

32 IRS, *ITIN Production Reports* (Oct. 30, 2010, Oct. 29, 2011, Oct. 27, 2012, and Oct. 26, 2013). Receipts are year-to-date totals from January 1 through the date of each report.

Even with a near 50-percent decline in ITIN applications and accompanying tax returns, the percentage of rejected applications has soared to 50.2 percent as shown in Figure 1.21.6 below.

FIGURE 1.21.6, Forms W-7 with Returns, Assigned ITINs, Rejected Applications, and IRS Reject Rate[33]



If most of the increase in the rejection rate is due to the new procedures, the net effect of the rule change has resulted in an additional 300,000 applications denied in 2013 alone.[34]

According to the IRS, the number one reason applications were placed in suspense was that "supporting identification documentation that was submitted is unacceptable."[35] The top reason for rejecting applications was that the applicant did not respond to the suspense notice requesting additional information.[36] Practitioners and applicants commonly report that the IRS is rejecting documentation they believe to be legitimate. There are multiple reasons for this:

- An IRS employee might not recognize that a document is valid, such as in cases where legitimate passports are rejected.
- An IRS employee may not recognize that a document is sufficient, which happened when the IRS rejected over 200 Canadian student applications because they lacked visas, even though the U.S. State Department does not require visas for Canadian students.[37]
- An official document from another country or region within that country, *e.g.*, a foreign birth certificate or school record, might not conform to the IRS's standards for these documents.

33 IRS, *ITIN Production Reports* (Oct. 30, 2010, Oct. 29, 2011, Oct. 27, 2012, and Oct. 26, 2013). Receipts are year-to-date totals from January 1 through the date of each report.

34 IRS, *ITIN Production Reports* (Oct. 29, 2011, Oct. 27, 2012, and Oct. 26, 2013). The rise in the reject rate from 16.6 percent in 2010 to 50.2 percent in 2013 shows an increase of approximately 300,000 additional rejected applications for PY 2013.

35 IRS response to TAS information request (Nov. 7, 2013).

36 *Id*.

37 TAS Systemic Advocacy Management System (SAMS) issue 28728.

The first and the second examples indicate a lack of employee training. The last example indicates the IRS's new procedures are poorly executed because they make certain forms of documentation inapplicable by not considering what these documents actually contain.[38]

Indications that the IRS suspended or rejected applications that it later approved, without receiving any additional documentation, are also disturbing.[39] Practitioners reported reapplying with identical supporting documents following a rejection and having the second application accepted.[40] In early 2013, the IRS placed 120,000 ITIN applications in R98 status pending a decision on acceptable certified copies of documents from the issuing agency.[41] Documents were held for 30 days before a decision was made to begin processing the applications.

Although both TIGTA and IRS's Wage and Investment, Research and Analysis (WIRA) have supplied research that touches on the level of compliance among ITIN filers, the IRS does not appear to have a comprehensive picture of the payment compliance, filing compliance, and return accuracy of this population.[42] Without this information, IRS personnel cannot adequately assess the benefits and detriments of various ITIN policy options. Instead of creating sweeping rules that block over half of ITIN applications, the IRS should evaluate how to detect fraud and prevent fraudulent refunds by running these returns through filters and databases, perhaps even an ITIN specific filter.

Requiring ITIN Applications to be Filed with Paper Returns During the Filing Season Burdens Affected Taxpayers and the IRS Alike, Hampering Efforts to Detect and Deter Fraud.

Requiring the majority of ITIN applicants to file during the filing season forces applicants to wait up to ten weeks for their applications to be processed and their original documentation returned, and even longer to receive refunds.[43] The IRS has stated, "associating the issuance of the ITIN with the filing of a tax return is still the only reliable method for the IRS to verify the number is being requested and properly used for tax administration purposes."[44] However, as demonstrated by exceptions for certain applicants, such as those claiming the benefits of a tax treaty or who are subject to withholding, there are ways for applicants to prove a tax administration purpose without filing a return. Indeed, the IRS allows applicants to provide copies of pay stubs with year-to-date information to verify that the applicant earned income in the case of a Form W-7 and Form W-2 mismatch.[45] There is no reason one or more pay stubs could not be accepted to prove income and a filing requirement prior to the filing of the tax return.

38 The IRS changed some requirements to accommodate records that did not comply with its standards. *See, e.g.*, Interim Procedural Update WI-03-0613-1108 (June 13, 2013) (updating IRM 3.21.263.5.3.4.2(3) to specify that nursery or kindergarten school letters for applicants under six do not require listing course work or grades). However, multiple practitioners reported to TAS at the Nationwide Tax Forums in August 2013 that clients frequently had records that they could not use or were rejected because the record did not comply with the IRS's standards despite it being a legitimate record.

39 For example, a practitioner at the 2013 IRS Nationwide Tax Forums informed TAS about receiving rejection notices for ITIN applicants, followed weeks later by notices that the ITINs were assigned.

40 Practitioners at the 2013 IRS Nationwide Tax Forums reported this issue.

41 R98 status is a rejection code for an application received without a mailing address. IRS response to TAS information request (Nov. 7, 2013).

42 *See* TIGTA Report. *See also* IRS, WIRA ITIN Preliminary Findings and Recommendations (July 13, 2012).

43 These were the expected wait times for the 2013 filing season. *See* IRS, Stakeholder Partnerships, Education and Communications (SPEC), *Certifying Acceptance Agent and Forensic Training* (Jan. 29, 2013).

44 IRS response to TAS information request (Nov. 7, 2013).

45 *Id*.

Requiring ITIN applications during the filing season forces the IRS to process them under short timelines and does not provide sufficient time for fraud review, a concern raised by TIGTA. The IRS has advised it does not plan to pursue electronic filing of the ITIN application, despite the increased potential to detect fraudulent applications through electronic filters.[46] If the IRS accepted applications throughout the year, with proof of a legitimate filing requirement, its employees could spend more time verifying applications and supporting documents, detecting fraudulent schemes, and creating filters to catch fraudulent applications. This approach would also allow the initial ITIN returns to be e-filed and run through the IRS's regular fraud and identity theft filters.

The IRS Provides Inadequate Customer Service to ITIN Applicants and Improperly Suspends or Rejects Thousands of Applications.

The IRS's inability to process ITIN applications efficiently, timely, and correctly deprives taxpayers of their fundamental right to quality service. The average ITIN unit process cycle time during calendar years 2011, 2012, and 2013 was 20, 21, and 20 days respectively, which at first glance appears to be an acceptable time.[47] However, the IRS does not measure cycle time on suspended and rejected applications from the taxpayer's perspective, *i.e.* from start to finish. Instead, the IRS only measures how quickly it arrives at a preliminary decision, without considering the time taxpayers wait for the IRS to respond to additional information that taxpayers submit following the initial suspension or rejection.[48] Furthermore, the IRS does not take into account reworked applications that were erroneously rejected, or delays in processing due to mail misrouting, a process that remains unimproved despite a nearly 50 percent drop in workload.[49] Delays in processing ITIN applications cause the applicants to wait long periods of time for their refunds without receiving interest on overpayments.[50]

The IRS also fails to deliver adequate customer service by its inability to track and locate ITIN applications and supporting documents. In a recent example, a taxpayer who needed to travel abroad for a medical emergency was unable to do so because the IRS could not locate the passport of the taxpayer's child.[51] The IRS conducted about 60 lost document searches in the ITIN program in 2013, and was successful in finding just 40 of them.[52] The current system for receiving and processing ITIN applications often does not allow the IRS to track applications until they are entered into a database, and once they are entered, there are still challenges to locating the documents.[53]

The lack of focus on customer service is also apparent through the ITIN services offered at TACs. The IRS promised to provide "*full-service assistance* for primary and dependent taxpayers at some key IRS

46 For a further discussion of this issue, see Most Serious Problem: International Service: *The IRS Is Taking Important Steps to Improve International Taxpayer Service Initiatives, but Sustained Effort Will Be Required to Maintain Recent Gains, supra*.

47 IRS, *ITIN Production Reports* (Oct. 29, 2011, Oct. 27, 2012, and Oct. 26, 2013). The IRS defines cycle time as "the number of work days in the processing cycle for documents and tax returns." IRS response to TAS information request (Nov. 7, 2013).

48 IRS response to TAS information request (Nov. 7, 2013). The National Taxpayer Advocate has previously raised concerns about how the IRS calculates cycle time on ITIN Applications. *See* National Taxpayer Advocate 2010 Annual Report to Congress, 324, 333.

49 *Id*.

50 Under IRC § 6611, overpayment interest is calculated based on when the return is filed in processable form, which includes the taxpayer's identifying number.

51 Taxpayer Advocate Management Information System (TAMIS) Case File 5573740. The consent to release taxpayer information is on file with TAS.

52 IRS response to TAS information request (Nov. 7, 2013) (stating that "[t]he volume of lost identity [document] searches in ITIN was not recorded for 2011 and 2012.").

53 For more details about the IRS's system for batching ITIN applications, see National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 45.

[TACs]," but many TACs require a valid U.S.-issued ID just to enter the building, which makes this option unavailable for many taxpayers.[54] In addition, the IRS permits TAC employees to certify only passports and national identity cards.[55] The IRS acknowledges that civil birth certificates and school records are used more frequently with ITIN applications than passports or national ID cards, yet TACs cannot certify these documents.[56] Only 17.8 percent of all applicants proved identity by CAA-certified copies of passports or national ID cards, or by mailing them directly to IRS, whereas birth certificates and school records comprised 61.6 percent of all documents submitted for identification.[57]

The IRS assigned 68.2 percent of all ITINs to alien dependents, the majority of whom proved identity by providing birth certificates and school records.[58] Because many, if not most, dependent aliens do not possess passports or national ID cards, they cannot have their documents certified by either a TAC or a CAA. Although the IRS increased the number of TACs certifying ITIN applications to 100 during the end of the 2013 filing season, it has not committed to expanding this program to more sites in 2014.[59]

ITIN applicants have reported multiple problems with applications being suspended or rejected, including:

- The lack of communication regarding the reason for the action;
- The inability to speak with IRS employees;
- The IRS's failure to notify taxpayers about the status of their applications and what steps are available to them;
- The rejection of applications with legitimate documents; and
- The inexplicable suspension or rejection of applications that were later processed without any further documentation.

A frequent complaint among taxpayers and practitioners is that the CP 566, *Suspense Notice*, does not explain why the application was suspended. The IRS revised suspension notices in January of 2013 to clarify requirements for school and medical records.[60] Still, these notices often fail to identify which document is unacceptable, meaning applicants must call the IRS to attempt to find out.

When taxpayers do receive a suspension notice, they may not hear anything more after submitting further documents as the IRS does not contact applicants again before issuing the rejection notice.[61] Once it

54 National Taxpayer Advocate 2012 Annual Report to Congress 176. Representatives of Low Income Taxpayer Clinics raised concerns about the requirement of many TACs or federal buildings in which some TACs are located to produce a valid, U.S.-issued ID to enter the building. 2013 Annual Low Income Taxpayer Clinic Grantee Conference, Recent Developments in IRS Policies and Procedures Related to ITIN Applications, panel discussion (Dec. 6, 2012).

55 *Cf*. National Taxpayer Advocate 2012 Annual Report to Congress 154, 173; and Servicewide Electronic Research Program (SERP) IRM 3.21.263.6.1.5 (Jan. 2, 2013).

56 IRS response to TAS information request (Nov. 7, 2013).

57 IRS response to TAS information request (Sept. 27, 2012). The above RTS measures are from PY 2012.

58 *Id*. The above RTS measures are from PY 2012.

59 *Id*.

60 IRS response to TAS information request (Nov. 7, 2013).

61 *Id.*

suspends an application, the IRS imposes another restriction that makes it difficult to submit replacement documents: applicants can no longer have a TAC certify their documents.[62]

Taxpayers will experience hardship from not having their original documents for an extended period (often many months), risking fines and incarceration in some locations.

A common complaint from tax practitioners is that they have no way of speaking with an IRS employee with access to the ITIN real-time system (RTS).[63] CAAs have reported to TAS that calls to the ITIN unit often go unanswered. During calendar year 2013, the average level of service for ITIN calls was only 55.3 percent, and the average speed per answer was 926 seconds, or more than 15 minutes.[64] According to the IRS, all toll-free assistors have access to RTS. However, the ITIN Real Time System Navigation Training, the only training course that teaches employees how to access RTS and search ITIN application records, contains no knowledge check or test to measure what employees learned.[65] Access to RTS is insufficient if employees do not know how to use the system and effectively answer applicants' questions. Furthermore, although toll-free assistors have the ability to transfer calls directly to the ITIN unit, the IRS does not publish this instruction in the IRM.[66]

The IRS did not adequately engage the stakeholder community during 2013 and continues to make burdensome changes without consulting or notifying stakeholders.

In 2013, the IRS conducted three meetings or calls with the stakeholder community.[67] Nevertheless, a common complaint among stakeholders is the IRS makes sudden changes to ITIN application procedures without communicating these changes to the public. An example involves the requirements for proving an exception to the requirement of filing the ITIN application with a return. TAS spoke to a corporation that pays out hundreds of thousands of royalty payments each year, including some to nonresident aliens who claim tax treaty benefits and thus need ITINs.[68] To assist nonresident aliens in obtaining an ITIN without having to file the Form W-7 with a tax return, this corporation provides payees with a standard supporting letter to submit to the IRS. Recently, the payees began receiving letters from the IRS stating that even though these standard letters were previously accepted, effective September 10, 2013, they will no longer be accepted without an original signature. This sudden unilateral procedural change without consulting stakeholders or providing them advanced notice shows a disregard for customer service in the ITIN program.

New CAA Procedures and Policies Discourage Program Participation.

CAAs provide a valuable resource to the IRS in ensuring an applicant is eligible for an ITIN and supporting documents are valid. However, the IRS has failed CAAs in terms of customer service,

62 *See* CP 566. *See* IRM 21.3.1.4.61.2 (June 11, 2013) ("Do not refer applicants receiving a CP 566 to a Taxpayer Assistance Center (TAC). Current procedures require the applicant to submit their original documents directly to SPC ITIN Operations in response to a suspense notice.").

63 TAS conversations with practitioners at IRS Nationwide Tax Forums in July and August of 2013.

64 IRS response to TAS information request (Nov. 7, 2013).

65 *See id*.

66 *See id.*

67 *Id.*

68 TAS phone conversation with stakeholder (Nov. 1, 2013). Applicants claiming tax treaty benefits do not have to file a Form W-7 with a federal tax return. *See* Instructions to Form W-7.

communication, and education.[69] Although the IRS implemented new training requirements for CAAs during 2013, including completion of mandatory forensic training by the end of the calendar year, the IRS waited to provide detailed guidance on what this entails. In a response to TAS on November 7, 2013, it stated, "IRS has identified two vendors who meet the established requirements for forensic training and anticipate providing further guidance to certifying acceptance agents on the website and by email distribution."[70] The IRS did not notify CAAs of this information by email or on IRS.gov until November 18, 2013, a little over a month before the due date for the training.

The IRS is Developing Procedures for Deactivating Old or Inactive ITINs That May Harm Taxpayers and Deprive Them of Their Rights.

The IRS is exploring options for deactivating ITINs issued before 2013 after certain periods of time or nonuse. While the National Taxpayer Advocate has recommended this approach in the past, she is concerned that the IRS may deactivate ITINS or let them expire without notifying taxpayers.[71] The IRS has not addressed a specific question from TAS about whether it would notify taxpayers before expiring or retiring ITINs in all circumstances.[72] It is imperative that the IRS communicate with taxpayers and notify them before deactivating or allowing existing numbers to expire.

CONCLUSION

Since the new IRS ITIN procedures were put into place, the number of ITIN applications and attendant tax returns has plummeted, while rejection levels have soared. The new procedures created barriers that prevent applicants from declaring income, filing returns, receiving refunds they are due under the law, and participating in the global economy. Absent necessary changes to the program, recommended by the National Taxpayer Advocate for several years, the ITIN program will continue to suffer in terms of facilitating compliance by ITIN taxpayers and preventing fraud.

69 For a further discussion of the IRS's lack of communication and education for CAAs, see National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 49.

70 IRS response to TAS information request (Nov. 7, 2013).

71 *See* National Taxpayer Advocate 2010 Annual Report to Congress 333; National Taxpayer Advocate 2008 Annual Report to Congress 130.

72 The IRS merely stated that "The Service is continuing to analyze the feasibility of expiring ITINs issued prior to 2013. We are on target to complete the analysis by the June 2014." IRS response to TAS information request (Nov. 7, 2013).

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Allow filing of ITIN applications throughout the year if submitted with proof of taxable income or a filing requirement.
2. Allow ITIN applications to be filed electronically.
3. Allow CAAs to certify copies of dependents' documentation instead of requiring original documents or copies certified by the issuing agency.
4. Allow TAC employees to certify all identity documents (beyond passports and national identity cards) that ITIN examiners currently accept for primary, secondary, and dependent applicants.
5. Require training with a knowledge check or test on the ITIN real time system for employees answering the toll-free lines and update the IRM to advise toll-free assistors of the capability to transfer calls to the ITIN unit.
6. Require notification to a taxpayer before an ITIN expires and allow the taxpayer time to apply for and obtain a new ITIN before the expiration of the old number.

MSP #22 OFFSHORE VOLUNTARY DISCLOSURE: The IRS Offshore Voluntary Disclosure Program Disproportionately Burdens Those Who Made Honest Mistakes

RESPONSIBLE OFFICIALS

John Dalrymple, Deputy Commissioner, Services and Enforcement
Heather C. Maloy, Commissioner, Large Business and International Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland , Commissioner, Wage and Investment Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

Since 2009, the IRS has generally required those who failed to report offshore income and file one or more related information returns (*e.g.*, the *Report of Foreign Bank and Financial Accounts* (FBAR)) to enter into successively more punitive offshore voluntary disclosure (OVD) programs.[1] Designed for "bad actors," these programs burdened "benign actors" who inadvertently violated the rules by requiring them to "opt in and opt out" to get a fair result. The programs were punitive, charging average penalties of more than double the unpaid tax and interest associated with the unreported accounts.[2] Because those opting out faced prolonged uncertainty and a risk of even more severe penalties, some agreed to pay more than they should, as described in prior reports.[3]

Unlike those who remain in the programs, those who opt out are audited, which essentially penalizes them for coming forward. On average, the IRS assessed penalties of nearly 70 percent of the unpaid tax and interest in the audits of those who opted out.[4] Thus, while those who opt out generally face smaller penalties than those inside the OVD programs, they still face very significant ones.

For those who remained in the 2009 program, the median offshore penalty applied to those with the smallest accounts (*i.e.*, those in the 10th percentile with accounts of $87,145 or less) was disproportionate — nearly six times the median unpaid tax.[5] Among unrepresented taxpayers with small accounts it

1 IRS, *Voluntary Disclosure: Questions and Answers*, http://www.irs.gov/uac/Voluntary-Disclosure:-Questions-and-Answers (first posted May 6, 2009) [hereinafter "2009 OVDP FAQ"]; IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, http://www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers (first posted Feb. 8, 2011) [hereinafter "2011 OVDI FAQ"]; IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers (first posted June 26, 2012) [hereinafter "2012 OVDP FAQ," or collectively the "OVD programs"]. The IRS subsequently established a "streamlined" program for certain non-residents, as described below.

2 IRS response to TAS information request (Sept. 17, 2013) (indicating $1.46 billion in tax and interest was assessed in connection with the 2009 and 2011 program certifications and amended returns, as compared to $3.95 billion in penalties).

3 *See* National Taxpayer Advocate 2012 Annual Report to Congress 134-153; National Taxpayer Advocate 2011 Annual Report to Congress 191-205; *Id*. at 206-72; National Taxpayer Advocate 2013 Objectives Report to Congress 7-8; *Id*. at 21-29. *See also* Taxpayer Advocate Directive 2011-1 (Aug. 16, 2011).

4 IRS response to TAS information request (Sept. 17, 2013) (indicating the IRS assessed about $30.38 million in tax and interest and $20.89 million in penalties).

5 Compliance Data Warehouse (CDW) (Sept. 27, 2013) (TAS analysis of closed cases where an offshore penalty was assessed, as reflected on AIMs and ERIS).

The National Taxpayer Advocate has offered many common sense recommendations that would bring taxpayers into compliance and help restore confidence in the IRS, but IRS has not fully adopted them.

was even more disproportionate — nearly eight times the unpaid tax.[6] It was also disproportionately greater than the median penalty paid by those with the largest accounts (*i.e.*, those in the 90th percentile with accounts of more than $4.2 million) who paid about three times the unpaid tax.[7] Given the harsh treatment applied to those with small accounts, some have made "quiet" disclosures by correcting old returns and others have begun to comply prospectively — in each case without subjecting themselves to the lengthy and seemingly-unfair OVD process.

While 7.6 million U.S. citizens reside abroad and many more U.S. residents have FBAR filing requirements,[8] the IRS received only 807,040 FBAR submissions in 2012.[9] Yet the FBAR audit rate is less than one quarter of one percent.[10] Thus, the IRS has likely failed to address significant information reporting noncompliance. The National Taxpayer Advocate has offered many common sense recommendations that would bring taxpayers into compliance and help restore confidence in the IRS, but IRS has not fully adopted them.

ANALYSIS OF PROBLEM

The IRS's OVD settlement programs are a good deal for "bad actors" but not for "benign actors."

The combination of the FBAR statute and the way the IRS administers it creates the potential for such draconian penalties that some taxpayers may agree to pay unwarranted amounts. The statute authorizes a maximum penalty of up to 50 percent of the maximum balance in each overseas account for each year of non-reporting (or, if greater, $100,000 per violation).[11] Because the statute of limitations period is six years, the maximum penalty for large accounts is essentially 300 percent of the maximum account balances (assuming a relatively constant balance).[12]

> **Example:** Assume a U.S. resident has a joint account with extended family abroad. The account has had a constant balance of $1 million for at least the past six years. Because this individual violated the reporting requirements by failing to file an FBAR over a six-year period, the penalty could be as high as $3 million — three times the balance! The penalty may be an even greater percentage of the balance if the account value has fallen since the end of the

6 Compliance Data Warehouse (CDW) (Sept. 27, 2013) (TAS analysis of closed cases where an offshore penalty was assessed, as reflected on AIMs and ERIS).

7 *Id*.

8 U.S. Department of State, Bureau of Consular Affairs, *Who We Are and What We Do: Consular Affairs by the Numbers* (May 2013), http://travel.state.gov/pdf/ca_fact_sheet.pdf.

9 IRS response to TAS information request (Aug. 12, 2013). As of November 25, 2013, the Treasury Department had processed only 594,061 FBAR filings in 2013, including 556,739 paper filings thru June 27 and E-filings thru September 30. IRS response to TAS information request (Dec. 6, 2013).

10 Even if the universe of potential violations only consisted of the FBARs filed in 2011, the 1,626 civil FBAR examinations closed in 2012 would reflect an audit rate of 0.2 percent (1,626/741,249). U.S. Department of the Treasury, *A Report to Congress in Accordance With § 361(B) of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* (CY 2012) (reporting 741,249 FBAR filings in 2011 and 1,626 civil FBAR examinations closed in 2012).

11 31 U.S.C. § 5321(a)(5)(C). The maximum penalty for nonwillful violations is $10,000, but it is difficult for taxpayers to predict in advance whether the IRS will seek the willful or the nonwillful penalty. *See* 31 U.S.C. § 5321(a)(5)(B).

12 A six-year statute of limitations applies to the civil FBAR penalty. *See* 31 U.S.C. § 5321(b)(1). Criminal penalties of up to $500,000 and 10 years in prison may also apply. 31 U.S.C. § 5321(a)(5)(C) and 5322; 31 C.F.R. § 1010.840(b).

> sixth year (or if the account is less than $200,000, as the maximum penalty is never less than $100,000). This would be true even if the taxpayer did not owe any U.S. tax on unreported income from the account, and even if the taxpayer's tax preparer did not inform him or her of the FBAR filing requirement.[13]

Far from allaying taxpayer concerns about the draconian impact of this statute, the IRS OVD programs magnify them. In general, the programs offer to settle potential FBAR and other penalties for failure to file information returns for a fixed amount called the "offshore penalty." The offshore penalty is 27.5 percent (or 20 or 25 percent for the 2009 and 2011 programs, respectively) of the highest account value during an eight-year period.[14] For taxpayers who believe the IRS can prove they willfully violated the disclosure statute and who might otherwise be subject to criminal prosecution, this is probably a good deal.[15] For others, the maximum civil penalty under the statute is $10,000 for each non-willful failure or zero if the reasonable cause exception applies.[16] Thus, the IRS settlement programs were generally not a good deal for those whose failure was not willful.[17]

Unrepresented taxpayers with small accounts paid more than those with representation or large accounts.

Under a "fair" settlement program, one might expect that those with larger undisclosed accounts — that produced greater amounts of unreported income – would be asked to pay a proportionately greater penalty.[18] By this measure, the IRS's 2009 program was unfair. The median offshore penalty under the 2009 OVDP for those with the smallest accounts was nearly six times the median unpaid tax, whereas it was only about three times the unpaid tax for those with the largest accounts, as shown in the following table.

13 However, a penalty may not apply if the taxpayer establishes reasonable cause. *See* 31 U.S.C. § 5321(a)(5)(B).

14 A six-year period (2003-2008) applied to the 2009 program. Our discussion focuses on the FBAR because it is often the largest and most disproportionate penalty involved. In very limited circumstances, some could qualify for an offshore penalty rate of 5 percent or 12.5 percent, applicable to certain dormant or small accounts, respectively. 2011 OVDI FAQ #52 and #53; 2012 OVDP FAQ #52 and #53.

15 Even in criminal cases, however, the government has had difficulty obtaining a penalty of more than 50 percent of the highest account balance, at least where the taxpayer has tried to correct the problem. *See, e.g.*, Jeremiah Coder, *Judge Chastises DOJ for Offshore Account Prosecution, Suggests Pardon*, 2013 TNT 81-3 (Apr. 26, 2013).

16 1 U.S.C. § 5321(a)(5)(B). *See also* IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) ("The burden of establishing willfulness is on the Service."); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7(4) (July 1, 2008) ("the assertion of multiple [FBAR] penalties … should be considered only in the most egregious cases.").

17 The offshore penalty is even more disproportionate if you consider that taxpayers are required to pay both an offshore penalty and an accuracy related penalty under the OVD programs. *See, e.g.*, 2012 OVDP FAQ 51.1. An accuracy-related penalty does not normally apply when a taxpayer files an amended return to correct an error before the error is detected by the IRS. *See, e.g.*, Treas. Reg. § 1.6664-2 (discussing qualified amended returns).

18 For example, under the IRS's "mitigation guidelines" those with unreported accounts of less than $250,000 are eligible for reduced FBAR penalties in connection with an examination. *See, e.g.*, IRM Exhibit 4.26.16-2 (July 1, 2008).

TABLE 1.22.1, Comparison of median 2009 OVD penalties to median unpaid tax by account size[19]

	Bottom 10 percent	Middle 80 percent	Top 10 percent
Offshore account(s) balance	$44,855	$607,875	$7,259,580
2009 OVDP penalty	$8,540	$117,803	$1,410,517
Additional tax, tax years 2002–2011	$1,472	$30,894	$452,966
Offshore penalty as a percent of tax assessed	580%	381%	311%

Moreover, among those with the smallest accounts (*i.e.*, the bottom 10 percent), those who were unrepresented paid an even greater median 2009 OVD penalty — 794 percent of the additional tax assessment for tax years 2003-2008.[20] By comparison, represented taxpayers in this group paid a median of 514 percent.[21] Perhaps unrepresented taxpayers with small accounts felt more pressure to accept a disproportionate offshore penalty than those who were represented or had larger accounts.

A new "streamlined" program is less burdensome, but is overly narrow and does not provide certainty.

Recognizing the OVD programs were excessively burdensome and unfair to benign actors, in 2012 the IRS created a "streamlined" program that allows some "low risk" nonresidents to avoid the burdensome opt-in-opt-out process.[22] However, the program still requires a voluminous submission (*e.g.*, a questionnaire, three returns, and six FBARs), is closed to U.S. residents, and fails to provide certainty for those deemed "high risk." Worse, the IRS has not clearly explained what will trigger this high risk designation.[23] For example, are you high risk if you owe $25,000 in tax? Applicants deemed high risk may be worse off than those making quiet disclosures or even ignoring the problem. After making a streamlined submission, the applicant may still face the possibility of draconian civil penalties and criminal

19 CDW (Sept. 27, 2013) (TAS analysis of closed cases where an offshore penalty was assessed, as reflected on AIMs and ERIS). All figures are medians rather than the averages because the data contains extreme outliers. These findings are consistent with data published by the Government Accountability Office (GAO), which suggests an even greater disparity between those with large and small accounts. *See* National Taxpayer Advocate 2014 Objectives Report to Congress 37-38 (discussing GAO, GAO-13-318, *IRS Has Collected Billions of Dollars, but may be Missing Continued Evasion* 13 (Mar. 2013) (Table 2)).

20 CDW (Nov. 14, 2013). TAS identified "unrepresented" taxpayers as those with no representative reflected on the Centralized Authorization File (CAF) — a database used to record third-party representation in tax matters — for any of the tax years 2003 to present. Taxpayers with a representative on the CAF at any time for any of those years were counted as "represented," even though they may have been unrepresented in connection with the OVD program. By this measure, 44 percent of those with accounts in the bottom 10 percent were unrepresented, as compared to 22 percent of those with accounts in the middle 80 percent, and 16 percent of those with accounts in the top 10 percent. CDW (Nov. 14, 2013). A third party who is only authorized to address delinquent FBAR issues and not tax issues might not be reflected on the CAF. However, representatives of OVD program participants should be reflected on the CAF because taxpayers who did not have income tax issues should not have applied to the OVD program(s). *See, e.g.*, 2009 OVDP FAQ 9.

21 *Id*.

22 GAO, GAO-13-318, *IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion* 20 (Mar. 2013) (discussing the reasons for the streamlined program).

23 In 2012, the IRS began allowing certain "low risk," nonresident nonfilers — those with simple returns and owing less than $1,500 in tax — to file the returns without triggering penalties. See IRS, *Instructions for New Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer U.S. Taxpayers* (Aug. 31, 2012), http://www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers. In early 2013, following publication of the National Taxpayer Advocate's recommendation to expand the streamlined program to both U.S. residents and those owing more than $1,500, the IRS eliminated the $1,500 threshold. *See* National Taxpayer Advocate 2014 Objectives Report to Congress 37-38.

prosecution. As of September 2013, 2,990 taxpayers had submitted returns under the streamlined program, reporting an additional $3.8 million in taxes, and 57 were identified as high risk.[24]

The IRS expects other benign actors to opt in and then opt out of an OVD program, subjecting themselves to more burden and risk than bad actors.

The only option for benign actors who feel the offshore penalty is "too severe given the facts of the case" is to opt out and be audited.[25] This is unappealing for many. Because IRS settlement programs are a good deal for bad actors concerned about criminal prosecution, bad actors do not need to opt out or risk draconian penalties. Moreover, the IRS initially processed applications from benign actors who are expected to opt out much more slowly than others, though it has recently begun to process them more quickly, as shown by the following table.

TABLE 1.22.2, OVD Program Applications, Dispositions, and Processing Times as of September 30, 2013[26]

	2009 OVDP		2011 OVDI		2012 OVDP	
	Number	Average Processing Days	Number	Average Processing Days	Number	Average Processing Days
Total cases	**11,217**	**N/A**	**13,160**	**N/A**	**4,046**	**N/A**
Total closed cases	**11,132**	**319.6**	**7,391**	**194.6**	**216**	**115.9**
Closed certifications	10,760	310.4	6,578	203.2	216	115.9
Closed opt-outs	277	590.6	813	128.6	0	N/A
Closed removals	95	651.8	0	N/A	0	N/A
Total open cases	**85**	**896.4**	**5,769**	**248.9**	**3,830**	**75.9**
Open certifications	32	970.5	5,482	245.0	3,821	75.9
Open opt-outs	33	780.5	249	302.4	2	125.3
Open removals	14	989.9	15	272.6	0	N/A
Open suspense	6	997.0	23	212.8	7	59.0

24 IRS response to TAS information request (Sept. 17, 2013). This figure does not include taxpayers who opted out of the 2011 OVD program into the streamlined program. For example, it does not include 339 of the 475 Canadians who opted out of the 2011 OVD program and who were placed into the streamlined program. *Id*. We understand this is an estimate, as a system error prevented accurate reporting on these cases before September 2013. The IRS was unable to provide data regarding the resources it used or the time it took to process streamlined submissions. *Id*.

25 2011 OVDI FAQ 51; 2012 OVDP FAQ 49 and 51.

26 IRS response to TAS information request (Oct. 29, 2013). These figures do not include the time that taxpayers waited for the IRS's Criminal Investigation Division to clear them to participate or for the IRS to load their cases onto its tracking system.

TAS has recently assisted benign actors who waited for extended periods, as illustrated in the example below. Thus, the IRS's inflexible opt-in-opt-out approach offered bad actors a relatively better deal and also provided them with better customer service than benign actors.[27]

> **Example**: A U.S. citizen residing in Sweden had a life savings of less than $1 million in various foreign accounts and funds. In 2010, he applied to the IRS's 2009 OVD program. Only after TAS issued a Taxpayer Assistance Order in 2012 did the IRS assign a revenue agent to review the submission. In February 2013, the taxpayer opted out. In May 2013 — more than two years after receiving the application — the IRS issued a warning letter. Although unrepresented during most of the process, the taxpayer still spent over $50,000 in fees and mailing costs, and countless hours typing emails to the IRS (that the IRS could not return) or on the phone during business hours in the U.S. — often at night in Sweden.[28]

The IRS's one-size-fits-all approach disproportionately penalizes those who apply.

As of September, 2013, nearly ten IRS examiners (9.5 FTEs) had examined 2,828 returns as a result of opt-out and removal cases, and assessed penalties equivalent to nearly 70 percent (on average) of the tax and interest due.[29] While these results are not as draconian as many fear, the IRS is still assessing substantial penalties against taxpayers who have voluntarily come forward to correct a mistake. By contrast, those who make quiet disclosures or ignore the problem are unlikely to be detected or penalized.[30] As the IRS closed only 1,626 civil FBAR examinations in 2012, its FBAR audit rate is less than one quarter of one percent.[31] Moreover, many of these examinations involved taxpayers who opted in and out of an OVD program in an effort to correct a mistake, rather than more egregious cases that the IRS could identify on its own.[32] Although it may try to do more in this area, the IRS is unlikely to have the resources to do significantly more. Its resources are tied up auditing (or certifying) those who came forward voluntarily. Thus, the IRS's programs effectively penalize taxpayers for coming forward even if they opt out. The National Taxpayer Advocate has recommended the IRS substitute a more nuanced three-category approach for its one-size-fits-all programs, as follows:[33]

---

27 This process made it difficult for benign actors to compute and pay the correct amount, while delaying their right to appeal and to be heard, each of which are fundamental taxpayer rights. For proposals to clarify these rights and others, see National Taxpayer Advocate 2011 Annual Report to Congress 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights) and The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration, supra*.

28 TAS has permission from the taxpayer to discuss these facts. For similar examples, see, *e.g.*, Marie Sapirie, *The Personal Impact of Offshore Enforcement*, 2013 TNT 136-1 (July 16, 2013).

29 IRS response to TAS information request (Sept. 17, 2013) (reporting the IRS examined 2,828 returns associated with opt outs or removals, spent 7 hours per return, assessed $24,373,726 in income tax, $6,005,301 in interest, $16,819,876 in tax-related penalties, and $4,069,795 in FBAR penalties). These examiners are very productive because those entering the program have already provided nearly everything they need to close the case — and have agreed to most, if not all, of the assessment for tax, interest, and tax-related penalties.

30 *See generally*, GAO, GAO-13-318, *IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion* (Mar. 2013) (GAO recommended and the IRS agreed to do more to detect quiet disclosures).

31 IRS response to TAS information request (Sept. 23, 2013) (reporting 1,626 FBAR examination closures for 2012, about 15 percent (or 239) of which resulted in warning letters). Although the number of people who should be filing an FBAR is unknown, even if it consists solely of those who actually filed one in 2012, the audit rate would be 0.2 percent (1,626 / 807,040). Thus, the IRS is using the relatively empty threat of criminal prosecution to drive people — including benign actors — into its programs. We say "relatively empty" because the IRS initiated only 30 criminal investigations of FBAR violations in 2012. *Id.*

32 As noted on the table above, the IRS has closed 277 opt outs from the 2009 program and 813 from the 2011 program. As all taxpayers who opt out are subject to an exam, IRS-reported examination closures likely included many who opted out.

33 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 134-153.

Category 1. Full relief from FBAR and information reporting penalties. Taxpayers who underreported offshore income by less than a reasonable threshold amount — at least as high as the IRC § 6662(d) threshold (*i.e.*, the greater of $5,000 or 10 percent of the tax required to be shown) — should be permitted to file delinquent returns without penalty, regardless of whether they are residents.[34] They should not be subject to the threat of being deemed "high risk" and potentially hit with the maximum penalties, as is the case under the new streamlined program.[35]

Category 2. Taxpayers who have reasonable cause or who acted non-willfully. Taxpayers who underreported more than the threshold but who believe they have reasonable cause or who acted non-willfully should explain their circumstances, file delinquent returns, pay any applicable tax, interest, and penalties under Title 26 (unless asserting reasonable cause). Depending on the circumstances and explanation, these taxpayers should be required to pay either the non-willful FBAR penalty or no penalty under the reasonable cause exception.[36] Because they are required to cooperate, the IRS should have little difficulty evaluating their circumstances without requiring them to opt in and then opt out. Rather than examining each of these returns in full, the IRS should examine a small percentage of them using its normal audit selection techniques, thereby improving its ability to identify noncompliance and encouraging voluntary compliance without unnecessarily burdening taxpayers.

The combination of the FBAR statute and the way the IRS administers it creates the potential for such draconian penalties that some taxpayers may agree to pay unwarranted amounts.

Category 3. Taxpayers not included in Category 1 or 2. Taxpayers who do not fall into categories one or two, but voluntarily come forward to correct their violations should be required to file delinquent or amended returns and pay tax, interest, delinquency and accuracy-related penalties, and the offshore penalty, as currently required under the 2012 OVDP.

For those in Category Two, the IRS could provide more comprehensive guidance and examples to help taxpayers, practitioners, and IRS employees determine whether reasonable cause applies, potentially reducing anxiety, uncertainty, and controversy in this area. Anti-abuse rules could discourage Category Three taxpayers from self-selecting into Category Two. This three-category approach could prevent the IRS from being viewed as extorting or bullying unjustified penalties from taxpayers — particularly unrepresented taxpayers with small accounts — and ultimately improve voluntary compliance.

34 Persons who failed to file an FBAR and did not report all of their income are currently required to pay the offshore penalty, even if they do not have a tax deficiency (*e.g.*, due to an offsetting foreign tax credit). *See, e.g.*, 2011 OVDI FAQ 17; 2012 OVDP FAQ 17; and 2012 OVDP FAQ 33.

35 IRS, *Instructions for New Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer U.S. Taxpayers* (Aug. 31, 2012), http://www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers.

36 Although IRS Fact Sheet 2011-13 provides some guidance, the IRS should more expressly define what constitutes "reasonable cause" for purposes of FBAR and provide examples about the difference between willful and non-willful violations based on the taxpayer's background, education level, cultural concerns, etc. The IRS should also clarify that it will not seek a penalty for a willful violation unless it can show "a voluntary intentional violation of a known legal duty." *See Ratzlaf v. U.S.*, 510 U.S. 135 (1994) (U.S. Supreme Court case discussing Bank Secrecy Act violations; however, not dealing with FBAR directly).

The government has imposed new and duplicative information reporting requirements, and made filing an FBAR more difficult.

Beginning in tax year 2011, the IRS has required some taxpayers to file duplicative information about foreign accounts on the FBAR and Form 8938, *Statement of Foreign Financial Assets*.[37] Thus far, the IRS has not adopted the National Taxpayer Advocate's recommendation (or a similar recommendation by the GAO) to reduce this duplicative reporting.[38]

Moreover, after June 30, 2013, the Financial Crimes Enforcement Network (FinCEN) requires the FBAR to be filed electronically on a new system that does not accept attachments (such as explanations for late filings), making compliance more difficult for some.[39] While the FinCEN BSA E-File system still does not accept attachments, as of October 1, 2013, it was updated to allow late FBAR filers to provide a 750 character explanation.[40] However, the system's inability to accept attachments could potentially generate unnecessary inquiries or audits.

Education, burden reduction, and improved guidance could bring millions of benign actors into compliance, while preserving respect for the IRS.

While 7.6 million U.S. citizens reside abroad and many more U.S. residents have FBAR filing requirements,[41] the Treasury Department processed only 807,040 FBAR filings in 2012.[42] Further, GAO has reported significant confusion about the reporting requirements, identified a significant number of participants in the IRS's programs who were unaware of the FBAR filing requirements, observed the IRS has failed to educate recent immigrants and that it has not formally evaluated any of its outreach efforts.[43] Thus, a more effective initiative — one combined with burden reduction and education — could prompt significantly more taxpayers to come into compliance.

The IRS has discontinued an FBAR Compliance Initiative Project to educate those with foreign bank accounts who are most likely to have FBAR violations (*e.g.*, immigrants to the U.S. and U.S. citizens

---

37 Sections 511 and 521 of the Hiring Incentives to Restore Employment Act (the HIRE Act), Pub. L. No. 111-147, 124 Stat. 71 (2010) (codified at IRC §§ 6038D and 1298(f)) enacted these new reporting requirements. It applied to taxable years beginning after March 18, 2010, but implementation was delayed. See Notice 2011-55, 2011-29 I.R.B. 53 (July 18, 2011). For further discussion of FATCA, see Most Serious Problem: *The Foreign Account Tax Compliance Act Has the Potential to Be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights, infra*.

38 *See, e.g.*, FinCEN, *Final Reminder for Electronic Filing Requirement* (June 29, 2012), http://www.fincen.gov/news_room/nr/html/20120629.html. For GAO's recommendation, see GAO, GAO-12-403, *Reporting Foreign Accounts to the IRS, Extent of Duplication Not Currently Known, but Requirements Can Be Clarified* 26 (Feb. 2012) (recommending "[A]s data becomes available, determine whether the benefits of implementing a less duplicative reporting process exceed the costs and if so, implement that process.").

39 *See, e.g.*, FinCEN, *Final Reminder for Electronic Filing Requirement* (June 29, 2012), http://www.fincen.gov/news_room/nr/html/20120629.html. Paper IRS FBAR Form TD F 90–22.1 was replaced by FinCEN FBAR Report 114, which must be filed electronically. Although international taxpayers report having access the internet from home more often than domestic taxpayers (85 percent vs. 77 percent for domestic), a smaller percentage actually e-file (27 percent vs. 72 percent overall in 2011). *See* Wage and Investment, Research and Analysis, *Understanding the International Taxpayer Market* 7, 13 (June 2011), www.irs.gov/pub/irs-utl/5_david_cico.pdf. It is unclear whether the FBAR e-filing requirement has reduced compliance. As of November 25, 2013, the Treasury Department had processed 594,061 FBAR filings in 2013, including 556,739 paper filings thru June 27 and 37,322 E-filings thru September 30. IRS response to TAS information request (Dec. 6, 2013). By comparison, there were 798,993 paper filings and 8,047 electronic filings, for a total of 807,040 FBAR filings in 2012. IRS response to TAS information request (Sept. 23, 2013).

40 IRS response to TAS information request (Dec. 6, 2013) (citing FinCEN Notice, *Important Notice to BSA E-Filers: Updated Report of Foreign Bank and Financial Accounts (FBAR), FBAR Batch Capability, and Web Site Updates* (Sept. 30, 2013), http://www.fincen.gov/whatsnew/html/20130930.html).

41 U.S. Department of State, Bureau of Consular Affairs, *Who We Are and What We Do: Consular Affairs by the Numbers* (Jan. 2013), http://travel.state.gov/pdf/ca_fact_sheet.pdf.

42 IRS response to TAS information request (Aug. 12, 20013).

43 GAO, GAO-13-318, *IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion* 21-22 (Mar. 2013).

abroad).[44] The National Taxpayer Advocate previously recommended the IRS reinstate this program.[45] The IRS could also reach out to those who immigrate to the U.S. when they apply for an ITIN, visa, or residency status. It could work with other agencies such as the State Department and the Department of Homeland Security.[46]

The National Taxpayer Advocate has also recommended the IRS use its normal guidance-making process to redesign its settlement programs, after taking stakeholder concerns into account, and publish the resulting guidance in the Internal Revenue Bulletin to avoid any confusion about what the rules are or whether the IRS will change them — by changing an FAQ posted to a website — without consulting with stakeholders. These steps would go a long way toward improving the fairness of the tax system, restoring respect for the IRS, and improving voluntary compliance.[47]

Moreover, the IRS should provide guidance about the information reporting required with respect to common situations.[48] For example, most people who have worked in Mexico have a government-mandated retirement account (called an AFORES).[49] In at least one case, an IRS Technical Advisor concluded a taxpayer should report them on Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, and Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, before the IRS could process the taxpayer's decision to opt out of the OVD program. Imposing new requirements at the end of the process without having clear public guidance on the subject delayed the process and frustrated the taxpayer.[50] Moreover, by some accounts, more than one million U.S. citizens reside in Mexico and many Mexican citizens reside in the U.S., and a large percentage of each group could be subject to information reporting on AFORES.[51] Thus, the IRS should issue clear guidance about what accounts are reportable (and on what form(s)) before it requires taxpayers to report them.

44 U.S. Department of the Treasury, *A Report to Congress in Accordance With § 361(B) of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 5 (CY 2009) ("the [IRS] project remains viable … [but] is currently closed."). Many foreign accounts are reflected in the Web-CBRS database. *Id*. at 5.

45 National Taxpayer Advocate 2012 Annual Report to Congress 134-153.

46 The IRS has shared FBAR information and filing reminders with the Department of State. IRS response to TAS information request (Sept. 23, 2013).

47 Research suggests that seemingly unfair procedures may increase tax evasion by Schedule C filers. *See e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-70 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

48 Taxpayer are confused about what foreign account information should be reported and how. *See, e.g.*, GAO, *IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion*, GAO-13-318, 21 (Mar. 2013); GAO, GAO-12-403, *Reporting Foreign Accounts to the IRS, Extent of Duplication Not Currently Known, but Requirements Can Be Clarified* 2, 18 (Feb. 2012).

49 *See, e.g.*, State Bar of California, Taxation Section, *Proposed Guidance: Why Mexican Retirement Funds Should not be Subject to the New Reporting Requirements Under IRC Section 1298(f)*, 2012 TNT 166-60 (Aug. 27, 2012).

50 TAS has permission from the taxpayer to discuss these facts.

51 *See id*. For further analysis, see, *e.g.*, State Bar of California, Taxation Section, *Proposed Guidance: Why Mexican Retirement Funds Should not be Subject to the New Reporting Requirements Under IRC Section 1298(f)*, 2012 TNT 166-60 (Aug. 27, 2012) (suggesting these holdings are reportable as PFICs on Form 8621, but urging an exception); Mexican Banking Association and Mexican Securities Industry Association, *Comments on the Foreign Account Tax Compliance Act, regulations to be issued thereunder, and Notice 2010-60* (Apr. 1, 2011), http://www.bsmlegal.com/PDFs/FATCA_MexicanComments.pdf (urging the IRS to exempt AFOREs from information reporting under FATCA).

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Expand and clarify the streamlined program to encourage all benign actors (including U.S. residents) to correct past noncompliance using less burdensome and punitive procedures (*e.g.*, expand and clarify who qualifies). Alternatively, adopt the three-category approach (described above), which does not require benign actors to opt out of the OVD program(s). As with other changes to OVD programs, the IRS should allow those who previously applied (even if they have signed closing agreements) to take advantage of the new approach.
2. Educate persons likely to have foreign accounts (*e.g.*, recent immigrants and U.S. citizens residing overseas) about the information reporting requirements. For example, consider working with other agencies such as the U.S. State Department and the Department of Homeland Security to provide information about the requirements to those who apply for an ITIN, visa, or residency status.
3. Issue guidance about what, if any, information reporting applies to AFOREs (*i.e.*, privatized social security accounts held by those who have worked in Mexico).
4. Incorporate all OVD FAQs and the streamlined program into a Revenue Procedure (or similar guidance published in the Internal Revenue Bulletin) that incorporates comments from internal and external stakeholders.
5. Reduce the duplicative reporting required on both Form 8938, *Statement of Foreign Financial Assets* and the FBAR.[52]

52 The IRS could reduce duplicative reporting by adding items reported on an FBAR to the existing list of items that taxpayers do not have to report on Form 8938. *See* Treas. Reg. § 1.6038D–7T. TAS understands the IRS has access to the FinCEN Query System, which allows IRS employees direct electronic access to the FinCEN database. Using this system, the IRS could download FBAR data for analysis. Therefore, it is unclear why the IRS would need taxpayers to report the same information on a Form 8938. However, the IRS continues to weigh the costs and benefits of this recommendation. IRS response to TAS information request (Dec. 6, 2013).

MSP #23 REPORTING REQUIREMENTS: The Foreign Account Tax Compliance Act Has the Potential to be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights

RESPONSIBLE OFFICIALS

John Koskinen, Commissioner of Internal Revenue
Heather C. Maloy, Commissioner, Large Business and International Division
Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

Congress has long been concerned that U.S. taxpayers are not fully disclosing the extent of financial assets held abroad.[1] In 2010, Congress passed the Foreign Account Tax Compliance Act (FATCA) to address this issue.[2] FATCA imposes extensive reporting obligations on U.S. taxpayers, foreign entities, and withholding agents.[3] Sanctions for FATCA noncompliance are so severe that failure to undertake the requisite reporting and disclosure can conceivably result in penalties in excess of the unreported foreign assets.[4]

The reporting obligations and potential penalties FATCA implements are, according to some expatriates and practitioners, responsible for the surge in the number of Americans renouncing their citizenship or permanent resident status.[5] Moreover, some foreign financial institutions (FFIs), such as DeutcsheBank, HSBC, and ING have reportedly been closing out foreign accounts of U.S. citizens in response to FATCA's "onerous U.S. Regulations."[6] Some stakeholders and commentators have questioned, from both a financial and tax policy perspective, whether the benefits of FATCA, including the additional tax

1 Some international tax policy experts believe that tax revenue losses are in the billions of dollars annually. Government Accountability Office (GAO), GAO-12-403, *Reporting Foreign Accounts to IRS: Extent of Duplication Not Currently Known, but Requirements can be Clarified*, App. 2 (Feb. 2012). A relatively recent response to this concern was passage of the Bank Secrecy Act, which requires U.S. citizens and residents to report foreign accounts on the FinCEN Report 114, *Report of Foreign Bank and Financial Accounts* ("FBAR"). *See* 31 U.S.C. § 5314(a).

2 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat 71 (2010) (adding Internal Revenue Code (IRC) §§ 1471-1474; 6038D).

3 For example, U.S. citizens, resident aliens, and certain non-resident aliens must file a Form 8938, *Statement of Specified Foreign Financial Assets*, with their annual federal income tax returns, reporting foreign assets exceeding certain thresholds. IRC § 6038(D)(a); Treas. Reg. § 1.6038D-2T(a). Reporting by certain domestic entities of interests in specified foreign financial assets will be required after the IRS issues final regulations under IRC § 6038D. IRC § 6038D(f); Prop. Reg. § 1.6038D-6; Notice 2013-10, 2013-8 I.R.B. 503. An individual may also have to file the FBAR and separate penalties may apply for failure to file each form.

4 IRC § 6038D(d); IRC § 6662(j). Any associated FBAR penalties would be in addition to these penalties imposed by the FATCA regime.

5 *See* Tom Geoghegan, *Why Are Americans Giving up Their Citizenship?*, BBC News Mag., Sept. 26, 2013, *available at* http://www.bbc.co.uk/news/magazine-24135021. More renunciations have occurred in 2013 than in any other year on record. *See* Laura Sanders, *More U.S. Taxpayers Renounce Citizenship,* Wall St. J., Nov. 14, 2013, at C3; 78 Fed. Reg. 68151, 2013-27072.

6 Rowan Morrison, *When Banks Pay the Price*, Editions Financial (Aug. 30, 2012), *available at* http://www.editionsfinancial.co.uk/2012/08/30/when-banks-pay-the-price/. *See also* Sofia Yan, *Banks Lock out Americans Over New Tax Law*, CNNMoney (Sept. 15, 2013), *available at* http://money.cnn.com/2013/09/15/news/banks-americans-lockout/; Simon Bradley, *U.S. Expats Feel the Burden of FATCA* (May 28, 2013), *available at* http://www.swissinfo.ch/eng/politics/US_expats_feel_the_burden_of_FATCA.html?cid=35932576; Tom Geoghegan, *Why Are Americans Giving up Their Citizenship?*, BBC News Mag. (Sept. 26, 2013), *available at* http://www.bbc.co.uk/news/magazine-24135021; Katie Holliday, *HSBC Cuts Ties with US Clients Ahead of FATCA*, Investment Week (July 21, 2011), *available at* http://www.investmentweek.co.uk/investment-week/news/2095508/hsbc-cuts-ties-clients-ahead-fatca.

revenue it is estimated to raise, are sufficient to justify the compliance burdens and economic hardships to which it subjects individuals and business entities.[7]

The ultimate undertaking of FATCA will be an international financial data regime with global information transparency.[8] Questions remain, however, about whether such a course is advisable, whether the information being compiled is necessary and will be effectively utilized, and whether the due process rights of taxpayers will be preserved.

To date, the IRS has provided guidance on, and implemented some key components of the administratively challenging FATCA regime. The law is still in its relative infancy, however, and the IRS should proceed with great care as it moves forward with FATCA implementation. The National Taxpayer Advocate cautions the IRS to gather only the information that it will actually use, to learn from its experiences with the Offshore Voluntary Disclosure programs to more effectively preserve the due process rights of taxpayers, and to burden impacted parties as little as possible.[9] Specifically, the National Taxpayer Advocate is concerned that:

- Reasonable cause relief or other leniency procedures for FATCA non-filers are not yet fully developed enough to favorably distinguish benign actors from bad actors, and to make penalty abatements or similar relief consistently available to good faith taxpayers.
- Absent a timely and effective mechanism for addressing inaccurate information reporting, taxpayers could face adverse consequences as a result of lax due diligence on the part of FFIs in the collection and transmission of accountholder data.
- The IRS has been slow in acting upon recommendations it has received from some well-informed stakeholders, including the Electronic Tax Administration Advisory Committee (ETAAC), the Government Accountability Office, and the National Taxpayer Advocate.

ANALYSIS OF PROBLEM

Background

Under FATCA, U.S. citizens, resident aliens, and certain non-resident aliens have expanded disclosure obligations and increased penalty exposures.

Two of FATCA's distinguishing characteristics are the vast quantity of taxpayer information it compiles and the potentially punitive measures it brings to bear in furtherance of its goal. U.S. citizens, resident aliens, and certain non-resident aliens must file a Form 8938 with their individual returns, reporting foreign assets exceeding specified thresholds.[10] American Citizens Abroad, a group speaking for non-resident

7 Frederic Alain Behrens, *Using a Sledgehammer to Crack a Nut: Why FATCA Will Not Stand*, 2013 Wis. L. Rev. 205 (2013); David Jolly & Brian Knowlton, *Law to Find Tax Evaders Denounced*, NY Times, Dec. 26, 2011, at B1. *See also* Joint Comm. on Taxation (JCT), JCX-5-10, *JCT Estimates Budget Effect of HIRE Act* (Feb. 23, 2010).

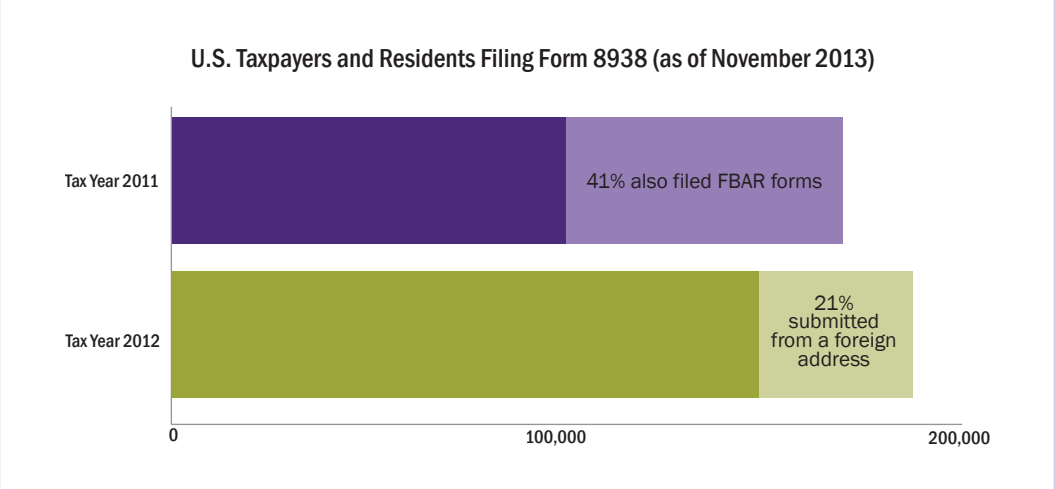
8 J. Richard Harvey, *Report from the Front Lines*, Tax Notes Today, 2012 TNT 151-9 (Aug. 6, 2012).

9 *See, e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress 134-153 (Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*).

10 Treas. Reg. § 1.6038D-2T(a). An unmarried taxpayer living in the U.S. must file a Form 8938 if the total value of the taxpayer's specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year. This threshold is doubled in the case of specified individuals who are married filing jointly. A qualifying unmarried taxpayer living abroad must file a Form 8938 if the total value of the taxpayer's specified foreign financial assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year. This threshold is doubled as well in the case of qualified individuals living abroad who are married filing jointly. *Id*.

U.S. taxpayers, estimates that completing the form will add an extra three hours to the tax preparation activities of its members.[11] Expatriates further complain that the additional complexity of the reporting obligations often requires professional assistance, which only adds to their compliance costs, even when they ultimately owe no additional U.S. tax.[12]

U.S. taxpayers and residents meeting the specified criteria have been required to file Forms 8938 with their annual income tax returns for their 2011 and 2012 taxable years. As of November 2013, approximately 170,000 taxpayers had filed Forms 8938 for Tax Year (TY) 2011, while about 187,000 had filed for TY 2012.[13] Roughly twenty-one percent of TY 2012 Form 8938 returns were submitted to the IRS from a foreign address.[14] Of the taxpayers filing Forms 8938 in TY 2011, approximately 41 percent also filed FBAR forms.[15]



Taxpayers who filed TY 2012 Forms 8938 were compliant overall, with virtually no returns showing Tax Delinquent Investigation (TDI) or Tax Delinquent Account (TDA) activity.[16] Analysis of the Form 8938 filer pool indicates Tax Delinquent Account activity on only one-half of one percent of those taxpayers' TY 2012 returns as opposed to TDA activity of approximately four percent for the overall universe of taxpayers for that tax year.[17]

Although a complete and reliable profile of Form 8938 filers has yet to fully emerge, this preliminary data suggests that those taxpayers who are following the FATCA filing requirements are generally compliant

11 David Jolly & Brian Knowlton, *Law to Find Tax Evaders Denounced*, NY Times, Dec. 26, 2011, at B1.

12 Tom Geoghegan, *Why Are Americans Giving up Their Citizenship?*, BBC News Mag. (Sept. 26, 2013), *available at* http://www.bbc.co.uk/news/magazine-24135021.

13 TAS Research, Compliance Data Warehouse, IRFT Entity and IRTF F1040 tables, data drawn Nov. 6, 2013. These numbers may change as more Tax Year 2012 returns filter in to the IRS.

14 Large Business & International Division (LB&I), International Business Compliance (IBC), and International Data Management (IDM) response to TAS research request (Nov. 1, 2013).

15 *Id*.

16 TAS Research, Compliance Data Warehouse, IRFT Entity table, data drawn Nov. 6, 2013. Virtually 100 percent of the population was in filing compliance according to repeater switch numbers on the CDW IRTF Entity table, and 99.5 percent were in payment compliance using the CDW IRTF Entity Open TDA Code.

17 TAS Research, Compliance Data Warehouse, IRFT Entity table, data drawn Nov. 6, 2013.

with respect to their overall tax obligations. Thus, to this point, the IRS is imposing additional reporting burdens and increased potential penalties primarily on a category of taxpayers that, under principles of quality tax administration, should be encouraged, rather than penalized.

Failure to timely file Form 8938 can result in a $10,000 penalty for failure to disclose, plus additional penalties escalating as high as another $50,000, if such nondisclosure continues after notification from the IRS.[18] Thus, a taxpayer with a $51,000 asset falling within the FATCA regime who does not receive or respond to an IRS notice that a Form 8938 must be filed is potentially subject to $60,000 of non-disclosure penalties with respect to the $51,000 asset. The severity of this regime is difficult to reconcile with the IRS principle that "Penalties should … be objectively proportioned to the offense."[19] Moreover, a failure to file, or even an omission of information on Form 8938, could, as a preliminary matter, cause the statute of limitations to remain open with respect to the Form 8938 and any related tax liability.[20] Despite the severity and impact of the penalty, the IRS has no mechanism for identifying the non-filing of Forms 8938, save for when the omission is uncovered as part of a standard, non-FATCA audit.[21]

In addition to the FATCA non-disclosure penalty, a taxpayer with an "undisclosed foreign financial asset understatement" may be liable for an accuracy penalty of 40 percent of the understatement of income occurring on the tax return itself.[22] Such sanctions would be in addition to any penalties arising under the FBAR regime of Title 31.[23] Given the large penalties for errors put forth by FATCA, taxpayers and their representatives have expressed concern for the "vast swath of the normally law-abiding filer community unable to afford the expensive services of a professional tax adviser."[24]

The FATCA reporting regime places significant burdens on FFIs and withholding agents.

Beyond the substantial risks and burdens facing taxpayers, another important aspect of FATCA is its approach to gathering information to validate and enforce the reporting of offshore income. Unless a foreign financial institution agrees to provide comprehensive information with respect to U.S. account holders, except for individuals with depository accounts having an aggregate value of $50,000 or less, either as a participating FFI or pursuant to an intergovernmental agreement negotiated between the U.S. and the FFI's home country, a broad range of U.S.-source payments to the FFI will be subject to a 30 percent withholding tax.[25]

---

18 IRC §§ 6038D(d)(1) and (d)(2). The two penalties contemplated by IRC § 6038D(d) can potentially aggregate to $60,000. These penalties are subject to abatement under IRC § 6038D(g) if the failure to file is "shown to be due to reasonable cause and not due to willful neglect." This determination will be made on a case-by-case basis taking into account all pertinent facts and circumstances. *See* Treas. Reg. § 1.6038D-8T(e).

19 Internal Revenue Manual (IRM) 20.1.1.2.1 (Nov. 25, 2011).

20 IRC § 6501(c)(8)(A).

21 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

22 IRC § 6662(j) defines an "undisclosed foreign financial asset understatement" as "the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset." The generation of taxable income from a foreign account to which IRC § 6038D would apply is considered to represent a "transaction" for purposes of the 40 percent understatement penalty. *See* JCT, JCX-4-10, *JCT Estimates Budget Effect of HIRE Act* 63, 64 (Feb. 23, 2010). Thus, the IRC § 6662(j) penalty is triggered by an understatement of income on the return associated with the non-reporting of a foreign asset, whereas the IRC § 6038D penalty arises solely on account of non-disclosure of the foreign asset, regardless of whether or not the asset generates taxable income during the year.

23 GAO, GAO-12-403, *Reporting Foreign Accounts to IRS: Extent of Duplication Not Currently Known, but Requirements Can Be Clarified*, App. 2 (Feb. 2012). *See also* National Taxpayer Advocate 2012 Annual Report to Congress 134, 141 (Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*).

24 David Jolly & Brian Knowlton, *Law to Find Tax Evaders Denounced*, NY Times, Dec. 26, 2011, at B1. *See also* Tom Geoghegan, *Why Are Americans Giving up Their Citizenship?*, BBC News Mag. (Sept. 26, 2013), *available at* http://www.bbc.co.uk/news/magazine-24135021.

25 IRC § 1471(a); IRC § 1473(1).

FATCA imposes extensive reporting obligations on U.S. taxpayers, foreign entities, and withholding agents.

Beginning after June 30, 2014, FATCA will charge withholding agents with the responsibility of determining whether they are obliged to undertake FATCA withholding, and of implementing that withholding whenever it is required.[26] This endeavor represents a large undertaking, both in terms of time and resources, the difficulty of which has been compounded by IRS delays in issuing regulations and finalizing forms.[27] FATCA compliance requires the development of substantial new systems and processes on the part of most withholding agents.[28] If a withholding agent fails to undertake the required withholding, the agent is personally liable for the uncollected funds.[29] On the other hand, if withholding agents unreasonably over-withhold, they are subject to claims from their counterparties.[30]

Starting in January 2014, FFIs will be expected to finalize their registration information with the IRS through a dedicated online IRS portal.[31] As the IRS finalizes and approves registrations, it will issue FFIs a global intermediary identification number (GIIN).[32] The IRS will electronically post the first FFI list in June 2014, and update it monthly. Review of this list will allow withholding agents to determine whether or not to withhold on payments made to FFIs.

Registered FFIs will be required to file information reports on their U.S. account holders beginning with respect to accounts held during the 2014 calendar year.[33] This reporting will be due no later than March 31 of the following year, and will typically occur through an electronic Form 8966, *FATCA Report*.[34] The primary identification mechanism of U.S. account holders on the Form 8966 will be taxpayers' Social Security numbers or tax identification numbers.[35] Taxpayers without such identifying numbers will generally be treated as recalcitrant account holders and will be subject to withholding undertaken by the FFI.[36]

26 Notice 2013-43, 2013-31 I.R.B. 113.

27 Payson Peabody, *SIFMA*, *Comments on the Final FATCA Regulations* (June 21, 2013), at p. 2, *available at* http://www.sifma.org/comment-letters/2013/sifma-submits-comments-to-the-us-department-of-treasury-and-the-irs-on-final-fatca-regulations/.

28 Payson Peabody, SIFMA, *Comments on the Proposed FATCA Regulations* (Apr. 30, 2012), *available at* http://www.sifma.org/issues/item.aspx?id=8589938585.

29 IRC § 1474(a).

30 Payson Peabody, *SIFMA*, *Comments on the Final FATCA Regulations* (June 21, 2013), at p. 2, *available at* http://www.sifma.org/comment-letters/2013/sifma-submits-comments-to-the-us-department-of-treasury-and-the-irs-on-final-fatca-regulations/; Treas. Reg. § 1.1474-1(f).

31 Notice 2013-43, 2013-31 I.R.B. 113.

32 *Id*. The GIIN will be used by the IRS in the application of FATCA as a global identifier of registered FFIs, and will also be used by withholding agents to validate the FATCA compliance of FFIs.

33 Notice 2013-43, 2013-31 I.R.B. 113. Given current uncertainties created by IRS delays in the issuance of guidance and final forms, however, a number of banking and financial industry associations have requested an extension in the milestone dates for implementing FATCA. *See* Payson Peabody, SIFMA *et al*., *Letter to Treasury and IRS, Request for Additional Extension of the FATCA, Phased Timeline* (Nov. 18, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589946219.

34 Notice 2013-43, 2013-31 I.R.B. 113

35 Both the paper and the electronic versions of the Form 8966 will specify applicable conventions for providing the name of the account holder. As in the case of Chapter 3 reporting, however, the name field will be subordinate to the SSN/TIN field for purposes of data collection and manipulation under FATCA. LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

36 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013); *see also* Treas. Reg. §1.1471-4.

Given the delays and other shortcomings associated with the IRS Individual Taxpayer Identification Number (ITIN) application procedures, some account holders, despite their best efforts, could find themselves subject to withholding as they experience the long wait for ITINs to be issued.[37]

The approach adopted by FATCA could be a highly effective means of obtaining the desired information, but, in addition to objections based on resource burdens, it has given rise to discussions of sovereignty issues, as well as concerns regarding economic repercussions. For example, Murray Rankin, the Canadian equivalent of a "Shadow Minister" for National Revenue, recently reiterated his party's concerns regarding FATCA:

> New Democrats are concerned with the prospect of a foreign nation unilaterally imposing obligations on Canadian banks to disclose personal information. The Canadian Government has a responsibility to protect Canada's tax base, and while we understand the United States' desire to protect their own tax base, this should not come at the cost of the rights of individuals residing in our own country. Cracking down on tax cheats should occur through international cooperation rather than unilateral action.[38]

By most measures, FATCA-related costs equal or exceed projected FATCA revenue.

The Congressional Joint Committee on Taxation estimates FATCA will generate additional tax revenue of approximately $8.7 billion over the next ten years.[39] By way of comparison, industry sources believe that overall private sector implementation costs could equal or exceed the amount that FATCA is projected to raise.[40] The IRS costs associated with long-term development and implementation of the FATCA regime have not been systematically quantified.[41] Similarly, the compliance costs and penalty exposure burdens on individual taxpayers are difficult to estimate, while, in addition to the compliance costs, business entities face possible application of the 30 percent withholding tax against non-compliant FFIs and potential liability against agents who do not undertake proper withholding.[42]

---

37 For more detailed information, see Most Serious Problem: *ITINs: ITIN Application Procedures Burden Taxpayers and Create a Barrier to Return Filing*, *supra*.

38 Letter from Murray Rankin, Member of Parliament for Victoria, Official Opposition Critic for National Revenue, to Canadian Minister of Finance James M. Flaherty (Sept. 25, 2013), *available at* http://maplesandbox.ca/wp-content/uploads/2013/09/Rankin-Letter-to-Flaherty.pdf; *see also* James Jatras, *Canada's Shadow Revenue Minister Warns Government against Sellout on FATCA!*, OpEdNews (Oct. 5, 2013), *available at* http://www.opednews.com/articles/Canada-s-Shadow-Revenue-Mi-by-James-Jatras-Canada-us-Integration-131005-282.html. For the IRS's response to allegations such as those raised by Mr. Rankin, see Robert Stack, *Myth vs. FATCA: The Truth about Treasury's Effort to Combat Offshore Tax Evasion*, Myth No. 7, Lexis Nexis (Sept. 20, 2013).

39 *See* JCT, JCX-5-10, *JCT Estimates Budget Effect of HIRE Act* (Feb. 23, 2010).

40 Deloitte Regulatory Review, *FATCA: Determined to Pierce the Corporate Veil* (Apr. 2011), p. 3, *available at* http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Regulatory%20Review%20April%202011/Deloitte_Regulatory_Review_April_2011_FATCA.pdf. Brian Kindle, *FATCA May Identify Tax Cheats, but Its Dragnet for Financial Criminals May Produce an Even Bigger Yield*, Association of Certified Financial Crime Specialists (Mar. 1, 2012), *available at* http://www.acfcs.org/fatca-may-identify-tax-cheats-but-its-dragnet-for-financial-criminals-may-produce-an-even-bigger-yield/.

41 GAO, GAO-12-484, *Foreign Account Reporting Requirements: IRS Needs to Further Develop Risk, Compliance, and Cost Plans* (Apr. 2012). In response to this GAO report, the IRS did quantify its 2011 and 2012 costs, and likewise projected costs through the end of FY 2013. LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013). Nevertheless, this analysis provides an incomplete picture of the required economic resources, as FATCA development and implementation will continue at least until 2017.

42 *See, e.g.*, Deloitte Regulatory Review, *FATCA: Determined to Pierce the Corporate Veil* (Apr. 2011), p. 3, *available at* http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/Financial%20services/Regulatory%20Review%20April%202011/Deloitte_Regulatory_Review_April_2011_FATCA.pdf.

The technology necessary for the IRS to utilize the information being gathered under FATCA is still in the early stages of development.

The IRS has started developing a data platform, referred to as the International Compliance Management Model (ICMM), to compile the information drawn from the Form 8966 that will employ recent and newly-designed technology and will adopt common international protocols.[43] These protocols will be used to facilitate bilateral information exchanges, which some governments require as a precondition for their cooperation in the FATCA regime. Such exchanges, which will occur under negotiated intergovernmental agreements, have given rise to substantial privacy concerns because they often will involve providing foreign governments with information regarding accounts held in the U.S.[44]

The reporting obligations and potential penalties FATCA implements are, according to some expatriates and practitioners, responsible for the surge in the number of Americans renouncing their citizenship or permanent resident status.

Eventually, the IRS plans to use the ICMM data platform to match information collected on Forms 8938 against the information gleaned from Forms 8966, 1042, and 1042S to identify and pursue non-filers.[45] The ICMM data platform, however, has not yet been built.[46] The technology project, which is a core feature of FATCA implementation, is in the early stages of developing business requirements, and funding for the project has only recently been approved.[47] The compliance application, which would match and compare the information reported by the various parties, is not scheduled for release until 2016 at the earliest.[48] Successful development of a functional, cutting-edge, data platform to compare and analyze the range of information gathered will be crucial to the long-term effectiveness of FATCA.

The IRS Should Preserve the Due Process Rights of Taxpayers by Issuing FATCA-specific Relief Procedures with Respect to Benign Non-filers.

FATCA sets forth substantial penalties to enforce compliance on the part of U.S. taxpayers, FFIs, and withholding agents. Given their relative lack of resources, however, individual taxpayers, particularly those residing abroad, are disproportionately likely to be subject to burdensome compliance initiatives and unnecessarily high penalties. As a result, the IRS should learn from its history with its OVD programs and proactively take steps to protect due process rights of taxpayers falling within the FATCA regime.[49]

Reasonable cause relief is contemplated for both the failure to file Form 8938 and for the related "undisclosed foreign financial asset understatement" penalties related to FATCA. The language of the associated regulations and IRM Part 20, however, is quite broad, and provides IRS personnel with little guidance

43 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

44 Letter from Congressman Bill Posey to Jack Lew, Secretary of the Treasury (July 1, 2013).

45 Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Person*; Form 1042S, *Foreign Person's U.S. Source Income Subject to Withholding*.

46 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

47 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

48 *Id*.

49 FATCA non-filers are subject to the OVDP program and related guidance. *See Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers. This program, however, has substantial deficiencies. *See* Most Serious Problem: *Offshore Voluntary Disclosure: The IRS Offshore Voluntary Disclosure Program Disproportionately Burdens Those Who Made Honest Mistakes*, *infra/supra*.

specific to FATCA regarding circumstances under which relief would be appropriate and should be granted.[50]

For example, IRM Part 20 explains that in considering a request for a reasonable cause abatement based on ignorance of the law, IRS personnel should weigh factors such as recent changes to the tax forms or law and the level of complexity of a tax or compliance issue. However, it also says ignorance of the law will constitute a valid excuse for non-compliance only if the taxpayer could not reasonably have been expected to know of the law.[51] Thus, a likelihood exists that IRS employees could take the position that, in all but extraordinary circumstances, even non-resident filers should be aware of FATCA, and therefore would have no basis for seeking relief from applicable penalties. Accordingly, without FACTA-specific guidance, the approach adopted by the IRS could be, at best, anecdotal, inconsistent, and unpredictable, and at worst, could systematically fail to properly address the circumstances of benign non-filers.

The IRS should quickly establish reasonable cause or similar relief procedures for FATCA non-filers that favorably distinguish benign actors from bad actors. Without such guidance, a real danger exists that reasonable cause relief under the FATCA regime may be available in theory but not be applied in practice. As a result, the National Taxpayer Advocate recommends that the IRS issue guidance indicating lenient treatment of benign non-filers with respect to the non-application or abatement of IRC §§ 6038D and 6662(j) penalties. Specifically, such leniency is particularly appropriate in the early years of the FATCA regime, where there is no indication of bad faith on the part of the taxpayer, and where penalties are, or would be, disproportionate as compared with the size of the foreign accounts in question and the related taxable income to be reported. The IRS should collaborate and consult with the National Taxpayer Advocate in the development of standards for reasonable cause or similar relief in this context.

The IRS Should Develop a Timely and Effective Mechanism for Addressing Information Reporting Errors of FFIs.

FFIs reporting account holder information either directly or indirectly to the IRS under the FATCA regime are subjected to a variety of due diligence requirements. Most of these rules focus on ensuring that the FFI is scrutinizing potential U.S. account holders with sufficient vigor, that adequate procedures and systems are in place for this process and that, indeed, the FFI is not in any way assisting account holders in escaping detection from the IRS.[52] Moreover, the IRS is developing technology to verify that the desired data fields on the electronic forms 8966 are complete.[53] Nevertheless, the IRS seems to have dedicated less energy to ensuring that the account holder information provided to the IRS is accurate or to establishing relief mechanisms for circumstances in which FFIs transmit erroneous information.

Given the vast swath of information being transferred by FFIs and compiled by the IRS as part of the FATCA regime, the information reported with respect to some U.S. taxpayers and residents will inevitably be wrong. Some will certainly be reported to have assets beyond what they actually possess, while others

50 Treas. Reg. § 1.6038D-8T; IRC § 6664(c); IRM Part 20, *Penalty and Interest*, which provides internal IRS guidance implementing the applicable reasonable cause regulations. In particular, see IRM 20.1.9.22 (Mar. 21, 2013), relating to IRC § 6038D penalties, and IRM 20.1.5.13 (Jan. 24, 2012) relating to IRC § 6662(b)(7) and (j) penalties. These sections incorporate the FATCA penalties into the IRM, but provide no FATCA-specific guidance with respect to reasonable cause or similar procedures.

51 IRM 20.1.1.3.2.2.6 (Nov. 25, 2011).

52 Treas. Reg. §§ 1.1471-4(c)(7) and 1.1471-4(f)(3).

53 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

will undoubtedly be listed as having accounts or assets they never owned. Common challenges banks face include "data quality errors caused by inaccurate translation, invalid addresses and aliases and data corruption caused by combining similar information across multiple systems."[54] Individuals and entities impacted by such inaccuracies run the risk of substantial penalties.

Intergovernmental agreements do address this issue in passing, but in a non-systematic and unsatisfactory fashion. They typically allude to the matter and then make provision for the U.S. Competent Authority (Competent Authority) to contact an FFI that is providing inaccurate information.[55] The IRS does furnish guidance to taxpayers for bringing issues before the Competent Authority, but the extent of the related time delays and administrative burdens on taxpayers is unknown.[56]

While Competent Authority intervention would certainly be beneficial in the most complex cases, the IRS should develop a more streamlined approach for resolving routine reporting errors by FFIs that is both timely and readily accessible to average taxpayers. Such a mechanism should certainly be in place by the time FFIs begin reporting account holder information in March 2015. Otherwise, the only practical recourse for affected taxpayers would appear to involve either prevailing on audit or petitioning the U.S. Tax Court for review of a notice of deficiency. In addition to the taxpayer's burden, the amount of IRS resources dedicated to this review would be staggering and also completely avoidable.

The IRS Should Act Responsively and Expeditiously to Implement Stakeholder Suggestions.

The IRS has sought and received significant comments and recommendations from stakeholders with respect to the ongoing development and implementation of FATCA. To its credit, the IRS has been responsive to many of these comments and suggestions. Nevertheless, the IRS has yet to act on important responses from some well-informed stakeholders.

For example, ETAAC has recommended that, to facilitate efficient compliance with the FATCA regime, the IRS should create mechanisms enabling withholding agents to undertake the real-time electronic matching and identification of GIINs assigned by the IRS to registered FFIs.[57] Such compliance technology would replace the current plan of requiring withholding agents to download GIIN numbers monthly and develop their own mechanisms for the review and validation of FATCA compliance by FFIs. ETAAC similarly recommended that the IRS further ease compliance burdens on FFIs by allowing direct uploads of registration information with, and related updates to the IRS.[58]

In response to an information request from the National Taxpayer Advocate, however, the IRS indicated that it would not implement ETAAC's recommendation regarding the real-time matching of

54 Informatica, *Ensure Accurate Account Holder Identification, Matching, and Quality Data for FATCA Compliance* (2013), *available at* http://www.informatica.com/us/solutions/industry-solutions/banking-and-capital-markets/fatca-compliance/.

55 Model Intergovernmental Agreement (Model 1), Article 5, No. 1, *available at* http://www.treasury.gov/press-center/press-releases/Documents/reciprocal.pdf; Model Intergovernmental Agreement (Model 2 Template), Article 4, No.1, *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Model-2-Agreement-to-Implement-11-14-2012.pdf. As per Rev. Proc. 2006-54, the Deputy Commissioner (International), Large and Mid-Size Business Division, acts as the U.S. competent authority in administering the operating provisions of tax treaties, including reaching mutual agreements in specific cases, and in interpreting and applying tax treaties. *See* Delegation Order 4-12 (Rev. 2), IRM 1.2.43 (July 1, 2010).

56 *See* IRS, Competent Authority Assistance, *available at* http://www.irs.gov/Individuals/International-Taxpayers/Competent-Authority-Assistance.

57 The Electronic Tax Administration Advisory Committee Annual Report to Congress (June 2013).

58 *Id*. at 30.

GIIN numbers because the recommendation involved significant technical and data protection issues.[59] According to the IRS, ETAAC's second suggestion regarding direct uploads of registration information is on the list for a system upgrade at some point in the future. As of the date of the National Taxpayer Advocate's inquiry, the IRS had yet to provide ETAAC with a reply to its recommendations.[60] Improved responsiveness to the suggestions and comments of well-informed stakeholders such as ETAAC is indispensable for FATCA implementation to move forward in a most efficient and least burdensome manner.

On a separate front, the National Taxpayer Advocate and the GAO have recommended that the IRS combine, or at least substantially revise, the Form 8938 and the FBAR form because the forms are significantly duplicative, which increases confusion and adds to the compliance burden for taxpayers.[61] In addition, a taxpayer who fails to report a single account on both forms could face two sets of penalties — the FBAR penalty under Title 31 and the non-disclosure penalty under Title 26.[62] To address this point, the IRS has published a FATCA/FBAR comparison chart on IRS.gov. While this chart is a helpful tool, it is not a comprehensive solution to this serious problem. Accordingly, the National Taxpayer Advocate reiterates her recommendation that the two forms be combined or at least substantially revised to eliminate or reduce duplication.

Another group whose input should be considered is the estimated seven million American citizens living abroad. The reporting obligations, the penalties for even inadvertent non-compliance, and the unintended economic consequences of FATCA, including the reported refusal by some FFIs to transact business with would-be U.S. account holders, fall with disproportionate force on this segment of taxpayers. As a result, their ideas for mitigating the negative impact of FATCA should be solicited and carefully examined. The National Taxpayer Advocate suggests the IRS work to obtain the recommendations of American citizens living abroad by holding roundtables or similar mechanisms.

CONCLUSION

The National Taxpayer Advocate recognizes that the implementation of FATCA is still a work in progress. Nevertheless, the IRS has not developed FATCA-specific guidelines under which benign non-filers can seek and obtain reasonable cause or similar relief with respect to related non-disclosure and underreporting penalties, and has yet to provide an adequate mechanism for addressing reporting errors of FFIs regarding U.S. account holders. Moreover, although the IRS has been responsive to some comments and suggestions throughout the development of the FATCA regime, the IRS has not acted upon advice it has received from some well-informed stakeholders. FATCA carries with it the potential for substantial resource burdens and significant due process concerns that will arise to the extent that the regime is not correctly and effectively implemented in practice as well as properly conceived in theory.

59 LB&I, IBC, and IDM response to TAS research request (Nov. 1, 2013).

60 Email correspondence from ETAAC Chair to TAS (Nov. 7, 2013).

61 National Taxpayer Advocate 2012 Annual Report to Congress 134, 141 (Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Programs Discourage Voluntary Compliance by Those Who Inadvertently Failed to Report Foreign Accounts*).

62 *Id*.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Undertake proactive steps to preserve the due process rights of taxpayers, by issuing FATCA-specific guidance for reasonable cause or similar relief, which adopts a measured approach to the imposition of penalties with respect to benign non-filers.
2. Ensure that U.S. taxpayers and non-residents have at their disposal a timely and effective mechanism for addressing information reporting errors of FFIs.
3. Act responsively and expeditiously to implement recommendations of stakeholders that have particular expertise on the effective implementation of FATCA.
4. Take immediate steps to eliminate or reduce duplication between the Form 8938 and the FBAR form.

MSP #24 DIGITAL CURRENCY: The IRS Should Issue Guidance to Assist Users of Digital Currency

RESPONSIBLE OFFICIALS

William J. Wilkins, Chief Counsel
Karen Schiller, Commissioner, Small Business/Self-Employed Division
Debra Holland, Commissioner, Wage and Investment Division
Heather C. Maloy, Commissioner, Large Business and International Division

DEFINITION OF PROBLEM

The use of digital currencies, such as bitcoin, is growing. In the four months between July and December 2013, bitcoin usage has increased by over 75 percent — from about 1,700 transactions per hour to over 3,000.[1] Over the same period, the market value of bitcoins in circulation increased more than ten-fold from about $1.1 billion to $12.6 billion.[2] Over 10,000 businesses reportedly accept payment in bitcoins.[3]

The IRS has not issued specific guidance addressing the tax treatment or reporting requirements applicable to digital currency transactions. Differing opinions are available on the Internet. People who are trying to comply with their federal income tax reporting obligations have complained that they are unsure about the rules.[4] Thus, IRS-issued guidance would promote tax compliance, particularly among those who want to comply. Moreover, it would eliminate the ambiguity that may encourage some digital currency users to avoid taxation and information reporting.

ANALYSIS OF PROBLEM

Digital currency is different from government-backed currency.

Unlike the U.S. dollar, a digital currency does not rely on a banking network for payment processing and is not backed or controlled by a government. Bitcoin is an example of a digital currency.

Bitcoin relies on cryptography and a peer-to-peer network to process and verify payments.[5] People can purchase bitcoins on an exchange or "mine" a limited amount by solving cryptographic problems — an activity that facilitates commerce by verifying or clearing transactions in the public ledger (called a "block

1 Bitcoin Watch, www.bitcoinwatch.com (visited July 23 and Dec.2, 2013). Wikipedia, the online encyclopedia, lists eight digital currencies. *See* http://en.wikipedia.org/wiki/Digital_currency (last visited Nov. 8, 2013). This discussion will focus on bitcoin because it appears to be the most widely used digital currency.

2 Bitcoin Watch, www.bitcoinwatch.com (visited July 23, 2013, and Nov. 8, 2013).

3 Bitpay, www.bitpay.com (last visited Nov. 8, 2013).

4 *See, e.g.*, David Steward, *Digital Currency: A New Worry for Tax Administrators?*, 2012 TNT 209-4 (Oct. 17, 2012); Trace Mayer, *A Lawyer's Take on Bitcoin and Taxes* (Jan. 18, 2012).

5 Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2012), https://en.bitcoin.it/wiki/Bitcoin:A_Peer-to-Peer_Electronic_Cash_System.

chain").[6] If a customer wants to send bitcoins to a merchant, the merchant gives the customer a public key.[7] The customer completes the transaction by signing with his or her public and private keys.

Digital currency is not subject to government manipulation, and facilitates quick, anonymous, irreversible, low-cost transactions.

Bitcoin appeals to those who do not trust banks or other financial institutions, who want to make quick, irrevocable transfers without paying for currency conversion, or who value privacy.[8] The supply of bitcoins is limited and controlled by an algorithm.[9] Unlike government-backed currency, no central authority can devalue bitcoins by printing more. Created in 2009, the supply of bitcoins will gradually increase, as they are minted (*i.e.*, "mined") at a controlled rate, until approximately 2140 when about 21 million are in circulation.[10] Thus, it is less likely to lose value as a result of government intervention or mismanagement than a government-backed currency. Indeed, turmoil in Cyprus reportedly led to a sharp increase in the price of bitcoins as people sought refuge in the digital currency as a kind of cyber gold.[11]

Bitcoin is convenient. International buyers and sellers can conduct transactions without the expense of having an intermediary clear them or convert funds into a national currency.

Bitcoin promotes anonymity because it uses peer-to-peer technology to operate with no central authority or clearinghouse. Although every transaction is open to the public, the identity of the parties is not. A person's bitcoins exist only on his or her computer, rather than on a centralized server that could be monitored and linked to an identity.[12]

Bitcoin is also convenient. International buyers and sellers can conduct transactions without the expense of having an intermediary clear them or convert funds into a national currency. Certain automated teller machines (ATMs), which went

6 *See, e.g.*, Government Accountability Office (GAO), *Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks*, GAO-13-516 (May 2013); Anthony Faiola, *The Rise of the Bitcoin: Virtual Gold or Cyber-Bubble?* Washington Post (Apr. 4, 2013), http://articles.washingtonpost.com/2013-04-04/world/38280106_1_bitcoin-satoshi-nakamoto-monetary-policy.

7 The public key is like an account number and the private key is like a password or PIN. The network uses these numbers to update the block chain, but they are not actually associated with any particular person. An e-wallet is a file on the owner's computer or similar device where bitcoin is stored. If the bitcoin keys are lost, so is the bitcoin. Thus, bitcoin stored in an e-wallet is more analogous to currency than to an account.

8 *See, e.g.*, Maureen Farrell, *Bitcoin Prices Surge Post-Cyprus Bailout*, CNN Money (Mar. 28, 2013), http://money.cnn.com/2013/03/28/investing/bitcoin-cyprus/index.html?iid=HP_LN. For these very reasons, the Federal Bureau of Investigation (FBI) is concerned about the illicit use of bitcoin by criminals, the European Central Bank (ECB) is concerned about the risk it could pose to the financial system, and the Treasury Department's Financial Crimes Enforcement Network (FinCEN) is concerned about its potential to circumvent Bank Secrecy Act (BSA) reporting requirements. *See* FBI, *Bitcoin Virtual Currency Unique Features Present Distinct Challenges for Deterring Illicit Activity*, Intelligence Assessment (Apr. 24, 2012), http://www.wired.com/images_blogs/threatlevel/2012/05/Bitcoin-FBI.pdf; ECB, *Virtual Currency Schemes* (Oct. 2012), http://www.ecb.int/pub/pdf/other/virtualcurrencyschemes201210en.pdf; FIN-2013-G001, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar.18, 2013), http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf.

9 Jon Matonis, *How Cryptocurrencies Could Upend Banks' Monetary Role*, American Banker (Mar. 15, 2013), http://www.americanbanker.com/bankthink/how-cryptocurrencies-could-upend-banks-monetary-role-1057597-1.html.

10 About Bitcoin, http://bitcoin.org/en/about (last visited Nov. 8, 2013). Bitcoins are created each time a miner solves an algorithm to "discover" a new "block" of bitcoin. The rate of block creation is approximately six per hour. *See* Bitcoin, *Controlled supply*, https://en.bitcoin.it/wiki/Controlled_Currency_Supply (last visited Nov. 8, 2013). The number of bitcoins generated per block is set to decrease geometrically, with a 50 percent reduction every four years. *Id*. Bitcoin supply will eventually decline as bitcoins are lost.

11 *See, e.g.*, Hibah Yousuf, *Bitcoins are a Bubble*, CNN Money (Apr. 5, 2013), http://buzz.money.cnn.com/2013/04/05/bitcoin-bubble/?section=money_topstories&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3a+rss/money_topstories+%28Top+Stories. A significant reduction in the rate at which new bitcoin was awarded to miners in 2013 also could have contributed to the recent run-up. *Id*.

12 Anonymous hackers reportedly demanded a ransom paid in bitcoins in exchange for the tax returns of former Republican presidential nominee, Mitt Romney. David Steward, *Digital Currency: A New Worry for Tax Administrators?*, 2012 TNT 209-4 (Oct. 17, 2012).

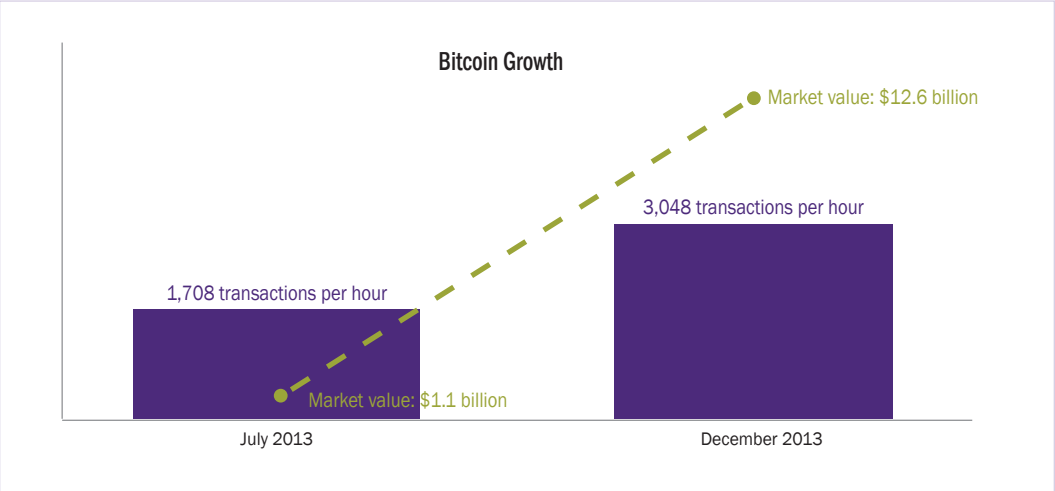
on sale in 2013, can convert between dollars and bitcoins, and bitcoins can be spent via computer or mobile phone.[13]

Among the potential benefits to merchants of bitcoin transactions are that they usually clear relatively quickly, are irreversible, carry low processing fees, and may avoid information reporting.[14] By comparison, credit card transactions generally take longer to clear, can be reversed, and are frequently subject to higher fees and greater information reporting.[15]

Bitcoin is growing.

As noted above, in the five months between July and December 2013, bitcoin usage has increased by over 75 percent — from about 1,700 transactions per hour to over 3,000.[16] Over the same period, the market value of bitcoins in circulation increased more than ten-fold from about $1.1 billion to $12.6 billion.[17] Traders at major banks reportedly keep watch on the bitcoin exchange rate.[18] Over 10,000 businesses reportedly accept payment in bitcoins.[19] BitPay, a business that helps merchants accept bitcoins, reports that over 10,000 businesses accept them.[20] About 60 percent of its clients are in the United States.[21]

FIGURE 1.24.1, Growth in Bitcoin Usage and Market Value



13 See BitcoinATM, https://bitcoinatm.com/ (last visited Nov. 8, 2013); Maureen Farrell, *Bitcoin ATMs Coming Soon*, CNN Money (Apr. 4, 2013), http://money.cnn.com/2013/04/04/investing/bitcoin-atms/index.html?source=cnn_bin.

14 About Bitcoin, http://bitcoin.org/en/about (last visited Nov. 8, 2013).

15 *See, e.g.*, Emily Jane Fox, *The New York Bar that Takes Bitcoins*, CNNMoney (Apr. 8, 2013), http://money.cnn.com/2013/04/08/investing/bitcoin-bar-new-york-city/index.html?source=cnn_bin.

16 Bitcoin Watch, www.bitcoinwatch.com (visited July 23, 2013, and Dec. 2, 2013).

17 *Id*.

18 Naomi O'Leary, *Bitcoin, the City traders' Anarchic New Toy*, Reuters (Apr. 1, 2012).

19 Bitpay, www.bitpay.com (last visited Nov. 8, 2013).

20 *Id*.

21 Brian Browdie, *BitPay Signs 1,000 Merchants to Accept Bitcoin Payments*, American Banker, Bank Technology News (Sept. 11, 2012), http://www.americanbanker.com/issues/177_176/bitpay-signs-1000-merchants-to-accept-bitcoin-payments-1052538-1.html. BitPay features merchants in the following categories: software, hardware, IT services, bars/restaurants, publishing, games, transportation, food delivery, dental services, metal dealers, and political campaign contributions. BitPay, *Featured Merchants*, https://bitpay.com/featured-merchants (last visited Aug. 6, 2013).

The IRS has not issued specific guidance addressing the tax treatment or reporting requirements applicable to digital currency transactions. People who are trying to comply with their federal income tax reporting obligations have complained that they are unsure about the rules.

Recent developments could increase bitcoin acceptance. The World Wide Web Consortium (W3C), a web browser standard-setting body, recently took steps that will allow most browsers to recognize bitcoin payment links.[22] For example, a website could have a "purchase with bitcoin" button, making it easier for consumers to use bitcoins for Internet purchases.

In addition, pending sales tax legislation could increase the use of bitcoins. Several bills would allow states to require out of state vendors to collect sales tax on sales to in-state residents.[23] These bills only provide for sales tax collection when the seller knows the purchaser's address. Unlike credit card sales that transmit the customer's billing address, a bitcoin sale does not identify the residence of the buyer, potentially allowing purchasers to avoid sales tax if they use bitcoins to pay for property that does not require a shipping address (*e.g.*, software or music).[24] For all of these reasons, bitcoins could become more popular as a result of this legislation.

Moreover, if digital currency establishes itself as a new asset class that is not correlated with other asset classes, then investors who want a diversified portfolio may begin to purchase it as an investment rather than as a medium of exchange. Thus, the use of bitcoin and similar digital currencies is likely to increase.

Taxpayers want to know the tax consequences of digital currency transactions.

Legitimate businesses — those who want to comply with the rules and do not want to be associated with tax evaders or criminal enterprises — have urged the government to issue clear rules about the tax consequences of digital currency transactions.[25] Following a 2008 recommendation by the National Taxpayer Advocate to issue guidance on the tax treatment of the transfer of digital items and currency,[26] the IRS created a web page that says it has already "provided guidance on the tax treatment of bartering, gambling, business and hobby income — issues that are similar to activities in online gaming worlds."[27] It suggests that existing guidance covers digital currency transactions, but does not explain when these transactions are sufficiently analogous to the transactions described in the guidance to be covered by existing rules.[28]

To fill the void left by the IRS's lack of specific guidance, interested parties are posting answers to "frequently asked questions" on the Internet about the tax treatment of digital currency transactions, some of

22 Christopher Mims, *Bitcoin Takes An Important Step Toward Becoming Part of Every Web Browser on the Planet*, Quartz (Apr. 25, 2013), http://qz.com/78014/bitcoin-is-now-part-of-the-web-sort-of/.

23 These various bills are generally titled the "Marketplace Fairness Act of 2013." *See e.g.*, S. 743; S. 336; and H.R. 684.

24 *See* Brian Fung, *What an Internet Sales Tax Could Mean for Your Bitcoin Stash,* National J. (Apr. 25, 2013), http://www.nationaljournal.com/tech/what-an-internet-sales-tax-could-mean-for-your-bitcoin-stash-20130425.

25 *See, e.g.*, David Steward, *Digital Currency: A New Worry for Tax Administrators?*, 2012 TNT 209-4 (Oct. 17, 2012). Representatives of the Cryptocurrency Legal Advocacy Group (CLAG), a nonprofit organization based at the University of Mississippi School of law, have also called for the IRS to issue guidance. *Id*.

26 National Taxpayer Advocate 2008 Annual Report to Congress 213.

27 IRS, *Tax Consequences of Virtual World Transactions* (Aug. 3, 2012), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Tax-Consequences-of-Virtual-World-Transactions.

28 The IRS's posting does not fully address the concerns raised by the National Taxpayer Advocate. *See* National Taxpayer Advocate 2008 Annual Report to Congress 213. At a recent hearing before Congress, government officials indicated the IRS is "actively working" on rules for bitcoin. Nathaniel Popper, *Regulators See Value in Bitcoin, and Investors Hasten to Agree*, N.Y. Times B1 (Nov. 19. 2013).

which may be incorrect, incomplete, or misleading.[29] For example, a popular tax preparation company's blog describes bitcoin as "The Taxless Currency."[30] Scholarly papers and at least one digital book are also available on the subject.[31] These materials often raise more questions than they answer.

For example, a U.S. resident generally does not recognize gain or loss when using dollars to purchase goods and services. As a result, some people may be surprised to learn that using bitcoins to purchase goods or services could trigger taxable gains or losses on the bitcoins themselves. Moreover, the character of any such gains or losses is not readily apparent. If a bitcoin is deemed property, then spending it could produce capital gains or losses.[32] On the other hand, if a bitcoin is a "nonfunctional currency" for tax purposes,[33] then spending it could produce ordinary income or loss under Internal Revenue Code (IRC) § 988(a)(1).[34]

Transactions involving digital currency may trigger information reporting, but the IRS is unlikely to get many reports unless it explains the rules.

U.S. citizens and residents who hold more than $10,000 in foreign accounts are required to report the accounts on Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR).[35] Those with certain foreign financial assets in excess of $50,000 must also report foreign accounts (and certain other foreign financial asset information) on Form 8938, *Statement of Specified Foreign Financial Assets*.[36] Like cash, bitcoins that are not held in an "account" may not be subject to these reporting requirements. However, some have speculated about whether bitcoins in e-wallets located on servers in foreign countries should be

29 *See, e.g.*, GAO, *Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks*, GAO-13-516 (May 2013) (discussing unanswered questions and misinformation available on the Internet). *See also* Bitcoin, *Tax Compliance*, https://en.bitcoin.it/wiki/Tax_compliance (last visited Nov. 8, 2013); Bitcoin Forum, *Bitcoin Accounting and taxes*, https://bitcointalk.org/index.php?topic=14334.0 (last visited Nov. 8, 2013); Cryptocurrency Legal Advocacy Group, Inc., CM#1001: *Staying Between the Lines: A Survey of U.S. Income Taxation and its Ramifications on Cryptocurrencies* (Apr. 15, 2012), http://theclag.org/CM%231001Final.pdf; Trace Mayer, *A Lawyer's Take on Bitcoin and Taxes* (Jan. 18, 2012).

30 Josh Ritchie, Bitcoins: *The Taxless Currency*, TurboTax blog (July 18, 2011), http://blog.turbotax.intuit.com/2011/07/18/bitcoins-the-taxless-currency/. Some people may be attracted to bitcoin because they want to avoid taxes. *See, e.g.*, Emily Corwin, *Early Champions of Bitcoin Reap Unexpected Windfall*, NPR (Nov. 29, 2013), http://www.npr.org/2013/11/29/247765501/some-n-h-bitcoin-adopters-favor-cryptocurrency-economy ("The idea here is to create a currency that circumvents both the government and taxes; and avoids banks and transaction fees. As Anarchist Curt Howland puts it...").

31 *See, e.g.*, Lowy and Abraham, *Taxation of Virtual Currency*, 2013 TNT 219-10 (Nov. 13, 2013); Adam Chodorow, *Tracing Basis Through Virtual Spaces*, 95 Cornell L. Rev. 283 (2010); Nell Beekman, *Virtual Assets, Real Tax: The Capital Gains/Ordinary Income Distinction in Virtual Worlds*, 11 Colum. Sci. & Tech. L. Rev. 152 (2012); Steven Chung, *Real Taxation of Virtual Commerce*, 28 Va. Tax. Rev. 733 (2009); Leandra Lederman, *EBay's Second Life: When Should Virtual Earnings Bear Real Taxes?*, 118 Yale L.J. 136 (2009); Theodore P. Seto, *When Is a Game Only a Game?: The Taxation of Virtual Worlds*, 77 U. Cin. L. Rev. 1027 (2009); Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L. J. 1 (2007); Leandra Lederman, *"Stranger than Fiction:" Taxing Virtual Worlds*, 82 NYU L. Rev. 1620 (2007); Trace Mayer, *A Lawyer's Take on Bitcoin and Taxes* (Jan. 18, 2012).

32 *See, e.g., Philip Morris Inc. v. Comm'r*, 71 F.3d 1040 (2d Cir. 1995), *aff'g* 104 T.C. 61 (1995); *National-Standard Company v. Comm'r*, 749 F.2d 369 (6th Cir. 1984), *aff'g* 80 T.C. 551 (1983)). However, if bitcoin were deemed personal use property, then taxpayers could not claim losses. IRC § 165(c). A different information-reporting regime may apply if bitcoin is treated as barter exchange credits or scrip. *See generally* Treas. Reg. §§ 1.6045-1(a)(4); 1.6045-1(e), 1.6045-1(f). Because there is no centralized clearinghouse for bitcoins, barter-exchange information reporting would be impractical.

33 In general, a nonfunctional currency is a currency other than the dollar. *See, e.g.*, Treas. Reg. § 1.988-1(c) (defining nonfunctional currency as a currency other than a taxpayer's (or qualified business unit's) functional currency); IRC § 985 (generally defining a taxpayer's (or qualified business unit's) functional currency as the dollar unless it uses another currency in the economic environment in which a significant part of its activities are conducted and in keeping its books and records).

34 IRC § 988(c)(1)(C). However, personal transactions (*i.e.*, those not related to a trade or business or the production of income) by an individual generally trigger capital gains (rather than ordinary income). *See* IRC § 988(e); Treas. Reg. § 1.988-1(a)(9). A limited exception provides that an individual recognizes no gain upon the disposition of a nonfunctional currency in a personal transaction unless the gain exceeds $200. *See* IRC § 988(e)(2). Other unanswered questions may arise in connection with bitcoin "mining."

35 *See generally* 31 U.S.C. § 5321(a)(5); 31 C.F.R. § 1010.350; Internal Revenue Manual (IRM) 4.26.16 (July 1, 2008). The FBAR is now filed on Form 114, which recently replaced Form TD F 90–22.1. *See* Form 114 (2013), http://www.fincen.gov/forms/bsa_forms/.

36 IRC § 6038D and 1298(f); Notice 2011-55, 2011-29 I.R.B. 53 (July 18, 2011). An FBAR is due on June 30 if the aggregate value of the foreign accounts exceeded $10,000 during the prior calendar year. 31 C.F.R. § 1010.306(c).

reported on these forms.[37] Moreover, when a business receives more than $10,000 in cash, it is generally required to report the transaction on Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, but it is not clear that the receipt of $10,000 in bitcoins would trigger this reporting requirement.[38]

In addition, bitcoin transactions are not necessarily subject to the information reporting that applies to credit cards and other payment cards under IRC § 6050W. Under this provision, a "payment settlement entity" is required to report the amount paid to those who receive more than 200 payments, provided they receive more than $20,000 in total.[39] A payment settlement entity generally must have a contractual obligation to make a payment in settlement of a transaction.[40] However, bitcoin transactions use a peer-to-peer network that does not depend on a contractual settlement mechanism. For this reason, it is not clear that they would trigger a reporting requirement. Thus, it would be helpful for the government to provide examples illustrating the extent to which each of these reporting regimes apply to common digital currency transactions.

CONCLUSION

It is the government's responsibility to inform the public about the rules they are required to follow.[41] The lack of clear answers to basic questions such as when and how taxpayers should report gains and losses on digital currency transactions probably encourages tax avoidance.

Many law-abiding taxpayers want to comply and to distinguish themselves from tax evaders.[42] Some are frustrated by the IRS's lack of guidance. According to the summary of a book that purports to identify bitcoin-related tax issues:

> The IRS is famous for expecting people to comply with tax rules that aren't even written yet. And, they have given no indication that they are going to help Bitcoin users out any time soon…. Because Bitcoin is new technology and not easily defined, in a legal sense, this will allow you to be much more creative and flexible and legally reduce your tax liability.[43]

37 The TD F 90-22.1 Form for Bitcoin, https://bitcointalk.org/index.php?topic=55260.msg657831 (last visited Aug. 6, 2013). Some guidance also suggests that persons who receive money for bitcoins may be required to file Form 104, *Currency Transaction Report*. FIN-2013-G001, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013), http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html. However, a merchant who accepts and transmits funds only as part of the sale of goods or services (other than money transmission services) is apparently excluded. *See id*. n. 10 (citing the exception provided by 31 CFR § 1010.100(ff)(5)(ii)(F)). Comments and articles posted to various websites suggest that some taxpayers are confused about what level of information reporting applies to them. Patrick Murck, *Today, We Are All Money Transmitters… (No, Really!)* (Mar. 19, 2013), https://bitcoinfoundation.org/blog/?p=152.

38 IRC § 6050I; Treas. Reg. § 1.6050I-1. *See also* 31 C.F.R. § 1010.330.

39 IRC § 6050W(a), (e).

40 IRC § 6050W(b).

41 The IRS mission is to "[P]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities…" IRM 1.1.1.1 (Mar. 1, 2006). Notwithstanding the National Taxpayer Advocate's 2008 recommendations, the IRS has still declined to help taxpayers "understand and meet their tax responsibilities" in connection with virtual economies and currencies. *See* National Taxpayer Advocate 2008 Annual Report to Congress 213.

42 *See generally* David J. Mack, ITAX: *An Analysis of the Laws and Policies Behind the Taxation of Property Transactions in a Virtual World*, 60 Admin. L. Rev. 749, 759 (Summer 2008) (urging the IRS to issue guidance on the taxation of virtual transactions, in part, to avoid creating "a society of unintentional tax cheats").

43 Trace Mayer, *A Lawyer's Take on Bitcoin and Taxes* (Jan. 18, 2012).

Promulgating guidance would make it more difficult for taxpayers to be "creative," allow law-abiding taxpayers to keep up with the times without undue burden, reduce traps for the unwary, and make it easier for IRS employees to enforce the law.

RECOMMENDATIONS

The IRS has not explained how existing rules apply to digital currency transactions with enough specificity to allow taxpayers to be sure they are following them or for IRS employees to enforce them.[44] The National Taxpayer Advocate recommends that the IRS issue guidance that at least answers the following questions:[45]

1. When will receiving or using digital currency trigger gains and losses?
2. When will these gains and losses be taxed as ordinary income or capital gains?
3. What information reporting, withholding, backup withholding, and recordkeeping requirements apply to digital currency transactions?
4. When should digital currency holdings be reported on an FBAR or Form 8938, *Statement of Specified Foreign Financial Assets*?

44 Without additional guidance, it will be very difficult for the government to determine (or prove) if a failure to report digital currency income or transactions is inadvertent or willful.

45 The GAO recently made similar recommendations. *See* GAO, *Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks*, GAO-13-516 (May 2013).

MSP #25 DEFENSE OF MARRIAGE ACT: IRS, Domestic Partners and Same-Sex Couples Need Additional Guidance

RESPONSIBLE OFFICIALS

Debra Holland, Commissioner, Wage & Investment Operating Division
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

Recently, the Supreme Court held unconstitutional the Defense of Marriage Act of 1996 (DOMA), § 3, which effectively had precluded federal recognition of same-sex marriage.[1] Recent IRS guidance resolved certain questions of same-sex spouses anticipated by the National Taxpayer Advocate in her 2012 Annual Report to Congress. While the decision and guidance answer fundamental questions, questions about implementation remain unanswered. Additionally, questions of unmarried domestic or civil union partners persist, such as:

- Is alimony after dissolution of a civil union includible by the recipient and deductible by the payer?
- Is community property created upon partnering with an individual of the same sex a taxable gift?

ANALYSIS OF PROBLEM

On June 26, 2013, *United States v. Windsor* generally ruled DOMA unconstitutional, resulting in federal recognition of same-sex marriages.[2] Specifically, the Supreme Court allowed an estate tax marital deduction to a widow whose wife had died in New York. In a companion case, the Supreme Court effectively allowed a lower court to strike Proposition 8, which had essentially banned same-sex marriage in California.[3] Immediately, the administration directed agencies to develop guidance to implement the law as interpreted by the Court.[4]

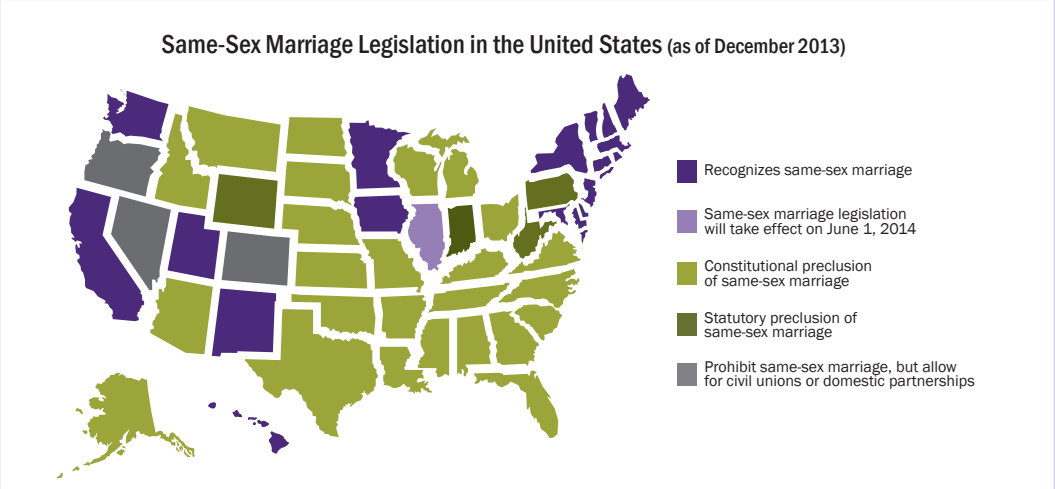
1 *See* 1 U.S.C. § 7, Pub. L. No. 104-199, 110 Stat. 2419.

2 *See U.S. v. Windsor*, 570 U.S. ___ (2013).

3 *See Hollingsworth v. Perry*, 570 U.S. ___ (2013).

4 *See* White House Office of the Press Sec'y, Statement by the Pres. on the Supreme Ct. Ruling on DOMA (June 26, 2013), at http://www.whitehouse.gov/doma-statement (last visited July 3, 2013) ("So we welcome today's decision, and I've directed the Attorney General to work with other members of my Cabinet to review all relevant federal statutes to ensure this decision, including its implications for Federal benefits and obligations, is implemented swiftly and smoothly.").

Currently, 16 foreign jurisdictions, 18 states, and the District of Columbia recognize same-sex marriage, while 32 states do not.[5] Of the latter, three states allow civil unions or domestic partnerships of same- or opposite-sex partners.[6]



Analysis of the latest Census data reflects about 132,000 same-sex marriages and 515,000 unmarried partnerships, about a fifth of which are raising children.[7] These numbers indicate that over a million individual taxpayers need guidance.

5 *See* Council on Foreign Rel'ns, *Same-Sex Marriage: Global Comparisons* (July 31, 2013) (Argentina, Belgium, Brazil, Canada, Denmark, France, Iceland, Mexico, Netherlands, New Zealand, Norway, Portugal, Spain, So. Africa, Sweden, Uruguay), *available at* http://www.cfr.org/society-and-culture/same-sex-marriage-global-comparisons/p31177 (last visited Aug. 19, 2013). American jurisdictions recognizing same-sex marriage are: Calif., Conn., Del., Hawaii, Ill., Iowa, Me., Md., Mass., Minn., N.H., N.J., N.M., N.Y., R.I., Vt., Wash. & D.C. Same-sex marriage legislation will take effect in Ill. on June 1, 2014. *See* http://www.ncsl.org/research/human-services/same-sex-marriage.aspx (last visited Nov. 25, 2013). The N.M. Supreme Court has effectively recognized same-sex marriage. *See Griego v. Oliver*, Docket No. 34,306 (N.M. Dec. 19, 2013). Twenty-nine states with constitutional preclusion of same-sex marriage are: Ala., Aka., Ariz., Ark., Colo., Fla., Ga., Id., Kans., Ken., La., Mich., Miss., Mo., Mont., Neb., Nev., N.C., N.D., Oh., Okla., Ore., S.C., S.D., Tenn., Tex., Utah, Va., Wisc.; four states with statutory preclusion of same-sex marriage are: Ind., Penn., W.V. & Wyo. *See* Nat'l Conference of State Legislatures, *Defining Marriage: Defense of Marriage Acts & Same-Sex Marriage Laws* (July 26, 2013), *available at* http://www.ncsl.org/issues-research/human-services/same-sex-marriage-overview.aspx (last visited Oct. 21, 2013). As of Dec. 23, 2013, Utah was issuing same-sex marriage licenses. *See Kitchen v. Herbert*, No. 2:13-cv-217 (D. Utah, Dec. 20, 2013).

6 Civil unions or domestic partnerships are allowed by three states (Colo., Nev., & Ore.) that prohibit same-sex marriage. *See* Nat'l Conference of State Legislatures, *Defining Marriage: Defense of Marriage Acts & Same-Sex Marriage Laws* (Jul. 26, 2013), *available at* http://www.ncsl.org/issues-research/human-services/same-sex-marriage-overview.aspx (last visited Oct. 23, 2013).

7 *See* Brief of Gary J. Gates as *Amicus Curiae* Supporting Respondents, *Hollingsworth v. Perry*, 570 U.S. ___ (2013) (No. 12-144) 25, 31, *available at* http://www.americanbar.org/publications/preview_home/12-144.html (last visited Aug. 19, 2013); *see also* Gary J. Gates, Ph.D., *Same-sex & Different-sex Couples in the American Community Survey: 2005-2011*, Williams Inst., Univ. of Calif. – L.A. (Feb. 2013), *available at* http://williamsinstitute.law.ucla.edu/research/census-lgbt-demographics-studies/ss-and-ds-couples-in-acs-2005-2011/ (last visited Aug. 19, 2013); Gary J. Gates & Abigail M. Cooke, *U.S. Census Snapshot*: 2010, Williams Inst., Univ. of Calif. – L.A, *available at* http://williamsinstitute.law.ucla.edu/ (last visited Nov. 27, 2013).

Because of the difference between federal and state law, same-sex spouses may have to file tax returns as single at one level but as married at the other. Before *Windsor*, spouses whose state recognized their marriage would file singly for federal but jointly for state tax purposes. While spouses whose state does not recognize their marriage may continue to file singly for state tax purposes, IRS guidance of August 29, 2013, clarified that they should file as married for federal tax purposes.[8]

After the Supreme Court Decision, the IRS Has Answered Questions from Prior ARCs.

The National Taxpayer Advocate's 2010 Annual Report to Congress requested guidance, listing five particular questions.[9] The IRS responded that guidance for a relatively small taxpayer population would be premature pending litigation, yet answered two of our questions along with several others in FAQs on IRS.gov. In anticipation of the Supreme Court decision, the 2012 Annual Report to Congress posed questions about amended returns and conflict of laws which IRS guidance now has answered, as discussed below.[10] In addition, the IRS clarified the rules of construction, which generally allow interpretation of gendered terms in context.[11] In particular, the IRS guidance interprets terms like "husband" and "wife" to apply to same-sex couples.[12]

8 *See* Rev. Rul. 2013-17, 2013-38 I.R.B. 21 (Aug. 29, 2013); *see e.g.* Va. Dep't of Tax'n, Tax Bull. 13-13, *Va. Income Tax Treatment of Same-Sex Marriage* (Nov. 8, 2013).

9 *See* National Taxpayer Advocate 2010 Annual Report to Congress 211, 215 (Most Serious Problem: *State Domestic Partnership Laws Present Unanswered Federal Tax Questions*).

10 *See* National Taxpayer Advocate 2012 Annual Report to Congress 449 (Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*).

11 *See* Rev. Rul. 2013-17; IRC § 7701; 1 USC § 1.

12 *See* Rev. Rul. 2013-17.

Taxpayers May Amend Returns in Open Years.

The 2012 Annual Report to Congress asked:

> If the Supreme Court finds a constitutional flaw in the statute, would that finding be retroactive? Could same-sex spouses amend their returns to file jointly? Conversely, would same-sex spouses who had avoided federal marriage penalties be held harmless?[13]

On the announcement of *Windsor*, no authority appeared to preclude same-sex spouses who would have owed less tax but for DOMA from amending returns for open years, extending to those for which they had filed "protective" claims, as some practitioners had advised, in anticipation of the Supreme Court decision, to preserve their rights to amend their single returns into joint returns.[14] By the same token, no authority appeared to compel same-sex spouses who had properly avoided marriage penalties under DOMA to amend.[15] The IRS guidance has confirmed these propositions.[16] Assuming that legitimate amended returns will arrive, the IRS should make sure that automatic sorting criteria do not ensnare these unusual filings, as discussed further below.

There Is a "Conflict of Laws."

For same-sex spouses whose state of domicile does not recognize their marriage duly celebrated in another state or country (*i.e.* a "conflict of laws"),[17] the *Windsor* case effectively forced the question of which law governs for federal tax purposes. Historically, the IRS had issued revenue rulings to recognize common-law marriage of taxpayers "who later move into a state in which a ceremony is required to initiate the marital relationship" and to disregard state anti-miscegenation statutes as unconstitutional.[18] The IRS cited this precedent in ruling that the state of celebration governs for federal tax purposes even if the taxpayers live in a state that does not recognize their marriage.[19]

The "conflict of laws" among states may be particularly acute for taxpayers who move frequently.[20] Various tax questions may turn on state law. In the case of a taxpayer who moves with a same-sex spouse and the spouse's child to a state that does not recognize their marriage performed in their home state, the IRS will continue to recognize both as spouses even if the taxpayer is no longer a stepparent.[21]

---

13 National Taxpayer Advocate 2012 Annual Report to Congress 545-55 (Status Update: *Federal Tax Questions Continue to Trouble Domestic Partners and Same-Sex Spouses*).

14 *See, e.g.*, Firm Comments on Tax Implications of Supreme Court's DOMA Decision, Tax Notes Today 153-10 (Aug. 1, 2013), reflecting letter to IRS on behalf of Human Rights Campaign, citing *Badaracco v. Comm'r*, 464 U. S. 386, 393 (1984) ("the Internal Revenue Code does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return").

15 Although regulations refer to amendment of inclusions and deductions in open years, applicability to filing status under law then prevailing would be unclear. *See* Treas. Reg. §§ 1.451-1(a); 1.461-1(a).

16 *See* Rev. Rul. 2013-17.

17 "That part of the law of each state which determines whether in dealing with a legal situation the law of some other state will be recognized, be given effect or be applied is called the Conflict of Laws." Restatement of Conflict of Laws § 1 (1934, 2013 ed.).

18 *See* Rev. Rul. 58-66, 1958-1 C.B. 60; Rev. Rul. 68-277, 1968-1 C.B. 526 (citing *Loving v. Va.*, 388 U.S. 1 (1967)).

19 *See* Rev. Rul. 2013-17 (citing Rev. Rul. 58-66).

20 For example, military service members may be assigned to various posts of duty which may or may not recognize same-sex marriage. *See* Under Sec'y of Defense, Memo. re: Further Guidance on Extending Benefits to Same-Sex Spouses of Military Members (Aug. 13, 2013) (authorizing leave to travel to a state that allows same-sex marriage), *available at* http://www.defense.gov/releases/release.aspx?releaseid=16203 (last visited Oct. 22, 2013).

21 *See* Answers to Frequently Asked Questions for Individuals of the Same Sex who Are Married Under State Law, Q&A6, *available at* http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples (last visited Oct. 22, 2013) ("Q6. If same-sex spouses (who file using the married filing separately status) have a child, which parent may claim the child as a dependent?").

Domestic Partners Still Need Guidance.

Questions also remain for domestic partners of the same or opposite sex whose state authorizes registration or civil unions. The 2013 guidance provides that the IRS will not treat partners as spouses.[22] In a 2011 letter to H&R Block that has generated commentary since it came "as a surprise to practitioners,"[23] the IRS Office of Chief Counsel (CC) had appeared to allow Illinois opposite-sex civil union partners to file jointly, which DOMA presumably would not have allowed for same-sex partners.[24] On the other hand, state and federal courts have indicated that partners are not "spouses."[25]

Because of the difference between federal and state law, same-sex spouses may have to file tax returns as single at one level but as married at the other.

Suppose a civil union state, such as Oregon, grants alimony to a former same-sex partner. Presumably, non-spouse partners remain under pre-statutory case law whereby the Supreme Court had held that alimony was a "natural" obligation neither includible by the (ex-) wife nor deductible by the (ex-) husband.[26] For spouses (now including same-sex spouses), Internal Revenue Code (IRC) §§ 71 and 215 would prescribe inclusion of alimony in the gross income of the recipient with a correlative deduction by the payer. In a state that recognizes same-sex marriage, such as nearby Washington, a former same-sex spouse therefore could amend a pre-*Windsor* return to deduct alimony. Under the recent IRS guidance, there seems to be no need for a corresponding amendment by the other ex-spouse, who before *Windsor* had not been required to include alimony received.[27]

In a state like Nevada that authorizes domestic partnership (but not same-sex marriage) resulting in community property, would registration result in a taxable gift of community property?[28] A Private Letter Ruling suggests not, but definitive guidance has not yet appeared.[29] Presumably, sole proprietors will continue to face the anomaly whereby their domestic partners — even if not working in the business — become subject to self-employment tax on half the income from community property because they are not spouses.[30]

Another question persists if a court places a child with the parent's same-sex partner — who may be precluded from adoption in certain states.[31] Would that placement come within the definition of "eligible

22 *See* Rev. Rul. 2013-17.

23 *See* Amy S. Elliott, *IRS Memo Indicates Civil Unions Are Marriages for Federal Tax Purposes*, Tax Notes Today 216-5 (Nov. 7, 2011).

24 *See* Gen. Info. Ltr. (Aug. 30, 2011) ("if Illinois treats the parties to an Illinois civil union who are of opposite sex as husband and wife, they are considered 'husband and wife' for purposes of Section 6013 of the Internal Revenue Code, and are not precluded from filing jointly").

25 *See Smelt v. Orange County*, 447 F.3d 673 (9th Cir. 2006) (denying standing to challenge DOMA by partners who "are not in a relationship that has been dubbed marriage by any state, much less by the State of California") *cert. den'd* 549 U.S. 959 (2006); *Bishop v. Okla.*, 447 F. Supp. 2d 1239, 1247 (N.D. Okla. 2006) (denying partners standing to challenge DOMA even though state statute grants a civil union "all the same benefits, protections and responsibilities under law" as marriage, because "a Vermont civil union is not the equivalent of a marriage"), *rev'd & remanded* on other issue 333 Fed. Appx. 361 (10th Cir. 2009); *Strauss v. Horton*, 46 Cal.4th 364, 445 (2009) ("the designation of 'marriage' is, by virtue of the new state constitutional provision, now reserved for opposite-sex couples"); *Knight v. Schwarzenegger*, 26 Cal.Rptr.3d 687, 690 (2005) ("domestic partners act did not constitute an amendment of the defense of marriage initiative").

26 *See Gould v. Gould*, 245 U.S. 151 (1917). As noted above, the IRS has not confirmed the applicability of this case law.

27 To avoid a "whipsaw," a payor claiming an alimony deduction must report the payee's Social Security number, facilitating IRS verification of the corresponding income inclusion. *See* Treas. Reg. § 1.215-1T, Q&A-1. In situations to which Rev. Rul. 2013-17 applies, however, this ruling would not require amendment of a return correctly filed before *Windsor*.

28 *See* National Taxpayer Advocate 2010 Annual Report to Congress 215.

29 *See* Priv. Ltr. Rul. 2010-21-048 (May 5, 2010).

30 *See* National Taxpayer Advocate 2012 Annual Report to Congress 452-53 (discussing IRC § 1402).

31 *See* Fla. Stat. § 63.042(2)(a) (limiting joint adoption to husband and wife); Miss. Code § 93-17-3 (disallowing adoption by same-sex couples); Utah Code § 78B-6-117 (prohibiting adoption "by a person who is cohabiting in a relationship that is not a legally valid and binding marriage").

foster child," meaning "an individual who is placed with the taxpayer by … judgment, decree, or other order of any court of competent jurisdiction" for tax dependency purposes?[32] Literally, a court may place the child, if not with a traditional foster parent, with a same-sex parent. Thus, the terms of the definition could apply to changing social and legal circumstances. This issue is particularly important for same-sex couples, who are six times more likely than opposite-sex couples to be raising foster children.[33] As a matter of rationale, the only reason to deny the dependency deduction would be failure to recognize the parental role of the partner.[34]

Employment Benefits May Present Conflict of Interest.

Generally, IRC §§ 105 and 106 exclude from gross income the value of employer-provided health coverage, which may extend to the employee's spouse and dependents. Before *Windsor,* in the case of a same-sex spouse who was neither a spouse nor a dependent for federal tax purposes, some employers extended health coverage that was not excludible. After *Windsor*, employers may seek payroll tax refunds to the extent coverage should have been excluded, and employees may amend returns to reduce gross income. IRS guidance confirms the viability of these amendments.[35] On the other hand, an employee who would face a marriage penalty may not wish to amend because in *"many cases the pre-tax savings will not outweigh the additional tax that may be due on an amended return claiming married status*."[36] As a matter of fact, employer and employee may have different desires.[37]

Same-Sex Spouses Now Are Related Parties.

Under DOMA, same-sex spouses were strangers at law, avoiding provisions that resulted in a marriage penalty.[38] By the same token, same-sex spouses did not need to file jointly to claim tax benefits for which opposite-sex spouses would have had to file jointly.[39] After *Windsor*, same-sex spouses are related parties for purposes such as installment sales, discharge of debt, losses, corporations, partnerships, and trusts.[40] If same-sex spouses had made arrangements assuming that their marriage was not recognized under DOMA, they must now make alterations, perhaps confronting property or contract law impediments, to reflect their marriage, at least for federal tax purposes.

---

32 IRC § 152(f)(1)(C) (defining "eligible foster child").

33 *See* Brief of Gary J. Gates as *Amicus Curiae* Supporting Respondents, *Hollingsworth v. Perry*, 570 U.S. ___ (2013) (No. 12-144) 39, *available at* http://www.americanbar.org/publications/preview_home/12-144.html (last visited Aug. 19, 2013); *see also* Gary J. Gates, Ph.D., *LGBT Parenting in the U.S.*, Williams Inst., Univ. of Calif. — L.A. (Feb. 2013) 1, 3, *available at* http://williamsinstitute.law.ucla.edu/research/census-lgbt-demographics-studies/lgbt-parenting-in-the-united-states/ (last visited Aug. 19, 2013).

34 *See* National Taxpayer Advocate 2012 Annual Report to Congress 454.

35 *See* Notice 2013-61, 2013-42 I.R.B. 432 (setting forth guidance for employers and employees to make refund claims or adjustments of payroll tax withholding for some benefits provided and monies paid to same-sex spouses); Answers to Frequently Asked Questions for Individuals of the Same Sex who Are Married Under State Law, available at http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples (last visited Sept. 12, 2013). *See also* Notice 2014-1, 2014-2 I.R.B. 1.

36 CCH Tax Briefing, *IRS Guidance on Same-Sex Marriage* 5 (Sept. 3, 2013) (itals. original).

37 Generally, an employer may claim a refund of overpaid Social Security tax only upon reimbursing the employee portion or obtaining employee consent. *See* Treas. Reg. § 31.6402(a)-2(a).

38 *See* Theodore P. Seto, *Unintended Tax Advantages of Gay Marriage*, 65 Wash. & Lee L. Rev. 1529 (2008).

39 *E.g.* IRC §§ 21(e)(2) (child-care credit), 22(e)(1) (elderly or disabled credit), 23(f)(1) (adoption credit), 25A(g)(6) (Lifetime Learning, Hope Scholarship, and American Opportunity Tax Credits), 32(d) (Earned Income Tax Credit), 36(c)(5) (First-Time Homebuyer Credit), 135(d)(3) (U.S. savings bond interest exclusion for college expenses), 137(e) (adoption exclusion), 163(h)(4)(A)(ii) (home mortgage interest deduction), 221(e)(2) (student loan interest deduction).

40 *See* IRC §§ 453, 108, 267, 318, 707, 672.

…to avoid unnecessarily freezing or rejecting amended and new returns from same-sex married taxpayers, the IRS must train its employees to recognize the many and diverse scenarios that can arise as tax administration transitions to recognizing same-sex marriages.

IRS Employees and Taxpayers Need Instruction.

The IRS needs to train employees and program systems to process relevant returns accurately. From July 24 to August 29, 2013, IRS instructions told employees to hold amended returns that referenced DOMA or *Windsor*.[41] Consequently, the IRS suspended hundreds of these claims.[42] On the other hand, same-sex spousal amendments that were not so labeled may have proceeded without delay – resulting in disparate treatment. The instruction above exemplifies how delays in guidance could have delayed the processing of claims of same-sex spouses.[43]

As individual rather than sophisticated corporate or institutional taxpayers, same-sex spouses need user-friendly guidance. To facilitate compliance, the IRS should consolidate the FAQs and related guidance into a single publication for non-traditional families.

At the same time, the IRS should review its systems for processing amended and new returns.[44] As discussed elsewhere in this report, IRS revenue protection filters may put certain returns in the limbo of refund fraud processes.[45]

CONCLUSION

In response to our 2010 Most Serious Problem discussion, the IRS said that guidance was premature pending litigation for a small taxpayer population.[46] The Supreme Court decision and administration directive disposed of the first concern. Regarding the population, there are significant demographic data, yet the IRS has issued guidance for discrete populations historically.[47] In addition to FAQs, further guidance should be both more authoritative (through published rulemaking like Revenue Ruling 2013-17 and Notice 2013-61 cited above) and more accessible (through a plain-language IRS Publication). Moreover, to avoid unnecessarily freezing or rejecting amended and new returns from same-sex married taxpayers, the IRS must train its employees to recognize the many and diverse scenarios that can arise as tax administration transitions to recognizing same-sex marriages.

41 Servicewide Electronic Research Program (SERP) Alert No. 13A0447 (July 24, 2013) ("If assigned a Form 1040X Amended return and "*Defense of Marriage Act,*" "*DOMA,*" "*Windsor v. the United States,*" or a reference pertaining to "*Recent Supreme Court Decision*" is notated on the claim, HOLD the claim.").

42 *See* IRS response to TAS research request (Oct. 29 & Nov. 1, 2013).

43 On a related note, IRM 21.7.5.3.4(3) (Oct. 1, 2013), relating to estate tax on same-sex couples, directs IRS employees to "Verify the validity of the marriage and U.S. citizenship." By contrast, Form 706, *U.S. Estate (and Generation-Skipping Transfer) Tax Return*, pt. 6 at 4, states: "A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount."

44 *See* IRM 21.6.1.4.3, Processing Separate-to-Joint Adjustments (Sept. 10, 2013); SERP Alert No. 13A0515 (Aug. 30, 2013) ("work all I[ndividual] M[aster] F[ile] DOMA claims in inventory or any new receipts following normal procedures").

45 *See supra* Status Update: *The IRS Still Refuses to Issue Refunds to Victims of Return Preparer Misconduct, Despite Ample Guidance Allowing the Payment of Such Refunds*; Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers*.

46 *See* National Taxpayer Advocate 2010 Annual Report to Congress 218.

47 *See, e.g.*, Rev. Proc. 2010-41, 2010-48 I.R.B. 781 (including guidance for return preparers without a Social Security number due to religious objection); Rev. Proc. 2010-31, 2010-40 I.R.B. 413 (setting forth guidance on when a foreign adoption is final for parents who claim a tax credit for expenses of adopting a child); Notice 2010-30, 2010-18 I.R.B. 650 (containing guidance for military spouses who are civilians working in a U.S. territory but claiming residence in a state); Rev. Rul. 2004-71, 2004-2 C.B. 74 (applying IRC § 6402 refund offset to community property in Arizona and Wisconsin); Rev. Rul. 2004-72, 2004-2 C.B. 77 (applying refund offset to community property in California, Idaho, and Louisiana); Rev. Rul. 2004-73, 2004-2 C.B. 80 (applying refund offset to community property in Nevada, New Mexico, and Washington); Rev. Rul. 2004-74, 2004-2 C.B. 84 (applying refund offset to community property in Texas).

RECOMMENDATIONS

The IRS should issue formal and informal guidance for:

- Same-sex spouses as questions continue to arise;
- Same- and opposite-sex partners who have marital attributes under civil union or similar state law;
- IRS employees to promptly process the foregoing returns and related claims; and
- Review of identity theft and revenue protection filters in light of common filing scenarios by same-sex spouses to ensure that the IRS does not freeze and delay refunds to legitimately married taxpayers.