

### INTRODUCTION

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

The chart that appears immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate has proposed in her 2001 through 2005 Annual Reports to Congress.<sup>1</sup> The Office of the Taxpayer Advocate places a high priority on working with the tax-writing committees and other staffs to try to resolve problems encountered by taxpayers. In addition to submitting legislative proposals in each annual report, the National Taxpayer Advocate meets regularly with members of Congress and their staffs and testifies at congressional hearings to describe the problems faced by taxpayers and to present legislative and administrative recommendations to mitigate those problems. As shown in the chart following this introduction, many of the recommendations included in our annual reports have received considerable congressional attention. The Office of the Taxpayer Advocate continues to work to ensure that each legislative recommendation we have made receives due consideration.

In the 109th Congress that just concluded, Congress enacted into law a proposal recommended by the National Taxpayer Advocate to consolidate appeals of Collection Due Process (CDP) determinations in the U.S. Tax Court.<sup>2</sup> Another provision enacted into law, which provides for Tax Court review of equitable claims in innocent spouse cases, was written in consultation with the Office of the Taxpayer Advocate.<sup>3</sup>

Also in the 109th Congress, the House of Representatives passed legislation to index Alternative Minimum Tax (AMT) exemption amounts for inflation. The National Taxpayer Advocate proposed to index AMT exemption amounts in her 2001 Annual Report to Congress.<sup>4</sup>

In addition, a number of legislative recommendations made by the National Taxpayer Advocate in previous annual reports were included in S. 1321, the Telephone Excise Tax Repeal Act of 2005, which the Senate Finance Committee approved in June 2006. Specifically, S. 1321 included the following proposals:

- ◆ **Regulation of Return Preparers.** Modeled on the National Taxpayer Advocate's proposal, § 203 of the bill instructs the Secretary of the Treasury to promulgate regulations establishing a system to regulate compensated unenrolled return prepar-

<sup>1</sup> An electronic version of the chart is available on the Taxpayer Advocate Service website at <http://www.irs.gov/advocate>. The electronic version of the chart will be periodically updated and will soon include a more detailed description of congressional action.

<sup>2</sup> Pension Protection Act, Pub. L. No. 109-280, § 855 (2006); National Taxpayer Advocate 2005 Annual Report to Congress 447-463. This change was also recommended by the Department of the Treasury.

<sup>3</sup> Tax Relief and Health Care Act, Pub. L. No. 109-432 (2006) (enacting H.R. 6111, 109<sup>th</sup> Cong. § 408).

<sup>4</sup> H.R. 4096, 109<sup>th</sup> Cong. (2005); National Taxpayer Advocate 2001 Annual Report to Congress 166-177.

ers. Preparers would be required to take an initial exam and to renew eligibility every three years, at which point they would be required to demonstrate completion of continuing education requirements.<sup>5</sup>

- ◆ **Increased Preparer Penalties.** Section 203(e) increases preparer penalties in IRC § 6695(a) through (c) from \$50 to \$1,000 or, in the case of three or more offenses in one calendar year, to \$500 per occurrence. The National Taxpayer Advocate proposed to raise these penalties as well as others.<sup>6</sup>
- ◆ **Public Awareness Campaign on Registration Requirements.** Section 203(g) requires the Secretary to conduct a public awareness campaign on the return preparer registration requirements. The National Taxpayer Advocate proposed a similar campaign in her 2003 annual report.<sup>7</sup>
- ◆ **IRA Re-Contributions After Improper Levies.** Section 303 of the bill allows a taxpayer to re-contribute the amount withdrawn from an IRA pursuant to an improper IRS levy where the taxpayer returns the funds (including interest) to the account within 60 days of receipt. This provision is based on a proposal contained in the 2001 annual report.<sup>8</sup>
- ◆ **Extension of Time to Contest IRS Levies.** Section 308 extends the period of time for the IRS to return monetary proceeds from the sale of wrongfully levied property from nine months to two years. This proposal was included in the 2001 annual report.<sup>9</sup>
- ◆ **Direct Filing Portal.** Section 310 of the bill is based on a proposal made by the National Taxpayer Advocate to establish a direct filing portal.<sup>10</sup>
- ◆ **Regulation of Payroll Tax Deposit Agents.** Section 321 of the bill requires licensing and bonding or annual audits of payroll tax deposit agents. A similar proposal was made in the National Taxpayer Advocate's 2004 annual report as part of a package of small business burden reduction recommendations.<sup>11</sup>
- ◆ **Federal Tax Deposit Penalty.** The bill clarifies the application of the Federal Tax Deposit (FTD) penalty in IRC § 6656. In her 2001 annual report, the National Taxpayer Advocate proposed to reduce the maximum FTD penalty rate from ten to

<sup>5</sup> S. 1321, 109<sup>th</sup> Cong. § 203 (2006); National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

<sup>6</sup> S. 1321, 109<sup>th</sup> Cong. § 203(e) (2006); National Taxpayer Advocate 2003 Annual Report to Congress 270-301. The bill also requires that each document filed with the IRS be signed by the paid preparer (if any). Similarly, the 2003 annual report recommended a penalty of \$100 per occurrence for failure to sign specified IRS forms.

<sup>7</sup> S. 1321, 109<sup>th</sup> Cong. § 203(g) (2006); National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

<sup>8</sup> S. 1321, 109<sup>th</sup> Cong. § 303 (2006); National Taxpayer Advocate 2001 Annual Report to Congress 202-214.

<sup>9</sup> *Id.*

<sup>10</sup> S. 1321, 109<sup>th</sup> Cong. § 310 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 471-477.

<sup>11</sup> S. 1321, 109<sup>th</sup> Cong. § 321 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

two percent for taxpayers who make deposits on time but not in the manner prescribed in the Code.<sup>12</sup>

- ◆ **IRS Promotion of Estimated Tax Payments through EFTPS.** Section 705 of the bill requires the IRS to study the potential for increased collection of estimated tax payments through the Electronic Federal Tax Payment System (EFTPS) and to report its findings. This provision is based on a proposal included in the 2005 annual report.<sup>13</sup>
- ◆ **Study on Use of Voluntary Withholding Agreements.** Section 706 requires the Secretary to study the use of voluntary withholding agreements between independent contractors and service recipients. This provision is based on one of the National Taxpayer Advocate's proposals to reduce the tax gap included in her 2004 and 2005 annual reports.<sup>14</sup>

Several provisions of S.1321, although not based on legislative recommendations presented in the National Taxpayer Advocate's Annual Reports to Congress, were drafted in consultation with the Office of the Taxpayer Advocate. For example, § 311 of the bill requires the IRS to establish procedures encouraging Free File companies to provide accessible services for the blind as well as to provide clearer information regarding the availability of free state tax return preparation and filing. The National Taxpayer Advocate raised this issue in testimony before the Senate Finance Committee and the Senate Appropriations Committee.<sup>15</sup>

In the 108th Congress, four of our proposals were enacted into law – a uniform definition of a child,<sup>16</sup> an “above-the-line” deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,<sup>17</sup> authorization for the IRS to enter into partial-pay installment agreements,<sup>18</sup> and the availability of income averaging for commercial fishermen.<sup>19</sup> In addition, at least a dozen of our recommendations

<sup>12</sup> S. 1321, 109<sup>th</sup> Cong. § 405 (2006); National Taxpayer Advocate 2001 Annual Report to Congress 222.

<sup>13</sup> S. 1321, 109<sup>th</sup> Cong. § 705 (2006); National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

<sup>14</sup> S. 1321, 109<sup>th</sup> Cong. § 706 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.

<sup>15</sup> S. 1321, 109<sup>th</sup> Cong. § 311 (2006); *Hearing on Tax Return Preparation Options for Taxpayers Before Senate Committee on Finance*, 109<sup>th</sup> Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Hearing on Internal Revenue Service FY 2007 Budget Request Before Senate Comm. On Appropriations, Subcomm. On Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies*, 109<sup>th</sup> Cong. (Apr. 27, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service). The National Taxpayer Advocate has also noted the need for taxpayer consent before tax return information is sent overseas, which is addressed in § 512 of S. 1321. *See* S. 1321, 109<sup>th</sup> Cong. § 512 (2006); National Taxpayer Advocate 2004 Annual Report to Congress 80-81 (The National Taxpayer Advocate commented in a 2004 Most Serious Problem discussion that taxpayers should be informed before their tax return information is released to a foreign preparer.).

<sup>16</sup> Working Families Tax Relief Act, Pub. L. No. 108-311, § 201 (2004).

<sup>17</sup> American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004).

<sup>18</sup> *Id.* at § 843 (2004).

<sup>19</sup> American Jobs Creation Act, Pub. L. No. 108-357, § 314 (2004).

passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003, or the full Senate as part of S. 882, the Tax Administration Good Government Act of 2004.<sup>20</sup>

We continue to advocate for the proposals we have made previously. In this report, we present ten new Key Legislative Recommendations and five new Additional Legislative Recommendations.

### KEY LEGISLATIVE RECOMMENDATIONS

#### Revising Congressional Budget Procedures to Improve IRS Funding Decisions

Under existing congressional budget procedures, the IRS is grouped together with the rest of the Department of the Treasury, the Department of Transportation, the Department of Housing and Urban Development and other agencies, and spending for all these programs must fit within a pre-established dollar cap. As a result, the IRS competes dollar-for-dollar against many other federal programs for resources. This procedure makes little sense. The IRS is the Accounts Receivable Department of the federal government. On a budget of about \$10.6 billion, the IRS currently collects about \$2.24 trillion a year. That translates to an average return-on-investment of about 210:1. If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line. Since the government is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to fund the IRS at a level that would maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. As the IRS has come under increasing pressure to close the “tax gap,” it should be recognized that the IRS suffers from a “resources gap,” and the IRS's lack of resources is a significant impediment to its ability to close the tax gap and thereby to reduce the federal budget deficit.

<sup>20</sup> The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from ten percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled federal income tax preparers.

### Repeal Private Debt Collection Provisions

The American Jobs Creation Act of 2004 authorized the IRS to enter into qualified collection contracts with private collection agencies.<sup>21</sup> In the 2005 Annual Report to Congress, we discussed how the complexity of federal tax law would impose heavy costs and burdens on the IRS to ensure that taxpayer rights would be fully protected.<sup>22</sup> In the Most Serious Problem section of this report, we address both the lack of a sound business case and lack of a tax administration case for the PDC initiative. As discussed in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the National Taxpayer Advocate recommends the repeal of IRC § 6306.

### Uniform Definition of Qualifying Child

The Working Families Tax Relief Act introduced a uniform definition of a qualifying child, effective for tax years beginning after December 31, 2004. This measure brought about some uniformity for the great majority of taxpayers, who previously had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions. The National Taxpayer Advocate recommends slight modifications to the uniform definition of a qualifying child to address certain unintended consequences.

### Eliminate (Or Simplify) Phase-Outs

Phase-outs reduce the availability of various tax benefits to taxpayers as their income increases. Phase-outs also add needless complexity to the Internal Revenue Code. Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, and likely reduces tax compliance. Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance. The National Taxpayer Advocate recommends that Congress repeal phase-outs. If outright repeal is not possible, Congress should reevaluate existing and proposed phase-outs to ensure they serve their intended purpose, without unduly impairing tax administration.

### Increase the Exempt Organization Information Return Filing Threshold

Organizations exempt from taxation under IRC § 501(c)(3) (except private foundations) are generally required to file annual information returns with the IRS if their annual gross receipts are normally more than \$25,000. This filing threshold has not been adjusted for inflation for 24 years, resulting in more small exempt organizations

<sup>21</sup> The American Jobs Creation Act of 2004, Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306 and other portions of the Code.

<sup>22</sup> We focused on the need for the IRS to provide direct training to private collection agency employees; however, the IRS instituted a train-the-trainer program wherein the private collectors train themselves. National Taxpayer Advocate 2005 Annual Report to Congress 76.

being subject to the filing requirement than originally intended. The recently enacted Pension Protection Act of 2006 requires all exempt organizations not subject to the information return filing requirement to file electronically with the IRS a notice setting forth basic information, such as the organization's name, location, and tax identification number. Because all exempt organizations must now annually report to the IRS, small exempt organizations should not be subject to the complex information return filing requirements. We recommend that the exempt organization information return filing threshold be statutorily increased to \$50,000 and that this threshold thereafter be adjusted for inflation, in increments.

### Filing Issues

Filing a tax return is a taxpayer's entry point into the federal tax system. Considering that our tax system is based on voluntary compliance, it is in the best interest of both the taxpayer and the IRS to ensure that the filing process runs smoothly. When a taxpayer sits down to prepare a return with a commercial preparer, the taxpayer should not worry that his or her confidential tax information will be used or disclosed inappropriately. Further, if a taxpayer inadvertently designates the wrong account number to receive a refund, the IRS should have the proper authorization to resolve the issue.

### Improve Offer In Compromise Program Accessibility

By accepting an offer to compromise a tax debt, the IRS collects money it would not otherwise collect and turns a noncompliant taxpayer into a compliant one. Despite offers being a good deal for both taxpayers and the IRS, the number of offers submitted and accepted has been declining in recent years, and fully 45 percent are simply returned to taxpayers without being considered. Recent legislation requires taxpayers who submit "lump-sum" offers to include a *nonrefundable* partial payment of 20 percent of the amount of the offer with the offer application. The IRS is likely to receive significantly fewer reasonable offers as a result of this requirement. Congress should repeal the partial payment requirement, or if repeal is not possible, it should: (1) provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an offer without considering it on the merits; (2) reduce the partial payment to 20 percent of current income and liquid assets that could be disposed of immediately without significant cost; and (3) create an economic hardship exception to the requirement.

### Elimination of Lengthy Collection Statute of Limitations Extensions

Prior to January 1, 2000 (the effective date of the IRS Restructuring and Reform Act of 1998 (RRA 98)), it was not uncommon for IRS collection personnel to ask taxpayers to extend the applicable collection statute for a period of years in order to guard against an expiration of the statute. Some extensions were for periods as long as ten, 20, 30, 40 or even 50 years. Through a combination of revisions to the law and changes to IRS policy, IRS collection personnel are now restricted in the extent to which they can request taxpayers to waive the collection statute of limitations; however, the changes were not

made retroactive. Consequently, there are still thousands of taxpayers (by our review in excess of 14,000 taxpayers with approximately 32,000 tax accounts) who granted lengthy CSED extensions in exchange for installment agreements prior to January 1, 2000 and who are still being subjected to collection action. Congress should eliminate the IRS's inventory of lengthy CSED extensions.

### **Levies on Fixed and Determinable Assets**

Under present law, the IRS may place a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the CSED to levy upon a taxpayer's retirement or disability benefits without any limitation in time. With the proposed change in law, the IRS would be able to levy upon a taxpayer's fixed and determinable right to retirement or disability benefits only in instances where the taxpayer has engaged in "flagrant" conduct. This recommendation impacts not only retirees and Social Security beneficiaries, but also victims of mass tort litigation. Under present law, the IRS is entitled to update its levy to demand full payment of all assessed and unassessed penalty and interest accruals, up to the full value of the taxpayer's distribution, as though the CSED had never expired. With the proposed change in law, the IRS could levy against a taxpayer's account only up to the dollar amount of taxes, penalties, and interest assessed as of the CSED.

### **Impairment Related Work Expenses**

Congress has enacted a number of tax incentives designed to encourage employment of taxpayers with a disability. One of these incentives is the impairment-related work expense deduction. This deduction allows taxpayers who have a physical or mental disability to claim a deduction for ordinary or necessary business expenses, even if the expenses do not exceed two percent of the taxpayer's adjusted gross income. However, the number of taxpayers who use the deduction is limited because it can only be taken when taxpayers itemize. Congress should amend Internal Revenue Code § 67(d) to allow taxpayers to take the impairment-related work expense deduction as an above-the-line deduction from gross income or, alternatively, restructure the deduction as a credit against tax.

## **ADDITIONAL LEGISLATIVE RECOMMENDATIONS**

### **Innocent Spouse Relief Fixes**

One fundamental problem with the innocent spouse relief rules is that they often require a difficult factual inquiry into what a spouse knew when he or she signed the return in question. In her 2005 annual report, the National Taxpayer Advocate recommended repealing joint and several liability, allocating liability between spouses in accordance with each spouse's income, and also reducing the IRS's ability to collect the liability from the nonliable spouse without first attempting to collect from the liable

spouse. If this comprehensive solution is not possible, Congress should consider the following innocent spouse relief “fixes:”

1. Require the IRS to include the last date to petition the Tax Court in any final determination letter it issues, and provide that a taxpayer may petition the Tax Court at any time before the date specified in an innocent spouse determination letter;
2. Suspend the period for filing a petition in Tax Court to obtain judicial review of an innocent spouse determination while a bankruptcy stay is in effect and for 60 days thereafter;
3. Require the IRS to establish a process, similar to its “audit reconsideration” process, to reconsider innocent spouse determinations after it has issued a final notice of determination;
4. Provide the Tax Court with jurisdiction to review the IRS’s community property relief determinations under IRC § 66(c);
5. Provide that a taxpayer may request equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities; and
6. When equitable relief is granted under IRC § 6015 or IRC § 66(c), provide that any resulting overpayments should be refunded or credited solely to the requesting spouse’s separate liability.

### **Military Issues**

Members of the U.S. armed forces, especially those serving in designated combat zones, face some special federal income tax situations, and are entitled to certain tax benefits due to their service. Increased military action and overseas deployments have highlighted how benefits designed to help U.S. troops can instead have a negative impact on these taxpayers. The National Taxpayer Advocate recommends that Congress amend IRC § 32(c)(2)(B)(vi) to make permanent the provision allowing military personnel the option to include nontaxable combat pay received for service in a designated combat zone as earned income for the purpose of computing the EITC. Additionally, the National Taxpayer Advocate recommends that Congress amend the Code to require a former employer to provide a taxpayer the option of having federal income tax withheld from his or her differential pay.

### **Amend IRC 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error**

The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed. If the taxpayer does not file a refund claim within the statutorily-permitted time, the IRS will not honor the claim, even if the mistake is attributable solely to IRS negligence and the taxpayer did not learn of the error prior to the refund statute expiration date (RSED). The National Taxpayer Advocate recommends that the IRS be required to send



out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged. Alternatively, the National Taxpayer Advocate recommends that taxpayers be allowed two years from the date they learned of the excess collection to file a refund claim if the excess collection is due to IRS negligence.

### **Federal Oversight of Quasi-Governmental Retirement Plans**

Congress has charged the Department of Labor with oversight responsibility over the administration of retirement plans offered by private entities. The Office of Personnel Management has oversight responsibility over the Civil Service Retirement System and the Federal Employees Retirement System. However, there is no parallel federal agency with oversight responsibility over the retirement plans of quasi-governmental entities. The National Taxpayer Advocate recommends that Congress designate a federal agency to maintain oversight responsibility for ensuring that quasi-governmental retirement plans carry out their fiduciary duties.

### **Collection Due Process and Uneconomical Levies**

Recent court decisions have held that the Appeals hearing officer need not verify that the IRS conducted the IRC § 6331(j) review prior to proposing a levy action that triggers the CDP hearing. Courts have also held that the Appeals hearing officer need not take into account the uneconomical nature of the levy under the CDP “balancing” of the government’s interests versus the intrusiveness of the action from the taxpayer’s perspective. However, the failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action renders that hearing meaningless. Failure to weigh these two factors fails to provide the necessary oversight of IRS collection activity that Congress intended. Thus, the National Taxpayer Advocate recommends Congress amend IRC §§ 6330(c)(1), (c)(2)(A), and (c)(3)(C) to clarify that the Appeals hearing officer, prior to making his or her determination under IRC § 6330(c)(3), consider the IRS analysis required under IRC §6331(j) in balancing the government’s interest in efficient tax collection with the taxpayer’s legitimate concern about the intrusiveness of the proposed levy action.

Alternative Minimum Tax				
<b>Repeal the Individual AMT</b> National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385.		Repeal the AMT outright.		
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
	HR 437	English	2/6/2001	Referred to the Ways & Means Committee
	S 616	Hutchinson	3/26/2002	Referred to the Finance Committee
Legislative Activity 107th Congress	HR 5166	Portman	7/18/2002	Referred to the Ways & Means Committee
	<b>Index AMT for Inflation</b> National Taxpayer Advocate 2001 Annual Report to Congress 82-100.		If full repeal of the individual Alternative Minimum Tax (AMT) is not possible, it should be indexed for inflation.	
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 4096	Reynolds	10/20/2005	Passed House 12/7/2005; Placed on Senate Legislative Calendar 12/13/2005.
	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 5505	Houghton	1/3/2003	Referred to the Ways & Means Committee
<b>Eliminate Several Adjustments for Individual AMT</b> National Taxpayer Advocate 2001 Annual Report to Congress 82-100.		Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual Alternative Minimum Tax purposes.		
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 1861	Harkin	10/7/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 1939	Neal	5/12/2003	Referred to the Ways & Means Committee

Tax Preparation and Low Income Taxpayer Clinics					
<p><b>Matching Grants for LITC for Return Preparation</b> National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.</p>	Create a grant program for return preparation similar to the Low Income Taxpayer Clinic (LITC) grant program. The program should be designed to avoid competition with VITA and should support the IRS' goal (and need) to have returns electronically filed.				
	Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
		HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
		S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.	
Legislative Activity 108th Congress	S 476	Grassley	2/27/2003	Referred to the Finance Committee	
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee	
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)	
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee	
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee	
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/an amendment - referred to Senate	
	HR 3991	Houghton	3/19/2001	Referred to the Ways & Means Committee	
	HR 7	Baucus	7/16/2002	Reported by Chairman Baucus, with an amendment referred to the Finance Committee	
<p><b>Regulation of Income Tax Return Preparers</b> National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.</p>	<p>Create an effective oversight and penalty regime for return preparers by taking the following steps:</p> <ul style="list-style-type: none"> <li>• Enact a registration, examination, certification, and enforcement program for federal tax return preparers;</li> <li>• Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return-preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight;</li> <li>• Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and</li> <li>• Require the IRS to take steps within its existing administrative authority, including requiring a checkbox on all returns in which preparers would enter their category of return preparer (<i>i.e.</i>, attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.</li> </ul>				
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status	
		HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
		S 832	Bingaman	4/18/2005	Referred to the Finance Committee

RECOMMENDATIONS

SECTION TWO

<i>(Legislative Activity 109th Congress continued)</i>	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336  9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614	
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee	
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)	
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee	
<b>Public Awareness Campaign on Registration Requirements</b> National Taxpayer Advocate 2002 Annual Report to Congress 216-230.	Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.				
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status	
	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee	
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee	
Legislative Activity 108th Congress	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336  9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.	
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee	
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)	
Legislative Activity 108th Congress	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee	
	<b>Increase Preparer Penalties</b> National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.			
	Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
HR 894		Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee	
S 832		Bingaman	4/18/2005	Referred to the Finance Committee	
Legislative Activity 108th Congress	S 1321	Santorum	6/28/2005	9/15/2006: Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.  9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614	
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee	
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)	

	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
<b>Small Business Issues</b>				
<b>Health Insurance Deduction/ Self-Employed Individuals</b> National Taxpayer Advocate 2001 Annual Report to Congress 223; National Taxpayer Advocate 2004 Annual Report to Congress 388-389.	Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 663	Bingaman	3/17/2005	Referred to the Finance Committee
	S 3857	Smith	9/16/2006	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	S 2130	Bingaman	4/15/2002	Referred to the Finance Committee
<b>Married Couples as Business Co-owners</b> National Taxpayer Advocate 2002 Annual Report to Congress 172-184.	Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/an amendment (5/19/2004)
	S 842	Kerry	4/9/2003	Referred to the Finance Committee
	HR 1640	Udall	4/3/2003	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
<b>Income Averaging for Commercial Fishermen</b> National Taxpayer Advocate 2001 Annual Report to Congress 226.	Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers			
Legislative Activity 108th Congress	Public L. No.: 108-357 § 314 (2004).			
<b>Election to be treated as an S Corporation</b> National Taxpayer Advocate 2004 Annual Report to Congress 390-393.	Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, U.S. Income Tax Return for an S Corporation.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee

<p><b>Regulation of Payroll Tax Deposits Agents</b> National Taxpayer Advocate 2004 Annual Report to Congress 394-399.</p>	<p>Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud.</p>			
<p>Legislative Activity 109th Congress</p>	<p>Bill Number</p>	<p>Sponsor</p>	<p>Date</p>	<p>Status</p>
	<p>S 3583</p>	<p>Snowe</p>	<p>6/27/2006</p>	<p>Referred to the Finance Committee</p>
<p>S 1321</p>	<p>Santorum</p>	<p>6/28/2005</p>	<p>9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.</p>	
<p>9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614</p>	<p><b>Tax Gap Provisions</b></p>			
<p><b>Reporting on Customer's Basis in Security Transaction</b> National Taxpayer Advocate 2005 Annual Report to Congress 433-441.</p>	<p>Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.</p>			
<p>Legislative Activity 109th Congress</p>	<p>Bill Number</p>	<p>Sponsor</p>	<p>Date</p>	<p>Status</p>
	<p>S 2414</p>	<p>Bayh</p>	<p>3/14/2006</p>	<p>Referred to the Finance Committee</p>
	<p>HR 5176</p>	<p>Emanuel</p>	<p>4/25/2006</p>	<p>Referred to the Ways &amp; Means Committee</p>
<p>HR 5367</p>	<p>Emanuel</p>	<p>5/11/2006</p>	<p>Referred to the Ways &amp; Means Committee</p>	
<p><b>IRS Promote Estimated Tax Payments Through EFTPS</b> National Taxpayer Advocate 2005 Annual Report to Congress 381-396.</p>	<p>Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.</p>			
<p>Legislative Activity 109th Congress</p>	<p>Bill Number</p>	<p>Sponsor</p>	<p>Date</p>	<p>Status</p>
	<p>S 1321</p>	<p>Santorum</p>	<p>6/28/2005</p>	<p>9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.</p>
<p>9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614</p>	<p><b>Study of Use of Voluntary Withholding Agreements</b> National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.</p>			
<p>Legislative Activity 109th Congress</p>	<p>Bill Number</p>	<p>Sponsor</p>	<p>Date</p>	<p>Status</p>
	<p>S 1321</p>	<p>Santorum</p>	<p>6/28/2005</p>	<p>9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.</p>
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Joint and Several Liability				
<p><b>Tax Court Review of Request for Equitable Innocent Spouse Relief</b> National Taxpayer Advocate 2001 Annual Report to Congress 128-165.</p>	Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.			
Legislative Activity 109th Congress	Public L. No: 109-432, § 408 (2006)			
Collection Issues				
<p><b>Return of Levy or Sale Proceeds</b> National Taxpayer Advocate 2001 Annual Report to Congress 202-214.</p>	Amend IRC § 6343(b) to extend the period of time within which a third party can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.			
Legislative Activity 109th Congress	Bill Number	Sponsor	Date	Status
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.  9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/an amendment (5/19/2004)
Legislative Activity 107th Congress	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3991	Houghton	3/19/2002	Defeated in House
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House
<p><b>Reinstatement of Retirement Accounts</b> National Taxpayer Advocate 2001 Annual Report to Congress 202-214.</p>	Amend the following Internal Revenue Code sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343: <ul style="list-style-type: none"> <li>• §401 – Qualified Pension, Profit Sharing, Keogh and Stock Bonus Plans</li> <li>• §408 – Individual Retirement Account, SEP-Individual Retirement Account</li> <li>• §408A – Roth Individual Retirement Account</li> </ul>			
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	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House

<p><b>Consolidation of Appeals of Collection Due Process Determinations</b></p> <p>National Taxpayer Advocate 2004 Annual Report to Congress 451-470.</p>	<p>Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.</p>															
<p>Legislative Activity 109th Congress</p>	<p>Pub. L. No. 109-280, § 855 (2006).</p>															
<p><b>Partial Payment Installment Agreements</b></p> <p>National Taxpayer Advocate 2001 Annual Report to Congress 210-214.</p>	<p>Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the Service.</p>															
<p>Legislative Activity 108th Congress</p>	<p>Public L. No. 108-357, § 833 (2004).</p>															
<p><b>Penalties &amp; Interest</b></p>																
<p><b>Interest Rate and Failure to Pay Penalty</b></p> <p>National Taxpayer Advocate 2001 Annual Report to Congress 179-182.</p>	<p>Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.</p>															
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<p><b>Interest Abatement on Erroneous Refunds</b></p> <p>National Taxpayer Advocate 2001 Annual Report to Congress 183-187.</p>	<p>Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice.</p>															
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<p><b>First Time Penalty Waiver</b></p> <p>National Taxpayer Advocate 2001 Annual Report to Congress 188-192.</p>	<p>Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.</p>															
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<p><b>Federal Tax Deposit (FTD) Avoidance Penalty</b></p> <p>National Taxpayer Advocate 2001 Annual Report to Congress 222.</p>	<p>Reduce the maximum Federal Tax Deposit penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the Code.</p>															



	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
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	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in House

**Family Issues**

<b>Uniform Definition of a Qualifying Child</b> National Taxpayer Advocate 2001 Annual Report to Congress 78-100.	Create a uniform definition of “qualifying child” applicable to tax provisions relating to children and family status.
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Legislative Activity 108th Congress	Public L. No. 108-311, § 201 (2004).
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<b>Means Tested Public Assistance Benefits</b> National Taxpayer Advocate 2001 Annual Report to Congress 76-127.	Amend the IRC §§ 152, 2(b), and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or “not married” status.
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	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee

<b>Credits for the Elderly or the Permanently Disabled</b> National Taxpayer Advocate 2001 Annual Report to Congress 218-219.	Amending IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.
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	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	S 2131	Bingaman	4/15/2002	Referred to the Finance Committee

**Electronic Filing Issues**

<b>Direct Filing Portal</b> National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Amend IRC §6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.
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	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336.  9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614

**Office of the National Taxpayer Advocate**

<b>Confidentiality of Taxpayer Communications</b> National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.			
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	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

<b>Access to Independent Legal Counsel</b> National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.			
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	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

**Other Issues**

<b>Disclosure Regarding Suicide Threats</b> National Taxpayer Advocate 2001 Annual Report to Congress 227.	Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.			
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	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

<b>Attorney Fees</b> National Taxpayer Advocate 2002 Annual Report to Congress 161-171.	Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees "above the line." Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.			
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Legislative Activity 108th Congress	Public Law 108-357, § 703 (2004).			
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<b>Attainment of Age Definition</b> National Taxpayer Advocate 2003 Annual Report to Congress 308-311.	Amend IRC § 7701 by adding a new subsection as follows: "Attainment of Age. An individual attains the next age on the anniversary of his date of birth."			
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	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 4841	Burns	7/15/2004	7/21/04 Passed House – 7/22/04 Received in the Senate
<b>Home-based Service Workers</b> National Taxpayer Advocate 2001 Annual Report to Congress 193-201.	Amend IRC § 3121(d) to clarify that home-based service workers (HBWs) are employees rather than independent contractors.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

## RECOMMENDATION

## #1

## REVISING CONGRESSIONAL BUDGET PROCEDURES TO IMPROVE IRS FUNDING DECISIONS

## PROBLEM

The Internal Revenue Service is the Accounts Receivable Department of the United States Government. On a budget of about \$10.6 billion,<sup>1</sup> the IRS currently collects about \$2.24 trillion a year.<sup>2</sup> That translates to an average return-on-investment (ROI) of about 210:1.<sup>3</sup>

Rather than recognizing the IRS's unique role as the revenue generator for the federal government, however, the congressional budget rules treat spending for the IRS exactly the same way they treat spending for all other federal agencies.

The current budget procedures work essentially as follows: Early each year, a spending ceiling is established for a category of programs that currently includes the Department of Transportation, the Department of the Treasury (of which the IRS is a part), the Department of Housing and Urban Development, the Judiciary, the District of Columbia, and independent federal agencies. The House and Senate Appropriations subcommittees with jurisdiction over this grouping of federal programs then must apportion the total number of dollars it receives among them. If more funding is provided for transportation programs, for example, less funding is available for the IRS. Thus, the IRS competes dollar-for-dollar against many other federal programs for resources.

These procedures make little sense. The IRS collects about 98 percent of all revenue the federal government receives.<sup>4</sup> The more revenue the IRS collects, the more revenue Congress may spend on other programs or may use to cut taxes or reduce the deficit. The less revenue the IRS collects, the less revenue Congress has available for other purposes.

If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line.

<sup>1</sup> Department of the Treasury, *FY 2007 Budget in Brief* at 59.

<sup>2</sup> Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006). The IRS actually collected \$2.51 trillion on a gross basis in FY 2006, but issued \$277 billion in tax refunds.

<sup>3</sup> When collecting tax from the vast majority of taxpayers who file returns and pay all or substantially all of the tax they owe voluntarily, the cost the IRS incurs per taxpayer is very low. As the IRS attempts to collect tax from noncompliant taxpayers through broader outreach efforts or through examination and collection actions, the cost per taxpayer rises substantially. Therefore, the *marginal* ROI the IRS achieves as it attempts to collect unpaid taxes is likely to be considerably lower than the average ROI of 210:1 that the IRS achieves on taxes paid voluntarily. But if the IRS were given more resources, most data indicate that the IRS could generate a substantially positive marginal ROI.

<sup>4</sup> In FY 2006, the IRS collected \$2.237 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 95 (Nov. 2006). Total federal receipts for FY 2006 were projected to be \$2.285 trillion. Office of Management and Budget, *Budget of the United States Government Fiscal Year 2007, Historical Tables* at 30 (table 2.1).

Since the IRS is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. If the IRS were given more resources, studies show the IRS could collect substantially more revenue.

Former IRS Commissioner Charles Rossotti has written:

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?”<sup>5</sup>

Yet obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS. Over the past few years, Congress has focused increasing attention on the “tax gap” – the difference between taxes owed and taxes paid. As part of this discussion, it should be recognized that the IRS currently suffers from a “resources gap,” and the IRS’s lack of resources is a significant impediment to its ability to help close the tax gap and thereby reduce the federal budget deficit.<sup>6</sup>

Finally, leaving aside the fiscal implications of the tax gap, the National Taxpayer Advocate believes that the size of the tax gap raises important equity concerns. Compliant taxpayers pay a great deal of money each year to subsidize noncompliance by others. Using data from the 2001 National Research Program study: Dividing the estimated 2001 net tax gap of \$290 billion<sup>7</sup> by the estimated 108,209,000 households that existed in the United States in that year<sup>8</sup> shows that each household was effectively assessed an

<sup>5</sup> Charles O. Rossotti, *Many Unhappy Returns: One Man’s Quest to Turn Around the Most Unpopular Organization in America* 278 (2005). On pages 278-286, Mr. Rossotti presents an interesting personal perspective on the budget process and the politics behind the chronic under-funding of the IRS.

<sup>6</sup> The chairman and ranking member of the Senate Budget Committee supported additional funding for the IRS in the FY 2007 budget resolution. Senator Judd Gregg acknowledged that the existing budget procedures have the effect of shortchanging the IRS. He said: “We’ve got to talk to the [Congressional Budget Office] about scoring on [additional funding provided to IRS]. Clearly there’s a return on that money.” Dustin Stamper, *Everson Pledges to Narrow Growing Tax Gap*, 110 Tax Notes 807 (Feb. 20, 2006). Similarly, Senator Kent Conrad stated: “Rather than a tax increase, I think the first place we ought to look ... is the tax gap. If we could collect this money, we’d virtually eliminate the deficit.” Emily Dagostino, *Senate Budget Resolution Would Increase IRS Enforcement Funding*, 110 Tax Notes 1129 (Mar. 13, 2006).

<sup>7</sup> See IRS News Release 2006-28, *IRS Updates Tax Gap Estimates* (Feb. 14, 2006) (accompanying charts). The National Research Program study estimated that the “gross tax gap” was about \$345 billion and the “net tax gap” (*i.e.*, the gross tax gap reduced by late payments and amounts collected as a result of IRS enforcement actions) was about \$290 billion.

<sup>8</sup> U.S. Census Bureau, Population Division (data as of March 2001).

average “surtax” of about \$2,680 to subsidize noncompliance.<sup>9</sup> That is not a burden we should expect our nation’s taxpayers to bear lightly.<sup>10</sup>

## EXAMPLES

### Example 1: IRS Under-funding Leaves Billions of Dollars on the Table

In his final report to the IRS Oversight Board in 2002, former Commissioner Rossotti presented a discussion titled “Winning the Battle but Losing the War” that detailed the consequences of the lack of adequate funding for the IRS. He identified 11 specific areas in which the IRS lacked resources to do its job, including taxpayer service, collection of known tax debts, identification and collection of tax from non-filers, identification and collection of tax from underreported income, and noncompliance in the tax-exempt sector.

Commissioner Rossotti provided estimates of the revenue cost in each of the 11 areas based on IRS research data. In the aggregate, the data indicated that the IRS was failing to collect \$29.9 billion each year and that it would have taken an additional \$2.2 billion in resources to collect those additional tax liabilities.

### Example 2: IRS Under-funding Gave Rise to Outsourcing Tax Collection

In the same report, former Commissioner Rossotti reported the IRS was receiving sufficient resources to work only 40 percent of some 4.5 million accounts receivable cases each year. IRS research estimated that with an additional \$296.4 million, the agency could collect \$9.47 billion.<sup>11</sup> That translates to a return on investment of 32:1. Among collection cases handled solely through phone calls, the IRS has estimated an ROI of about 13:1.<sup>12</sup>

Yet Congress has not provided the IRS with sufficient funding to work these accounts. This lack of funding led the Administration to request authority to outsource the collection of certain tax debts to private collection agencies. Congress granted the requested authority in 2004,<sup>13</sup> and the IRS began to send cases to private debt collectors in September of 2006.

<sup>9</sup> The IRS’s most current estimate of the tax gap is based primarily on audits it conducted on tax returns filed for 2001.

<sup>10</sup> Significantly, the IRS Oversight Board reports there is substantial public support for an enhanced IRS compliance program provided that it is balanced. The Oversight Board conducts an annual survey of taxpayer attitudes and found that two-thirds of taxpayers support additional funding for both IRS assistance and enforcement. See IRS Oversight Board, *2005 Taxpayer Attitude Survey*.

<sup>11</sup> Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).

<sup>12</sup> Government Accountability Office, GAO-06-1000T, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, at 17 (July 26, 2006).

<sup>13</sup> Pub. L. No. 108-357, § 881(a)(1) (enacting IRC § 6306).

Under the terms of the program, the IRS is paying out commissions of nearly 25 percent of each dollar collected to the private collection agencies. The IRS is also bearing significant additional costs to create, maintain, and oversee the program.<sup>14</sup>

While the ROI of using private collectors is impossible to quantify with precision, internal IRS estimates show that the IRS, if given the funding, could generate a substantially higher ROI than private contractors receiving commissions of nearly 25 percent can produce. For each dollar a PCA collects, the IRS will receive about 75 cents and the PCA will keep about 25 cents, resulting in an ROI of, at best, 3:1. The significant administrative costs the IRS is incurring to run the program, including the opportunity costs of pulling experienced IRS personnel off higher dollar work to assist with this initiative, reduce the ROI further. Despite supporting the use of private debt collectors because of IRS resource limitations, IRS Commissioner Mark Everson has repeatedly acknowledged that IRS employees could collect unpaid taxes more cheaply and efficiently.<sup>15</sup>

The result of under-funding the IRS in this area is that the government is not maximizing its revenue collection and the risk of taxpayer rights violations has been heightened due to the use as collectors of non-governmental employees who will receive only limited taxpayer-rights training.<sup>16</sup>

## RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations:

1. Congress should consider revising its budget rules in a manner that allows the budget and appropriations committees to make a judgment about the answer to the question: “What level of funding will maximize tax compliance, particularly voluntarily compliance, with our nation’s tax laws, with due regard for protecting taxpayer rights and minimizing taxpayer burden?” and then set the IRS funding level accordingly, without regard to spending caps.
2. In allocating IRS resources, Congress should keep in mind that tax compliance is a function of both high quality taxpayer service and effective tax-law enforcement, and it is essential that the IRS continue to maintain a balanced approach to improving tax compliance. Previous attempts to give the IRS

<sup>14</sup> For a detailed discussion of the private debt collection program, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *supra*.

<sup>15</sup> See, e.g., Dustin Stamper, *Everson Admits Private Debt Collection Costs More, Defends Return Disclosure Regs*, 111 Tax Notes 11 (Apr. 3, 2006).

<sup>16</sup> Senator Max Baucus recently highlighted another example of the counterproductive impact of shortchanging IRS funding. In FY 2006, Congress imposed a one-percent across-the-board funding rescission on domestic discretionary spending, and the IRS absorbed a reduction of about \$100 million as a consequence. Citing GAO data, Senator Baucus estimated that the \$100 million in “savings” would ultimately cost the U.S. Treasury about \$1 billion in lost tax collections. He stated: “[E]ven small reductions in collection and taxpayer services are penny-wise, pound-foolish. Sparing the IRS budget may be the best way to bring in more owed revenue and end deficit spending.” News Release, Senator Max Baucus, *\$100 Million Budget Cut to IRS May Cost \$1 Billion or More in 2006 Tax Collections* (May 22, 2006).

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additional funding beyond the levels provided under the spending caps have focused exclusively on providing additional funding for enforcement activities. That is probably because the *direct* ROI resulting from enforcement actions is most susceptible to measurement. However, it is important to emphasize that direct enforcement revenue in FY 2006 came to only \$48.7 billion, or 2 percent, of total IRS tax collections of \$2.24 trillion.<sup>17</sup> The remaining 98 percent of IRS tax collections resulted from a combination of taxpayer service programs and the *indirect* (*i.e.*, deterrent) effect of IRS enforcement actions. To increase compliance, the IRS should make improvements in both taxpayer service and enforcement – and in the technology needed to support them.

3. Congress should provide increases in IRS personnel funding at a steady but gradual pace, perhaps two percent to three percent a year above inflation. We do not think the IRS can ramp up its staffing more quickly without encountering significant transitional difficulties. However, Congress should consider providing more rapid funding increases for technology and research improvements, as the transitional challenges of absorbing additional resources are probably less significant in these areas and the potential exists to generate substantial productivity gains.
4. To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing the IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would require to perform the additional work, and the likely return-on-investment of performing that work. In this connection, Congress should consider directing the IRS to undertake additional research studies, perhaps utilizing the expertise of outside experts, to improve the accuracy of its ROI estimates for various categories of work, especially taxpayer service and the indirect effect of enforcement actions, including the downstream costs of such work. Improved methods should also be developed to verify, retrospectively, the *marginal* ROI that the IRS has achieved for each category of work.

<sup>17</sup> In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of \$48.7 billion. Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was \$2.24 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* 95 (Nov. 2006).



**PRESENT LAW**<sup>18</sup>

For each fiscal year, the Executive Branch develops a detailed budget proposal that the President transmits to Congress. Congress then analyzes the President's proposal, holds hearings, and develops a budget resolution that reflects its priorities.

Like most federal agencies, the IRS begins to prepare its budget request in earnest roughly two years before the beginning of the fiscal year for which it would take effect. The IRS request is subject to review and approval by the IRS Oversight Board and is then submitted to the Secretary of the Treasury for consideration.<sup>19</sup> The Treasury Department has the authority to modify the IRS budget request as it deems appropriate, and it then submits a budget request for the full Treasury Department, including the IRS, to the Office of Management and Budget (OMB) for its consideration. OMB receives and modifies budget requests from all departments and agencies and ultimately prepares a comprehensive government-wide budget proposal that the President submits to Congress no later than the first Monday in February.

After receiving and studying the President's budget proposal, Congress begins developing a budget for the upcoming fiscal year, which begins on October 1st. The Congressional Budget and Impoundment Control Act of 1974, as amended (the "Budget Act"), provides the blueprint for today's congressional budget process.<sup>20</sup> The Budget Act created the House and Senate Budget Committees and requires them to develop a budget resolution each year setting forth budgetary levels for the upcoming fiscal year and planning levels for at least the four succeeding years. Among other things, the budget resolution sets out an aggregate spending total and a breakdown of that total by committee with jurisdiction over the spending.

Federal spending is generally classified as either "mandatory" or "discretionary." Mandatory spending refers to outlays that are required by criteria established in legislation within the jurisdiction of the authorizing committees, rather than by action of the appropriations committees. Examples include Social Security and Medicare benefits, veterans' benefits, and interest paid on the public debt. Discretionary spending refers to all other spending and is determined annually by the appropriations committees.

<sup>18</sup> The description of present law is drawn largely from a report prepared by the staff of the Senate Budget Committee. See Staff of the Senate Comm. On the Budget, 105<sup>th</sup> Cong., *The Congressional Budget Process* (Comm. Print 1998).

<sup>19</sup> See IRC § 7802(d)(4), which provides that the IRS Oversight Board shall have the responsibility "[t]o (A) review and approve the budget request of the Internal Revenue Service prepared by the Commissioner; (B) submit such budget request to the Secretary of the Treasury; and (C) ensure that the budget request supports the annual and long-range strategic plans [of the IRS]."

<sup>20</sup> Pub. L. No. 93-344, 88 Stat. 297 (1974), as amended.

Section 302(a)(2) of the Budget Act requires the budget resolution to allocate levels of budget authority and outlays to each committee.<sup>21</sup> All discretionary outlays are allocated to the Appropriations Committee, and section 302(b) of the Budget Act requires the Appropriations Committee to sub-allocate its allocation among its subcommittees. Thus, as a practical matter, each Appropriations subcommittee competes against every other Appropriations subcommittee for dollars.

Once a subcommittee obtains its § 302(b) sub-allocation, it generally has the authority to apportion its funding as it sees fit among the programs within its jurisdiction. IRS spending falls under the jurisdiction of the subcommittee with responsibility for the budgets of the Department of Transportation, the Department of the Treasury (which includes the IRS), the Department of Housing and Urban Development (HUD), the Judiciary, the District of Columbia, and independent agencies. Colloquially, this is referred to as the “TTHUD subcommittee,” and the bill the subcommittee produces is referred to as the “TTHUD appropriation.” Thus, as a practical matter, a second level of competition occurs at this level, as each Federal agency is essentially pitted for dollars against the other agencies within the Appropriations subcommittee’s jurisdiction.

The appropriations ceiling of the TTHUD subcommittee is not affected by the revenue the IRS collects as a result of its appropriated funds. In FY 2006, the overall TTHUD appropriation was \$88.2 billion.<sup>22</sup>

#### REASONS FOR CHANGE

Spending caps were instituted in 1990 to help control federal spending at a time when Congress became concerned that the budget deficit was spiraling out of control.<sup>23</sup> Significantly, the caps appear to have been imposed with classic spending programs in mind.

The IRS, however, is not a classic spending program. Because the IRS produces a substantially positive return on the funding it receives, more funding for the IRS, within reasonable limits, should produce the opposite effect of more funding for most programs – more resources for the IRS should *reduce* the federal deficit.

Moreover, as a practical matter, the IRS does not fare well in a competition for dollars against true spending programs. Where federal funding for local transportation programs or HUD grants are at stake, for example, state and local governments, private businesses, and advocacy groups will advocate forcefully for their interests, and

<sup>21</sup> The term “budget authority” refers to the authority Congress grants to government agencies to enable them to enter into obligations that will result in outlays. The term “outlays” refers to disbursements made by the U.S. Treasury in the form of checks or cash.

<sup>22</sup> See H.R. Conf. Rep. No. 109-307 (2005) (setting FY 2006 TTHUD appropriation at \$89,135,149,000); Pub. L. No. 109-148, Title III, chap. 8, § 3801 (imposing an across-the-board rescission of one percent against domestic discretionary spending, including the TTHUD appropriation).

<sup>23</sup> Omnibus Budget Reconciliation Act of 1990, Title XIII (Budget Enforcement Act), Pub. L. No. 101-508, 104 Stat. 1388 (1990).

Members of Congress will try to deliver funding for their constituents. By contrast, few outside interests advocate forcefully for more IRS funding. Thus, the nature of the process for allocating dollars between the IRS and other programs under the jurisdiction of the TTHUD Appropriations subcommittee operates to shortchange IRS funding levels.<sup>24</sup>

In light of the IRS's unique role as the government's revenue generator, we believe IRS funding decisions should stand on their own and not be subject to the general spending caps.

### EXPLANATION OF RECOMMENDATIONS

In this section, we will explain each of the recommendations listed above in more detail.

#### Recommendation #1: Revise Process for Making IRS Funding Decisions

In light of the IRS's unique role as the accounts receivable department of the federal government, we recommend that Congress amend the budget rules so that it can first make a judgment about what funding level will maximize federal tax compliance and then fund the IRS at that level, without regard to other budget decisions. In making its judgment about the appropriate IRS funding level, due consideration should be given to protecting taxpayer rights, minimizing taxpayer burden, and preserving principles of equity.

One way to implement this approach would be to keep the IRS within the TTHUD appropriation bill but break that bill into two parts – one providing a funding cap for the IRS and one providing a funding cap for all other programs. The budget committees would set the funding cap for the IRS.<sup>25</sup> The appropriations committees then would retain discretion to appropriate funds at the cap or at a lesser level and to provide direction concerning how the funds are to be spent. The rules should explicitly authorize the committees to set the cap at a level that they believe will maximize tax compliance, especially voluntary compliance, with due regard for the protection of taxpayer rights and minimization of taxpayer burden. In setting the cap and making funding decisions, the budget and appropriations committees would consider the President's budget request as well as input from the tax-writing committees, the Congressional Budget Office (CBO), the Joint Committee on Taxation, the Government Accountability Office, the Congressional Research Service and any other office that they choose to consult to obtain revenue estimates and guidance concerning the likely return on IRS spending.

We offer this approach only as an illustration of a way to implement the general principle we are recommending. We do not have sufficient expertise in the congressional budget process to craft a comprehensive solution, and we are cognizant of the important

<sup>24</sup> See Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 282 (2005) (noting bluntly that “[t]he IRS has no supporters lobbying members of Congress, contributing to political action committees, or knocking on doorbells before elections.”).

<sup>25</sup> Two caps would have to be established for total appropriations – one for the IRS and one for all other discretionary spending.

roles that the budget committees, the appropriations committees, and the tax-writing committees play. Our overriding recommendation is simply that the committees of jurisdiction collaborate to devise and implement procedures that reflect the general principles we have outlined.

We note that in each of the past two years, the Administration proposed a contingent budgetary mechanism known as a “program integrity cap” in an attempt to provide the IRS with additional funding. Under this mechanism, additional funding for tax-law enforcement would have been provided if, but only if, Congress agreed to fund at least the existing base of enforcement activities. The Senate endorsed the concept, but the House did not go along. Although there may have been subtle differences in detail, a similar approach was used in FY 1995 to give the IRS additional funding.<sup>26</sup> Because the budget and appropriations committees have become familiar with this mechanism, it may be a viable way to channel additional funding to the IRS.

However, we have two concerns about the use of program integrity caps. First, the mechanism operates simply to mitigate the effects of what we are arguing is a flawed

<sup>26</sup> For FY 1995, the congressional budget resolution provided for an adjustment of budget resolution spending levels to allow additional funding for an “Internal Revenue Service Compliance Initiative.” H. Con. Res. 218, 103<sup>rd</sup> Cong. § 25 (1994) (enacted). The provision authorized an adjustment to reflect amounts of additional new budget authority or additional outlays of up to \$405 million per year provided certain conditions were met. Although there is no indication the initiative failed or generated strong opposition, control of Congress changed the next year and the provision was repealed for subsequent years. H. Con. Res. 67, 104<sup>th</sup> Cong. § 209 (1995) (enacted). The joint explanatory statement accompanying the conference report on the FY 1995 budget resolution provision (which originated as Section 54 of the Senate amendment to the House-passed budget resolution) provided additional information about the specifics of the approach: Section 54 of the Senate amendment allows for additional appropriations for an Internal Revenue Service Compliance initiative. If the Congress appropriates the base amounts requested for the Internal Revenue Service in the President’s budget for fiscal year 1995 and a variety of other conditions are met, then Congress can also appropriate additional amounts for a compliance initiative without triggering points of order that might otherwise lie against such legislation. Under sections 54(a) and 54(b) of the Senate amendment, upon the reporting of an appropriation bill funding the compliance initiative and the satisfaction of the conditions listed, the Chairman of the appropriate Budget Committee must file revised appropriations caps, allocations to the Appropriations Committee, functional levels, and aggregates to clear the way for the incremental spending for the initiative. This procedure parallels that used in reserve funds . . . , which allow deficit-neutral legislation to proceed without points of order even if that legislation pays for direct spending with revenues. Similarly, section 54 of the Senate amendment allows appropriations legislation to proceed without points of order if it is demonstrated that the revenues raised by those appropriations would offset the costs of the appropriations. The first parenthetical language in the matter after subsection (a)(3) establishes the first condition precedent, that the Congress appropriate the base amounts requested for the Internal Revenue Service in the President’s Budget for fiscal year 1995. Subsection (d) lists the other conditions: enactment of a Taxpayer Bill of Rights 2, initiation of an Internal Revenue Service educational program as mandated by the Taxpayer Bill of Rights 1 and 2, a finding by the Congressional Budget Office that by virtue of revenues raised, the appropriations will not increase the deficit, and a restriction of funds made available pursuant to this authority to carrying out Internal Revenue Service compliance initiative activities. The House resolution contains no such provision. The conference agreement contains as section 25 a provision similar to that in Section 54 of the Senate amendment. In particular, section 25(a)(2) of the conference agreement more explicitly spells out the condition precedent that Congress first appropriate the base amounts requested for the Internal Revenue Service in the President’s Budget for fiscal year 1995 before the provisions of this section apply. Similarly, the conference agreement revises subsection (d), which sets forth the other conditions precedent. H.R. Conf. Rep. No. 103-490 at 58 (1994).

conceptual approach to funding the IRS. It would not alter the existing framework under which the IRS competes for funding against other government programs, and it would not explicitly peg future IRS funding decisions to the goal of maximizing tax compliance. Second, the mechanism in the past has been proposed solely to boost enforcement spending (*i.e.*, the additional funding could be used only for tax-law enforcement and would only be provided if Congress agreed to fund at least the existing base of enforcement activities). As discussed below in more detail, tax compliance is a function not only of enforcement but also of taxpayer service, and it is important to maintain a balanced approach between the two. If program integrity caps are used in the future, we urge that consideration be given to providing additional funding for taxpayer service as well as enforcement.

### **Recommendation #2: Maintain a Balanced Approach to Tax Compliance That Emphasizes the Central Role of Taxpayer Service Programs as Well as Enforcement Actions**

In FY 2006, IRS enforcement activities (which include collection actions, examinations, and document matching) resulted in the direct collection of \$48.7 billion. The IRS has cited this figure, a modest increase over direct revenue collected in the prior year, as a measure of its progress in improving tax compliance.

As noted above, however, direct enforcement revenue constituted only about 2 percent of the \$2.24 trillion the IRS collected in FY 2006.<sup>27</sup> Fully 98 percent of IRS collections resulted from the IRS's taxpayer service programs and the *indirect* deterrent effects of its enforcement actions.<sup>28</sup>

When it comes to tax compliance, taxpayer service represents the carrot and enforcement represents the stick. Both play critical roles.<sup>29</sup> Indeed, the IRS's five-year strategic plan is based on the formula: "Service + Enforcement = Compliance."<sup>30</sup> The IRS views service as helping taxpayers to understand their tax obligations through such activities

<sup>27</sup> In FY 2006, IRS enforcement activities (collection actions, examinations, and document matching) resulted in the direct collection of \$48.7 billion. Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006). Total tax collection by the IRS, after the issuance of tax refunds, was \$2.24 trillion. Government Accountability Office, GAO-07-136, *Financial Audit: IRS's Fiscal Years 2006 and 2005 Financial Statements* at 95 (Nov. 2006).

<sup>28</sup> IRS enforcement actions have two indirect deterrent effects – one on other taxpayers and one on the future compliance of the taxpayer against whom enforcement action was taken. First, as word of tax enforcement actions against some taxpayers spreads, other taxpayers realize there is a risk that noncompliance on their part will be detected, and that realization makes them more likely to comply. Second, once a taxpayer has faced enforcement action in one year, the taxpayer himself is more likely to comply in future years.

<sup>29</sup> In 1996, for example, IRS researchers estimated that every dollar the IRS spent on return preparation generated \$396 of additional tax revenue. See Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996). See Most Serious Problem: *Small Business Outreach*, *supra*; Most Serious Problem: *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance*, *supra*; Most Serious Problem: *Reasonable Accommodations for Taxpayers with Disabilities*, *supra*.

<sup>30</sup> See *IRS Strategic Plan 2005-2009*. In the Preface to this report, the National Taxpayer Advocate discusses an alternative way to view IRS programs based on taxpayer behavior.

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as publicizing the requirement to file tax returns and pay taxes, publishing tax forms and explanatory guidance, answering taxpayers' tax-law questions and even preparing tax returns, and assisting taxpayers who need other help in complying.<sup>31</sup> The IRS views enforcement as including such activities as verifying compliance on the part of taxpayers, reaching determinations about a taxpayer's correct tax liability if different from what the taxpayer reported, litigating against taxpayers where disputed issues arise, and taking actions to collect unpaid tax.

With additional funding, the IRS can do more through taxpayer service to improve compliance. For example, many small businesses are started by individuals who lack detailed knowledge of the tax laws and do not have the resources to hire tax attorneys or accountants. When they hire a few workers, they often do not realize that they are assuming tax reporting, tax withholding, and tax payment obligations, and they often do not understand enough about the details of complying with the requirements to do so with reasonable effort.

Another example: The largest chunk of the tax gap is attributable to income underreporting. Consideration should be given to the possible benefits of launching an advertising campaign each tax season that links the payment of taxes with civic duty and emphasizes our shared responsibility for supporting our nation's important services and benefits. If done well, such a campaign could change attitudes toward the tax system. Even if a public campaign only reduced underreporting by two or three percent, the dollars involved could translate to a significant return on investment. Moreover, if this campaign were incorporated into secondary education civics and business administration lessons, we could help future taxpayers understand the importance of compliance with tax obligations.

An analysis of IRS enforcement data illustrates both the lack of adequate enforcement resources and the payoff of closing as much of the tax gap as possible through improved taxpayer service. The IRS examination rate is currently less than one percent, and the majority of examinations are limited-scope examinations conducted by mail.<sup>32</sup> Traditional face-to-face audits occur at a rate of only 0.023 percent, or about one out of every 435 taxpayers.<sup>33</sup> Even if the IRS were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year and only about one out of every 217 taxpayers would be subject to a face-to-face audit.

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<sup>31</sup> Former Commissioner Rossotti has written:

Some critics argue that the IRS should solve its budget problem by reallocating resources from customer support to enforcement. In the IRS, customer support means answering letters, phone calls, and visits from taxpayers who are trying to pay the taxes they owe. Apart from the justifiable outrage it causes among honest taxpayers, I have never understood why anyone would think it is good business to fail to answer a phone call from someone who owed you money.

Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* 285 (2005).

<sup>32</sup> Internal Revenue Service, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 20, 2006).

<sup>33</sup> *Id.*

In short, many aspects of taxpayer service are akin to a wholesale operation that reaches groups of taxpayers (*e.g.*, outreach and education), while IRS audits constitute a far more costly retail operation that requires individual taxpayer contact. Thus, the IRS should pursue a balanced approach to tax compliance that puts priority emphasis on improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.<sup>34</sup>

### Recommendation #3: Provide Steady But Gradual Increases in IRS Funding

In former Commissioner Charles Rossotti's final report to the IRS Oversight Board in 2002, he described the serious total staffing shortages the IRS was facing. He stated that the IRS needed "steady growth in staff in the range of 2 percent per year."<sup>35</sup> The context shows he was discussing real increases (*i.e.*, increases above those required to maintain current services).

At first blush, real annual staff growth of two percent might appear to be an extremely limited request, but the IRS faces significant challenges in adding and training staff. Examination and collection procedures, in particular, are complex, as is the underlying tax law, and experienced personnel must be pulled off revenue-producing priority cases to provide extensive training to new hires. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate taxpayer rights.

However, the IRS probably can absorb more rapid funding increases in technology and research, both of which have the potential to increase IRS productivity substantially.

Better technology would allow the IRS to achieve significant efficiencies in a broad range of taxpayer service and enforcement areas. For example, it would allow the IRS to offer taxpayers a wider range of e-filing options to increase the number of taxpayers who file their returns electronically rather than on paper (which would save IRS the cost of manually entering data from the roughly 64 million individual income tax returns it received on paper last year),<sup>36</sup> and it would allow the IRS to expand its document-matching capabilities, which tend to produce high returns on investment because automated processes are relatively inexpensive to operate and maintain.

<sup>34</sup> For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance both to help increase future compliance and to better apply IRS outreach, education, and other voluntary compliance initiatives.

<sup>35</sup> Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 18 (Sept. 2002).

<sup>36</sup> Internal Revenue Service Data Book: 2005, table 3 (showing total number of individual income tax returns filed in FY 2005 was 132,844,632) and table 4 (showing total number of individual income tax returns filed electronically in FY 2005 was 68,476,328). The total number of individual income tax returns filed on paper in FY 2005 – 64,368,304 – is the difference between these numbers.

Better research would allow the IRS to assess the most cost effective ways of meeting taxpayer service needs and to target its limited enforcement resources to maximize its return on investment. We discuss the importance of obtaining more accurate ROI estimates for the IRS's major categories of work under Recommendation #4 below.

In the past, congressional support for additional IRS funding has come in fits and starts. It will not be helpful to provide too much additional funding immediately. It also will not be helpful to provide additional funding for a year or two and then to change direction. To maximize its ability to do its job, the IRS needs to receive gradual but steady real increases in its total funding every year for at least the next five to ten years.

**Recommendation #4: Direct the IRS to Improve the Accuracy of Its ROI Estimates and Report to Congress Annually or Semiannually on Its Progress**

To assist Congress in performing its oversight responsibilities and determining the appropriate IRS funding level in future years, Congress should require the IRS to provide annual or semiannual reports detailing the IRS's progress in handling all significant categories of work, including the known workload, the percentage of the known workload the IRS is able to handle and the percentage of the known workload the IRS is not able to handle, the additional resources the IRS would need to perform the additional work, and the likely return-on-investment of performing that work. Much of this information was published in former Commissioner Rossotti's final report to the IRS Oversight Board,<sup>37</sup> but we have not seen updated statistics published in this format since that time.

To provide Congress with meaningful information, the IRS will need to conduct more research to improve the accuracy of its ROI calculations. As we have noted above, direct enforcement revenue constitutes only about two percent of the revenue the IRS collects. Ninety-eight percent of the revenue the IRS collects derives from its taxpayer service programs and the indirect deterrent effect of its enforcement activities. Yet the IRS currently does not have adequate data on which to make accurate estimates of the ROI of its various categories of work, including taxpayer service programs and the indirect effect of its enforcement activities as a whole and broken down by their key components. Developing better data should be made a priority objective. Moreover, ROI estimates should include costs relating to the downstream consequences – such as increased phone calls or correspondence, Appeals conferences, and Taxpayer Advocate Service cases – of the various categories of IRS work.

We acknowledge that developing reasonably accurate modeling is a significant challenge and will require a commitment of resources. Nonetheless, we have recommended in the past and continue to believe that this information will more than pay for itself by

<sup>37</sup> Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System* 16 (Sept. 2002).



helping the IRS make better resource allocation decisions and will provide Members of Congress with additional information on which to base future funding decisions.<sup>38</sup>

### Possible Concerns About This Proposal

In talking with congressional staff and others when formulating this proposal, a number of helpful questions and concerns emerged. We list and attempt to address some of the more significant ones.

**Concern #1:** *The Congressional Budget Office cannot accurately quantify the return on investment associated with most IRS expenditures. How can Congress be expected to set a budget level based on the goal of maximizing tax compliance if CBO can't determine what that level is?*

**Response:** We think it is important to avoid making the “perfect” the enemy of the “good.” If Congress believes more funding will improve compliance and increase net tax revenue, it should not be hamstrung in its ability to provide that funding because of the limitations of existing modeling. Just as a business sets a budget for its accounts receivable department by making its best judgment on the basis of available information, Congress should make its best judgment based on available information about the optimal IRS funding level to maximize tax compliance. In making its judgment, it would of course take into account the best estimates and advice of the CBO and others.

Our suggestion that IRS funding be ramped up slowly should also help to allay this concern: Congress can reassess each year whether the IRS is spending its funding wisely and make appropriate adjustments, if warranted. Moreover, if Congress provides the IRS with the funding to conduct much-needed research about the ROI of various categories of its work, this information will inform congressional funding decisions in the future.

**Concern #2:** *Congress periodically hears special pleas that various government programs should be exempt from the budget caps. If the IRS is exempted, wouldn't that create a slippery slope that ultimately could undo the function of the caps?*

**Response:** The case for treating the IRS differently is unique. The IRS collects 98 percent of all federal revenue. No other agency or program can make that claim. And as a consequence of the IRS's role as the government's revenue generator, the availability of funds for Congress to appropriate to other agencies and programs rests on the IRS's ability to maximize tax compliance. That is why we believe Congress should make IRS funding decisions based solely on its judgment about what funding level would maximize compliance, especially voluntary compliance, with due regard

<sup>38</sup> The congressional budget rules currently prohibit the CBO or OMB from treating changes in discretionary appropriations to the IRS as giving rise to scorable increases in tax receipts. See H.R. Conf. Rep. No. 101-964 (1990). See also Office of Management and Budget, *OMB Circular No. A-11*, Part 8, Appendix A, Principle 14 (2006). Since changes to IRS funding levels undoubtedly have an impact on tax collections, this prohibition seemingly reflects the current difficulty of devising accurate estimates.

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for the protection of taxpayer rights and minimization of taxpayer burden. To do otherwise actually shortchanges other programs.

Moreover, excessive concern about “slippery slopes” can result in reluctance to make meritorious exceptions to general rules. If an exception is meritorious, it is important to provide a rationale that explains the exception and draws the exception narrowly. We think the case for making IRS funding decisions without regard to spending caps constitutes a meritorious exception.

**Concern #3:** *Would setting a goal of maximizing compliance cause millions more taxpayers to get audited every year and potentially lead to rampant violations of taxpayer rights?*

**Response:** We would oppose that outcome strongly and do not believe our proposal should lead to that result. Our proposal emphasizes (1) gradual increases in funding in the range of two percent a year (after inflation); (2) the need to bolster taxpayer service programs and not merely enforcement; and (3) the overriding importance of protecting taxpayer rights and minimizing taxpayer burden. With a current face-to-face audit rate of only one out of every 435 taxpayers, the IRS can do considerably more compliance work before audit rates become unacceptably high – and it can certainly improve and expand taxpayer services without burdening anyone.

Moreover, Congress will serve as a natural check against potential IRS overzealousness, assisted by input from the National Taxpayer Advocate, the IRS Oversight Board, the Treasury Inspector General for Tax Administration (TIGTA), and the Government Accountability Office (GAO). If taxpayers begin to experience significant inconvenience as a result of new IRS initiatives, they will complain to their elected representatives and Congress will have the opportunity to intervene, just as it did when it passed the IRS Restructuring and Reform Act of 1998 in response to taxpayer complaints about IRS overzealousness in the 1990s.

**Concern #4:** *In the past, there has not always been a sense that the IRS has spent its funding wisely. What kind of oversight is needed?*

**Response:** The tax-writing committees and the Appropriations subcommittees with jurisdiction over IRS funding should conduct oversight and make judgments, assisted by input from the GAO, TIGTA, the IRS Oversight Board, and the National Taxpayer Advocate.

**Concern #5:** *How much difference will more funding make in closing the tax gap?*

**Response:** The National Taxpayer Advocate has long advocated three broad strategies for closing the tax gap: (1) fundamental tax simplification, with an emphasis on making economic transactions more transparent; (2) expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and (3) a more robust IRS compliance program that appropriately balances taxpayer service and enforcement.

More robust taxpayer service and enforcement initiatives will not close a \$290 billion tax gap by themselves, but they could well reduce the gap by tens of billions of dollars. As discussed above, former Commissioner Rossotti's final report to the IRS Oversight Board indicated that the IRS was leaving \$29.9 billion on the table each year and that it would take an additional \$2.2 billion in resources to collect those additional tax liabilities. While better research is needed to develop revised and more precise estimates, these data provide a general sense of the return more robust compliance could produce.

**Concern #6:** *Would this proposal undermine the role of the IRS Oversight Board, the Treasury Department, or the Office of Management and Budget in developing the Administration's budget request for the IRS?*

**Response:** No. The IRS fulfills one part of the broader mission of the Treasury Department, and the Treasury Department historically has exercised (and should exercise) significant oversight over the IRS. Under existing procedures, the IRS budget request is (1) subject to review and approval by the IRS Oversight Board, (2) reviewed and modified by the Secretary of the Treasury and his budget staff, and (3) submitted by the Secretary of the Treasury to the Office of Management and Budget, which ultimately makes decisions about the Administration's budget request on behalf of the President. No part of this proposal would alter those procedures in any way.

## RECOMMENDATION

## #2 REPEAL PRIVATE DEBT COLLECTION PROVISIONS

**PROBLEM**

The American Jobs Creation Act of 2004 authorized the IRS to enter into qualified collection contracts with private collection agencies.<sup>1</sup> In the 2005 Annual Report to Congress, we discussed how the complexity of federal tax law would impose heavy costs and burdens on the IRS to ensure that taxpayer rights would be fully protected.<sup>2</sup> In the Most Serious Problem section of this report, we address both the lack of a sound business case and lack of a tax administration case for the PDC initiative. As discussed in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the National Taxpayer Advocate recommends the repeal of IRC § 6306.

**EXAMPLE**

The IRS placed a continuous levy on a taxpayer's Alaska Permanent Fund dividend payment to satisfy a delinquent tax debt. The taxpayer claimed to the IRS that he had already sent a payment to the IRS to satisfy the debt. The taxpayer believed the IRS was still investigating his claim that the payment had been received when his account was assigned to a private debt collection agency, which began calling the taxpayer on an almost daily basis for payment. Pursuant to the IRS's Private Debt Collection Policies and Procedures Guide, private collectors are encouraged to maintain pursuit of full payment even when the IRS is receiving payments by levy.<sup>3</sup> The taxpayer came to TAS which traced the taxpayer's payment and discovered that the taxpayer had in fact paid the delinquent amount to the IRS. TAS obtained a return of the IRS's levy proceeds and had the case transferred back to the IRS from the private debt collector.

**RECOMMENDATION**

Repeal IRC § 6306, thereby terminating the PDC initiative.

**PRESENT LAW**

Internal Revenue Code § 6306(a) authorizes the IRS to enter into "qualified collection contracts." A qualified collection contract is a contractual arrangement between the IRS and private collection agencies (PCAs) in which the PCAs are engaged to:

- ◆ Locate and contact taxpayers;

<sup>1</sup> The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306 and other portions of the Code.

<sup>2</sup> We focused on the need for the IRS to provide direct training to private collection agency employees; however, the IRS instituted a train-the-trainer program wherein the private collectors train themselves. National Taxpayer Advocate 2005 Annual Report to Congress 76.

<sup>3</sup> IRS Private Collection Agency Policy and Procedures Guide 49-51 (2006).

- ◆ Request full payment from taxpayers: if the taxpayers cannot make full payment, PCAs are authorized to offer installment agreements providing for full payment of the liability for a period of up to five years; and
- ◆ Obtain specified financial information from taxpayers.<sup>4</sup>

As compensation for these services, IRC § 6306(c) authorizes PCAs to retain up to 25 percent of the amount collected from taxpayers.<sup>5</sup> PCAs employees are also subject to certain restrictions.<sup>6</sup>

**REASONS FOR CHANGE**

As we set out in detail in the Most Serious Problem, True Costs and Benefits of Private Debt Collection, the central tenets underpinning the Private Debt Collection initiative are not supported by the facts:

- ◆ The initiative is not cost effective;
- ◆ The cases assigned to private collectors are not “easy;”
- ◆ The IRS is substantially different from other federal agencies using private collectors; and
- ◆ The hidden costs to customer service, transparency, consistency and tax compliance make this initiative cost prohibitive.<sup>7</sup>

**Cost Efficiency**

The IRS acknowledges that it performs this work more efficiently than private collectors, but has stated as justification for the initiative that it does not have the resources to work these cases.<sup>8</sup> More recently, however, the IRS has told us that it will not work these cases, even if additional resources are allocated to the IRS.<sup>9</sup> This reasoning is contrary to the typical rationale used by the federal government for contracting out its functions, which focuses first on whether the particular work to be performed is commercial (and thus capable of being contracted out) and not inherently governmental

<sup>4</sup> IRC § 6306(b)(1).

<sup>5</sup> The IRS is also paying PCAs an administrative fee for certain unresolved accounts. IRS Request for Quotations, Request No. TIRNO-05-Q-00187, at I-20 and I-34 (¶ J.4.4.12).

<sup>6</sup> PCAs are:

- ◆ Prohibited from engaging in any act from which IRS employees are prohibited; IRC § 6306(b)(2).
- ◆ Prohibited from utilizing subcontractors to contact taxpayers, provide quality assurance services, and compose debt collection notices; IRC § 6306(b)(3)(A)-(C).
- ◆ Subject to the Fair Debt Collection Practices Act (15 U.S.C. § 1692), to the extent not superseded by other provisions; IRC §§ 6304 and 7602(c).

<sup>7</sup> For full discussion of these issues, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *supra*.

<sup>8</sup> *FY 2007 Appropriations for the Internal Revenue Service: Hearing Before the Subcomm. on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, House Comm. on Appropriations*, 109th Cong., 2nd Sess (Mar. 29, 2006)(testimony of Mark W. Everson, Commissioner of Internal Revenue).

<sup>9</sup> IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

(and thus not capable of being contracted out), and then focuses on whether the private sector or public sector can perform the work more cost efficiently.<sup>10</sup> The IRS has never certified the types of activities being performed by collectors as “commercial” as part of its annual Federal Activities Inventory Report (FAIR) Act reporting requirements,<sup>11</sup> and, at least until 2003, the IRS considered tax collection as inherently governmental.<sup>12</sup>

### No Easy Cases

The cases which the IRS planned to send to private collectors in the first phase of the initiative (Release 1.1) were significantly more complex than anticipated. For the next phase of the initiative (Release 1.2), the IRS has installed data systems to automate processes, thereby using fewer IRS personnel for manual processing. The IRS is relying on these data systems to assign many more cases than have been assigned to date, and the IRS expects to assign cases with more complex features. For example, the IRS plans to assign cases with associated unresolved delinquent tax return investigations. Thus, the cases will not just involve simple balance due accounts; rather, private collectors will be asked to handle complicated issues such as whether taxpayers have an obligation to file a tax return, issues which are, in fact, inherently governmental. As the example above demonstrates, private collection employees are also working on cases with active levies pending. Private collection agencies are not trained to handle these cases. Moreover, the IRS data systems and selection software are not always able to screen the cases which the IRS agrees are inappropriate for assignment.

**EXAMPLE:** During the design phase of this initiative, the IRS agreed that it would be inappropriate to assign existing Taxpayer Advocate Service cases to private collectors. However, the data systems used for Release 1.2 of the PDC initiative are not capable of identifying and screening out TAS cases automatically. The IRS’s solution is to manually review all 446,000 cases for assignment in the next three years for TAS involvement.

Screening out TAS cases is vitally important since these taxpayers have demonstrated they are experiencing an economic or systemic burden or significant hardship. However, manually reviewing all cases for assignment dramatically adds to the need for IRS manual involvement in the process, thereby adding still more costs to the initiative.

<sup>10</sup> IRS Office of Competitive Sourcing, IRS A-76 Primer, (Feb. 2005), available at [http://www.irs.gov/pub/cmp-src/learn\\_more/irs\\_a76\\_primer.pdf](http://www.irs.gov/pub/cmp-src/learn_more/irs_a76_primer.pdf); see also Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

<sup>11</sup> Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, see Note § 5; see also IRS Federal Activities Inventory Reform Act certifications, available at: <http://www.treas.gov/offices/management/dcfo/procurement/fair/inventories/index.html>.

<sup>12</sup> In OMB Circular A-76 (which sets forth the standards under which federal work is subject to competitive sourcing), as it existed in 1999, the collection of taxes was specifically listed as an inherently governmental function. In 2003, OMB Circular A-76 was revised to remove all specific examples of inherently governmental functions; see also General Accounting Office, *IRS: Issues Affecting IRS’s Private Debt Collection Pilot* (Jul. 18, 1997), indicating that the IRS and the Department of Treasury have long considered the collection of taxes to be an inherently governmental function.

### Comparison to Other Federal Agencies

In the Most Serious Problem section of this report, we analyze the validity of the comparison of the IRS, with its vast collection resources and tax compliance mission, to other federal agencies as justification for the initiative. At this point in the initiative, the private collectors are using 75 collection representatives and the IRS is using 65 employees to monitor them. Unlike other federal agencies, the IRS clearly has the resources to do what the private collectors are doing. However, the IRS has indicated that even if it had more resources it would not work these cases; the priority is too low.<sup>13</sup> As we have pointed out elsewhere in this report,<sup>14</sup> the real issue is one of collection strategy and the IRS's willingness to make initiating contact with taxpayers a major part of that strategy.

### Hidden Costs of Private Debt Collection

More important than the financial costs, are the hidden costs that make private debt collection cost prohibitive: costs to customer service, transparency of operations, consistent treatment for similarly situated taxpayers and tax compliance. The IRS has made tremendous strides in customer service over the past 6 years; however, private collection agencies become the face of the IRS for many taxpayers assigned to private collectors. Taxpayers with special needs, such as those who have limited English proficiency or are disabled, are not being well served by private collection agencies.<sup>15</sup>

Elsewhere in this report we discuss the importance of transparency in the operations of the IRS toward maintaining the public's trust and confidence in the government.<sup>16</sup> However, the private collection agencies have designated their operational plans as proprietary information that cannot be disclosed without their consent. The National Taxpayer Advocate was unable to report on troubling aspects of private collection agency collection scripts in this report. To the extent the IRS wishes to release any part of these plans, it must first ask the PCAs' permission. Thus, the IRS has surrendered an important part of the public's trust for the sake of this initiative.

Consistent treatment for similarly situated taxpayers is a goal that the IRS strives to achieve; however, with up to ten different private collection agencies in Release 1.2, each with their own collection scripts, form letters, and operational plans, it appears that the IRS has also surrendered this goal for the sake of the initiative.

<sup>13</sup> IRS, *Filing and Payment Compliance* (Nov. 14, 2006).

<sup>14</sup> See Most Serious Problems, *Early Intervention in Collection Cases and Levies*, *supra*.

<sup>15</sup> For discussion of taxpayers with special needs, see Most Serious Problems, *Reasonable Accommodations for Taxpayers with Disabilities and Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance*, *supra*.

<sup>16</sup> See Most Serious Problem, *Transparency Of The IRS*, *supra*. For a detailed discussion of the lack of transparency of private collection agency operations, see also Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *supra*.

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Lastly, we do not know the effect on tax compliance from this initiative – it is too early to be sure; however, we do know that the IRS is risking much for a small return on investment, if any.<sup>17</sup> In its response to the Most Serious Problem on private debt collection in this report, the IRS lauds the fact that at least now these cases are being worked. There may be some element of truth to this statement; however, we think it faint praise, inasmuch as it is the IRS that refuses to work these cases, even if additional resources are allocated.

**EXPLANATION OF RECOMMENDATION**

The IRS's Private Debt Collection initiative is not cost efficient, adds unnecessary costs and burdens to taxpayers, diminishes the improved image of the IRS, and surrenders too many valuable components of our tax administration system. Therefore, Congress should repeal IRC § 6306 and thereby terminate the Private Debt Collection initiative.

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<sup>17</sup> Taxpayers pay over \$2 trillion dollars in taxes voluntarily each year. Statistics of Income, *IRS Data Book, 2004-2005*, available at <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>. The IRS predicts that this initiative will net approximately \$1 billion over ten years.



## RECOMMENDATION

## #3

## UNIFORM DEFINITION OF QUALIFYING CHILD

## PROBLEM

Until 2005, the Internal Revenue Code contained multiple definitions of a “child” for purposes of the Code’s most basic provisions.<sup>1</sup> Taxpayers ended up with vastly different – and in many cases inaccurate – results among these provisions with respect to the same child.<sup>2</sup> The National Taxpayer Advocate recommended in 2001 that Congress adopt a uniform definition of a qualifying child.<sup>3</sup>

The Working Families Tax Relief Act (WFTRA)<sup>4</sup> introduced a uniform definition of a qualifying child (UDOC). This measure brought about some uniformity for the great majority of taxpayers, who previously had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions. This legislation was supported by the Bush administration, the Joint Committee on Taxation, the National Taxpayer Advocate, the American Bar Association Section of Taxation, the American Institute of Certified Public Accountants, the Tax Executives Institute, and many academics.<sup>5</sup>

The new law, effective for tax years beginning after December 31, 2004, has done just what it set out to do – it has provided uniformity for *most* taxpayers, reduced the burden of recordkeeping for *most* taxpayers, and eliminated the need for the IRS to inquire into the most personal aspects of *most* taxpayers’ lives. As with any legislation attempting simplification via uniformity, there inevitably are winners and losers; that is the price of tax simplification.

<sup>1</sup> IRC § 2(b) (Head of Household); IRC § 21 (Child and Dependent Care Credit); IRC § 24 (Child Tax Credit); IRC § 32 (Earned Income Tax Credit); IRC § 151 (Dependency Exemption); and IRC § 7703(b) (Determination of Marital Status).

<sup>2</sup> For example, a child could qualify the taxpayer for head of household (or for head of household filing status) because the taxpayer paid more than half the actual cost of maintaining a home for the child and the taxpayer, but the child may not qualify as a dependent of the taxpayer because the taxpayer did not pay more than half the support of the child, including any imputed support of the child.

<sup>3</sup> National Taxpayer Advocate 2001 Annual Report to Congress 82-100.

<sup>4</sup> The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).

<sup>5</sup> See, e.g., Lindy Paull, Chief of Staff, Joint Committee on Taxation, Testimony Before the House Committee on Ways and Means (July 17, 2001); Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code*, JCS-3-01, vol. II, at 44 - 66 (Apr. 2001); Gene Steuerle, *How Complexity Arises for Low-Income Taxpayers*, 92 Tax Notes 561 (July 23, 2001); National Taxpayer Advocate, 2001 Annual Report to Congress, 82-100; Les Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 Or. L. Rev. 351, 371-72 (2002); Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Tax Executives Institute, *Letter Regarding Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002); Robert Greenstein, Executive Director, Center on Budget and Policy Priorities, Statement Before the House Appropriations Subcommittee on Transportation and Treasury (May 7, 2003); The Honorable Fred T. Goldberg, Jr., Commissioner, Internal Revenue Service, 1989 -1992, Testimony Before the House Committee on Ways and Means (June 15, 2004); Elizabeth Maresca, Associate Clinical Professor, Fordham University School of Law, Testimony Before the House Committee on Ways and Means (June 15, 2004); American Bar Association Section of Taxation, *Letter Regarding Pending Tax Legislation* (June 30, 2004); American Bar Association Section of Taxation, *Letter Regarding H.R. 1308 – Working Families Tax Relief Act of 2004* (Oct. 18, 2004).

Some commentators have expressed concerns that the new definition and certain related changes have not truly led to simplification, and have raised examples where the new rules have unintended consequences.

### EXAMPLES

#### **Example 1: Parent Provides Support for Child Living With Grandparents**

A six-year-old boy lives the entire year with his grandparents, who are married and receive \$20,000 in pension income for the year. Throughout the year, the boy's father sent payments totaling \$25,000 to the grandparents for the support of the child. The boy is the qualifying child of the grandparents because the relationship, residency, age, and support tests are met. Even though the father provided more than half the support of his son, the father may not claim the son as a qualifying child because the father did not share a principal place of abode with his son for over half of the taxable year. The father also cannot claim his son as a qualifying relative because the son is a qualifying child of the grandparents.

#### **Example 2: Parentless Teenage Twins Who Live with a Neighbor**

The twins are qualifying children with respect to each other (they meet the residency, relationship, age, and support tests). The neighbor provides all of the support for the teenage children, but under the current rules would not be able to claim the children as qualifying relatives because each child is a qualifying child of the other.<sup>6</sup>

#### **Example 3: Live-In Boyfriend Who Provides Support for Girlfriend and Her Child**

A single mother lives with her boyfriend and her ten-year-old son. The mother has no earned income; the boyfriend earns \$30,000 per year and supports his girlfriend and her son. Under the current rules, the son is the qualifying child of the girlfriend (he meets the residency, relationship, age and support tests). The boyfriend may not claim the girlfriend's son as a qualifying child because the child does not meet the relationship test. The boyfriend may not claim the girlfriend's son as a qualifying relative because the son is the qualifying child of the girlfriend. Further, if the relationship is in violation of local law, the girlfriend will not be considered a member of the boyfriend's household for determination of household status.<sup>7</sup>

<sup>6</sup> The children meet all of the tests for a qualifying relative with respect to the neighbor because the children have the same principal place of abode as the neighbor for the entire tax year and are part of the neighbor's household (relationship test), the children do not have gross income in excess of the amount of the dependency exemption, and the neighbor provides more than half of the support for the children. See IRC § 152(d). However, the requirement that a qualifying relative cannot be the qualifying child of the taxpayer or another taxpayer prevents the neighbor from claiming the children. See IRC § 152(d)(1)(D). But for this requirement, the neighbor would be entitled to claim the children as qualifying relatives.

<sup>7</sup> IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

**Example 4: Affluent Family with a “Boomerang” Older Child**

The parents in this home earn \$400,000 and live with their 28-year-old son, who earns \$25,000 a year as a medical resident, and also have two teenage daughters. The daughters are qualifying children of the parents (the daughters meet the residency, relationship, age, and support tests), but the parents do not benefit from claiming dependency deductions for their daughters because of the alternative minimum tax. Under the current rules, if the parents do not claim the daughters as dependents, the 28-year-old son can claim his younger siblings as qualifying children.<sup>8</sup>

**Example 5: Another Taxpayer with a “Boomerang” Older Child**

A single parent in this home earns \$75,000. The 28-year-old son earns \$10,000 in income and lives at home with his parent. The son fails the age test for a qualifying child. The son is not a qualifying relative because he makes more than the exemption amount.<sup>9</sup> Thus, the single parent cannot claim the child for purposes of the dependency exemption or the head of household status. Prior to the UDOC, the parent could have filed as head of household because there was no “exemption amount” limitation.

**RECOMMENDATIONS**

To address the concerns identified above, the National Taxpayer Advocate recommends that Congress consider the following changes to the Uniform Definition of a Qualifying Child:

1. Amend IRC § 152(d)(1)(D) so that the term “qualifying relative” means an individual “who is not claimed as a qualifying child of such taxpayer or of any other taxpayer for any taxable year in the calendar year in which such taxable year begins.”
2. Amend IRC § 152(c)(4)(A) to incorporate the following parent-preference rule:
 

If a parent resides with his or her qualifying child for more than one-half of the year, a taxpayer who is not the child’s parent shall not be eligible to claim the child as a qualifying child. The foregoing rule shall not apply to a taxpayer if the taxpayer is eligible to claim the child’s parent for the dependency exemption.

<sup>8</sup> Under the tie-breaker rule in IRC § 152(c)(4), if an individual is claimed as a qualifying child by two or more taxpayers, such individual shall be treated as the qualifying child of the taxpayer who is the parent of the individual. If more than one parent claims the individual, then the child will be considered the qualifying child of the parent who resided with the child for the longer period of time. If both parents resided with the child for the same amount of time, then the parent with the higher adjusted gross income (AGI) for such taxable year is entitled to claim the child as a qualifying child. If no parent claims the child as a qualifying child, then the taxpayer with the highest AGI for such taxable year is entitled to claim the child as a qualifying child. Note that the tie-breaker rule does not apply unless two or more taxpayers actually claim the same individual as a qualifying child. This is in contrast to the limitation in IRC § 152(d)(1)(D) that denies an individual from being treated as a qualifying relative if such individual is a qualifying child of any taxpayer, even if not actually claimed as a qualifying child of any taxpayer.

<sup>9</sup> IRC § 152(d)(1)(B).

**PRESENT LAW**

Under UDOC, a dependent must be either a “qualifying child” or a “qualifying relative.”<sup>10</sup> The other family status provisions incorporate the definition of a qualifying child, but retain rules specific to each code section (such as age and income restrictions).

*Qualifying Child*

In general, an individual must meet four tests to be a qualifying child under UDOC;

- 1. Relationship Test.** The child must be the taxpayer’s child (including an adopted child, stepchild, or eligible foster child), brother, sister, stepbrother, stepsister, or descendent of one of these relatives. An adopted child includes a child lawfully placed with a taxpayer for legal adoption even if the adoption is not final. An eligible foster child is any child placed with a taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.<sup>11</sup>
- 2. Residency Test.** The child must have the same principal place of abode as the taxpayer for more than half of the tax year. Exceptions apply for temporary absences for special circumstances: children who were born or died during the year, children of divorced or separated parents, and kidnapped children.<sup>12</sup>
- 3. Age Test.** The child must be under a certain age, depending on the tax benefit claimed.<sup>13</sup>
- 4. Support Test.** The child cannot provide more than half of his or her own support during the year.<sup>14</sup>

*Qualifying Relative*

If an individual does not meet the requirements for a qualifying child, the individual may be a dependent of the taxpayer if the individual meets the requirements to be a qualifying relative. In general, an individual must meet four tests to be a qualifying relative.

- 1. Relationship Test.** The individual must be a child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual (other than the spouse) who, for the taxable year of the taxpayer, has the

<sup>10</sup> IRC § 152(a).

<sup>11</sup> IRC §§ 152(c)(1)(A), 152(c)(2), and 152(f)(1).

<sup>12</sup> IRC §§ 152(c)(1)(B) and 152(f)(6); Treas. Reg. §§ 1.152-1(b) and 1.152-2(a)(2)(ii).

<sup>13</sup> IRC §§ 152(c)(1)(C) and 152(c)(3).

<sup>14</sup> IRC § 152(c)(1)(D).

same principal place of abode as the taxpayer and is a member of the taxpayer's household.<sup>15</sup>

2. **Gross Income Test.** An individual must have gross income for the taxable year less than the exemption amount.<sup>16</sup>
3. **Support Test.** The taxpayer must provide more than one-half of the individual's support for the calendar year in which the taxable year begins.<sup>17</sup>
4. **Not a Qualifying Child.** To be a qualifying relative, an individual may not be a qualifying child of the taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.<sup>18</sup>

#### *Tie-Breaker Rule*

Sometimes a child meets the tests to be a qualifying child of more than one taxpayer. However, only one taxpayer can treat the child as a qualifying child. If the taxpayers have the same qualifying child, they may decide among themselves who will claim the child. If they cannot agree and more than one taxpayer files a return claiming the same child, the IRS will use the tie-breaker rules explained in the table below to determine which taxpayer will be allowed to claim the child.<sup>19</sup> In the past, these tiebreaker rules applied only to a qualifying child for the Earned Income Tax Credit (EITC). For tax years beginning after December 31, 2004, generally, a child is treated as the qualifying child of only one taxpayer for all of the provisions that employ the uniform definition of a qualifying child (head of household filing status under IRC § 2, the child and dependent care credit under IRC § 21, the child tax credit under IRC § 24, the earned income credit under IRC § 32, and the dependency exemption under IRC § 151). This rule is applied to these provisions as a group, rather than on a section-by-section basis.<sup>20</sup> That is, taxpayers may not “split the baby” to divide the benefits.<sup>21</sup>

#### REASONS FOR CHANGE

The UDOC was intended to simplify a complex and cumbersome process. We must recognize that there will be losers in tax simplification. We must also recognize that, as with most new legislation, there will be some unintended consequences.

For taxpayers in situations such as those described in the examples above, we need to decide whether not getting the intuitively “right” answer warrants muddying up and

<sup>15</sup> IRC §§ 152(d)(1)(A) and 152(d)(2). However, IRC § 152(f)(3) provides that an individual shall not be treated as a member of the taxpayer's household if at any time during the taxable year the relationship between such individual and the taxpayer is in violation of local law.

<sup>16</sup> IRC § 152(d)(1)(B).

<sup>17</sup> IRC § 152(d)(1)(C).

<sup>18</sup> IRC § 152(d)(1)(D).

<sup>19</sup> IRC § 152(c)(4).

<sup>20</sup> CC Notice 2006-86, 2006-41 I.R.B. 680.

<sup>21</sup> There is an exception to the “split the baby” rule for divorced or separated parents, discussed below.

complicating the Code. We also must be careful not to undermine the very clear benefits of the UDOC – or, in other words, to throw out the qualifying child with the bathwater. In adopting a single definition of a child where five<sup>22</sup> definitions existed previously, Congress provided a monumental service to approximately 160 million Americans.<sup>23</sup> To blow these examples out of proportion and then add back to the Code five different definitions of a child by repealing the WFTRA would be a disservice to 160 million people and would constitute terrible public policy.

The National Taxpayer Advocate recommends that Congress proceed cautiously with any proposed changes to the UDOC. Each modification potentially weakens prior simplification efforts and may lead to additional unintended consequences.

#### EXPLANATION OF RECOMMENDATIONS

Examples 1 through 3 above are situations in which the UDOC denies tax benefits to taxpayers who we might want to receive them, due to a quirk in the definition of a qualifying relative. According to the definition of a “qualifying relative” in IRC § 152(d)(1)(D), an individual who is a qualifying child of another taxpayer may not be a qualifying relative. This definition allows a situation in which an individual may not be claimed as a qualifying relative solely because the individual met the definition of a qualifying child of a taxpayer, even if such individual was not actually claimed as a qualifying child by any taxpayer.

Congress can eliminate the problem in Examples 1 through 3 by adding two simple words – “claimed as” – to IRC § 152(d)(1)(D) so that the term “qualifying relative” means an individual “who is not **claimed as** a qualifying child of such taxpayer or of any other taxpayer for any taxable year in the calendar year in which such taxable year begins.”

This change treats taxpayers as mature individuals who are able to structure their affairs rationally and decide among themselves who is the “right” person to claim various family status benefits. Note that to be a qualifying relative, an individual must still meet the support test and the gross income test. All of these limitations were in the Code prior to enactment of the UDOC, so this change merely opens the door for the individual to meet the definition of a qualifying relative.

Example 4 describes a situation where the UDOC rules allow a windfall for taxpayers who clearly were not the intended beneficiaries of these rules. Here, allowing taxpayers to decide among themselves enables taxpayers to game the system, or at least come up

<sup>22</sup> UDOC made changes to five of the six definitions of a child; it did not affect IRC § 7703(b) (Determination of Marital Status).

<sup>23</sup> The family status provisions potentially affect 81 million taxpayers and 79 million children. IRS Compliance Data Warehouse, *Tax Year 2004 Individual Return Transaction File*.

with a result that does not accurately reflect the economic responsibilities and circumstances of the household.<sup>24</sup>

One solution would be to bring back the recently repealed “cares for” test as applied to siblings.<sup>25</sup> However, the “cares for” test was difficult to administer and involved the submission of a great deal of personal information on the part of the taxpayer and the exercise of discretion on the part of IRS examination employees. As a result, the National Taxpayer Advocate endorses the approach suggested by the American Bar Association that provides an appropriate trade-off between increased complexity and precision.<sup>26</sup> This recommendation provides for a parent-preference rule that eliminates the “claimed as” requirement of the tie-breaker rule in IRC § 152(c)(4)(A) so that each taxpayer’s eligibility to claim a qualifying child could be determined without reference to another taxpayer’s tax return information. In situations where IRC § 152(b)(1) (which prohibits an individual who is a dependent of another taxpayer from claiming any dependents) precludes a parent from claiming a qualifying child, a non-parent can claim the qualifying child.

Example 5 above describes a situation in which reasonable minds might differ as to whether the result is a problem. The parent in Example 5 may be able to claim the son as a dependent if the son meets the requirements for a qualifying relative. There is no age requirement for qualifying relatives, so the son being 28 years old does not prevent his parent from claiming him as a qualifying relative. But because the son makes more than the exemption amount (\$3,300 in 2006), he is not considered a qualifying relative of his parent.

Note that if the son was between jobs and earned less than the exemption amount, the parent would be able to claim head of household status and claim the son as a dependent. The National Taxpayer Advocate does not consider this to be an unreasonable policy. That is, if your able-bodied adult child has an economic setback, then all the taxpayers of the U.S. will help that person get on his feet via the tax system. But if your able-bodied adult child is staying with you to save a few dollars, we will not ask other taxpayers to subsidize that decision. We recommend no change for this “unintended” consequence in Example 5.

<sup>24</sup> Note that this problem has existed within the EITC context for several years (*i.e.*, pre-UDOC enactment). Nothing in IRC § 32 prevents taxpayers who are eligible to claim a child for the EITC from agreeing among themselves who should actually claim the credit. The tie-breaker rule in the pre-2005 IRC § 32(c)(1)(C) applied only when an individual was actually claimed by two or more taxpayers. So in this case, under the pre-2005 rules, if the parents did not claim the children, the 28-year-old son could claim his siblings if he cared for the siblings as his own children and is otherwise eligible for the EITC.

<sup>25</sup> Under the prior rules, IRC § 32(c)(3)(B)(i)(II) required that a taxpayer claiming as a qualifying child a brother, sister, stepbrother, or stepsister, or a descendant of any such individual must care for the child as the taxpayer’s own child. There was a great deal of uncertainty on the part of taxpayers as to what constituted “caring for” the child as one’s own child. See *Gilmore v. Commissioner*, T.C. Summ. Op. 2004-38; *Barajas v. Commissioner*, T.C. Summ. Op. 2002-59. Because the “cares for” test was vague and hard to administer, Congress eliminated the “cares for” requirement when it passed the UDOC rules.

<sup>26</sup> American Bar Association Section of Taxation, *Report Regarding the Uniform Definition of Qualifying Child* 8-9 (July 24, 2006).

## RECOMMENDATION

## #4 ELIMINATE (OR SIMPLIFY) PHASE-OUTS

**PROBLEM**

Phase-outs reduce the availability of various tax benefits to taxpayers as their income increases.<sup>1</sup> Over 60 million returns are affected each year by one or more phase-outs.<sup>2</sup> As an example, the dependent care tax credit is gradually reduced for taxpayers with incomes between \$15,000 and \$43,000.<sup>3</sup> Increasing marginal income tax rates as income rises would similarly impose a greater amount of tax on higher income taxpayers. Unlike an increase in marginal rates, however, phase-outs often tax an additional dollar earned by a low or middle income taxpayer more heavily than an additional dollar earned by a high income taxpayer.

Phase-outs also add needless complexity to the Internal Revenue Code. Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, and likely reduces tax compliance. Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance.

**EXAMPLES**

The following examples illustrate how phase-outs create surprisingly high effective marginal tax rates for low and middle income taxpayers and increase complexity for everyone.

**Example 1: Earned Income Tax Credit and Dependent Care Tax Credit**

If a single taxpayer, who has two qualifying children, earned \$33,000 in wage income and received a \$500 bonus in 2005, she would get the benefit of only about 52 percent of the bonus. At her income level, she is in the phase-out range for both the earned income tax credit (EITC) and for the dependent care tax credit.<sup>4</sup> At the end of the year, after filling out four different forms, schedules, and worksheets, she would discover that the \$500 bonus had cost her \$240 in refundable tax credits – \$105 in EITC (from \$471

<sup>1</sup> For purposes of this discussion, we use the term “phase-out” to include phase-downs, which also reduce (but do not eliminate) benefits as income increases. However, we do not use the term phase-out to include reductions in tax benefits resulting from changes in items other than income. For example, we do not use the term phase-out to refer to a reduction in the credit for producing fuel from nonconventional sources as the price of oil increases, or to refer to a reduction in the credit for qualified electric vehicles over time. IRC § 45k (credit for producing fuel from a nonconventional source); IRC § 30 (credit for qualified electric vehicles).

<sup>2</sup> This data is compiled from the Individual Return Transaction File (IRTF) for Tax Year 2004 from the Compliance Data Warehouse (CDW).

<sup>3</sup> IRC § 21(a)(2).

<sup>4</sup> IRC § 21; IRC § 32. We assume she files as head of household and has \$6,000 in qualified child care expenses.



to \$366) and \$135 in the refundable portion of the child tax credit (from \$1,664 to \$1,529).<sup>5</sup> In other words, each dollar of the bonus would reduce these credits by about 48 cents. In contrast, taxpayers in the highest income tax bracket generally pay the IRS only 35 cents of each additional dollar they earn.<sup>6</sup>

### Example 2: Social Security Benefit Exclusion and Hope Credit

If a 63-year-old retiree with \$15,000 in social security benefits, \$10,000 in wage income, \$23,000 in taxable pension income and two children in college received the same \$500 bonus in 2005, he could face an effective marginal tax rate of more than 83 percent.<sup>7</sup> Because the nontaxable portion of his social security benefits is phased-out as his income increases, the \$500 bonus would increase his taxable income by \$925. Since he is in the 15 percent tax bracket, the additional income would increase his federal income tax by \$135 (approximately 15 percent x \$925).<sup>8</sup> Because the taxpayer is also in the phase-out range for the Hope credit for educational expenses, the bonus would reduce his Hope credit by \$279 (from \$2,994 to \$2,715).<sup>9</sup> Thus, at the end of the year, after completing an additional worksheet and tax form, the taxpayer would discover that his \$500 bonus increased his income tax liability by about \$414 (\$135 + \$279) so he would only get to keep \$86 (or 17 percent).<sup>10</sup> In contrast, if the \$500 bonus were paid to

<sup>5</sup> See *id.*; IRC § 24. The reduction in the refundable portion of the child tax credit is caused, in part, by the phase-out of the dependent care tax credit, as reflected on lines 48, 52, 66, and 68 of Form 1040. For a discussion of how to figure the EITC, see Publication 596, *Earned Income Credit* (2005) and Form 1040, *Instructions* (2005). The taxpayer is directed to the following forms, schedules, and worksheets: Form 2441, *Child and Dependent Care Expenses*; Form 1040 Instructions, *Child Tax Credit Worksheet*; Form 1040 Instructions, *Worksheet A-Earned Income Credit or Worksheet B-Earned Income Credit*; and Schedule EIC, *Earned Income Credit*.

<sup>6</sup> IRC § 1. Further, many taxpayers probably fill out additional forms, schedules, and worksheets only to find out they are not eligible for the benefits and some who are eligible may not bother to find out. Commentators have suggested that one of the benefits of the child tax credit is that it ameliorates the effect of the EITC phase-out in some cases. See, e.g., Lawrence Zelenak, *Redesigning The Earned Income Tax Credit As A Family-Size Adjustment To The Minimum Wage*, 57 Tax L. Rev. 301, 307 (Spring 2004). Even if it does, complicating the law with another credit that has its own phase-out requires more forms, worksheets and schedules, which will undoubtedly lead to mistakes involving over- and under-claims.

<sup>7</sup> This analysis assumes that before computing the Hope credit phase-out, each child would qualify for the full \$1,500 credit. It also ignores employment taxes, which would increase the taxpayer's marginal tax rate by another 7.65 percent, as well as state income taxes and college financial aid computations based on income. See, e.g., IRC § 3101. Such taxes and aid reductions could easily mean that the bonus generates liabilities that exceed 100 percent of the bonus.

<sup>8</sup> See Form 1040, *Instructions* 68 (2005) (tax tables).

<sup>9</sup> For taxpayers in the phase-out range, the Hope credit can be computed by multiplying the tentative credit of \$3,000 by a fraction the numerator of which is \$53,000 minus the taxpayer's modified adjusted gross income (MAGI) and the denominator of which is \$10,000. In the first scenario with no bonus, the taxpayer's MAGI is \$43,025, so the fraction is .998  $((\$53,000 - \$43,025) / \$10,000)$ , and the credit is \$2,994  $(\$3,000 * .998)$ . In the second scenario a bonus that increases the taxpayer's MAGI by \$925 to \$43,950, so the fraction is .905  $((\$53,000 - \$43,950) / \$10,000)$  and the credit is \$2,715  $(\$3,000 * .905)$ .

<sup>10</sup> The taxpayer would have to fill out Form 1040, *Social Security Benefits Worksheet*, the worksheets in Publication 590, or the worksheet in Publication 915 to determine how the bonus would affect the tax treatment of his social security benefits. He would need to fill out Form 8863, *Education Credits*, to determine the amount of his Hope credit.

someone in the highest 35 percent income tax bracket they would typically get to keep \$325 ( $\$500 - (\$500 \times 35 \text{ percent})$ ).

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress eliminate phase-outs. In the event the cost considerations make outright repeal unrealistic, then the National Taxpayer Advocate recommends Congress consider the questions discussed below (in the Explanation of Recommendation section) with respect to each existing phase-out, and require a discussion of these questions to be included with any proposal that includes a phase-out.

### PRESENT LAW

The Internal Revenue Code contains more than 20 tax benefits that are phased-out for higher income taxpayers, as shown on Table 2.4.1 below. It uses different measures of income to determine whether and how to reduce each tax benefit. For example, some phase-outs use “earned income” from personal services, others use “adjusted gross income” (AGI), and others start with AGI but then apply certain modifications to adjust it in a variety of ways.<sup>11</sup> The effect of marital and filing status on the phase-out range also varies from phase-out to phase-out. Since some phase-outs are adjusted for inflation and others are not, the combination of ways that multiple phase-outs affect a taxpayer may change every year, even if the taxpayer’s filing status and income stay the same.

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<sup>11</sup> “Adjusted gross income” is “gross income” reduced by certain deductions. See IRC § 62.

**TABLE 2.4.1, SELECTED 2005 INDIVIDUAL INCOME TAX PROVISIONS WITH INCOME-BASED PHASE-OUTS<sup>12</sup>**

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
1. Dependent care tax credit (sec. 21)	\$15,000-\$43,000	Same as joint filers	No credit, unless separated	AGI	No	35% credit percentage reduced (but not below 20%) by one point for each \$2,000 over the threshold
2. Credit for elderly and disabled (sec. 22)	\$10,000-\$20,000 if one qualifying spouse; \$25,000 if two qualifying spouses	\$7,500-\$17,500	\$5,000-\$12,500	AGI	No	Credit reduced by one-half of the income over the threshold and by certain nontaxable payments
3. Adoption credit (sec. 23)	\$159,450-\$199,450	Same as joint filers	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
4. Child tax credit (sec. 24)	\$110,000	\$75,000	\$55,000	MAGI #1*	No	Credit reduced by \$50 for each \$1,000 (or fraction thereof) of income that exceeds the threshold
5. Hope credit (sec. 25A)	\$87,000-\$107,000	\$43,000-\$53,000	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
6. Lifetime learning credit (sec. 25A)	\$87,000-\$107,000	\$43,000-\$53,000	No credit	MAGI #1*	Yes	Credit reduced ratably over the phase-out range
7. Retirement contribution credit (sec. 25B)	50% credit: \$0-\$30,000; 20% credit: \$30,000-\$2,500; 10% credit: \$2,500-\$50,000	HOH: 50% credit: \$0-\$22,500; 20% credit: \$22,500-\$24,375; 10% credit: \$24,375-\$37,500; Other single filers use MFS table	50% credit: \$0-\$15,000; 20% credit: \$15,000-\$16,250; 10% credit: \$16,250-\$25,000;	MAGI #1*	No <sup>13</sup>	Credit percentage level declines at specific income thresholds
8. Earned income tax credit (sec. 32)	No children: \$8,530-\$13,750; One child: \$16,370-\$33,030; More than one child: \$16,370-\$37,263	No children: \$6,530-\$11,750; One child: \$14,370-\$31,030; More than one child: \$14,370-\$35,263	No credit	Greater of (a) earned income or (b) AGI	Yes	Credit reduced by percentage of income over the threshold

<sup>12</sup> The Joint Committee on Taxation published a similar table in 2001. See Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 80 (Apr. 2001), available at <http://www.house.gov/jct/s-3-01vol2.pdf>. Phase-out ranges that have been adjusted for inflation reflect adjustments for 2005. See Rev. Proc. 2004-71, 2004-50 I.R.B. 970 (Dec. 13, 2004).

<sup>13</sup> The adjusted gross income amounts used to determine the applicable percentage for calculating the credit are adjusted for inflation beginning in calendar year 2007. IRC § 25B(b)(3); Rev. Proc. 2006-53, 2006-48 I.R.B. 996, § 2.01 (Nov. 9, 2006).

## RECOMMENDATIONS

SECTION  
TWO

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
9. AMT exemption (sec. 55(d)(3))	\$150,000-\$382,000	\$112,500-\$273,500	\$75,000-\$191,000	Alternative minimum taxable income (AMTI)	No	Exemption reduced by 25% of the AMTI in excess of the threshold
10. Overall limitation on itemized deductions (sec. 68) <sup>14</sup>	\$145,950-various	Same as joint filers	\$72,975-various	AGI	Yes	Deductions reduced by lesser of 3% of AGI over threshold or 80% of itemized deductions
11. Exclusion of social security and railroad retirement benefits (sec. 86)	First tier: \$32,000; Second tier: \$44,000;	First tier: \$25,000; Second tier: \$34,000	First and second tiers: \$0, unless separated	MAGI #2* plus one-half of the benefits	No	Includible amount is generally 50% of income between first and second tier (up to 50% of benefits), plus 85% of income in excess of second tier, but not more than 85% of benefits
12. Exclusion of interest from education savings bonds (sec. 135)	\$91,850-\$121,850	\$61,200-\$76,200	No exclusion	MAGI #3*	Yes	Exclusion reduced ratably over the phase-out range
13. Exclusion for adoption assistance programs (sec. 137)	\$159,450-\$199,450	Same as joint filers	No exclusion	MAGI #4*	Yes	Exclusion reduced ratably over the phase-out range
14. Personal exemption (sec. 151) <sup>15</sup>	\$218,950-\$341,450	Single: \$145,950-\$268,450; HOH: \$182,450-\$304,950	\$109,475-\$170,725	AGI	Yes	Exemption reduced ratably over the phase-out range
15. Deduction for IRA with retirement plan (sec. 219)	\$70,000-\$80,000	\$50,000-\$60,000	\$0-\$10,000	MAGI #5*	No <sup>16</sup>	Deduction reduced ratably over the phase-out range; special rounding rules apply

<sup>14</sup> The limitation on itemized deductions is reduced by 1/3 in tax years beginning in 2006 and 2007, reduced by 2/3 in tax years beginning in 2008 and 2009, and repealed for tax years beginning after December 31, 2009. However, it is set to return for taxable years beginning after December 31, 2010. IRC § 68(g) and (f); Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38 § 901 (June 7, 2001).

<sup>15</sup> The phase-out of the personal exemption is reduced by 1/3 in tax years beginning in 2006 and 2007, reduced by 2/3 in tax years beginning in 2008 and 2009, and repealed for tax years beginning after December 31, 2009. IRC § 151(d)(3)(E); Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38, § 901 (June 7, 2001). However, it is set to return for taxable years beginning after December 31, 2010. *Id.*

<sup>16</sup> This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 219(g)(8); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
16. Deduction for IRA with spouse in a retirement plan (sec. 219(g)(7))	\$150,000-\$160,000	N/A	\$0-\$10,000	MAGI #5*	No <sup>17</sup>	Deduction reduced ratably over the phase-out range; special rounding rules apply
17. Deduction of interest on qualified student loans (sec. 221).	\$105,000-\$135,000	\$50,000-\$65,000	No deduction	MAGI #6*	Yes	Deduction reduced ratably over the phase-out range
18. Qualified tuition deduction (sec. 222) <sup>18</sup>	\$130,000-\$160,000	\$65,000-\$80,000	No deduction	MAGI #7*	No	Maximum deduction limited to \$4,000 below range, \$2,000 within range, and eliminated for income above the range
19. Eligibility for Roth IRA (sec. 408A)	\$150,000-\$160,000	\$95,000-\$110,000	\$0-\$10,000	MAGI #8*	No <sup>19</sup>	Contribution limits reduced ratably over the phase-out range; special rounding rules apply
20. Eligibility for IRA to Roth IRA conversion (sec. 408A) <sup>20</sup>	\$100,000	Same as joint filers	Not eligible for rollover	MAGI #8*	No	Not eligible for conversion if income exceeds threshold
21. Passive rental real estate loss deduction or credit (sec. 469(i))	\$100,000-\$150,000	Same as joint filers	\$50,000-\$75,000; Not eligible if living with spouse	MAGI #9*	No	Deduction or deduction equivalent credit reduced by 50% of income above lower threshold
22. Passive rental real estate credit attributable to rehabilitation credit (sec. 469(i))	\$200,000-\$250,000	Same as joint filers	\$100,000-\$125,000; Not eligible if living with spouse	MAGI #9*	No	Credit reduced by 50% of income above lower threshold

<sup>17</sup> This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 219(g)(8); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

<sup>18</sup> The qualified tuition deduction expires for tax years beginning after 2005. IRC § 222(e). However, it may be retroactively extended. For example, the Estate Tax Extension of Tax relief Act of 2006 (H.R. 5970) would retroactively extend it to tax years beginning before 2008.

<sup>19</sup> This phase-out is adjusted for inflation beginning in calendar year 2007. IRC § 408A(c)(3)(C); Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (Nov. 9, 2006).

<sup>20</sup> For tax years beginning after 2009, conversions of traditional IRAs to Roth IRAs will be allowed without any restrictions based on modified AGI and taxpayer filing status. See IRC § 408A(c)(3)(B), as amended by Section 512 of the Tax Increase prevention and Reconciliation Act of 2005 (TIPRA), P.L. 109-222 (May 17, 2006).

Provision	Joint Filer	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-out	Indexed for Inflation	Operation
23. Eligibility for Coverdell education accounts (sec. 530)	\$190,000-\$220,000	\$95,000-\$110,000	Same as single	MAGI #1*	No	Contribution limits ratably reduced over the phase-out range
24. First-time D.C. homebuyer credit (sec. 1400(C))	\$110,000-\$130,000	\$70,000-\$90,000	\$70,000-\$90,000	MAGI #1*	No	Credit ratably reduced over the phase-out range

\* MAGI #1 is AGI computed without regard to IRC §§ 911, 931 and 933. IRC § 23(b)(2)(B); IRC § 24(b); IRC § 25A(d)(3); IRC § 25B(e); IRC § 530(c)(2); IRC § 1400C(b)(2).

MAGI #2 is AGI computed without regard to IRC §§ 135, 137, 199, 221, 222, 911, 931 and 933. IRC § 86(b)(2).

MAGI #3 is AGI computed after application of IRC §§ 86, 469 and 219 but without regard to IRC §§ 135, 137, 199, 221, 222, 911, 931 and 933. IRC § 135(c)(4).

MAGI #4 is AGI computed after application of IRC §§ 86, 135, 219 and 469 but without regard to IRC §§ 137, 199, 221, 222, 911, 931, and 933. IRC § 137(b)(3).

MAGI #5 is AGI computed after application of IRC §§ 86 and 469 but without regard to IRC §§ 135, 137, 199, 219, 221, 222, and 911. IRC § 219(g)(3).

MAGI #6 is AGI computed after application of IRC §§ 86, 135, 137, 219, and 469 but without regard to IRC §§ 199, 221, 222, 911, 931, and 933. IRC § 221(b)(2)(C); Treas. Reg. § 1.221-1(d)(2).

MAGI #7 is AGI computed after application of IRC §§ 86, 135, 137, 219, 221 and 469 but without regard to IRC §§ 199, 911, 931, and 933. IRC § 222(b)(2)(C).

MAGI #8 is MAGI #5 reduced by amounts included in gross income under IRC § 408A(d)(3) or by reason of a required distribution under IRC § 408A(c)(5). IRC § 408A(c)(3)(C).

MAGI #9 is AGI computed without regard to IRC §§ 86, 135, 137, 199, 219, 221, 222 and certain passive activity losses. IRC § 469(i)(3)(F).

## REASON FOR CHANGE

**Phase-outs reduce middle class work incentives, create inequity**

Most tax experts agree that phase-outs should be simplified or eliminated.<sup>21</sup> One reason for such agreement may be that phase-outs often cause an additional dollar earned by a low or middle income taxpayer to be taxed more heavily than an additional dollar earned by a higher income taxpayer.<sup>22</sup> If higher marginal tax rates reduce incentives to work and earn more income, phase-outs reduce such incentives for low and middle income taxpayers more than for high income taxpayers.<sup>23</sup>

In addition, because phase-outs are based on different measures of income, they may cause two taxpayers with the same amount of income to be liable for different amounts of tax. Such differences in tax liability may violate notions of horizontal equity or fairness.

**Phase-outs may result from the budget process rather than tax policy goals**

Phase-outs sometimes serve no coherent policy goal that cannot be better served by simply adjusting marginal tax rates. One policy reason for the dependent care and child tax credits is that the tax code should recognize that families with children have less of an “ability to pay” than families with the same income, but without children.<sup>24</sup> The policy is based on recognizing the cost of children, not on level of income. Thus, a phase-out of these credits based on income is inconsistent with the underlying policy.

To be sure, some phase-outs could be based on the notion that high income taxpayers do not need a given tax incentive. For example, policymakers could deny Individual

<sup>21</sup> See, e.g., Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 88 (Apr. 2001), available at <http://www.house.gov/jct/s-3-01vol2.pdf>; American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Inc., *Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002) (Attachment B: Simplification of Phase-Outs Based on Income Levels), available at <https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf>; Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, xiv (Nov. 2005), available at <http://www.taxreformpanel.gov/final-report/>. See also, Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 Va. Tax Rev. 645, 731 (Spring 2003) (arguing that the case against phase-outs has been overstated, but stating that the Joint Committee Report’s proposal to eliminate certain phase-outs deserves consideration because of the effect of phase-outs on effective marginal tax rates).

<sup>22</sup> For an analysis of the effect of various phase-outs on marginal rates, see Joint Committee on Taxation, JCS-3-98, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (Feb. 3, 1998) available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=1998\\_joint\\_committee\\_on\\_taxation&docid=f:46072.wais](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=1998_joint_committee_on_taxation&docid=f:46072.wais).

<sup>23</sup> To conclude that phase-outs affect taxpayer behavior (rather than just incentives) would require an assumption that taxpayers generally know how phase-outs affect them. As discussed below, however, phase-outs are complex, concealing their true operation, perhaps blunting any rational behavioral response by taxpayers. Thus, it is possible that phase-outs might not have a significant effect on hours worked by taxpayers. However, if policymakers assume a given tax benefit will affect behavior, for consistency they should assume a phase-out of the benefit will to some extent also affect behavior.

<sup>24</sup> See, e.g., S. Rept. No. 105-33, at 3 (1997) (noting “[T]he Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family’s reduced ability to pay taxes as family size increases.”); H.R. Rept. No. 105-48, at 310 (1997) (same).

Retirement Account (IRA) deductions to high income taxpayers for tax policy reasons. Since the purpose of the IRA deduction is to provide an incentive to save for retirement,<sup>25</sup> policymakers could determine that the savings rate for high income taxpayers is sufficient and they do not need any extra tax incentive to save for retirement.

However, the uncertainty generated by a phase-out may reduce the effectiveness of a tax incentive even among taxpayers who are not subject to it, blunting any tax policy justification for the phase-out. If an eligible taxpayer cannot be certain at the beginning of the year that he or she will be eligible for the IRA deduction, he or she may not make an IRA contribution. Even if the taxpayer makes an extra effort at the end of the year to find out that he or she would be eligible, he or she may be less likely to have the resources to fund a significant IRA contribution on short notice.

These potential drawbacks suggest that phase-outs are sometimes enacted based on revenue considerations rather than sound tax policy.<sup>26</sup> When the Joint Committee on Taxation “scores” how much a tax benefit provision will cost the government, the provision will cost less if it does not apply to higher income taxpayers. The net cost could be the same if the provision were enacted without a phase-out but paired with a marginal tax rate increase applicable to certain middle and high income taxpayers. Although, unlike phase-outs, a marginal rate increase would not subject low and middle income taxpayers to higher effective marginal tax rates than high income taxpayers, Congress may be unwilling to vote for a visible tax rate increase even if it is paired with a tax benefit. Thus, complicated phase-out provisions may sometimes be used to make tax hikes at various income levels more palatable rather than because they make sense from a tax policy standpoint.

### Phase-outs create confusion and complexity

Indeed, phase-outs are good at obscuring their true effect. Policymakers, taxpayers, and those charged with explaining tax benefit rules to taxpayers may have difficulty keeping track of the details of how a given phase-out works and who it affects. This complexity is exacerbated by the fact that different phase-out provisions are based on different measures of income, use different phase-out methods, and are only sometimes indexed

<sup>25</sup> See H.R. Rept. No. 93-770, at 124-125 (1974), reprinted in 1974-3 C.B. 244, 367-368.

<sup>26</sup> See Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. I, 67 (Apr. 2001), available at <http://www.house.gov/jct/s-3-01vol2.pdf>; Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, Ch. 5, 64 (Nov. 2005), available at <http://www.taxreformpanel.gov/final-report>.



for inflation.<sup>27</sup> The phase-outs shown on Table 2.4.1 above use 12 different measures of income.

Such complexity is also burdensome for taxpayers because determining whether they are eligible for a given tax benefit requires them to fill out an additional worksheet, form, or schedule, which is like filling out another tax return. The staff of the Joint Committee on Taxation estimated that for 2001, over 30 million phase-out worksheets would be required, and noted that most worksheets contain 10 to 20 lines which may themselves require additional computations.<sup>28</sup> The taxpayer must recalculate his or her income on these quasi-returns and then apply the appropriate income-based limitation.<sup>29</sup> Each extra entry and computation adds time and expense to the return filing process, and also increases the likelihood that taxpayers will make errors.

### Complexity reduces tax compliance

Since phase-outs make it more difficult for taxpayers to predict whether or not they will be eligible for a given tax incentive, they also make it more difficult for taxpayers to estimate their liability ahead of time, potentially leading to noncompliance, or estimated tax or under-withholding penalties. Taxpayers who owe a balance upon filing their return are more likely than others to understate their liabilities.<sup>30</sup> Moreover, one study found that more than 20 percent of such taxpayers with a balance due failed to pay it in full.<sup>31</sup> Thus, the complexity associated with phase-outs likely reduces tax compliance.<sup>32</sup>

For other taxpayers who can estimate how phase-outs will affect them, phase-outs provide planning opportunities. Such taxpayers can shift income, such as capital gains, from one year to another (or to related taxpayers) to avoid phase-outs, at least in some

<sup>27</sup> In contrast to phase-outs, phase-ins, such as the one applicable to the earned income tax credit, increase tax benefits as a taxpayer's income increases. Although, in general, phase-ins can generate complexity as readily as phase-outs, the phase-in applicable to the EITC furthers the purpose of the credit, which is to provide an additional incentive for low income taxpayers to earn more income, perhaps justifying its existence. See generally, S. Rept. No. 94-36, at 33 (1975), reprinted in 1975-1 C.B. 590, 595; H.R. Rept. No. 94-19, at 10 (1975), reprinted in 1975-1 C.B. 569, 573-74. We do not currently recommend eliminating the EITC phase-in.

<sup>28</sup> See Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 87 (Apr. 2001), available at <http://www.house.gov/jct/s-3-01vol2.pdf>.

<sup>29</sup> The Joint Committee on Taxation staff estimated that eliminating nine phase-outs would allow the IRS to eliminate approximately 75 worksheet or form lines. Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Vol. II, 89 (Apr. 2001), available at <http://www.house.gov/jct/s-3-01vol2.pdf>.

<sup>30</sup> Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

<sup>31</sup> *Id.*

<sup>32</sup> Potential reductions in tax compliance are apparently not taken into account when the Joint Committee on Taxation generates an estimate of the cost of a tax expenditure that includes a phase-out provision. See Joint Committee on Taxation, JCX-1-05, *Overview of Revenue Estimating Procedures and Methodologies used by the Staff of the Joint Committee on Taxation*, 11 (Feb. 2, 2005), available at <http://www.house.gov/jct/x-1-05.pdf> (stating “[u]nlike revenue estimates, tax expenditure estimates do not include behavioral responses or possible interaction with other incentives.”).

years. For example, a taxpayer could manage his capital gain income so as to avoid the Hope credit phase-out. The taxpayer could either liquidate assets to pay for college in the year before the expenditures or borrow to finance college and wait to liquidate assets until after the year(s) in which he makes educational expenditures. In contrast, another taxpayer might liquidate assets in the same year as paying the educational expenses, increasing his taxable income in those years and subjecting himself to the Hope credit phase-out.<sup>33</sup> Such planning opportunities may reduce horizontal equity and the perceived fairness of the tax system, which may in turn, reduce tax compliance.

### Phase-outs reduce interest in improving tax rules and tax administration

Because phase-outs reduce the number of people who can claim a tax benefit, such as the EITC or the dependent care credit, they also reduce the constituency for sensible tax laws and the demand for the IRS to adopt sensible procedures for administering them. If middle and high income taxpayers are relatively unaffected by a tax provision, they and their advisors may have little incentive to suggest ways to improve it. Thus, over time, eliminating phase-outs could have the effect of improving income tax legislation and administrative guidance relating to tax benefit programs.

### Phase-outs burdensome, not “efficient”

The notion that phase-outs are somehow efficient because they relieve middle and high income taxpayers (*i.e.*, those who are fully phased-out of a tax benefit) from having to fill out the additional worksheets, forms, and schedules that are associated with a tax benefit is probably not correct. In many cases, such ineligible taxpayers still have to fill out the worksheets, schedules, and forms (or at least read or pay to have an advisor read the instructions) only to discover that they are not eligible for the benefit. Even if phase-outs reduced paperwork and complexity for certain high income taxpayers, the benefit of such reductions would be very small because such taxpayers are typically better equipped than low and middle income taxpayers to deal with such paperwork and complexity by having a tax preparer or computer software fill out complex worksheets, forms, and schedules.<sup>34</sup> Further, phase-outs require low and middle income taxpayers to fill out more lines on worksheets, forms, and schedules to claim tax benefits. Such burdens likely more than offset any potential efficiency gains obtained by high income taxpayers.

### EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that Congress eliminate phase-outs based on the tax administration considerations discussed above. Alternatively, if the cost of outright repeal makes that unrealistic, then the National Taxpayer Advocate recom-

<sup>33</sup> Higher income taxpayers can use a similar strategy to avoid the phase-out of the AMT exemption in alternate years.

<sup>34</sup> W&I Research Group 5, *Nationwide Analysis Tax Year 2003*, Pub. 4210 (Sept. 2005) (suggesting low income taxpayers are less likely to use preparers than high income taxpayers).

mends policymakers consider the following questions with respect to each existing phase-out and as they draft tax reform proposals. The National Taxpayer Advocate also recommends that Congress require a discussion of these questions to be included with any proposal that includes a phase-out.

1. Can we identify a tax policy reason (other than revenue scoring) for using each phase-out? Do those tax policy benefits outweigh the cost of complexity and noncompliance that the phase-out will generate? If so, do such policy reasons suggest a particular income level at which a phase-out makes sense?
2. Is it feasible to use a single measure of income for each phase-out, such as “adjusted gross income?” Is there a good policy reason to deviate from the existing measures of income that outweighs the complexity such deviation will create? Will those policy reasons justify increasing the number of computations and “quasi-returns” (*i.e.*, additional forms, schedules, and worksheets) that taxpayers have to fill out each year and the noncompliance that such complexity will generate?
3. Are there important tax policy reasons not to index each phase-out for inflation? Unless phase-outs are indexed for inflation, the real income level set by policymakers to trigger them will drift downward each year until the tax benefit affects only a few of the lowest income taxpayers while burdening all taxpayers with a needlessly complex tax code. Unindexed phase-outs might also begin to overlap with other phase-outs that are indexed for inflation, producing unexpectedly high effective marginal tax rates at certain income levels.
4. Should phase-outs create penalties for married or unmarried taxpayers or otherwise affect taxpayers differently based on filing status?
5. Should phase-out ranges be wide or narrow? Phase-out ranges that eliminate tax benefits gradually (*e.g.*, ratably) over a reasonably wide phase-out range are less likely to create unexpectedly high effective marginal tax rates. When phase-outs result in unexpectedly high effective marginal tax rates they make it difficult for taxpayers to predict their liability ahead of time, reduce the incentive to work, and create planning opportunities for taxpayers who are able to shift income from one year to the next or to related individuals or entities. However, phase-outs with wider phase-out ranges generally affect more taxpayers directly, and also provide some tax benefit to more taxpayers.
6. Is there any tax policy reason for phase-out formulas to differ as widely as they do? Uniform and simple phase-out formulas might make it easier for taxpayers to figure out how additional income will affect their tax benefits. They might also allow the IRS to reduce the number of forms, worksheets, and schedules that taxpayers need to fill out.
7. Is there a good policy reason for phase-out ranges to overlap? On one hand, overlapping phase-outs can create unexpectedly high effective marginal income

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tax rates for taxpayers in those ranges. On the other hand, creating standard phase-out ranges, as proposed by some practitioner groups, could have the advantage of increasing the transparency of the tax code because taxpayers may be more likely to know what the phase-out range is and whether they are likely to be subject to it.<sup>35</sup> Uniform ranges might also enable the IRS to reduce the number of forms, worksheets, and schedules required to administer phase-outs.

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<sup>35</sup> See American Bar Association, American Institute of Certified Public Accountants, and Tax Executives Institute, Inc., *Recommendations of the AICPA/ABA/TEI Task Force on Tax Simplification* (Sept. 13, 2002) (Attachment B: Simplification of Phase-Outs Based on Income Levels), available at <https://www.abanet.org/tax/pubpolicy/2002/020913lt-atb.pdf> (proposing three standard phase-out ranges: one for benefits targeted to low income taxpayers, one for benefits targeted to middle income taxpayers, and one for benefits targeted to high income taxpayers).

## RECOMMENDATION

**#5 INCREASE THE EXEMPT ORGANIZATION INFORMATION RETURN FILING THRESHOLD****PROBLEM**

Under Internal Revenue Code § 501, certain specified organizations are exempt from federal taxation. These organizations, however, are generally required to file information returns with the IRS. When a tax exempt organization required to file an information return fails to do so or does not complete the return correctly, the Code imposes penalties on the organization.<sup>1</sup>

IRC § 501 exempts several types of organizations from federal taxation. The vast majority are formed for “religious, charitable, scientific, testing for public safety, literary, or educational purposes” under IRC § 501(c)(3).<sup>2</sup> In fiscal year 2005, there were more than one million § 501(c)(3) exempt organizations on file with the IRS.<sup>3</sup> Most of these organizations are small public charities.<sup>4</sup> More than 60 percent of exempt organizations on file with the IRS have less than \$100,000 in net assets, and more than half have less than \$25,000 in income.<sup>5</sup>

These small exempt organizations have limited resources and rely heavily on the services of volunteers. About half of all exempt organizations rely solely on volunteer staffs and another third have fewer than ten employees<sup>6</sup> Many exempt organizations do not have professional tax or accounting staffs and rely on volunteers to ensure that the organization complies with its filing requirements and accurately prepares its returns.<sup>7</sup>

The tax exempt information return filing requirements are complex. Exempt organizations are generally required to file IRS Form 990, Return of Organization Exempt from Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. The IRS estimates that the time to prepare and complete Form 990 (and accompanying schedules) is more than 216 hours – or 27 working days, and time to complete

<sup>1</sup> See IRC § 6652(c)(1)(A).

<sup>2</sup> In FY 2005, more than 1 million of the 1.7 million total tax exempt organizations were formed under IRC § 501(c)(3) (more than 61 percent). IRS Data Book 2005, Table 22-*Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2002-2005*.

<sup>3</sup> IRS Data Book 2005, Table 22.

<sup>4</sup> IRC § 501(c)(3) also provides that certain “private foundations” are exempt from federal taxation. “Private foundation” is defined in IRC § 509(a). Because the filing requirements for private foundations differ from the filing requirements of public charities, this section of the National Taxpayer Advocate’s Annual Report to Congress deals only with organizations exempt from taxation under IRC § 501(c)(3) that are not private foundations.

<sup>5</sup> IRS, *SOI Tax Study, Exempt Organizations: IRS Master File*, at <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html>.

<sup>6</sup> IRS Tax Exempt and Government Entities Division, *FY 2005 Strategic Assessment 3*.

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

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Form 990-EZ (the “short form”) is more than 133 hours (nearly 17 working days).<sup>8</sup> Exempt organizations that do not have accounting staffs or cannot afford professional assistance to complete these returns are likely to make mistakes and file returns with incorrect or incomplete information.

When an exempt organization files an incorrect or incomplete return, it is subject to penalties. The IRS can abate these penalties if an exempt organization can show that a late or incomplete return was attributable to “reasonable cause;”<sup>9</sup> but when an exempt organization – particularly a smaller one – has to devote resources to working with the IRS to abate penalties, it draws resources from the organization’s charitable functions.

Under current law, exempt organizations with annual gross receipts that are normally more than \$25,000 must file an information return with the IRS.<sup>10</sup> This \$25,000 filing threshold was set administratively in 1982 and has not been adjusted for inflation in 24 years.<sup>11</sup> The statutory filing threshold of \$5,000 has not been changed since it was enacted in 1969.<sup>12</sup> In the meantime, the Consumer Price Index has increased 449 percent since 1969 and 109 percent since 1982.<sup>13</sup> Thus, an exempt organization with gross receipts of \$25,100 for the 2006 tax year must file an information return, even though its gross receipts would have been only \$ 4,572 in 1969 dollars and \$12,010 in 1982 dollars. Conversely, \$5,100 of gross receipts in 1969 would be equal to \$28,001 in today’s dollars and \$25,100 of gross receipts in 1982 would be equal to \$52,459 today. Because the filing threshold has not been adjusted for inflation, many small exempt organizations must deal with burdensome and complex filing requirements.

The outdated filing threshold will affect more and more exempt organizations as it remains static. The number of section 501(c)(3) organizations on file with the IRS has increased 15 percent since 2002.<sup>14</sup> The growth of the exempt organization sector is one reason that all exempt organizations not required to file an information return with the IRS must file an annual electronic notice with the IRS setting forth basic information about the organization.<sup>15</sup>

<sup>8</sup> 2005 Instructions for Forms 990 and 990-EZ, 45. For a more detailed discussion about the complexities of the exempt organization filing requirements, see National Taxpayer Advocate 2005 Annual Report to Congress 295-298.

<sup>9</sup> IRC § 6652(a)(3); IRM 3.12.12.2.6.8 – Reasonable Cause; IRM 20.1, See Rev. Proc. 79-8, 1979-1 C.B. 487; Policy Statement P-2-7, P-2-9, and P-2-11.

<sup>10</sup> IRS, *Instructions for Form 990 and Form 990-EZ 2* (2005).

<sup>11</sup> Announcement 82-88, 1982-25 IRB 23.

<sup>12</sup> IRC § 6033(a)(3)(A)(ii).

<sup>13</sup> United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, available at [www.bls.gov/cpi](http://www.bls.gov/cpi).

<sup>14</sup> IRS Data Book 2005, Table 22. IRC § 501(c)(3) organizations have increased from 909,574 in 2002 to 1,045,979 in 2005.

<sup>15</sup> IRC § 6033(i).

**EXAMPLE**

In 1987 Mr. and Mrs. Siddons formed ABC Co. as a chartering organization to sponsor Troop 416 of the Boy Scouts of America. Troop 416 is located in Springfield, a small town in the midwestern United States. Upon its formation, ABC Co. applied for and received tax exempt status under IRC § 501(c)(3). ABC Co.'s primary function is to solicit and receive donations to support the troop. Since 1987, ABC Co. has been staffed by Mr. and Mrs. Siddons and Mr. Hastings, proprietor of the local hardware store. In 1998, the Siddons' son, Whitey, an English teacher at Springfield High School, also began helping out with ABC Co. All four individuals serve on a volunteer basis and receive no compensation.

For tax years 1987 through 2001, ABC Co. averaged less than \$25,000 in gross receipts. Nearly all of ABC Co.'s receipts are from donations made by the scouts' parents and local businesses and from Troop 416's annual mulch sale.

Since 1987, Troop 416's membership has expanded and ABC Co.'s receipts from donations have increased. Additionally, the Troop 416's mulch supplier has increased prices. The troop sells about the same amount of mulch each year, but gross receipts from the mulch sale have increased because the troop has to increase the price each year to cover its costs. For tax years 2000 through 2002, ABC Co. averaged more than \$30,000 in gross receipts. For its 2005 tax year, ABC Co.'s gross receipts were nearly \$35,000.

Because its gross receipts had increased above the \$25,000 filing threshold for 2000 through 2002, ABC Co. began filing Form 990-EZ in 2003 (for its 2002 tax year). Whitey Siddons volunteered to file ABC Co.'s information returns because he had taken two semesters of basic accounting while earning his English degree at State University. In 2004, the IRS informed ABC Co. that it had been assessed a penalties totaling \$1,500 for ABC Co.'s 2002 tax year because ABC Co. had failed to file required schedules with its 2002 Form 990-EZ. Paying this penalty will put Troop 416's planned summer trip to the Philmont Scout Ranch in jeopardy. Neither Whitey nor the other ABC Co. volunteers have dealt with the IRS before, and they are concerned that hiring a lawyer or accountant to handle the problem may cost as much as paying the penalty.

**RECOMMENDATION**

Amend Internal Revenue Code section 6033(a)(3)(A)(ii) to (1) increase the statutory information return filing threshold for IRC § 501(c)(3) organizations (excluding private foundations) from \$5,000 to \$50,000, and (2) provide that the statutory filing threshold be adjusted for inflation in subsequent years.

**CURRENT LAW**

Internal Revenue Code § 501(a) provides that an organization described in section 501(c) shall generally be exempt from federal income taxation. Section 501(c)(3) provides that certain organizations organized and operated exclusively for religious,

charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition are exempt from federal income taxation under section 501(a). Code section 509(a) provides that certain section 501(c)(3) organizations are defined as private foundations. Organizations organized under section 501(c)(3) that are not private foundations under section 509(a) are generally referred to as public charities.

IRC § 6033(a) requires, with certain exceptions, every organization exempt from tax under section 501(a) to file an annual information return with the IRS. Most exempt organizations that are not private foundations must file Form 990, Return of Organization Exempt from Income Tax.<sup>16</sup> An organization required to file Form 990 may file instead a Form 990-EZ, Short Form Return of Organization Exempt from Income Tax, if the organization's gross receipts during the year are less than \$100,000 and its total assets at the end of the year are less than \$250,000.<sup>17</sup> An organization that meets the Form 990-EZ filing requirements can still file Form 990, if it chooses to do so.<sup>18</sup>

Code § 6033(a)(3)(A)(ii) provides that a tax exempt organization is exempt from filing an information return with the IRS if its annual gross receipts are normally not more than \$5,000.<sup>19</sup> Section 6033(a)(3)(B) provides that the Secretary of the Treasury may relieve any organization from the 6033(a)(1) filing requirement where the Secretary determines that such filing is not necessary to the "efficient administration of the internal revenue laws." Treas. Reg. § 1.6033-2(g)(6) delegates this authority to the Commissioner of Internal Revenue.

With the Tax Reform Act of 1969 (1969 Act), Congress began requiring more exempt organizations to file information returns with the IRS.<sup>20</sup> The 1969 Act also provided, that certain section 501(c)(3) organizations were exempt from information return filing if their annual gross receipts were normally not more than \$5,000.<sup>21</sup> This statutory \$5,000 gross receipts threshold remains in place today.<sup>22</sup> However, the IRS has twice increased

<sup>16</sup> Treas. Reg. § 1.6033-2(a)(2)(i). Tax exempt private foundations must file Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation. *Id.*

<sup>17</sup> IRS, *Instructions for Form 990 and Form 990-EZ 2* (2005).

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

<sup>19</sup> The Code and regulations also provide that the following organizations are exempt from the filing requirement: (1) a church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church (IRC § 6033(a)(3)(A)(i), Treas. Reg. § 1.6033-2(g)(1)(i)); (2) a school below college level affiliated with a church or operated by a religious order (IRC § 6033(a)(3)(C)(ii), Treas. Reg. § 1.6033-2(g)(1)(vii)); a mission society sponsored by, or affiliated with, one or more churches or church denominations, more than one-half of whose activities are conducted in, or directed to persons in a foreign country (IRC § 6033(a)(3)(C), Treas. Reg. § 1.6033-2(g)(1)(iv)); an exclusively religious activity of any religious order (IRC § 6033(a)(3)(A)(iii), Treas. Reg. § 1.6033-2(g)(1)(ii)); and a state institution whose income is excluded from gross income under IRC § 115(a) (IRC § 6033(a)(3)(B), Treas. Reg. § 1.6033-2(g)(1)(v)).

<sup>20</sup> Pub. L. No. 91-172 § 101(d) (1969).

<sup>21</sup> *Id.*

<sup>22</sup> IRC § 6033(a)(3)(A)(ii).



the filing threshold administratively under the authority granted in IRC § 6033(a)(3)(B). For tax years ending on or after December 31, 1976, the gross receipts filing threshold was increased to \$10,000.<sup>23</sup> On January 1, 1982, the IRS increased the threshold to \$25,000 for tax years ending on or after December 31, 1982.<sup>24</sup> To determine whether an organization's gross receipts do not normally exceed \$25,000, the IRS uses the following formula:

- ◆ If an organization has been in existence a year or less, then its gross receipts can be up to \$37,500.
- ◆ If an organization is between one and three years old, then the average of its last two years of receipts can be up to \$30,000.
- ◆ If an organization has been in existence for three years or more, then the average of its preceding three years cannot exceed \$25,000.<sup>25</sup>

Internal Revenue Code § 6652(c)(1)(A) imposes a \$20 per day penalty (up to \$10,000 or five percent of the organization's yearly gross receipts) for each day a return required under § 6033 is not filed or filed with missing or incomplete information. For exempt organizations with annual gross receipts exceeding \$1 million, the penalty is \$100 per day (up to \$50,000).<sup>26</sup>

For tax years beginning after 2006, IRC § 6033(i) requires organizations exempt from information reporting under IRC § 6033(a)(3)(A)(ii) or (a)(3)(B) to electronically file an annual notice with the IRS setting forth:

- ◆ The organization's legal name;
- ◆ Any name under which such organization operates or does business;
- ◆ The organization's mailing address and Internet web site address (if any);
- ◆ The organization's taxpayer identification number (TIN);
- ◆ The name and address of a principal officer; and
- ◆ Evidence of the continuing basis for the organization's exemption from the information return filing requirements.<sup>27</sup>

An organization required to file these notices that fails to do so for three consecutive years will lose its tax exempt status.<sup>28</sup>

<sup>23</sup> See Rev. Proc. 83-23, 1983-1 C.B. 687 and Announcement 82-88, 1982-25 IRB 23.

<sup>24</sup> Announcement 82-88, 1982-25 IRB 23.

<sup>25</sup> IRS, *Instructions for Form 990 and Form 990-EZ* 3 (2005).

<sup>26</sup> IRC § 6652(c)(1)(A).

<sup>27</sup> IRC § 6033(i).

<sup>28</sup> IRC § 6033(j)(1).

## REASONS FOR CHANGE

### *Congressional Intent and Legislative History*

Under current law, more small tax exempt organizations are required to file an annual information return with the IRS than was originally intended. In the Tax Reform Act of 1969 Congress provided that certain § 501(c)(3) organizations were required to begin filing information returns, but organizations would remain exempt from information return filing if their annual gross receipts were normally not more than \$5,000.<sup>29</sup> The Code does not provide for this filing threshold to be adjusted for inflation. The 1969 Act also provided that the Secretary of the Treasury could relieve any exempt organization from the information return filing requirement where the Secretary determines that filing an information return is “not necessary to the efficient administration of the internal revenue laws.”<sup>30</sup> The Secretary has delegated this authority to the IRS.<sup>31</sup>

The 1969 Act increased the reporting requirements for exempt organizations to “provide the Internal Revenue Service with the Information needed to enforce the tax laws” and to prevent certain exempt organizations from abusing the tax exemption provisions without IRS scrutiny.<sup>32</sup> Congress did not intend, however, for the increased filing requirements to reach small organizations. Congress did not want to force these small organizations “to consume the few assets they possess in order to hire lawyers and accountants to prepare an annual [return].”<sup>33</sup> Thus, Congress included the \$5,000 statutory filing exception in the 1969 Act.

### *Administrative Adjustments and Economic Change*

Congress has not changed the statutory \$5,000 annual gross receipt filing threshold since 1969,<sup>34</sup> but the IRS has increased the filing threshold administratively under its section 6033(a)(3)(B) discretionary exception authority. For tax years ending on or after December 31, 1976, the gross receipts filing threshold was increased to \$10,000.<sup>35</sup> On January 1, 1982, the IRS increased the threshold to \$25,000 for tax years ending on or after December 31, 1982.<sup>36</sup> Both increases came because the IRS realized that the information return filing threshold was not high enough to “relieve relatively small

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<sup>29</sup> Pub. L. No. 91-172 § 101(d) (1969).

<sup>30</sup> IRC § 6033(a)(3)(B).

<sup>31</sup> Treas. Reg. § 1.6033-2(g)(6).

<sup>32</sup> See S. Rep. No. 91-552, 52 (1969); H.R. Rep. No. 91-413, pt. 1, 36 (1969); H.R. Conf. Rep. No. 91-782, 286 (1969); Cong. Rec., S15,646-48 (Nov. 24, 1969).

<sup>33</sup> Cong. Rec., S15647 (Nov. 24, 1969) (statement of Sen. Curtis). See also Cong. Rec., H7096 (Aug. 7, 1969) (statement of Congressman Mills listing Boy Scouts, Girl Scouts, and the PTA as examples of organizations that should be exempt from the filing requirements).

<sup>34</sup> IRC § 6033(a)(3)(A)(ii).

<sup>35</sup> Announcement 77-62 (April 25, 1977); see Rev. Proc. 83-23, 1983-1 C.B. 687 and Announcement 82-88, 1982-25 IRB 23.

<sup>36</sup> Announcement 82-88, 1982-25 IRB 23.

organizations from the [Form 990] filing requirements.”<sup>37</sup> Twenty-four years after this last adjustment, however, the \$25,000 filing threshold remains in place.

While the filing threshold has remained constant, economic conditions have changed. Since 1982, the Consumer Price Index (CPI) has increased 109 percent.<sup>38</sup> Thus, an exempt organization with gross receipts of \$25,000 in 1982 would have gross receipts of over \$52,000 in 2006 dollars.<sup>39</sup> Conversely, an exempt organization with \$25,000 in gross receipts today would have had just under \$12,000 in gross receipts in 1982 dollars. In other words, when adjusted for inflation, the \$25,000 filing threshold requires information return filing by exempt organizations that have gross receipts of less than half of the threshold as enacted in 1982. The CPI has also increased nearly 450 percent since the \$5,000 statutory exception was first enacted.<sup>40</sup>

*Effects on Small Exempt Organizations*

Requiring “relatively small” exempt organizations to grapple with the complex Form 990 filing requirements unnecessarily drains resources from both small exempt organizations and the IRS. Small exempt organizations that rely on volunteers rarely have access to professional tax advice. So, the current filing threshold requires many small volunteer-run organizations to take their chances filing the required returns themselves, or to turn to the IRS for help.

*Complex Requirements*

Volunteers attempting to file an exempt organization’s information return must make a significant time commitment. Table 2.5.1 shows the latest IRS estimates for preparing and completing Forms 990 and 990-EZ.

**TABLE 2.5.1, ESTIMATED TIME FOR COMPLETING FORMS 990 AND 990-EZ AND RELATED SCHEDULES**<sup>41</sup>

Form	Record-keeping	Learning about the law or form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
990	102 hr., 36 min.	15 hr., 4 min.	21 hr., 8 min.	1 hr., 4 min.	139 hr., 52 min.
990-EZ	29 hr., 10 min.	11 hr., 36 min.	14 hr., 24 min.	32 min.	55 hr., 42 min.
Schedule A	49 hr., 44 min.	9 hr., 26 min.	10 hr., 39 min.	—	69 hr., 49 min.
Schedule B	4 hr., 46 min.	1 hr., 23 min.	1 hr., 31 min.	—	7 hr., 40 min.

<sup>37</sup> Announcement 82-88, 1982-25 IRB 23.

<sup>38</sup> United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, available at [www.bls.gov/cpi](http://www.bls.gov/cpi).

<sup>39</sup> *Id.*

<sup>40</sup> United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, available at [www.bls.gov/cpi](http://www.bls.gov/cpi).

<sup>41</sup> IRS, *Instructions for Form 990 and Form 990-EZ*, 45 (2005).

According to the information shown in Table 2.5.1, it will take an exempt organization 217 hours and 31 minutes to prepare, complete and file Form 990 with Schedules A and B. That task would take one person working full time more than 5 ½ weeks to complete.<sup>42</sup> And the 990-EZ “short” form will take 133 hours and 11 minutes to prepare; keeping a full time person busy for over three weeks.<sup>43</sup>

#### *Limited IRS Resources*

When volunteers and exempt organization staff who are not “tax people” have to prepare and file these lengthy and complex returns, they may try and turn to the IRS for assistance. Unfortunately, the assistance the IRS can offer may not be particularly helpful. Calls to the IRS concerning exempt organization filing requirements are routed to the IRS Tax Exempt and Government Entities Division’s (TE/GE) toll-free customer assistance line. For fiscal years 2003 through 2005, the TE/GE toll-free line answered only about 60 percent of its calls.<sup>44</sup> This low service rate is mostly attributable to the extraordinarily high demand in customer phone calls. From fiscal year 1999 to fiscal year 2003, calls to TE/GE’s toll-free customer assistance line grew 243 percent.<sup>45</sup> As a result, even though TE/GE is answering more calls every year, the ratio of calls answered to calls received is generally decreasing.<sup>46</sup> These numbers indicate that more and more exempt organizations are turning to the IRS for help with filing requirements and other questions, but the IRS does not have the resources to provide the help needed. As a result, exempt organizations that do not have tax experts on staff may be on their own.<sup>47</sup>

#### *Penalties and Abatements*

When volunteers without tax expertise have to prepare lengthy and complex information returns, mistakes are likely. When an exempt organization files an information return with missing or incorrect information, the IRS is required to assess a Daily Delinquency Penalty (DDP) on the organization until the missing information is supplied or the defect is cured.<sup>48</sup> If the penalized organization later supplies the missing return or information, or corrects the error, and can show reasonable cause for the mistake, the IRS will abate the assessed DDPs.<sup>49</sup> IRS DDP abatement rates demonstrate

<sup>42</sup> 217 hours and 35 minutes divided by 40 hours per week equals 5.4 work weeks.

<sup>43</sup> 133 hours and 14 minutes divided by 40 hours per week equals 3.3 work weeks.

<sup>44</sup> Telephone Data Report, TE/GE Toll Free Customer Service, Cincinnati, FY 2003-2004; TE/GE Cincinnati Call Center, Call Data Summary FY 2005. See also TE/GE, *Strategic Assessment FY 2006 2*. The IRS Wage and Investment Division (W&I) recently began operating the TE/GE toll-free customer assistance line in conjunction with other IRS help lines. It is anticipated that this change will improve the TE/GE line service level.

<sup>45</sup> TE/GE, *Strategic Assessment FY 2006 2*.

<sup>46</sup> *Id.*

<sup>47</sup> For a more detailed discussion of this subject, see National Taxpayer Advocate 2005 Annual Report to Congress 302-304.

<sup>48</sup> IRC § 6652(c)(1)(A).

<sup>49</sup> IRC § 6652(a)(3); IRM 3.12.12.2.6.8 – Reasonable Cause; IRM 20.1, Rev. Proc. 79-8, Policy Statement P-2-7, P-2-9, and P-2-11.

that most exempt organizations are able to cure defects in their returns and show that the mistakes or omissions were due to reasonable cause. Table 2.5.2 shows the number of DDPs assessed and abated from tax years 1992 through 2005.

**TABLE 2.5.2, DAILY DELINQUENCY PENALTY ASSESSMENTS AND ABATEMENTS**<sup>50</sup>

Year	Number of Penalties Assessed	Number of Penalties Abated	Percent	Amount of Penalties Assessed	Amount of Penalties Abated	Percent
2000	61,065	43,959	72.0	\$175,478,613	\$145,588,460	83.0
2001	57,451	39,631	69.1	\$165,128,263	\$129,909,678	78.7
2002	69,575	45,470	65.4	\$207,557,338	\$149,111,426	71.8
2003	74,249	41,690	56.1	\$229,901,830	\$138,919,162	60.4
2004	81,154	45,903	56.6	\$235,925,748	\$143,219,698	60.7
2005	88,714	49,752	56.1	\$251,000,718	\$150,157,959	59.8
<b>Total</b>	<b>432,208</b>	<b>266,405</b>	<b>61.6</b>	<b>\$1,264,992,510</b>	<b>\$856,906,383</b>	<b>67.7</b>

Table 2.5.2 indicates that for the last six tax years, the IRS has abated almost 62 percent of all assessed DDPs and nearly 68 percent of all assessed DDP dollars. These high abatement numbers indicate that exempt organizations are making frequent but correctable errors when filing required information returns.<sup>51</sup> Table 2.5.3 shows the most common Form 990 and 990-EZ filing errors.

**TABLE 2.5.3, THE MOST COMMON FORM 990 AND 990-EZ FILING ERRORS**<sup>52</sup>

Form 990	Form 990-EZ
Missing Schedule B or the box in Item M is not checked <sup>53</sup>	Missing Schedule B or the box in Item H is not checked <sup>54</sup>
Missing or incomplete Schedule A	Missing or incomplete Schedule A
Missing signature	Request to file Form 990 (total assets more than \$250,000)
Part IV-A, Schedule A (support schedule) is missing or incomplete	Request to file Form 990 (gross receipts more than \$100,000)
Part IV (reconciliation of revenue/expenses) is missing or incomplete	Missing signature
Clarification of subsection (request copy of determination letter)	Clarification of subsection (request copy of determination letter)

<sup>50</sup> IRS Enforcement Revenue Information System (ERIS) and Statistics of Income (SOI) for EO Returns, 2000-2005 DDP assessments and abatements.

<sup>51</sup> For a more detailed discussion on the IRS's high DDP abatement rate and possible administrative remedies, see National Taxpayer Advocate 2005 Annual Report to Congress 292-314.

<sup>52</sup> Most Common Reasons the IRS May Need to Contact You (available at <http://www.irs.gov/charities/article/0,,id=96359,00.html>).

<sup>53</sup> Item M on Form 990 requires a filing organization to check a box if the organization is not required to file Schedule B.

<sup>54</sup> Item H on Form 990-EZ requires a filing organization to check a box if the organization is not required to file Schedule B.

Table 2.5.3 demonstrates that most Form 990 and 990-EZ errors are attributable to inadvertent and clerical mistakes. The top two errors for both forms are missing or incorrect Schedules A or B. These errors are probably so frequent because many smaller exempt organizations do not realize they have to file these schedules with their return. It also appears that these errors are generally curable and that the affected organizations should be able to demonstrate that the errors were due to reasonable cause. The high DDP abatement rate indicates that this scenario is playing out on an annual basis.

The continuing cycle of DDP assessment and abatement is not good for anyone. Exempt organizations that receive DDP assessments that are due to curable errors must use their limited resources to work with the IRS to try and receive abatements. Or they may simply pay the penalties to avoid dealing with the IRS at all – this latter course not only wastes the organization’s limited resources, but the organization is likely to be penalized again if does not work with the IRS to find out *why* the IRS assessed penalties. The DDP assessment/abatement cycle also wastes IRS resources. When more than 60 percent of all assessed DDPs are eventually abated, IRS employees are spending significant time determining whether the mistakes that gave rise to the assessments were attributable to reasonable cause.

Many DDP assessments could be avoided altogether if smaller exempt organizations were not required to file an information return. Because the most frequent filing mistakes are attributable to inadvertent and clerical errors, it follows that most errors that trigger a DDP assessment are being made by smaller exempt organizations that rely on volunteers to prepare and file their information returns.<sup>55</sup> Increasing the information return filing threshold to \$50,000 and adjusting the threshold for inflation in the future would “relieve relatively small [tax exempt] organizations from the filing requirements” and prevent these small organizations and the IRS from using their valuable resources to deal with DDP assessments and abatements.

#### *Small Exempt Organizations: Flying Below the Radar?*

Since it increased the information return filing threshold to \$25,000 in 1982, the IRS has said next to nothing about it.<sup>56</sup> Thus, the only stated rationale for setting the threshold at \$25,000 is that it was intended to “relieve relatively small organizations from the filing requirements.”<sup>57</sup> To our knowledge, the IRS has never publicly explained

<sup>55</sup> The IRS no longer tracks Form 990 and 990-EZ error frequency, but when it last reported error frequency in 1998, more than half of all Form 990 and 990-EZ errors were attributable to missing or incorrect Schedules A. IRS, *Common Errors Found on Form 990 and Form 990-EZ* (available at [http://www.qual990.org/common\\_errors.html](http://www.qual990.org/common_errors.html)). The National Taxpayer Advocate recommends that the IRS resume error frequency tracking so that it may better educate exempt organizations about common errors and how these errors can be prevented.

<sup>56</sup> We found only two official IRS pronouncements that mention Announcement 82-88: Rev. Proc. 83-23 (establishing and maintaining for reference purposes a list of 501(c)(3) organizations exempt from filing) and PLR 8337094 (June 17, 1983) (holding that local chapters of a social welfare organization organized under IRC § 501(c)(4) were not required to file a Form 990 if their annual gross receipts were normally below the \$25,000 filing threshold).

<sup>57</sup> Announcement 82-88.

why it has not adjusted this threshold for inflation for nearly a quarter century. One possible explanation could be, however, that the IRS is concerned that raising the filing threshold could allow many smaller organizations to operate under the IRS's radar. In fact, this was one of the primary reasons Congress increased exempt organization filing requirements in 1969.<sup>58</sup> When there is no IRS scrutiny, the potential for abusing the tax exempt laws or operating illegitimate "charities" is high. Thus, any IRS concerns about small organizations abusing the Code's exemption provisions are valid and the IRS's failure to raise the filing threshold is understandable.

These concerns are largely alleviated, however, by the enactment of the Pension Protection Act of 2006. Section 1223 of this Act amended Code section 6033 to require organizations exempt from the information filing requirements under sections 6033(a)(3)(A)(ii) or (a)(3)(B) to file electronically with the IRS an annual notice setting forth basic information including the organization's name (and any previous names), mailing address, Internet web site address (if any), TIN, name and address of a principal officer, and evidence of the continuing basis for the organization's exemption from the information return filing requirements.<sup>59</sup> An organization required to file these notices that fails to do so for three consecutive years will lose its tax exempt status.<sup>60</sup>

Under this new provision all exempt organizations that are exempt from filing because their annual gross receipts do not normally exceed the filing threshold are required to provide the IRS with basic information on an annual basis. These annual electronic "check ins" will prevent any tax exempt organization from operating under the IRS's radar.<sup>61</sup> This reporting requirement should minimize concerns about illegitimate exempt organizations avoiding IRS scrutiny because of an increased filing threshold. Because all small tax exempt organizations are now required to electronically submit basic information to the IRS, the filing threshold should be increased to \$50,000 to relieve those "relatively small" organizations that were never intended to be subject to the complex and cumbersome Form 990 filing requirements. And the \$50,000 filing threshold should be adjusted for inflation in later years to prevent those "relatively small" organizations from being subject to the information return filing requirements solely because of inflation.

An increased filing threshold would greatly benefit small tax exempt organizations. These organizations would no longer have to comply with the cumbersome and complex Form 990 requirements and no longer have to deal with Daily Delinquency

<sup>58</sup> See S. Rep. No. 91-552, 52 (1969); H.R. Rep. No. 91-413, pt. 1, 36 (1969); H.R. Conf. Rep. No. 91-782, 286 (1969); Cong. Rec., S15,646-48 (Nov. 24, 1969).

<sup>59</sup> IRC § 6033(i).

<sup>60</sup> IRC § 6033(j)(1).

<sup>61</sup> Exempt organizations are also generally subject to state filing requirements. In California, for example, exempt organizations must file Form 3500, Exempt Application, and Form 199, California Exempt Annual Information Return, with the California Franchise Tax Board. (California Franchise Tax Board, Publication 927, *Exempt Organizations: Nonprofit doesn't mean tax exempt* (Jul. 2003). State filing requirements also help to prevent small exempt organizations from operating without government oversight.

Penalties when they make mistakes. An increased filing threshold would also benefit the IRS. If fewer exempt organizations were required to file information returns, there would be fewer calls to TE/GE's overburdened toll-free customer assistance line. The IRS could also devote fewer resources to dealing with DDP abatements. Further, because all small exempt organizations are now required to file annual electronic notices with the IRS, there is very little risk that relieving more small exempt organizations from the filing requirements will increase noncompliance or abuse of the tax exempt provisions of the Code.<sup>62</sup> With these new protections in place, information return filing by "relatively small" exempt organizations is not necessary to the efficient administration of the internal revenue laws. In fact, relieving these small organizations of the burdens of information return filing would actually increase administrative efficiency.

#### EXPLANATION OF RECOMMENDATIONS

A \$50,000 filing threshold approximates the 109 percent CPI increase since the \$25,000 threshold became effective in 1982.<sup>63</sup> And providing that the increased threshold be adjusted for inflation will prevent small organizations from being captured by the filing requirements as the CPI continues to increase.

Increasing the filing threshold and adjusting it for inflation thereafter could be accomplished administratively.<sup>64</sup> There are, however, several disadvantages of waiting for the IRS to increase the threshold by administrative action. As a starting point, the initial exempt organization filing threshold was *statutory*. Congress included the \$5,000 gross receipts threshold in the 1969 Act to avoid placing filing burdens on small exempt organizations.<sup>65</sup> Congress failed, however, to provide for this initial \$5,000 to be adjusted for inflation. Because the initial gross receipts filing threshold was statutory and because Congress has not adjusted this threshold for inflation for 37 years, a statutory threshold increase is appropriate.

There are at least three more reasons why a statutory threshold adjustment is preferable to an administrative adjustment. First, administrative changes are subject to Treasury and IRS workload priorities. There are eight projects related to exempt organizations listed on the Treasury/IRS 2006-2007 Priority Guidance Plan, none of which are related to the information return filing threshold.<sup>66</sup> Second, there is no indication that the IRS is planning on, or even thinking about, considering whether the current \$25,000 filing

<sup>62</sup> The IRS could cross reference the information obtained under the new electronic notice requirement with information from state oversight agencies to identify organizations that are abusing the tax exemption provisions.

<sup>63</sup> See United States Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, available at [www.bls.gov/cpi](http://www.bls.gov/cpi).

<sup>64</sup> IRC § 6033(a)(3)(B); Treas. Reg. § 1.6033-2(g)(6).

<sup>65</sup> Cong. Rec., S15647 (Nov. 24, 1969) (statement of Sen. Curtis). See also Cong. Rec., H7096 (Aug. 7, 1966) (statement of Congressman Mills listing Boy Scouts, Girl Scouts, and the PTA as examples of organizations that should be exempt from the filing requirements).

<sup>66</sup> Department of the Treasury, *2006-2007 Priority Guidance Plan*, (Aug. 15, 2006).



threshold continues to be appropriate. The current threshold has been in place for 24 years and the IRS has said almost nothing about the threshold since it was adopted in 1982. Third, even if the IRS administratively increased the filing threshold sometime in the near future, there is no indication that the IRS would also administratively provide for the threshold to be adjusted for inflation. Based on the IRS's lack of action in the past, it is unlikely that any increase would be revisited or reevaluated for economic appropriateness for many years.

These problems could all be avoided by codifying a \$50,000 threshold to be adjusted for inflation in future years. By acting legislatively, Congress can ensure that small exempt organizations will not be burdened with the Form 990 filing requirements and thus be free to use their full resources to fulfill their charitable and community service purposes. This change is now possible because small exempt organizations must file electronically with the IRS every year. This new filing requirement will prevent exempt organizations of any size from disappearing entirely.

## RECOMMENDATION

## #6

## FILING ISSUES

Filing a tax return is one of taxpayers' main entry points into the federal tax system. Considering that the system is based on voluntary compliance, it is in the best interest of both the taxpayer and the IRS to ensure that the filing process runs smoothly. When a taxpayer sits down to prepare a return with a commercial preparer, the taxpayer should not worry that his or her confidential tax information will be used or disclosed inappropriately. Further, if a taxpayer inadvertently designates the wrong account number to receive a refund, the IRS should have the proper authorization to resolve the issue.

The National Taxpayer Advocate continues to call for the establishment of minimum levels of competency for return preparation by developing a federal system to register, test, and certify unenrolled return preparers. She also believes that Congress and the IRS can improve preparer oversight by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.<sup>1</sup>

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**USE AND DISCLOSURE OF TAX RETURN INFORMATION**
**PROBLEM**

Section 7216 of the Internal Revenue Code and the regulations thereunder do not prohibit tax return preparers from using or disclosing tax return information for purposes of soliciting business. The existing regulations and proposed regulations thereunder permit a preparer to use or disclose the information for purposes of soliciting business, if the taxpayer has given written consent for the preparer to do so.<sup>2</sup> However, taxpayers often receive stacks of forms to sign when hiring preparers to handle their taxes. There is no real way to determine whether taxpayers completely understand that they are authorizing the preparer to release their data to a third party, and from that point, their privacy and confidentiality may not be protected.

**EXAMPLE:**

A taxpayer goes to a paid preparer to have his federal and state individual tax returns done. The preparer asks him to sign a stack of papers on which he has highlighted the

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<sup>1</sup> 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; *Regulation of Federal Tax Return Preparers, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong. (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers, Hearing Before the U.S. Senate Committee on Finance*, 109th Cong. (April 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

<sup>2</sup> Treas. Reg. § 301.7216-3(a) permits a tax return preparer, with the written consent of a taxpayer, to use tax return information to promote nontax products and services currently offered by the preparer or a member of the preparer's affiliated group. Prop. Treas. Reg. § 301.7216-3(a) eliminates the affiliated group restriction, thereby essentially allowing a preparer to use or disclose tax return information, with the written consent of the taxpayer, for purposes of soliciting business for anyone.

appropriate place for the taxpayer's signature. The preparer briefly explains what each form contains. The taxpayer signs a form which the preparer explains as "a form providing me consent to analyze your tax information to determine if any products or services will benefit you." The taxpayer signs the consent form along with the others in the stack but does not realize that the form authorizes the preparer to analyze (or "use") the tax information for purposes of marketing nontax-related products or services, and this "analysis" has no time limits. The preparer completes the taxpayer's federal return, then tells the taxpayer he is due a \$2,000 refund and can have his check tomorrow, but first he has to fill out a refund anticipation loan application from Bank X and a separate disclosure consent form. When the taxpayer signs both forms, he does not understand that the preparer will share confidential tax return information with Bank X and that the tax laws do not prevent Bank X from disclosing the information to an independent third party.

### RECOMMENDATION

Congress should amend IRC §§ 7216 and 6713 to:

- ◆ Prohibit use or disclosure of tax return information for purposes other than tax preparation and filing of returns. The statutes should specifically prohibit the use or disclosure of information for the business solicitation of nontax-related products or services, including but not limited to those related to tax refund delivery and the protection from IRS audit.
- ◆ Specifically state the exception currently in Treas. Reg. § 301.7216-2(e), which provides that IRC §§ 7216(a) does not apply to a tax return preparer who is lawfully engaged in the practice of law or accountancy. This exception allows the individual to use or disclose tax return information to another employee or member of the preparer's law or accounting firm for purposes of rendering other legal or accounting services for the taxpayer.
- ◆ Clarify the reach of IRC § 7216(a) to include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation.
- ◆ Specifically state that the regulations issued thereunder must require safe harbor language to include in all written consents. The safe harbor language should address the limitations and duration of the consents as well as provide detailed contact information for the taxpayers to report violations or inquire about their rights.
- ◆ Prohibit the disclosure or use of information to or by any tax return preparer located outside of the United States, unless the taxpayer has provided written consent.

### PRESENT LAW

Internal Revenue Code § 7216 imposes a criminal penalty on preparers of income tax returns who knowingly or recklessly make unauthorized uses or disclosures of tax return

information,<sup>3</sup> while IRC § 6713 imposes a civil penalty for preparers' improper use or disclosure of such information. Both statutes and the regulations issued thereunder establish privacy protections by limiting a preparer's ability to use or disclose confidential information. The existing statutes and regulations permit a preparer, with the written consent of a taxpayer, to use tax return information to promote nontax products and services offered by the preparer or a member of the preparer's affiliated group.<sup>4</sup> Moreover, with written taxpayer consent, a preparer may disclose tax return information to any third party as directed by the taxpayer.

Treasury Regulation § 1.301.7216-2 includes exceptions to the written consent requirements of IRC § 7216. Such exceptions include, but are not limited to, the following:

- ◆ Use or disclosure in the case of related taxpayers;
- ◆ Disclosure pursuant to an order of the court or a federal or state agency;
- ◆ Use or disclosure for use in revenue investigations or court proceedings;
- ◆ Disclosure by attorneys and accountants;
- ◆ Disclosures by or to certain fiduciaries;
- ◆ Disclosures by one officer, employee, or member of the tax return preparer to another officer, employee, or member of the same tax return preparer; and
- ◆ Use or disclosure in preparation or audit of state returns.

In December 2005, the IRS and Treasury issued proposed regulations and a related draft revenue procedure.<sup>5</sup> The preamble to the proposed regulations states the proposed rules address taxpayers' consent to the disclosure or use of tax return information in an electronic environment. The proposed changes also focus on provisions designed to ensure that taxpayers give knowing, informed, and voluntary consent for such uses and disclosures. The proposed regulations allow preparers to obtain written consent for solicitation of services or facilities furnished by any person rather than limiting solicitations to the services or facilities offered by the preparer or a member of the preparer's "affiliated group." The proposed regulations would also require the taxpayer to consent in writing before the preparer releases information overseas, even when the overseas recipient is with the same firm.<sup>6</sup>

<sup>3</sup> IRC § 7216(a) specifically states that the section applies to "returns of tax imposed by chapter 1". Further, Treasury Reg. § 301.7216-1(b)(1) defines "tax return" as "any return (or amended return) of the income tax imposed by chapter 1 or 2 of the Code."

<sup>4</sup> Treas. Reg. § 301.7216-3.

<sup>5</sup> The Department of Treasury and the IRS have placed the IRC § 7216 regulation project on the *Office of Tax Policy and Internal Revenue Service 2006 – 2007 Priority Guidance Plan*, Tax Administration, Item 35 (Aug. 15, 2006).

<sup>6</sup> REG. 137243-02, 2006-3 I.R.B. (containing Prop. Treas. Reg. §§ 301.7216-1 to -3); Notice 2005-93, 2005-52 I.R.B. 1204 (containing Proposed Revenue Procedure 2005-93). For a more detailed discussion of the benefits included in the proposed regulations and revenue procedure, see *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Comm. on Finance*, 109th Cong. 2nd Sess. (Apr. 4, 2006) (Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents for preparers to use and disclose tax return information under IRC § 7216. The procedure contains mandatory language to include in consents, addressing the limitations and duration of the consents. It also contains mandatory language detailing contact information for the Taxpayer Advocate Service, so taxpayers can learn more about their rights under IRC § 7216, as well as contact information for the Treasury Inspector General For Tax Administration (TIGTA) to report violations.<sup>7</sup>

### REASONS FOR CHANGE

After the IRS and Treasury released the aforementioned proposed regulations and draft revenue procedure for public comment, the rules came under fire for not protecting taxpayers enough. A number of consumer protection groups argued the rules would allow commercial tax preparers to share and even sell confidential taxpayer information to third party marketers and database brokers.<sup>8</sup> Further, after the initial disclosure of tax return information to a third party, the tax laws and regulations would not restrict the redisclosure of information by the third party.<sup>9</sup>

Concerns raised about the proposed rules have also received congressional attention. Section 512 of S.1321, The Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act, directs the Secretary to amend the regulations under IRC § 7216 to prohibit the disclosure or use of information to or for any person unless such disclosure or use is in connection with preparing or filing, or providing services in connection with the preparation or filing of, a tax return. The bill also directs the Secretary to amend the regulations to prohibit use or disclosure of information to or by any tax return preparer located outside of the United States unless the taxpayer has granted consent to such disclosure or use, a provision that is consistent with the approach taken in the proposed regulations. However, S.1321 was never enacted into law.

In the Senate Report issued in connection with S.1321, the Finance Committee stated it found the use of tax information as a source of clients or data in nontax preparation lines of business “troubling.” Specifically, the Committee stated it was “concerned that tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return .... Taxpayers may not understand how these products work, or even that they are giving consent to these products or services as a part of the stack of forms they signed during the tax preparation process.” To address

<sup>7</sup> IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

<sup>8</sup> See, e.g., National Consumer Law Center, IRS Proposal Would Let Tax Preparers Sell Citizen Tax Records to Third Parties (March 8, 2006).

<sup>9</sup> Several commentators also objected to the requirement to obtain written consent for use or disclosure involving overseas activities by tax return preparers because this requirement would add unnecessary and burdensome steps to the current tax return processes of many multinational practices. See, e.g., American Institute of Certified Public Accountants, Comments on Proposed Regulations, REG-137243-02 Regarding Guidance to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations (Mar. 8, 2006).

these concerns, the Committee stated that it is appropriate to prohibit the use or disclosure of tax return information for a nontax preparation purpose.

The Committee also stated it is important for a taxpayer, with or without multinational dealings, to provide knowing consent to the transmission of tax return information to tax return preparers overseas, because of the difficulty of policing IRC § 7216 violations outside the United States.<sup>10</sup> Finally, the Committee recommended that both IRC §§ 6713 and 7216 expand the definition of “tax return preparer” to reflect current technology and business practices. The term should thus include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation.<sup>11</sup>

#### EXPLANATION OF RECOMMENDATIONS

The privacy of tax return information is fundamental to tax administration. Taxpayers need assurance that their information is protected during and after the tax preparation and filing experience. Accordingly, Congress should amend both IRC § 7216 and § 6713 to include clear language safeguarding the confidential nature of this information. The statutes should include explicit language to provide the following protections.

##### *Prohibition on Use or Disclosure for Purposes Other than Tax Preparation and Filing*

Internal Revenue Code §§ 7216 and 6713 should include language prohibiting the use or disclosure of tax return information for purposes other than tax preparation and filing of returns. In addition, the statutes should specifically state that such prohibition includes, but is not limited to, the use or disclosure of tax return information for purposes of soliciting products or services offered in relation to refund delivery or protection from IRS audit. The regulations issued thereunder can provide examples of preparers obtaining written consents for the purpose of marketing nontax-related products, including refund anticipation loans, and audit protection. The regulation could illustrate the distinction between marketing products and advice rendered during the tax preparation process. For example, a preparer is allowed to advise a taxpayer of the existence of software products to track trade or business expenses or assign value to charitable contributions. However, a preparer should not be able to take this process one step further and actually disclose the taxpayer’s information to the software vendor, with or without the taxpayer’s written consent.

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<sup>10</sup> S. Rep. No. 109-336, 109th Cong., 2d Sess. 86-90 (2006).

<sup>11</sup> *Id.* at 84-96.

### *Exception for Accountants and Attorneys*

IRC § 7216 should also specify that preparers engaged in the lawful practice of law or accountancy<sup>12</sup> are still permitted to use or disclose tax return information to another employee of their firms for purposes of rendering other legal or accounting services. This would allow state licensed accountants or attorneys to use or disclose the information to provide such additional services as business or estate planning.<sup>13</sup>

### *Expand Definition of “Tax Return Preparer”*

Internal Revenue Code § 7216(a) specifically states that the section applies to “returns of tax imposed by chapter 1.” Further, Treasury Reg. § 301.7216-1(b)(1) defines “tax return” as “any return (or amended return) of the income tax imposed by chapter 1 or 2 of the Code.” The definition of “tax return preparer” in Treas. Reg. § 301.7216-1(b)(2) hinges on the definition of “tax return.” Thus, IRC § 7216 only applies to preparers of income tax returns.

As stated by the Senate Finance Committee, IRC § 7216 must reflect current technology and business practices. Thus, it should clearly reach preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to return preparation, and contractors performing services in connection with return preparation. This would require amendments to IRC § 7216(a) and Treas. Reg. §§ 301.7216-1(b)(1) and (2).

### *Require Safe Harbor Language*

Internal Revenue Code § 7216 should specifically state that the regulations issued thereunder provide safe harbor language for written consents. There is no reference to such language in the existing statute and regulations. However, Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents for preparers to use and disclose tax return information under IRC § 7216. The proposed procedure contains mandatory language to include in consents, addressing the limitations and duration of the consents. As noted above, it also contains mandatory language detailing contact information for the Taxpayer Advocate Service, so taxpayers can learn more about taxpayer rights under IRC § 7216 as well as contact information for the TIGTA to report violations.<sup>14</sup>

Due to the importance of providing such necessary information on limitations, duration of consents, and contact information, the statute should require the IRS to issue safe harbor language to be included in written consents. Section 7216 must detail exactly what type of information the safe harbor language should include. The regulations can

<sup>12</sup> The National Taxpayer Advocate highly recommends that Treasury and the IRS amend the regulations to clearly define the term “practice of accountancy.” In addition to state licensed accountants and attorneys, the definitions should include enrolled agents, a designation granted by the IRS Office of Professional Responsibility.

<sup>13</sup> See Treas. Reg. § 301.7216-2(e) and Prop. Treas. Reg. § 301.7216-2(h).

<sup>14</sup> IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

either specify the language, or as in the proposed regulations, the regulations can provide that the IRS will issue such guidance in the form of a revenue procedure.<sup>15</sup>

*Written Consent Required Before Use or Disclosure to or by Preparer Located Overseas*

IRC §§ 7216 and 6713 should prohibit the disclosure or use of information to or by any tax return preparer located outside the country, unless the taxpayer has provided written consent. Due to the fundamental importance of protecting taxpayers from unknowingly having their confidential tax information disclosed overseas, where the IRS has very little chance of enforcing disclosure rules, the language should be part of the statutes rather than in the regulations.

The Taxpayer Advocacy Panel (TAP) has raised a real concern that disclosing confidential tax return information overseas without adequate safeguards, even with the taxpayer's written consent, increases the potential for identity theft and gross abuse of taxpayer data. To address these concerns, the TAP recommended that, in addition to obtaining the taxpayer's written consent, the preparer should redact all identifying information before releasing the information overseas. The proposed redaction would entail replacing all personal data (such as Social Security numbers, dates of birth, telephone numbers, and financial account information) with a combination client number or similar cross-identifier.<sup>16</sup> The National Taxpayer Advocate believes that this recommendation is worthy of exploration. It is unclear whether the proposed redaction requirement is feasible; however, identity theft is a serious issue, and the IRS should give due consideration to the TAP's recommendation.

The National Taxpayer Advocate is unpersuaded by comments on the proposed regulations which essentially state that requiring a written consent before disclosing abroad would place an unnecessary burden on multinational practices. Multinational practices are complex in nature, and requiring an additional written consent before releasing data overseas does not seem unreasonable. Further, multinational taxpayers may be equally unaware of the transfer of data across borders and deserve the same protections as individual taxpayers with solely domestic dealings.<sup>17</sup>

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<sup>15</sup> See Prop. Treas. Reg. § 301.7216-3(a)(3).

<sup>16</sup> Letter from Larry T. Combs, Chair, Taxpayer Advocacy Panel, to Mark W. Everson, Commissioner, Internal Revenue Service (Aug. 18, 2006) (available at [http://www.improveirs.org/Events/2006\\_Recoms\\_to\\_IRS\\_Commiss.pdf](http://www.improveirs.org/Events/2006_Recoms_to_IRS_Commiss.pdf)).

<sup>17</sup> The European Union has strict privacy laws restricting the transfer of data across borders. See [http://ec.europa.eu/justice\\_home/fsj/privacy/overview/index\\_en.htm](http://ec.europa.eu/justice_home/fsj/privacy/overview/index_en.htm).



## MISDIRECTED TAX REFUND DEPOSITS

### PROBLEM

The National Taxpayer Advocate has previously raised the issue of misdirected income tax refunds.<sup>18</sup> As the IRS launches its new split-refund program,<sup>19</sup> the risk of taxpayers inadvertently providing incorrect routing transfer numbers (RTNs) or account numbers for purposes of direct deposit increases significantly. There are no procedures allowing the IRS to resolve the issue when a taxpayer inadvertently provides the wrong RTN or account number to the IRS for purposes of direct deposit of an income tax refund. Financial institutions are not required to verify whether the name on the designated account matches the name of the depositor/taxpayer. The IRS has no authority to take money out of the incorrect account or receive confidential information from the financial institution about the owner of the incorrect account. The IRS can only contact and rely on the financial institution to persuade the incorrect account owner to return the misdirected funds. While the institution is required to take corrective action when the mistake is its own, it is not required to do anything if the mistake is made by the taxpayer.

### EXAMPLE:

A taxpayer hired a paid preparer who completed her federal income tax return, which showed a \$2,000 refund. The preparer explained the various refund delivery options and the taxpayer chose to have the return electronically filed with the refund direct deposited into her checking account. After waiting about three weeks without receiving the refund, the taxpayer looked up its status on the “Where’s My Refund?” service on the IRS website, which showed that the refund was already deposited into the account. The taxpayer looked back at the return and realized she mistakenly gave the preparer an incorrect bank account number (with two digits switched). She called the IRS and was told it was her mistake, but the IRS would contact the bank for her. After a few weeks, the taxpayer received a letter from the IRS stating that it has no authority to retrieve the refund from the incorrect account and instructing her to contact the bank directly to resolve the issue.

### RECOMMENDATION

Amend the Internal Revenue Code to create a process through which the IRS can work with financial institutions to (1) identify the account holder of a misdirected income tax

<sup>18</sup> National Taxpayer Advocate 2005 Annual Report to Congress 315-325, 464-465.

<sup>19</sup> The IRS’s split refund program allows taxpayers who choose to direct deposit income tax refunds the ability to designate up to three accounts at financial institutions on the new IRS Form 8888. IRS, News Release, IRS Expands Taxpayers’ Option for Direct Deposit of Refunds (May 31, 2006).

refund deposit, and (2) request the return of misdirected funds by the account holder of the account which incorrectly received the funds.<sup>20</sup>

### PRESENT LAW

The Right to Financial Privacy Act prohibits financial institutions from releasing financial records except under limited circumstances.<sup>21</sup> Specifically, 12 U.S.C. § 3402 bars government authorities from accessing financial information of any customer from a financial institution unless the records are reasonably described and are disclosed as enumerated in 12 U.S.C. §§ 3404 through 3408, which include customer authorizations, administrative subpoena or summons, search warrants, judicial subpoenas, or formal written requests. Section 3402 also provides for limited exceptions, one of which includes 12 U.S.C. § 3413. Section 3413(c) provides “[n]othing in this chapter prohibits disclosure of financial records in accordance with procedures authorized by [the Internal Revenue Code].” The Internal Revenue Code does not currently include procedures through which the IRS can obtain information about an account holder who receives a misdirected direct deposit refund.

### REASONS FOR CHANGE

In 2004, the IRS Wage & Investment (W & I) division’s Accounts Management function created a task force to investigate the problem of misdirected refunds. In its final report, the task force concluded “[a]lthough the number of misdirected deposits is minimal, compared to the total direct deposits, the impact on the taxpayer is substantial.” The report stated that misdirected deposits for calendar year 2004 amounted to less than .004 percent of the 49.3 million direct deposits. However, the number of direct deposited refunds increases each year.<sup>22</sup>

The number of direct deposits is certain to grow significantly in the 2007 filing season with the beginning of the split-refund program, which allows taxpayers to allocate their refunds among up to three different accounts at U.S. financial institutions. Taxpayers designate the accounts on IRS Form 8888, Direct Deposit of Refund. While the goal of the initiative is to encourage higher savings and more banking, it also increases the risk of taxpayers providing incorrect RTNs or account numbers, which will result in misdirected deposits.<sup>23</sup>

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<sup>20</sup> The IRS should also explore the ability of financial institutions to perform name verification before the funds are deposited into the account. This analysis should determine whether existing technology supports matching. It should also explore the feasibility of name matching in cases where the ownership of the bank accounts does not correlate precisely with the information given to the IRS. For example, a married couple has a joint checking account with the primary account holder listed as the secondary Tax Identification Number (TIN) on the tax return. Another concern is where taxpayers designate accounts owned by family members or friends. Direct Deposit Task Force, Direct Deposit Study (Jun. 2005).

<sup>21</sup> 12 U.S.C. § 3401 *et seq.*

<sup>22</sup> Direct Deposit Task Force, Direct Deposit Study (June 2005). The Taxpayer Advocate Service participated in the Direct Deposit Task Force.

<sup>23</sup> See IRS News Release, IRS Expands Taxpayers’ Options for Direct Deposit of Refunds (May 31, 2006).

Once a tax refund is misdirected due to taxpayer error, the IRS may contact the financial institution and ask it to return the money. If the institution does not comply, the IRS sends the taxpayer a letter explaining what happened and instructing the taxpayer to contact the financial institution to resolve the issue.<sup>24</sup> The institution is not authorized to release information to the IRS about the owner of the incorrect account.<sup>25</sup> If the IRS received information about the account holder, it could institute erroneous refund procedures to recover the funds.<sup>26</sup>

### EXPLANATION OF RECOMMENDATIONS

The Right to Privacy Act clearly states that the restrictions on disclosing financial information are subject to the provisions of the Internal Revenue Code.<sup>27</sup> However, the Code does not currently authorize the IRS to receive information from a financial institution about the owner of a financial account which incorrectly receives a misdirected direct deposit refund. If the Code were amended to authorize the IRS to receive a limited amount of information about the account holder, the IRS would be able to contact the account holder. Further, the Code should provide procedures for the IRS to request the account holder to return the misdirected funds. If the account holder refuses to return the money, the IRS can institute erroneous refund procedures.<sup>28</sup>

### REGULATION OF ENROLLED RETURN PREPARERS

#### Recommendation

The National Taxpayer Advocate continues to recommend that Congress should:

- ◆ Enact a registration, examination, certification, and enforcement program for unenrolled return preparers;<sup>29</sup> and
- ◆ Impose an effective oversight and penalty regime for preparers and others associated with the commercial tax preparation sector.<sup>30</sup>

<sup>24</sup> IRM § 21.4.1.4.7.

<sup>25</sup> 12 U.S.C. § 3402; National Taxpayer Advocate 2005 Annual Report to Congress 323-325.

<sup>26</sup> IRM § 21.4.5.1 *et seq.* The IRS will recover a misdirected deposit by voluntary repayment, filing an Erroneous Refund Suit against the taxpayer under IRC § 6532(b), and by offsets. IRM § 21.4.5.14. However, IRM § 21.4.5.10 states that the IRS is not responsible for misdirected direct deposits that are a result of bank error or the taxpayer providing the wrong Routing Transit Number (RTN) or bank account number. Accordingly, the IRM provision states that the IRS will not reissue the refund if error in cases of bank or taxpayer error.

<sup>27</sup> 12 U.S.C. § 3413.

<sup>28</sup> IRC § 7405; IRM § 21.4.5.1 *et seq.*

<sup>29</sup> For more details on the proposed program, see National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

<sup>30</sup> For a more detailed discussion of the proposal to increase preparer penalties, see National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

## RECOMMENDATIONS

SECTION  
TWO**EXPLANATION OF RECOMMENDATION**

Since 2002, the National Taxpayer Advocate has advocated the establishment of minimum levels of competency for return preparation by developing a federal system to register, test and certify unenrolled return preparers. She has also proposed to strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate. These proposals have been discussed at length in previous Annual Reports to Congress and congressional testimony.<sup>31</sup>

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<sup>31</sup> 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; *Regulation of Federal Tax Return Preparers, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong. (Jul. 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers, Hearing Before the U.S. Senate Committee on Finance*, 109th Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

## RECOMMENDATION

## #7

## IMPROVE OFFER IN COMPROMISE PROGRAM ACCESSIBILITY

## PROBLEM

By accepting an offer to compromise a tax debt, the IRS collects money it would not otherwise collect and turns a noncompliant taxpayer into a compliant one by requiring the taxpayer, as a condition of the offer agreement, to timely file returns and timely pay taxes for the following five years.<sup>1</sup> In short, accepting a reasonable offer is a good deal for both the taxpayer and the government.

Despite offers being good for both taxpayers and the IRS, between FY 2001 and FY 2006 the number of offers submitted by taxpayers declined by 53 percent and the number of offers accepted has declined by 62 percent.<sup>2</sup> In FY 2006, the IRS returned fully 45 percent of all offers without even considering them on the merits.<sup>3</sup> Although the IRS's imposition of a \$150 offer in compromise (OIC) user fee and 2004 revisions to the OIC form may have reduced the number of unrealistic OIC submissions, the decline in submissions may also be due to an increasing number of taxpayers and practitioners reaching the conclusion that the offer process is not working as well as it should, even with respect to reasonable offers.<sup>4</sup>

OIC submissions are likely to decline even further as a result of recent legislation. Section 509 of P.L. 109-222, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), effective July 16, 2006, makes it more difficult for taxpayers to submit an OIC. For example, TIPRA requires taxpayers who submit "lump-sum" offers to include a nonrefundable partial payment of 20 percent of the amount of the offer with the offer application.<sup>5</sup> Upon reviewing a representative sample of offers accepted by the IRS immediately prior to TIPRA's effective date, TAS found that about 72 percent

<sup>1</sup> Form 656, *Offer in Compromise* (Jul. 2004). An IRS study found that about 80 percent of taxpayers in its sample with accepted OICs remained substantially compliant during the requisite period. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 6 (Sept. 2004).

<sup>2</sup> The number of offers submitted by taxpayers has declined from 125,390 in FY 2001 to 58,586 in FY 2006 and the number of offers accepted by the IRS has also declined from 38,643 in FY 2001 to 14,734 in FY 2006. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

<sup>3</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2006).

<sup>4</sup> TIGTA has concluded that the OIC user fee, imposed in November 2003, is responsible for reducing OIC submissions by 28 percent, but it is difficult to conclude that the continued reduction in OIC submissions in FY 2005 is due to the OIC fee. See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). The Form 656, *Offer in Compromise*, was revised in July 2004, and the revision was publicized in October 2004.

<sup>5</sup> TIPRA also requires taxpayers who submit "periodic payment offers," which are paid in more than five installments, to include the first proposed installment along with any offer. IRC § 7122(c)(1). For additional details, see Notice 2006-68, 2006-31 I.R.B. 105. The IRS recently issued further guidance. See Memorandum For Directors, Collection Area Offices, From Frederick W. Schindler, Director, Collection Policy, *Interim Guidance Memorandum for Internal Revenue Manual 5.8, Offer in Compromise* (Jul. 28, 2006) (hereinafter referenced as an IRM dated July 28, 2006).

of taxpayers submitting offers that the IRS ultimately accepted did not appear to have sufficient funds available to make the required TIPRA payment before the offer was accepted.<sup>6</sup> Thus, the IRS may receive significantly fewer reasonable offers as a result of the partial payment requirement.

Although taxpayers whose income is below the federal poverty threshold are exempt from both the OIC user fee and the partial payment requirements,<sup>7</sup> the National Taxpayer Advocate, the Government Accountability Office (GAO), and tax practitioners have all expressed concern that the partial payment requirement could reduce the accessibility of the OIC program to low income taxpayers and others who are experiencing financial difficulties.<sup>8</sup> The following hypothetical example illustrates the difficulty some taxpayers now face in submitting offers.

#### EXAMPLE

The IRS determines that a taxpayer with a \$150,000 liability has \$150 in assets and \$210 per month of net disposable income not required for reasonable basic living expenses.<sup>9</sup> The IRS would require the taxpayer to pay at least \$10,230 to compromise the liability, determined by adding 48 months of future income ( $\$210 \times 48 = \$10,080$ ) to the taxpayer's \$150 in assets.<sup>10</sup> The taxpayer is required to include a nonrefundable \$2,046 partial payment and a \$150 user fee with his lump-sum offer application. The taxpayer's parents would be willing to lend him \$10,080 if they could be sure he would use the money to fund an OIC and make a fresh start. Based on current statistics, the IRS returns or rejects most OICs. If the IRS returned or rejected the OIC, the \$2,046 partial payment would be applied to the taxpayer's liability rather than to the OIC. Thus, the taxpayer's parents decline to loan him the money to make an offer.

#### RECOMMENDATION

Modify Internal Revenue Code § 7122(c) so that taxpayers are not required to include a partial payment with "lump-sum" offer applications.

Alternatively, modify the OIC rules as follows:

<sup>6</sup> The margin of error for this figure was +/- 4.3 percent. TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis).

<sup>7</sup> See Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

<sup>8</sup> See, e.g., Government Accountability Office, GAO-06-525, *IRS Offers In Compromise, Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program*, 38-39 (Apr. 2006); ABA Tax Sec., *Comments in Response to Notice 2006-68 Regarding Definition of "Low-Income" and Waiver Authority under Section 7122(c)(2)(C)* (Oct. 16, 2006), available at <http://www.abanet.org/tax/pubpolicy/2006/101606notice2006-68.pdf>.

<sup>9</sup> We assume the taxpayer's income exceeds the low income threshold.

<sup>10</sup> Form 656, *Offer in Compromise* 6 (Jul. 2004). Less than 48 months of future income would be required if less than 48 months remained on the statute of limitations period for collection. IRM 5.8.5.5.5(2) (Sept. 1, 2005).

1. Provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an OIC before or after accepting it for processing. The IRS could use the existing Collection Appeals Process, which allows it to review appeals in just 5 days.<sup>11</sup>
2. Provide an exception to the partial payment requirement for taxpayers who do not have immediate access to current income and liquid assets that could be used to fund an offer without incurring significant costs (e.g., taxable income or penalties resulting from the withdrawal of assets from a qualified retirement plan). For those taxpayers who have immediate access to such funds, the partial payment requirement should be 20 percent (for lump-sum offers) of any current income and liquid assets that could be disposed of immediately without significant cost.
3. Apply the low income exception in cases where payment of the combined OIC user fee and partial payment (or borrowing for such payments) would cause an economic hardship.

## PRESENT LAW

### Partial Payments Required by TIPRA

A “lump-sum” offer, one payable in five or fewer installments, must be accompanied by a down payment of 20 percent of the amount of the offer.<sup>12</sup> Other offers, payable in six or more installments (called periodic payment offers), must be accompanied by a down payment of the amount of the first proposed installment.<sup>13</sup> The taxpayer must make additional installments while the IRS is evaluating a periodic payment offer or it is deemed withdrawn.<sup>14</sup>

### IRS Return of Offers

If a taxpayer fails to submit the required partial payment along with the OIC or to meet various other requirements, the IRS may return it to the taxpayer as “unprocessable.”<sup>15</sup> If the IRS returns the OIC as unprocessable, it will retain any partial payment, but refund the \$150 OIC user fee.<sup>16</sup> If the IRS returns the OIC after accepting it for processing, the IRS will retain both the partial payment and the user fee.<sup>17</sup> The IRS will

<sup>11</sup> See generally, IRM 8.7.2 (Dec. 1, 2006).

<sup>12</sup> IRC § 7122(c)(1)(A).

<sup>13</sup> IRC § 7122(c)(1)(B).

<sup>14</sup> IRC § 7122(c)(1)(B)(ii).

<sup>15</sup> IRC § 7122(d)(3)(C); Treas. Reg. § 301.7122-1(d)(2).

<sup>16</sup> See Notice 2006-68, 2006-31 I.R.B. 105.

<sup>17</sup> See, e.g., Treas. Reg. § 300.3(b)(3); IRM 5.8.3.5 (Jul. 28, 2006); IRM 5.8.1.9 (Jul. 28, 2006). Processable OIC returns based on the taxpayer's failure to provide requested financial information are subject to managerial review. See Treas. Reg. 301.7122-1(f)(5)(ii).

reconsider its decision to return an OIC in certain limited circumstances, but the taxpayer cannot appeal the OIC return decision to the Appeals function.<sup>18</sup>

### Low Income Waiver

Both the OIC user fee regulations and TIPRA authorize the IRS to define a threshold below which a taxpayer will be considered “low income” and exempt from the OIC user fee and partial payment requirements.<sup>19</sup> The IRS defined “low income” as income below 100 percent of the federal poverty level for both purposes.<sup>20</sup> However, we understand the IRS is revising its offer in compromise form, Form 656, which would increase these thresholds to about 250 percent of the federal poverty level.

### REASON FOR CHANGE

#### No Appeal of OIC Return Decisions

##### *Historic Reasons for Returning an OIC*

Under procedures in effect as of June 2006, before TIPRA became effective, the IRS would return OICs as unprocessable and refund any user fee, if the taxpayer:

- ◆ Had not filed all returns;
- ◆ Was not current with employment tax deposits for the current quarter and the prior two quarters;
- ◆ Was in bankruptcy; or
- ◆ Did not submit the OIC user fee.<sup>21</sup>

Similarly, the IRS would return OICs after accepting them for processing (called “processable returns”), but retain the user fee, for various reasons, including the IRS’s determination that:

- ◆ The OIC was submitted solely to delay collection;

<sup>18</sup> See Treas. Reg. § 301.7122-1(f)(5)(ii) (noting that “return of the offer does not constitute a rejection of the offer for purposes of this provision and does not entitle the taxpayer to appeal the matter to Appeals...”). Collection personnel will reconsider the decision to return an OIC if: (1) The offer was returned in error; (2) The offer was returned because the IRS did not receive sufficient information, and (a) The taxpayer timely sent the information to the IRS but the IRS did not associate it with the case; (b) Serious illness or injury of the taxpayer prevented the taxpayer from submitting the information timely (illness or injury of the representative will not be considered); or (c) There was a death in the taxpayer’s immediate family or disaster (such as a fire or flood) that prevented the taxpayer from timely mailing the information; (3) The offer was returned because the taxpayer failed to perfect it by providing an additional Form 656 and application fee when the original Form 656 included both joint and separate liabilities or individual or joint and corporation or partnership liabilities; (4) The offer was returned because the taxpayer submitted a fee waiver form, Form 656-A (instead of paying the \$150 fee) that the IRS did not accept and the taxpayer later provided proof that the IRS reached an incorrect conclusion; or (5) The offer was returned because the taxpayer failed to make sufficient estimated tax payments, or withholding and the taxpayer later provided proof that such payments or withholding were not required. IRM 5.8.7.3.1 (Sept. 1, 2005).

<sup>19</sup> See Treas. Reg. § 300.3; IRC § 7122(c)(2)(C).

<sup>20</sup> See Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

<sup>21</sup> See IRM 5.8.3.4.1 (Sept. 1, 2005).



- ◆ The taxpayer failed to file a tax return or pay a liability;
- ◆ The taxpayer was in bankruptcy;
- ◆ The OIC was no longer processable;
- ◆ The taxpayer failed to supply sufficient financial information; or
- ◆ The OIC was accepted for processing in error.<sup>22</sup>

#### *Current Reasons for Returning OICs*

Under new procedures, the IRS is using similar criteria to determine whether to return an OIC. However, the IRS will now return an OIC if the taxpayer fails to submit the required partial payment.<sup>23</sup> We understand the IRS may also begin returning OICs after accepting them for processing if they include unassessed tax periods.<sup>24</sup> Another change is that the IRS is no longer requiring taxpayers to file all required returns before accepting an OIC for initial processing.<sup>25</sup> Instead, the IRS will wait until after accepting the OIC for processing to return it if the taxpayer has not filed all returns within the time allowed by the IRS. Thus, there is no reason to expect the IRS to return significantly fewer OICs.

#### *Partial Payment Requirement Increases Taxpayer Burden Resulting from OIC Returns*

As noted above, when the IRS returns an OIC for any reason, it retains any partial payment it has received.<sup>26</sup> In the past, only the \$150 user fee was at stake if the IRS returned a processable OIC, but now 20 percent of the offer (or other partial payment) is also at stake. Thus, the potential economic impact of the IRS's decision to return an OIC will be much greater than under prior law. This impact will multiply each time the taxpayer has to resubmit an OIC.

#### *The IRS Often Returns OICs*

Although in FY 2006 the IRS disposed of fewer OICs by returning them to taxpayers than it did in 2004, it still returned 45 percent of all OICs either before (26 percent) or after (19 percent) accepting them for processing and before evaluating whether to accept or reject them, as shown on the following table.<sup>27</sup>

<sup>22</sup> See, e.g., Treas. Reg. § 301.7122-1(f)(5)(ii); Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.04; IRM 5.8.3 (Sept. 1, 2005); Form 656, *Offer in Compromise*, 2 (Jul. 2004). IRS data suggests that it also returns offers for other reasons that are not clearly reflected in the IRM. See, e.g., National Taxpayer Advocate 2004 Annual Report to Congress 311, 317 (reprinting IRS OIC return data).

<sup>23</sup> We note the IRS is not currently requiring taxpayers to submit the full amount of the partial payment due on a lump-sum offer before they begin to process the OIC, but is requiring payment of the first installment on a periodic payment offer. Notice 2006-68, §§ 2.02 and 3.01; IRM 5.8.3.13 (Jul. 28, 2006).

<sup>24</sup> Instructions to Form 656, *Offer in Compromise* 6 (Nov. 2006) (draft).

<sup>25</sup> See IRM 5.8.3.13 (Jul. 28, 2006).

<sup>26</sup> See, e.g., IRM 5.8.3.5 (Jul. 28, 2006); IRM 5.8.1.9 (Jul. 28, 2006).

<sup>27</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2006).

TABLE 2.7.1, OIC DISPOSITIONS BY FISCAL YEAR<sup>28</sup>

Fiscal Year	FY 2001		FY 2002		FY 2003		FY 2004		FY 2005		FY 2006	
Disposition	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%
Not Processable	16,185	14	32,897	23	30,406	22	38,553	31	22,713	25	16,733	26
Processable Return	27,751	25	50,492	35	49,079	36	32,358	26	20,068	22	12,350	19
Withdrawn/Terminated	16,654	15	13,621	10	8,431	6	7,859	6	7,377	8	5,407	8
Rejected	13,976	12	16,952	12	27,336	20	25,654	21	22,105	24	14,945	23
Accepted	38,643	34	29,140	20	21,570	16	19,546	16	19,080	21	14,734	23
<b>Total</b>	<b>113,209</b>		<b>143,102</b>		<b>136,822</b>		<b>123,970</b>		<b>91,343</b>		<b>64,169</b>	

If a taxpayer wants the IRS to consider an offer that was returned, he or she must often submit another OIC. The GAO determined that 40 percent of the IRS's OIC inventory in FY 2005 was made up of repeat offers, many of which the IRS had previously returned.<sup>29</sup> Given the new partial payment requirement, many taxpayers may no longer be able to afford to resubmit returned offers because the IRS does not refund the partial payment (or allow the taxpayer to apply the payment to another OIC) when it returns an offer.

#### *OIC Returns are De Facto Rejections Which Involve Discretion and Judgment*

OIC returns amount to *de facto* rejections, which involve the exercise of discretion and judgment.<sup>30</sup> Differences of opinion could occur in any number of ways. For example, consider the following situations involving processable OIC returns:

- ◆ The IRS returns an OIC because it determines the taxpayer has not filed a tax return. The taxpayer claims that he or she is not required to file the return in question.
- ◆ The IRS returns an OIC because it determines the taxpayer is not current with estimated tax payments. The taxpayer disputes the IRS's determination that he or she has underpaid estimated taxes because the taxpayer has had significant changes in current year income and business expenses.
- ◆ The taxpayer claims the low income exception for the partial payment or OIC user fee. The IRS disallows the exception and returns the OIC. The taxpayer does not agree with the IRS's determination of his or her current income.

<sup>28</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

<sup>29</sup> Government Accountability Office, GAO-06-525, *IRS Offers In Compromise, Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program* 13-14 (Apr. 2006).

<sup>30</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 319-320, 339 (Most Serious Problem: Offers In Compromise).

- ◆ The IRS returns an OIC because it determines the taxpayer did not provide additional financial information, as requested. The information requested by the IRS was actually included in the taxpayer’s response, but not in the specific form requested by the IRS.
- ◆ The IRS returns an OIC because it determines the taxpayer did not provide additional financial information, as requested. However, the IRS did not actually need the information it requested to fully process the OIC.
- ◆ The IRS returns an OIC because it determines that the taxpayer submitted it “solely to delay collection.” The taxpayer does not agree.

In these types of situations, the taxpayer may be unsuccessful in resolving the dispute through routine communication with IRS Collection function employees and managers who are involved in the return decisions. Moreover, it is possible for IRS employees to “get it wrong” when they make OIC return decisions. In one study, the Treasury Inspector General for Tax Administration (TIGTA) determined 15 percent of the OICs returned after acceptance for processing were returned in error.<sup>31</sup> An IRS study indicated that 24 percent of all resubmitted OICs were ultimately accepted, suggesting that in some cases the IRS’s decision to return the OIC may not have been necessary.<sup>32</sup>

Given the significant exercise of discretion involved in OIC return decisions, the IRS should afford taxpayers who have had processable OICs returned the opportunity to have their cases reviewed by Appeals. Although such an appeal might delay collection efforts in some cases, it is necessary to provide consistent treatment of taxpayers and help address the decline in OIC submissions, especially now that taxpayers have more at stake when the IRS returns an OIC. The IRS could minimize such delay by adopting procedures similar to its Collection Appeals Program (CAP), which provide for processing appeals in just 5 days.<sup>33</sup>

### Low Income Exception Not Broad Enough to Preserve OIC Program Accessibility

Both the OIC user fee regulations and TIPRA authorized the IRS to define a threshold below which a taxpayer will be considered “low income” and exempt from the user fee and partial payment requirements.<sup>34</sup> The preamble to the OIC user fee regulations explains:

“Offers from low income taxpayers are excepted from the fee in light of section [7122(d)(3)(A)], which prohibits the IRS from rejecting an offer from a low income taxpayer solely on the basis of the amount offered.... Requiring payment of a user

<sup>31</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2003-30-182, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program* 1 (Sept. 2003).

<sup>32</sup> See SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 4-5 (Sept. 2004).

<sup>33</sup> IRM 8.7.2.2 (Dec. 1, 2006).

<sup>34</sup> See Treas. Reg. § 300.3; IRC § 7122(c)(2)(C).

fee from a low income taxpayer would undermine section [7122(d)(3)(A)] in cases where the taxpayer does not have the ability to pay the fee.”<sup>35</sup>

In the Internal Revenue Service Restructuring and Reform Act of 1998, Congress defined a taxpayer as “low income” for purposes of receiving assistance from a low income taxpayer clinic as 250 percent of the federal poverty level established by the Department of Health and Human Services (DHHS).<sup>36</sup>

#### *Poverty Level “Low Income” Definition Too Low*

The National Taxpayer Advocate and the practitioner community unsuccessfully urged the IRS not to adopt an OIC user fee, or if it was adopted to set the “low income” user fee exception threshold at 250 percent of the federal poverty level.<sup>37</sup> Although the IRS is modifying its definition of “low income,” the IRS initially defined a person as “low income” for purposes of the OIC user fee exception if his or her income was below 100 percent of the federal poverty level.<sup>38</sup>

Presumably, taxpayers who do not make enough money to provide for basic living expenses should be classified as low income. The federal poverty level for a family of four is \$20,000.<sup>39</sup> The same family would be allowed \$48,660 per year to provide for basic living expenses (not including expenses for health or child care) under the IRS’s own expense standards, assuming they lived in the District of Columbia and needed two cars.<sup>40</sup> \$48,660 is nearly 250 percent of the federal poverty level (250 percent X \$20,000 = \$50,000). Thus, the IRS has implicitly concluded that such a family of four living in Washington, DC, needs an income of about 250 percent of the poverty level to provide

<sup>35</sup> T.D. 9086, 68 FR 48,785 (Aug. 15, 2003) (preamble).

<sup>36</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 § 3601(a) (1998); IRC § 7526(b)(1)(B)(i). The monthly OIC low income threshold for households in the 48 contiguous states is \$833 for one person, \$1,083 for two, \$1,333 for three, \$1,667 for four, \$1,917 for five, \$2,167 for six, \$2,417 for seven, \$2,667 for eight, and an additional \$333 for each additional person. Form 656, *Offer In Compromise* (Jul. 2004) (instructions and worksheet for Form 656-A, *Income Certification for Offer In Compromise Application Fee*). It is annually adjusted for inflation.

<sup>37</sup> See, T.D. 9086, 68 FR 48,785 (Aug. 15, 2003); National Taxpayer Advocate FY 2002 Annual Report to Congress 18, n12. See also, Herbert N. Beller, American Bar Association, Section of Taxation, *ABA Members Suggest Waiving Proposed OIC User Fees for Low Wage Earners*, 2003 TNT 30-39 (Feb. 13, 2003); National Society of Accountants, *Accounting Group Won’t Back Proposed User Fee for OIC Program*, 2003 TNT 34-18 (Feb. 20, 2003); The Chicago Bar Association, *Bar Association Members Oppose Proposal to Charge OIC User Fee*, 2003 TNT 34-17 (Feb. 20, 2003); Joseph Barry Schimmel, *Attorney Challenges Definition of ‘Low-Income Taxpayer’ for Proposed OIC Regs*, 2003 TNT 11-33 (Jan. 16, 2003).

<sup>38</sup> See Treas. Reg. § 300.3(b)(1)(ii); Notice 2006-68, 2006-31 I.R.B. 105.

<sup>39</sup> The poverty guidelines are available at <http://aspe.hhs.gov/poverty/06poverty.shtml>.

<sup>40</sup> The national standard expense allowance for a family of four earning \$20,000 is \$941 per month. The local standard expense allowance for a family of four living in the District of Columbia is \$1,878 per month or the taxpayer’s actual expenses, whichever is less. Assuming the family owned two cars, the transportation standard expense allowance would be \$803 (\$471+\$332) per month for ownership costs, and \$433 per month for operating costs. \$941 + \$1,878 + \$803 + \$433 = \$4,055 per month. \$4,055 X 12 months = \$48,660 per year. Even if the family did not have any vehicles, the IRS would permit them to retain \$37,416 per year (\$941 for national standards + \$1,878 for local standards + \$299 for public transportation X 12 months) plus necessary expenses for health and child care.

for basic living expenses. Perhaps for this reason, we understand that the IRS is working to increase these thresholds to about 250 percent of the federal poverty level.

#### *Partial Payment Requirement Will Reduce OIC Program Accessibility*

Even if the IRS increases the low income threshold, however, the partial payment requirement will reduce the number of meritorious offers the IRS receives from taxpayers experiencing financial difficulty. Taxpayers generally must offer the net equity in their assets plus their *future income* for several years.<sup>41</sup> Since future income is not yet in the taxpayers' hands, they must fund offers with assets that the IRS would not ordinarily collect, such as home equity, qualified retirement plans (e.g., an IRA) in addition to unsecured loans or gifts from family or other third parties. Many taxpayers will be unable to access these funding sources to satisfy the 20 percent down payment requirement before the IRS has accepted their offers. For example, unless the IRS can provide assurances that it will accept the offer:

- ◆ A lender may not lend against property subject to a tax lien;
- ◆ A taxpayer might hesitate to withdraw funds from an IRA, incurring federal, state, and local income tax and a ten percent penalty for early withdrawal;<sup>42</sup> and
- ◆ A third party such as a friend, relative, or employer who would otherwise give or loan funds for the offer might not be willing to provide funds after all, since before the IRS accepts the offer, the third party cannot be sure those funds will help the taxpayer make a fresh start.

At the time the 20 percent down payment is required, taxpayers and third parties have no assurance that the IRS will accept an offer, especially since the IRS accepted only about one in four offers in FY 2006.<sup>43</sup> Thus, some taxpayers who would otherwise be able to submit meritorious offers will not be able to do so because they cannot afford to pay 20 percent of the offer amount without any prior assurance that the IRS will review and accept it.

Further, in a representative sample of 414 offers accepted by the IRS immediately prior to TIPRA's effective date, TAS found the funds that taxpayers proposed to use to pay the offer amount were most often from sources that would probably not be available in the absence of an accepted offer, as follows.<sup>44</sup>

<sup>41</sup> The number of years of future income required depends on the payment term: four years for cash offers, five years for short term deferred payment offers, or the period remaining before expiration of the statute of limitations period for collection for deferred payment offers. See Form 656, *Offer in Compromise*, 6 (Jul. 2004). A lump-sum offer must be paid in full within five months of acceptance in order to use only four years of future income. IRM 5.8.3.5(1) (Jul. 28, 2006).

<sup>42</sup> The IRS generally will not levy on a qualified plan unless the taxpayer's behavior has been "flagrant." See IRM 5.11.6.2 (Mar. 15, 2005). If it does, no early withdrawal penalty applies. IRC § 72(t)(2)(A)(vii).

<sup>43</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2006).

<sup>44</sup> TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis). TAS obtained a sample of closed case files from the Brookhaven and Memphis campuses that had not yet been sent offsite.

TABLE 2.7.2, SOURCE OF FUNDING FOR ACCEPTED OFFERS

Funding Source	Number <sup>45</sup>	Percent <sup>46</sup>	Margin of Error (+/-)
Friends or Family	232	56.0	4.8
Commercial Loan	24	5.8	2.3
IRA / 401K	9	2.2	1.4
Property Sale	10	2.4	1.5
Unsecured Credit	5	1.2	1.1
Current Income	123	29.7	4.4
Other	7	1.7	1.2
None Listed	18	4.3	2.0

The same study found about 72 percent of taxpayers submitting offers that the IRS ultimately accepted did not appear to have sufficient funds available to make the required TIPRA payment before the offer was accepted.<sup>47</sup> Even among taxpayers whose income exceeded 250 percent of the poverty level, about 71 percent did not have sufficient funds to make the required payment.<sup>48</sup> Thus, many taxpayers who otherwise would have submitted acceptable offers may no longer be able to afford to submit them.

One alternative may be for such taxpayers to submit “low-ball” offers based on the amount of the partial payment they can afford, rather than what would be a reasonable offer amount. However, the IRS may be more likely to return such offers as “solely to delay collection.” Since the IRS would retain any partial payment submitted with the offer, taxpayers who would otherwise have been able to submit acceptable offers may be discouraged from using the offer process.

#### *OIC User Fee May Have Reduced OIC Program Accessibility and Meritorious Offers*

Recent experience with the \$150 OIC user fee, applicable to offer applications beginning in November 2003, is also consistent with the notion that the 20 percent partial payment requirement will reduce the number of meritorious offer submissions and acceptances even among taxpayers eligible for the low income exception. TIGTA concluded the volume of OICs received from taxpayers at almost all income levels – even those eligible for the low income exception – declined after implementation of the user

<sup>45</sup> TAS sampled 414 cases, but these figures add to 428 because some taxpayers used multiple funding sources.

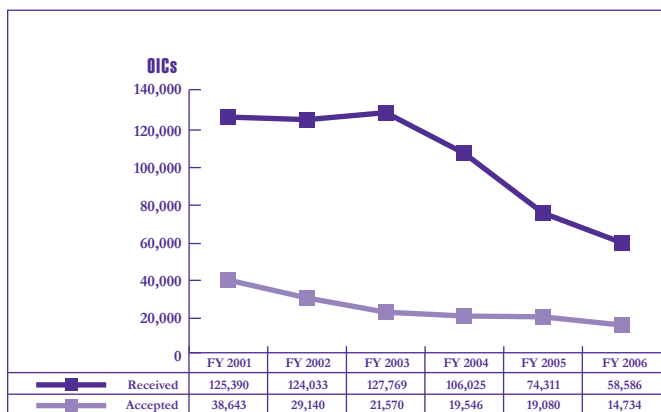
<sup>46</sup> Percentages exceed 100 percent because some taxpayers had multiple funding sources.

<sup>47</sup> The margin of error for this figure was +/- 4.3 percent. TAS Research, *Sources of OIC Funding* (Oct. 2006) (preliminary analysis).

<sup>48</sup> The margin of error for this figure was +/- 6.4 percent. The study found that about 49 percent of accepted offers came from taxpayers whose incomes exceeded 250 percent of the poverty level.

fee.<sup>49</sup> The number of offers accepted by the IRS also declined.<sup>50</sup> Since the OIC user fee was implemented, both OIC submissions and acceptances have been declining, as shown below.

TABLE 2.7.3, OICs RECEIVED AND ACCEPTED BY FISCAL YEAR<sup>51</sup>



Assuming the IRS only accepts meritorious offers, the fact that the number of offers accepted has declined from 21,570 in FY 2003 to 14,734 in FY 2006, or about 32 percent, suggests that meritorious offer submissions are also declining.<sup>52</sup>

*Declining OIC Program Accessibility Will Increase Collection Accounts*

The combination of the \$150 OIC user fee and the new 20 percent down payment requirement will increase the difficulty taxpayers face in getting the IRS to consider their offers. As a result, the partial payment requirement is likely to reduce the number of meritorious offer submissions and acceptances even further, which in turn is likely to increase the number of unresolved collection accounts and reduce federal revenue.<sup>53</sup>

<sup>49</sup> See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). TIGTA speculated that low income taxpayers may not have known that they were exempt from the fee. *Id.*

<sup>50</sup> The IRS accepted 21,570 offers in FY 2003, 19,546 in FY 2004, 19,080 in FY 2005. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2003-FY 2005).

<sup>51</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006); Collection Activity Report No. 5000-108 (FY 2001-FY 2005).

<sup>52</sup> SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2004-FY 2006). Another explanation could be that the IRS is returning and rejecting meritorious offers in greater numbers.

<sup>53</sup> No data is currently available that would shed light on how the requirement is affecting OIC acceptances, but preliminary data suggest that the requirement may have accelerated the decline in OIC receipts. Monthly OIC receipts in FY 2005 exceeded monthly receipts in FY 2006 by 814 in May, 619 in June, -1,574 in July (reflecting an increase in advance of the TIPRA effective date), 1,911 in August, and 1,790 in September. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2005-FY 2006). Receipts continued the decline in early FY 2007, with October 2006 receipts of 3,772, which is 1,148 below the 4,920 received in October 2005. SB/SE, *Offer in Compromise Program, Executive Summary* (FY 2007-October).

## EXPLANATION OF RECOMMENDATION

### Eliminate the Partial Payment Requirement

The National Taxpayer Advocate recommends that Congress eliminate the partial payment requirement for lump-sum offers. This change is expected to improve accessibility of the OIC program.

### Provide for Appeals of OIC Return Decisions

If the partial payment requirement is not eliminated, the National Taxpayer Advocate recommends that Congress give taxpayers the ability to appeal OIC return decisions (both before and after acceptance for processing), as well as deemed withdrawals, to the IRS Appeals function. Appeals could use its CAP procedures, which provide for processing appeals in five days.<sup>54</sup> If an OIC is not considered “pending” (*i.e.*, because it was not accepted for processing), the IRS could still levy during any such appeal.<sup>55</sup> The National Taxpayer Advocate recommends that any such levy amounts be treated as deposits that can be used to fund the offer if it should not have been returned.

Since the possibility that the IRS will unreasonably return an OIC and keep the non-refundable partial payment may prevent taxpayers from obtaining the funds needed to submit an offer, such a process might improve accessibility of the OIC program. It might also help to restore taxpayers’ and practitioners’ confidence that if they follow the rules, the IRS will at least evaluate their offers on the merits. Such confidence might encourage taxpayers and practitioners that it is worthwhile to submit reasonable offers that the IRS can accept.

### Expand Exceptions to the Partial Payment Requirements

#### *Exception for Taxpayers with Insufficient Liquid Assets and Current Income*

The National Taxpayer Advocate recommends creating an exception to the partial payment requirement for taxpayers who do not have immediate access to current income or liquid assets that could be used to fund an offer without significant costs. For example, the exception should apply when the taxpayer has insufficient current income and liquid assets to pay the offer amount and proposes to fund it with:

- ◆ Amounts provided (via gift or loan) by one or more third parties;
- ◆ Borrowing against illiquid assets such as real property; or
- ◆ Amounts from a qualified retirement account, the withdrawal of which would constitute a taxable event.

To the extent the taxpayer can fund the offer using current income or liquid assets that can be used without incurring significant costs, however, the partial payment requirement should be 20 percent of the amount of the offer that the taxpayer can obtain from

<sup>54</sup> IRM 8.72.2 (Dec. 1, 2006).

<sup>55</sup> IRC § 6331(k)(1) (prohibiting levy while an OIC is pending); Treas. Reg. § 301.7122-1(d)(2).



current income and the disposal of such liquid assets net of any transaction costs. The IRS could create an online calculator to help taxpayers determine the applicable partial payment and OIC user fee. This recommendation is intended to enable taxpayers who do not have sufficient liquid assets to comply with existing partial payment requirements to submit reasonable offers along with a partial payment that reasonably reflects their ability to pay.

#### *Exception for Economic Hardship*

The National Taxpayer Advocate also recommends that Congress allow the IRS to apply the low income exception to a taxpayer if payment of the combined OIC user fee and partial payment (or borrowing for such payments) would result in an economic hardship.<sup>56</sup> This may occur if a taxpayer's allowable expenses exceed income, even if the income exceeds 250 percent of the federal poverty level. For example, if a taxpayer has a medical condition requiring an expensive treatment not fully covered by insurance and the partial payment and user fee (or costs to obtain such funds, such as income tax on an IRA withdrawal or closing costs on a home equity loan) would deplete assets or income which may be needed for that treatment, the taxpayer would be exempt from the OIC user fee and partial payment requirements. Since effective tax administration (ETA) offers based on hardship, as well as OICs based on doubt as to collectibility involving special circumstances, both involve situations where payment of the liability would result in an economic hardship, the IRS should also have discretion to automatically apply the low income exception to such offers.<sup>57</sup>

<sup>56</sup> Economic hardship could be defined by reference to IRC § 6343 and Treas. Reg. § 301.6343-1(b)(4).

<sup>57</sup> Because the current OIC fee regulations recognize that such taxpayers may not be able to afford the fee, they provide that the IRS will refund the fee (or apply it to the offer) when an ETA or doubt as to collectibility offer based on special circumstances is accepted based on economic hardship. See Treas. Reg. § 300.3(b)(2)(i) and (ii). However, it does not make sense for the IRS to require the taxpayer to make a payment that it will later refund if it determines that the payment caused an economic hardship. The IRS should rely on the taxpayer's determination regarding what will constitute an economic hardship, subject only to subsequent verification, especially since we rely on a signed statement from the taxpayer to determine initial eligibility for the low income OIC fee exception. See Form 656-A, *Income Certification for Offer in Compromise Application Fee* (Jul. 2004).

## RECOMMENDATION

## #8

## ELIMINATION OF LENGTHY COLLECTION STATUTE OF LIMITATIONS EXTENSIONS

**PROBLEM**

The IRS generally has ten years to collect a tax liability.<sup>1</sup> The running of the ten-year statutory period for collections is suspended in situations when taxpayers elect certain rights that have the effect of bringing a temporary halt to the IRS's collection actions.<sup>2</sup> The date beyond which the IRS is no longer permitted to collect a tax is known as the collection statute expiration date (CSED).

Prior to January 1, 2000 (the effective date of the CSED related provisions of the IRS Restructuring and Reform Act of 1998 (RRA 98)),<sup>3</sup> it was not uncommon for IRS collection personnel to ask taxpayers to extend the applicable collection statute for a period of years to guard against an expiration of the statute. Some extensions were for periods as long as ten, 20, 30, 40, or even 50 years. Through a combination of revisions to the law and changes to IRS policy, IRS collection personnel are now restricted in the extent to which they can request taxpayers to waive the collection statute of limitations; however, the changes were not made retroactive. Consequently, there are still thousands of taxpayers (by our review in excess of 14,000 taxpayers with approximately 32,000 tax accounts) who granted lengthy CSED extensions in exchange for installment agreements prior to January 1, 2000, and who are still being subjected to collection action.<sup>4</sup>

**EXAMPLE**

The IRS assessed a liability against a taxpayer for the 1990 tax year on June 10, 1991, establishing a collection statute expiration date (CSED) of June 10, 2001. In 1997, a revenue officer requested that the taxpayer to sign a Form 900 (Tax Collection Waiver) to avoid enforced collection efforts and in conjunction with the taxpayer entering into an installment agreement with the IRS. The Form 900 waiver extended the collection statute of limitations period 25 years to June 10, 2026. In 2001, the taxpayer's economic circumstances changed, and he became unemployed. The taxpayer defaulted on his installment agreement in the year 2000. When the taxpayer's wife obtained employment in 2002, the IRS levied her salary. The taxpayer came to the Taxpayer Advocate Service (TAS) for assistance, and TAS assisted with a levy release, which the IRS agreed

<sup>1</sup> IRC § 6502(a).

<sup>2</sup> IRC §§ 6331(i)(5) and 6503(a) provide that the running of the statutory period for collection is suspended during periods in which the IRS cannot levy upon the taxpayer's assets. There are a number of actions that taxpayers can take that have the affect of bringing a temporary cessation to collection activity, such as requesting a Collection Due Process hearing under IRC §§ 6330 and 6320 (see IRC § 6630(e) for suspension provision) or filing a bankruptcy petition (*see* IRC § 6503(h) for suspension provision).

<sup>3</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c), 112 Stat. 685.

<sup>4</sup> In September of 2006, the Taxpayer Advocate Service Research function requested a review of the IRS's data bases for delinquent accounts in which a waiver was granted prior to January 1, 2000 and which are still open collection accounts. The results of the research demonstrated that there were at least 14,000 such taxpayers.

to in exchange for a resumption of payments on the installment agreement. The taxpayer recalled signing the Form 900 in 1991, but indicated to the TAS case advocate that he did not understand the consequences of signing the form, *i.e.*, he did not understand that the waiver allowed the IRS to pursue the debt for an additional 25 years beyond the date which the law generally required the IRS to cease collection action.

### RECOMMENDATIONS

Eliminate the IRS's inventory of lengthy CSED extensions by enacting legislation that will terminate all CSED extensions on accounts that were in existence before January 1, 2000 and were granted in connection with installment agreements. This provision should be similar to RRA 98 section 3461(c), which eliminated many lengthy CSED extensions as of December 31, 2002 but which did not apply to CSED extensions granted in connection with installment agreements.<sup>5</sup> To ensure that taxpayers who granted the IRS CSED extensions prior to the effective date of RRA 98 are subject to the same policies and procedures applicable to taxpayers today, a new sunset provision should be enacted to give the IRS two years to take enforcement action if it is appropriate to do so, after which the collection statute will expire.

### PRESENT LAW

Over the last six years, the law and IRS policy with respect to CSED extensions has evolved favorably with respect to taxpayers. Prior to RRA 98, IRS collection personnel who sought to protect against expiration of the collection statute routinely sought CSED extensions from taxpayers through a signed Form 900 (Tax Collection Waiver). Moreover, IRS guidance predating RRA 98 (an example of which is set out below) was lacking as to when it was appropriate to seek CSED extensions from taxpayers as well as the appropriate duration of the CSED extension:

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.<sup>6</sup> (emphasis added)

Without specific guidelines on CSED extensions, some IRS collection personnel erred towards seeking lengthy CSED extensions. Taxpayers do not always understand the implications of signing the Form 900 (Tax Collection Waiver) or other CSED extension documents. As the following excerpt from an RRA 98 Senate Committee report demonstrates, Congress focused on collection statute extensions because of its concern that taxpayers were often times not informed about their legal rights or about the consequences of extending both the assessment and collection periods:

<sup>5</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c)(2), 112 Stat. 685.

<sup>6</sup> IRM 53(11)(1) (Oct. 28, 1993). This IRM provision is no longer in force and effect and has been superseded by new procedures.

The Committee believes that taxpayers should be fully informed of their rights with respect to the statute of limitations on assessment. 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.<sup>7</sup>

The Senate version of RRA 98 section 3461(c) eliminated all CSED extensions; however, the House of Representative's version sought only to ensure that taxpayers were provided notification of their rights with respect to CSED extensions. In the Conference Committee, a compromise provision was adopted eliminating all CSED extensions, except for those in connection with installment agreements and levy releases.<sup>8</sup>

#### *RRA 98 Changes to the Law on CSED Extensions*

RRA 98 brought about numerous changes to the practice of seeking CSED extensions. Section 3461(c) of RRA 98 amended section IRC § 6502, effective as of January 1, 2000, to limit the IRS's ability to secure from taxpayers agreements to extend the statutory period for collection. As a result of this change, under current law, the IRS and taxpayers can now only agree to an extension of the statutory limitations period for collection under 6502(a) in two circumstances:

- 1) The extension is agreed to at the same time as an installment agreement between the taxpayer and the IRS; or
- 2) The extension is agreed to prior to a release of levy.<sup>9</sup>

Additionally, RRA 98 section 3461(c)(2)(B) contained a sunset provision which terminated certain CSED extensions (*i.e.*, all CSED extensions except those entered into in connection with an installment agreement) effective December 31, 2002.<sup>10</sup> Congress also mandated that the IRS inform taxpayers about their right to refuse to extend the CSED.<sup>11</sup>

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<sup>7</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub L. No. 105-206, Sen. Rep. 105-174, Sec. 3461 (June 24, 1998).

<sup>8</sup> Compare Sen. Rep. 105-174 87 (June 24, 1998) and House of Rep. No. 105-599 286 (June 24, 1998) to final version of RRA 98 § 3461(c).

<sup>9</sup> IRC § 6502(a)(2).

<sup>10</sup> If a waiver was secured in conjunction with the granting of an installment agreement, the period for collection expires ninety days after the date specified in the waiver. If the waiver was not obtained in conjunction with an installment agreement, such as in conjunction with an offer in compromise, the period for collection expired on the later of December 31, 2002, or the end of the original collection statute. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(c)(2), 112 Stat. 685.

<sup>11</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 3461(b)(2), 112 Stat. 685.

Although RRA 98 did not eliminate CSED extensions in connection with installment agreements or levy releases, the changes enacted as part of RRA 98 reflected a congressional belief “that the IRS should collect all taxes within 10 years, and that such statute of limitations should not generally be extended.”<sup>12</sup> Consequently, the IRS changed its policy such that it would no longer seek CSED extensions in excess of five years beyond the CSED.<sup>13</sup> This change in policy was not made retroactive; thus, the accounts of thousands of taxpayers with lengthy CSED extensions have remained active in the IRS’s collection inventory.

#### *American Jobs Creation Act of 2004: Partial Pay Installment Agreements*

In 2004, Congress granted the IRS authority to enter into partial pay installment agreements for situations when the outstanding liability cannot be fully satisfied within the remaining time period before the expiration of the CSED.<sup>14</sup> In conjunction with the new authority to enter into partial pay installment agreements, the IRS again limited the extent to which collection personnel could seek extensions of the collection statute of limitations to those situations in which a partial pay installment agreement were granted.<sup>15</sup> However, even in cases in which taxpayers qualify for partial pay installment agreements, the IRS requests CSED extensions in limited circumstances.<sup>16</sup> Thus, under current policy, the IRS generally no longer permits extensions of the CSED in connection with installment agreements or levy releases.

### REASONS FOR CHANGE

The evolution of the law and policy with respect to CSED extensions has been favorable to taxpayers, such that taxpayers are no longer asked to waive an important right to qualify for an installment agreement.<sup>17</sup> Because the changes were not given retroactive application, however, there are thousands of taxpayers subject to collection action because of the lengthy CSED extensions. Table 2.8.1 shows the results of research

<sup>12</sup> Joint Tax Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 105 (Nov. 24, 1998).

<sup>13</sup> See IRM 5.14.2.1(3) (Jul. 7, 2005), (referencing policy); see also Treasury Inspector General for Tax Administration, *Improvements Are Needed to Comply with Legal and Procedural Requirements for Collection Statute Extensions and Installment Agreements* 5 (Aug. 2001) (indicating that despite change policy the audit discovered instances of lengthy CSED extensions obtained from taxpayers).

<sup>14</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 843(a) (2004); see IRM 5.19.1.5.5 for partial pay installment agreement procedures.

<sup>15</sup> IRM 5.14.2.1 (Jul. 7, 2005).

<sup>16</sup> CSED extensions in connection with partial pay installment agreements will only be sought where there is an asset that will come into the possession of a taxpayer after the CSED and liquidation of that asset offers the best case resolution (in lieu of liquidating existing assets to partially pay the liability). IRM 5.14.2.2.3(1)(a) (Jul. 7, 2005).

<sup>17</sup> Courts have held that this waiver of the collection statute of limitations period is not a contract, but rather is a waiver of a defense. See *Strange v. United States*, 282 U.S. 270, 276 (1931); *Florsheim Bros. Drygoods Co. v. U.S.*, 280 U.S. 453, 468 (1930). For more recent case discussing this principle, see *Foutz v. U.S.*, 72 F.3d 802 (10th Cir. 1995) (holding that new law extending collection statute of limitations period from six years to ten years rendered debt collectible and a waiver of the six year collection statute prior to the enactment of the new law was not a contract binding government to collect in a shorter collection period).

analysis by the Taxpayer Advocate Service Research function, which reveals that there are over 32,000 active accounts with lengthy CSED extensions in the IRS's collection inventory. The table also demonstrates that the IRS has received at least one payment in the last 16 months from 14 percent of the taxpayers with lengthy CSED extensions. These payments are made up of voluntary payments from taxpayers and involuntary levy payments.

**TABLE 2.8.1, TAX ACCOUNTS WITH LENGTHY CSED EXTENSIONS**

Extension Period	No Payment Since Sept. 1, 2005	With Payment Since Sept. 1, 2005	Total
10-19 years	22,110	3,803	25,913
20-29 years	3,732	589	4,321
30-39 years	1,034	164	1,198
40-49 years	368	48	416
≥ 50 years	471	73	544
<b>Total</b>	<b>27,715</b>	<b>4,677</b>	<b>32,392</b>

Because some of the tax accounts in the table above reflect taxpayers with multiple accounts, Table 2.8.2 below provides the number of taxpayers affected by lengthy CSED extensions, equaling approximately 14,000 taxpayers.

**TABLE 2.8.2, TAXPAYERS WITH LENGTHY CSED EXTENSIONS**

Extension Period	No Payment Since Sept. 1, 2005	With Payment Since Sept. 1, 2005	Total
10-19 years	8,264	3,406	11,670
20-29 years	1,560	0	1,560
30-39 years	331	136	467
40-49 years	113	43	156
≥ 50 years	134	61	195
<b>Total</b>	<b>10,402</b>	<b>3,646</b>	<b>14,048</b>

These findings are consistent with the IRS's 2003 study of accounts with extended CSEDs which found that in 2002 there were approximately 20,000 taxpayers with extended CSEDs, of which approximately 15,000 made payments (both voluntary payments and involuntary payments) of approximately \$17,000,000.<sup>18</sup> Each year there are marginally fewer affected taxpayers as some extended CSEDs expire, and each year the IRS collects less from these extended CSED accounts.<sup>19</sup> However, as the tables above demonstrate, the CSEDs of many of these taxpayers will extend far into the future, subjecting these taxpayers to potential collection action when, presumably, they will

<sup>18</sup> IRS Research Project, *Payment Compliance for IMF Installment Agreements Resulting from IRC 6159*, 3 (Jan. 31, 2003).

<sup>19</sup> In 2001, for example, the IRS collected approximately \$36 million from extended CSED accounts while it collected less than half of that in 2002. *Id.*

no longer be of working age. Moreover, these taxpayers are being subject to collection action or potential collection action under a collection policy which was abandoned by the IRS for all other taxpayers over five years ago. It is not equitable to subject these 14,000 taxpayers to such dramatically different treatment.<sup>20</sup> Consistent treatment for similarly situated taxpayers is a vital component of our tax administration system.<sup>21</sup>

There are other reasons for Congress to legislatively eliminate these lengthy CSED extensions. The IRS has experienced longstanding problems maintaining adequate systems for tracking CSEDs; thus, the accuracy of the information it has for these taxpayers is questionable. In our 2004 Annual Report to Congress, we detailed serious problems with the IRS's data systems which could not accurately calculate taxpayer CSEDs.<sup>22</sup> As a result of the 2004 report, the IRS and TAS established a task force to address CSED (CSED Task Force) related problems. Together, the IRS and TAS identified tens of thousands of taxpayer accounts that had incorrect CSEDs. While much progress was made, one of the most significant problems identified with incorrect CSEDs still awaits correction almost two years later.<sup>23</sup>

There are also problems for the IRS in administering collection of lengthy CSED accounts, and these problems can translate into additional burden upon taxpayers. Because RRA 98 section 3461 terminated CSED extensions entered into before January 1, 2000 to the extent they were not in connection with installment agreements, current collection efforts on these cases requires a determination as to whether the CSED extension was obtained in conjunction with an installment agreement.<sup>24</sup> Because some of these accounts can be decades old, it is not unusual for there to be a dispute about whether the CSED extension was granted or whether it was in conjunction with an installment agreement or levy release. The burden of proving the existence of the collection waiver lies with the government, and in court, the government must attempt to

<sup>20</sup> For example, compare a taxpayer seeking an installment agreement before RRA 98 who was asked to extend the CSED for 50 years as a condition of obtaining the installment agreement to a taxpayer today who can obtain an installment agreement or partial pay installment agreement without any CSED extension.

<sup>21</sup> One of the objectives of RRA 98 was consistent treatment for similarly situated taxpayers which was accomplished through a reorganization of the IRS into operating divisions. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, Part Two, Title I.A.1, IRS Mission and Restructuring (§§ 1001 and 1002) 17.

<sup>22</sup> National Taxpayer Advocate 2004 Annual Report to Congress 180-192.

<sup>23</sup> In the 2004 report, we assisted the IRS in identifying limitations in the IRS data systems that caused incorrect calculations in certain situations where taxpayers filed offers in compromise with the IRS. National Taxpayer Advocate 2004 Annual Report to Congress 180-192. The IRS has developed a fix for this particular problem so that new accounts can be calculated correctly; however, the implementation of the system has been delayed several times and is now on schedule for implementation in 2007.

<sup>24</sup> For discussion of IRS policy of determining when an installment agreement is obtained "in conjunction with" a CSED extension and disputes arising from the IRS's determination, see National Taxpayer Advocate 2004 Annual Report to Congress 185.

## RECOMMENDATIONS

produce the original CSED extension signed by the taxpayer.<sup>25</sup> When there is a dispute about whether a CSED extension was agreed to and under what circumstances, the IRS often relies on its account transcripts rather than original documents. The fact that some of these extensions may be 10, 20, 30, 40 or even 50 years old, only increases the likelihood of these disputes.

**EXPLANATION OF RECOMMENDATION**

Eliminating the IRS's inventory of extended CSED accounts in which taxpayers have granted lengthy CSED extensions makes sense from a taxpayer fairness perspective and from a tax administration perspective. In 1998, the Senate was prepared to eliminate all CSED extensions based in part on its findings that taxpayers were not adequately informed about their rights and its belief that the IRS should be able to collect its debts within 10 years. Since that time, the IRS has almost fully implemented the Senate's position by permitting CSED extensions only for partial pay installment agreements, and even in that instance, CSED extensions are limited to certain narrow factual circumstances. However, the IRS has made these policy corrections prospectively, leaving thousands of taxpayers behind with the prospect of potential collection action long into the future.

By enacting this legislation, Congress would be taking the final necessary step towards resolving the problem of lengthy CSED extensions. Enacting this legislation would not let these taxpayers "off the hook" but would give them a reasonable sense of certainty for the conclusion of the debt and would give the IRS two years to attempt resolution on the account. Thus, we have recommended creating a sunset provision terminating collection on these accounts as of December 31, 2008.

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<sup>25</sup> *United States v. McGaughey*, 977 F.2d 1067, 1071 (7th Cir. 1992), *cert. denied*, 507 U.S. 1019 (1993) (holding government has burden of proving existence of waiver of collection statute of limitations and in this case, the IRS demonstrated a reasonable search for original documents and secondary evidence was sufficient to demonstrate existence of waiver).



## RECOMMENDATION

## #9

## LEVY ACTIONS ON FIXED AND DETERMINABLE RIGHTS

## PROBLEM

A levy is a legal seizure of property to satisfy a tax debt.<sup>1</sup> The IRS levy program is a necessary means of collection, and when used appropriately is a fundamental component of tax enforcement. If a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, the IRS may levy against any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien, unless it is exempt.<sup>2</sup>

The IRS generally has ten years from the date of the assessment to collect the tax by levy.<sup>3</sup> However, in practice, it is possible for the IRS to collect these payments well after the expiration of the statutory collection period for collecting the tax. For example, streams of payments (such as retirement and Social Security benefits, pensions, royalties, bond interest payments, and fixed trust payments) may be seized by a levy that attaches to all future payments to which the taxpayer is entitled, so long as there is a fixed and determinable right to these payments at the time of levy.<sup>4</sup>

Furthermore, under the IRS's interpretation of current law, a levy served prior to the collection statute expiration date (CSED) may be updated post-CSED to reflect the full amounts of tax, penalty, and interest due as of the date of the final payment, as though the CSED had not expired, for any period listed on the levy.

## EXAMPLE

The IRS assessed taxes and penalties totaling \$50,000 against a taxpayer in April 1995. The taxpayer began receiving \$923 a month (the average monthly payment for a Social Security beneficiary<sup>5</sup>) from the Social Security Administration in January 2004. In September 2004, the IRS placed a levy on this taxpayer's fixed and determinable right to Social Security benefits.

By this time, the taxpayer owes the IRS \$72,000 in back taxes, penalties, and interest. Each month, the IRS receives \$223 of the taxpayer's Social Security benefits. If we assume an interest rate of five percent, more than \$10 of interest will accrue daily (over \$300 per month) on the \$72,000 liability. Because the IRS applied the levy prior

<sup>1</sup> Internal Revenue Code (IRC) § 6331 provides the IRS with statutory authority to levy funds held by a third party.

<sup>2</sup> See IRC § 6334 for an enumeration of property exempt from levy.

<sup>3</sup> See IRC § 6502.

<sup>4</sup> See Treas. Reg. § 301.6343-1(b) (levy on a fixed and determinable right to payment includes payments to be made after the CSED does not become unenforceable upon the CSED); Rev. Rul. 55-210, 1955-1 C.B. 544 (only one notice of levy needs to be served to effectively reach vested benefits subsequently payable in other contexts).

<sup>5</sup> Social Security Administration, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot, Table 2, Social Security Benefits* (Aug. 2006).

to the April 2005 CSED, it may continue to receive the taxpayer's Social Security payments until the taxpayer's death (because the \$223 levy is less than the monthly interest accrual).

### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress pass legislation to:

1. Restrict the IRS's ability to levy under section 6331(a) upon a taxpayer's fixed and determinable right to future retirement and disability benefits (including Social Security and private pension and disability plan benefits) unless the taxpayer has exhibited flagrant conduct; and
2. Exclude post-CSED accruals of penalties and interest from IRS collection when the IRS makes a pre-CSED levy upon a taxpayer's fixed and determinable rights to future payments.

### PRESENT LAW

Internal Revenue Code (IRC) § 6502 provides generally that the tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun within ten years after the date of assessment. If the IRS has levied prior to the expiration of this statutory period, the IRS may receive payments in the future. Each tax assessment has a collection statute expiration date (CSED).

Pursuant to IRC § 6331(a), the IRS may levy against any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien if a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, unless it is exempt.<sup>6</sup>

Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future, and will not be released under this condition unless the liability is satisfied. Thus, certain streams of payments can be seized by a single levy that attaches to all future payments to which the taxpayer is entitled, so long as there is a fixed and determinable right at the time of levy. The liability remains enforceable to the extent of the value of the levied upon property.

IRC § 6601(e) and § 6665 provide that interest and penalties, respectively, shall be assessed, collected, and paid in the same manner as taxes.

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<sup>6</sup> See IRC § 6334 for an enumeration of property exempt from levy.

## REASONS FOR CHANGE

### *Retirement Benefits*

Distributions from retirement plans and Social Security Administration (SSA) benefits are intended to provide for the welfare of the elderly and the disabled. Generally, this population relies heavily on these monthly distributions to meet their basic living expenses. For example, Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and is the *only* source of income for more than 20 percent of this population.<sup>7</sup>

The IRS will not levy under § 6331(a) on accumulated funds (the corpus) in retirement assets, such as an IRA, unless the taxpayer has engaged in “flagrant” conduct.<sup>8</sup> The Service does not apply the “flagrant” conduct standard to the stream of payments from retirement assets, such as an IRA.<sup>9</sup> Instead, IRM 5.11.6.1(1) provides that “discretion” should be used before levying retirement income.

When the IRS levies on Social Security income payments, it uses the standard of “discretion.”<sup>10</sup> It does not use the standard of “flagrant” conduct because the IRS is not seeking accumulated funds from the SSA.

Today, for example, if a taxpayer were receiving a monthly retirement payment from both an IRA and Social Security, the IRS would use the same standard in serving a levy—the IRS would use its discretion. The National Taxpayer Advocate believes that the IRS should use the flagrant standard for levies on a stream of monthly retirement payments from Social Security or an IRA or private pension. The IRS should be consistent in its approach to levying on retirement assets and retirement benefits. Congress should allow the IRS to levy on taxpayers’ fixed and determinable rights to retirement and disability benefits only in cases where taxpayers have exhibited flagrant conduct, the same standard the IRS uses when it contemplates levy action on retirement assets.

### *Post-CSED Accruals*

Taxpayers may find themselves in situations where the payments they are able to make are less than the interest accrual associated with their underlying IRS liabilities. Unless circumstances change to enable a taxpayer to pay down the tax debt, such a taxpayer would be indebted to the IRS for eternity.

<sup>7</sup> Social Security Administration, *Fast Facts & Figures About Social Security, 2005* (Sept. 2005). For a more detailed overview of the demographics of the population receiving Social Security benefits, see Most Serious Problem, *Levies, supra*.

<sup>8</sup> IRM 5.11.6.2(5) (Mar. 15, 2005).

<sup>9</sup> IRM 5.11.6.2(1) states “These instructions cover money accumulated in a pension or retirement plan, as well as Individual Retirement Arrangements (IRAs). They do not deal with levying retirement income.”

<sup>10</sup> In contrast, the IRS does not use any standard with respect to Federal Payment Levy Program (FPLP) levies on Social Security payments under IRC 6331(h); the FPLP is an automated process with no income filter. See Most Serious Problem, *Levies, supra*, and Most Serious Problem, *Collection Issues of Low Income Taxpayers, supra*.

Limiting the amount subject to levy to the balance due at the CSED would provide taxpayers and the IRS with the opportunity to achieve closure with respect to an assessment. Congress intended to provide the IRS a finite window of time to collect assessed taxes by virtue of the CSED (generally ten years from the date of assessment). It is unfair to subject taxpayers who have fixed and determinable rights to future payments to IRS collection action until death.

#### EXPLANATION OF RECOMMENDATION

This recommendation protects the retirement benefits of elderly and disabled taxpayers from IRS levies, absent flagrant conduct. Under present law, the IRS, by virtue of placing a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the CSED, is able to levy upon a taxpayer's retirement or disability benefits without any limitation in time. With the proposed change in law, the IRS would be able to levy upon a taxpayer's fixed and determinable right to retirement income only in instances where the taxpayer has engaged in "flagrant" conduct. Examples of flagrant conduct include situations where a taxpayer has been convicted of tax evasion for the tax debt or has been assessed with a fraud penalty for the tax debt.<sup>11</sup>

This recommendation impacts not only retirees and Social Security beneficiaries, but also victims of mass tort litigation. For example, in 1989 the *Exxon Valdez* oil spill catastrophe gave rise to thousands of tort claims by those whose livelihoods were impacted by the accident. The distribution of proceeds to plaintiffs was delayed by multiple appeals and other legal proceedings; some plaintiffs did not receive any distributions until 2005. Many of these plaintiffs had outstanding federal tax liabilities from prior years. Because the plaintiffs had a fixed and determinable right to damages, the IRS was able to serve upon the settlement fund administrators a mass levy via magnetic tape in 1990, prior to the CSED.

Under present law, the IRS is entitled to update its levy to demand full payment of all assessed and unassessed penalty and interest accruals, up to the full value of the taxpayer's distribution, as though the CSED had never expired. With the proposed change in law, the IRS could levy against a taxpayer's account only up to the dollar amount of taxes, penalties, and interest assessed as of the CSED.

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<sup>11</sup> See IRM 5.11.6.2(5) (Mar. 15, 2005).

## RECOMMENDATION

## #10

## IMPAIRMENT RELATED WORK EXPENSES

## PROBLEM

Congress has created a number of tax credits and deductions to increase the employment rate for workers who have disabilities. One of these incentives is the impairment-related work expense deduction.<sup>1</sup> However, the taxpayer can only take this deduction if he or she itemizes instead of using the standard deduction.<sup>2</sup> This approach makes the deduction unavailable for many disabled taxpayers, who have low incomes and fewer deductible expenses, and thus benefit more from the standard deduction.<sup>3</sup> Generally, itemizing deductions is beneficial for taxpayers who have higher income and deductible expenses such as medical care, mortgage interest, state and local taxes, charitable contributions, and casualty losses.

## EXAMPLE

Mary is legally blind and earns \$15,000 a year. She had to spend \$1,200 on equipment and devices for accommodating her disability in the workplace. Mary is filing her return as a single person and would like to deduct the \$1,200. To do so, Mary must itemize but she only has another \$2,300 in deductible expenses for a total deduction of \$3,500. While this would reduce her taxable income to \$11,500, taking the standard deduction for single individuals, which is \$5,000 in 2005, would reduce Mary's taxable income to \$10,000. Financially it makes more sense for Mary to take the standard deduction, but she will be unable to deduct the \$1,200 she spent on equipment and devices that enable her to work.

## RECOMMENDATION

Amend Internal Revenue Code § 67(d) to allow taxpayers to take the impairment-related work expense as an above-the-line deduction from gross income or, alternatively, restructure the deduction as a credit against tax.

## PRESENT LAW

The impairment-related work expense deduction applies to taxpayers who have a physical or mental disability. This disability must functionally impair or substantially limit one or more major life activities (*e.g.*, performing manual tasks, walking, speaking, breathing, learning, and working).<sup>4</sup> These expenses must be ordinary and necessary

<sup>1</sup> IRC § 67(d).

<sup>2</sup> IRC §§ 63 and 67(b)(6)(d).

<sup>3</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html). The median income for people with a nonsevere disability is \$22,000, compared to \$25,000 for people with no disability and \$12,000 for people with a severe disability. The poverty rate for people ages 25 to 64 with a nonsevere disability is 11 percent. This compares to 26 percent for those with severe disabilities and eight percent of those with no disabilities.

<sup>4</sup> Treas. Reg. § 1.190-2(a)(3).

business expenses for attendant care at the taxpayer's place of work or other ordinary and necessary expenses connected to the taxpayer's place of work.<sup>5</sup> If the taxpayer meets these guidelines, he or she can deduct these expenses, even if the expense does not exceed two percent of the taxpayer's adjusted gross income.<sup>6</sup>

#### REASON FOR CHANGE

Americans with disabilities are employed at a significantly lower rate than those without disabilities.<sup>7</sup> This low employment rate can be attributed to a number of factors, including a lack of appropriate job opportunities, limited access to public transportation, and the burden of additional costs for accommodations in the workplace. The impairment-related work expense tax deduction gives taxpayers with disabilities an incentive to enter the workforce and helps alleviate additional costs they may incur. Unfortunately, the usefulness of this deduction is limited because it is only available to taxpayers who itemize deductions.<sup>8</sup> Therefore, to better assist disabled taxpayers entering into the workforce, Congress should abolish this limitation and allow eligible taxpayers to use the deduction in all circumstances, or convert the deduction to a credit applied against the taxpayer's tax liability.

#### EXPLANATION OF RECOMMENDATION

Currently, the number of taxpayers who use the impairment-related work expense deduction is limited because it can only be taken when taxpayers itemize.<sup>9</sup> Eliminating this barrier and allowing taxpayers to use the deduction, regardless of whether they itemize, will allow more taxpayers with a disability to claim the deduction. Alternatively, the deduction could be converted to a tax credit, which would offset the taxpayer's tax liability. Broadening the applicability of the deduction or credit will have a positive impact on the disability community. For example, it will help reduce the burden of

<sup>5</sup> IRC §§ 67(d) and 162.

<sup>6</sup> IRC § 67(b)(6), (d).

<sup>7</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html). There are 11.8 million Americans (comprising six percent of the population) between the ages of 16 and 64 who report the presence of a medical condition that makes it difficult to find a job or remain employed. Fifty-six percent of people ages 21 to 64 having some type of disability were employed in the 2001. Out of the 56 percent, the employment rate ranges from 82 percent of those with a nonsevere disability to 43 percent with a severe disability. Forty-four percent of people with a nonsevere disability work full-time, year-round. This compares to 53 percent of those without a disability and 13 percent with a severe disability.

<sup>8</sup> IRC § 67(d).

<sup>9</sup> Tax Year 2004 Individual Returns Transaction File (IRTF) located on the IRS Compliance Data Warehouse. In tax year 2004, there were 1.4 million returns reporting a positive value on the "Other Deductions" line of Schedule A. This represents 3.1 percent of all Schedule A filers. The total amount of all "other deductions" claimed, which includes expenses besides impairment-related work expenses, was only 1.6 percent of all itemized deductions reported on Schedule A. The number of taxpayers who claim the impairment related work expense cannot be separately identified because the IRS does not break out the other deductions information. These low numbers indicate that the impairment-related work expense deduction is claimed at a low rate.

costly accommodations, and encourage taxpayers with disabilities to enter the workforce.<sup>10</sup>

Adopting this recommendation would set the impairment-related work expense deduction apart from other miscellaneous deductions. Congress already treats the deduction differently than some others by not applying the two percent adjusted gross income threshold.<sup>11</sup> Congress should use its authority to broaden the availability of the impairment-related work expense deduction to help taxpayers with disabilities enter and remain in the workforce.

<sup>10</sup> Freedom Scientific, at <http://www.freedomscientific.com/>. This company sells screen reading programs (JAWS) and screen magnification programs (Magic) for the blind and visually impaired. The development of this technology has been very helpful to individuals who are blind or visually impaired. However, these programs can also be very expensive for persons of limited means, costing from \$1,000 to \$2,000 or more.

<sup>11</sup> IRC § 67(b)(6)(d). The impairment-related work expense deduction is not subject to the two percent floor that applies to miscellaneous itemized deductions. Generally, miscellaneous itemized deductions shall be allowed only to the extent that the aggregate of the deduction exceeds two percent of the person's adjusted gross income.

**INTRODUCTION: "INNOCENT SPOUSE" RELIEF FIXES**

Federal income tax liabilities of married persons are sometimes imposed by law on or collected from a spouse who did not earn the income subject to tax and who, as a result, may have no ability to pay the liability. Under current law, these problems are addressed in part by the relief rules of Internal Revenue Code (IRC) §§ 6015 and 66, which we refer to, collectively, as the "innocent spouse" rules.<sup>1</sup> In general, these relief rules either reallocate income (and other items) between spouses or relieve one spouse of liability for tax attributable to the other. One fundamental problem with the innocent spouse rules is that they often require a difficult factual inquiry into what a spouse knew when he or she signed the return in question.

In her 2005 annual report, the National Taxpayer Advocate proposed a comprehensive solution to the problems posed by the taxation of married taxpayers and existing relief rules.<sup>2</sup> The proposal would repeal joint and several liability and allocate liability between spouses in accordance with each spouse's income. It would also reduce the IRS's ability to collect the liability from the nonliable spouse without first attempting to collect from the liable spouse, which it has the ability to do in community property jurisdictions. Specifically, the National Taxpayer Advocate recommended that Congress:

- ◆ Eliminate joint and several liability for joint filers.<sup>3</sup> Require married taxpayers to file a split-column tax return, which identifies separate items of income, deduction, credit, and payment, similar to the combined return adopted by a number of states.
- ◆ Repeal the rule of *Poe v. Seaborn*<sup>4</sup> that each spouse is taxed on one-half of any community income (*i.e.*, generally income earned by either spouse or generated by community property during marriage and sometimes income generated by separate property during marriage). Instead, apply the federal rules for allocating a nonresident alien's community income to all couples, with slight modification.<sup>5</sup>
- ◆ Require the IRS to exhaust efforts to collect against assets under the liable spouse's control before collecting against assets under the nonliable spouse's control, unless such efforts would be futile.<sup>6</sup>

In the event that Congress does not enact these recommendations, there are a number of problems with the existing innocent spouse rules that Congress should address, as follows.

<sup>1</sup> See IRC § 6015 (joint and several liability relief); IRC § 66 (community property relief).

<sup>2</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse).

<sup>3</sup> Revise IRC § 6013(d), which imposes joint and several liability.

<sup>4</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>5</sup> See IRC § 879(a). Our 2005 proposal would allocate "other income" to the spouse with control of the income.

<sup>6</sup> This requirement would mirror what is required before the IRS may collect on a transferee liability under current law. See, *e.g.*, *U.S. v. Russell*, 241 F.2d 879 (1st Cir. 1957); IRM 4.10.13.3 (Mar. 30, 2005).



**ADDITIONAL LEGISLATIVE RECOMMENDATION: EXTEND PERIOD FOR FILING A TAX COURT PETITION; IMPROVE FINAL DETERMINATION LETTERS****PROBLEM**

Even though the IRS's relief determination under IRC § 6015 is subject to judicial review,<sup>7</sup> the IRS is not required to provide and does not provide taxpayers with the last date to petition the U.S. Tax Court in the final determination letters it issues to them in connection with requests for innocent spouse relief. In contrast, IRS deficiency determinations are similarly subject to judicial review, but Congress has directed the IRS to assist taxpayers by providing them with the last date to petition the Tax Court in notices of deficiency.<sup>8</sup> Providing such assistance is important because it may be difficult for some taxpayers to determine the deadline for filing a petition in Tax Court without professional assistance, assistance which many taxpayers who need relief may be unable to afford. Sixty-five percent of the taxpayers who request innocent spouse relief make less than \$30,000 per year.<sup>9</sup> Thus, it may be even more helpful for the IRS to include the last date to petition the Tax Court in innocent spouse determination letters than to include it in notices of deficiency.

Perhaps one reason the IRS does not include the last date to petition the Tax Court in its notice of determination letters is that if the IRS enters a date beyond the requisite period and the taxpayer relies on it, then the taxpayer could miss the filing deadline. In contrast, if the IRS enters a date beyond the requisite period for filing a Tax Court petition in a notice of deficiency, then a taxpayer will not be harmed as long as he or she files the petition on or before the date contained in the notice of deficiency because IRC § 6213(a) provides that a taxpayer may petition the Tax Court any time on or before the date specified in the notice.

**EXAMPLE**

The IRS denied innocent spouse relief to W and she petitioned the Tax Court.<sup>10</sup> Because W was unrepresented, she had difficulty computing the deadline for filing a

<sup>7</sup> IRC § 6015(e).

<sup>8</sup> IRC § 6213(a); IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3463(a), 112 Stat. 685 (1998).

<sup>9</sup> W&I Research, *Strategic Forecasting & Analysis, Innocent Spouse Data Summary* (Oct. 3, 2005) (statistics based on 2001 data).

<sup>10</sup> As a result of recent litigation, various courts held that the Tax Court did not have jurisdiction to review the IRS's innocent spouse determinations under IRC § 6015(f) where the IRS had not asserted a deficiency (*i.e.*, cases involving only equitable relief from underpayments of tax reported on the return). See, e.g., *Comm'r v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *rev'g Ewing v. Comm'r*, 118 T.C. 494 (2002); *Bartman v. Comm'r*, 446 F.3d 785 (8th Cir. 2006) (following the Ninth Circuit's decision in *Ewing*); *Sjodin v. Comm'r*, 97 A.F.T.R.2d (RIA) 2622 (8th Cir. 2006); *Billings v. Comm'r*, 127 T.C. 7 (2006). The National Taxpayer Advocate originally planned to include a recommendation to provide such jurisdiction. However, a bill to provide Tax Court jurisdiction (H.R. 6111) in these circumstances passed both houses of Congress and was signed by the President on December 20, 2006. Thus, for purposes of this discussion we assume the Tax Court has jurisdiction to review all IRS determinations under IRC § 6015.

petition with the Tax Court. As a result, W missed the deadline for filing a timely petition.

### RECOMMENDATION

Require the IRS to include the last date to petition the Tax Court in any final determination letter the IRS issues in connection with an election or request for innocent spouse relief in a manner similar to that provided by IRC § 6213(a).<sup>11</sup> Provide that a taxpayer may petition the Tax Court within 90 days of the date of the determination or by the date specified in the letter, whichever is later.<sup>12</sup>

### ADDITIONAL LEGISLATIVE RECOMMENDATION: SUSPEND THE PERIOD FOR FILING A TAX COURT PETITION DURING BANKRUPTCY

#### PROBLEM

The period for filing a Tax Court petition to obtain judicial review of an IRS innocent spouse relief determination is not suspended during bankruptcy. Any such petition must be filed on or before the 90th day after the IRS mails its final determination.<sup>13</sup> The taxpayer may not file a Tax Court petition during a bankruptcy proceeding in violation of the bankruptcy stay.<sup>14</sup> In contrast, while a bankruptcy stay is in effect and for 60 days thereafter, the period for filing a petition for the Tax Court to redetermine a deficiency is suspended.<sup>15</sup>

#### EXAMPLE

The IRS denied innocent spouse relief to W and sent her a final notice of determination immediately before she had to file for bankruptcy to prevent other creditors from foreclosing on her assets. The bankruptcy lasted beyond the 90 day period for filing a petition in Tax Court. As a result, W had no opportunity to file a timely Tax Court petition.

<sup>11</sup> The National Taxpayer Advocate made a similar recommendation in her 2001 report. See National Taxpayer Advocate 2001 Annual Report to Congress 159-165.

<sup>12</sup> Although legislation is not required to allow the IRS to revise its determination letters to include the last date for filing a petition, legislation is required to allow taxpayers to rely on the date shown in such letters.

<sup>13</sup> IRC § 6015(e)(1).

<sup>14</sup> See *Drake v. Comm'r*, 123 T.C. 320 (2004). See also, *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006). A "stay" is automatically triggered when a bankruptcy petition is filed. This stay prohibits the commencement or continuation of legal or enforcement activities with respect to the debtor. See generally, 11 U.S.C. 362. The Tax Court, in *Drake v. Comm'r*, found that the filing of a petition by the taxpayer/debtor violated the stay. The Bankruptcy Court, in *In re Drake*, concluded that the issuance of the final notice by the IRS also violated the stay. The government has appealed the decision in *In re Drake* and the appeal is currently pending.

<sup>15</sup> IRC § 6213(f). The IRS is authorized to issue a notice of deficiency during the pendency of a bankruptcy proceeding as a specific exception to the automatic stay. *Id.*

**RECOMMENDATION**

Suspend the period for filing a petition in Tax Court to obtain judicial review of an innocent spouse determination while the stay resulting from a bankruptcy filing is in force and for 60 days thereafter in a manner similar to that provided by IRC § 6213(f).<sup>16</sup>

**ADDITIONAL LEGISLATIVE RECOMMENDATION: REQUIRE THE IRS TO ESTABLISH A RECONSIDERATION PROCESS FOR INNOCENT SPOUSE DETERMINATIONS****PROBLEM**

Except in very limited circumstances, the IRS has no process that allows it to reconsider an innocent spouse determination after it issues a final determination letter.<sup>17</sup> Additionally, except in limited circumstances, a taxpayer cannot file a second claim for innocent spouse relief for the same tax liability, even if the taxpayer's circumstances have changed.<sup>18</sup> The lack of a reconsideration process may be a problem for taxpayers if they are unable to articulate all of the relevant facts or to provide sufficient documentation when they first seek innocent spouse relief. The IRS considers factors such as economic hardship, which may change over time, in determining whether to grant relief.<sup>19</sup> Thus, the IRS's determination may also depend on when the taxpayer seeks relief. As a result, the IRS may deny relief to some taxpayers simply because they sought relief before their financial situation deteriorated, because they failed to emphasize important facts, failed to recognize the importance of providing certain documentation, or simply failed to timely respond to follow-up questions from the IRS.

In contrast, after an audit that results in a deficiency assessment, a taxpayer has an opportunity to request "audit reconsideration" by Compliance if he or she provides additional information not considered during the original examination.<sup>20</sup> One primary

<sup>16</sup> The National Taxpayer Advocate made a similar recommendation in her 2004 report. See National Taxpayer Advocate 2004 Annual Report to Congress 490.

<sup>17</sup> See IRM 25.15.7.11.10 (Sept. 1, 2006) (referencing LEM 25.15.1.4 (May 5, 2005), which describes those limited circumstances).

<sup>18</sup> Treas. Reg. § 1.6015-1(h)(5). The IRS will consider a second election for relief under IRC § 6015(c) to separate the liability (a "separate liability election"). IRC § 6015(c)(3)(A)(i); Treas. Reg. § 1.6015-3(a). The separate liability election allows a taxpayer who is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for a 12-month period to elect to limit his or her liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items. IRC § 6015(c). A taxpayer may file a separate liability election if, upon making an initial election or request for relief, the taxpayer was ineligible to elect separation of liability solely because he or she was not divorced, widowed, or legally separated, or had not been a member of the same household as the nonrequesting spouse during the requisite period, and the taxpayer satisfies this requirement when filing the second separate liability election. See Treas. Reg. § 1.6015-1(h)(5).

<sup>19</sup> Rev. Proc. 2003-61, 2003-2 C.B. 296.

<sup>20</sup> See IRM 4.13.1.4(1)(d) (Oct. 1, 2006); IRM 1.2.1.3.16 (Sept. 20, 1999) (Policy Statement P-2-89). Sometimes taxpayers request audit reconsideration because they did not appear for the audit, moved and did not receive IRS correspondence, or have new documentation to present. See IRM 4.13.1.3 (Oct. 1, 2006).

purpose of the audit reconsideration process is to help ensure that assessed liabilities are correct and that the IRS resolves cases with similar facts in a consistent manner.<sup>21</sup>

The IRS may realize some cost savings as a result of its decision not to establish a reconsideration process for innocent spouse determinations, but any such savings come at the expense of collecting the correct amount of tax from innocent spouses. The absence of a reconsideration process may also result in more litigation of innocent spouse issues, however, perhaps eliminating any such cost savings. Moreover, without a reconsideration process, the IRS will be less likely to resolve cases with similar facts consistently.

#### EXAMPLE

The IRS sent W a final notice of determination denying her request for innocent spouse relief that she had prepared and submitted without the assistance of a tax practitioner. Two years later, when W's financial situation deteriorated so that full payment of the liability would create an economic hardship, she sought advice from a practitioner. The practitioner advised her that the IRS would likely have granted her request for relief if she had emphasized certain important facts and provided more complete documentation. Since the IRS also considers "economic hardship" as a factor in determining whether to grant innocent spouse relief, the practitioner advised that W's existing financial situation would make the IRS even more likely to grant relief. W could not obtain relief, however, because she could not submit another election or request for relief and the IRS would not reconsider its final innocent spouse determination.

#### RECOMMENDATION

Require the IRS to establish a process, similar to its audit reconsideration process, to reconsider innocent spouse determinations after it has issued a final notice of determination.<sup>22</sup>

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<sup>21</sup> See IRM 4.13.1.1(2) (Feb. 1, 2003).

<sup>22</sup> The National Taxpayer Advocate made a similar recommendation in her 2001 and 2005 reports. See National Taxpayer Advocate 2005 Annual Report to Congress 334, 343; National Taxpayer Advocate 2001 Annual Report to Congress 159-165. Although IRS may not need any additional legislative authority to create such a process, the IRS seems to believe that it requires the authority to rescind a notice of determination, similar to its authority under IRC § 6212(d), to create an audit reconsideration-type process for innocent spouse determinations. See National Taxpayer Advocate 2005 Annual Report to Congress 326, 340 (Most Serious Problem: Innocent Spouse Processing, IRS Comments).

**ADDITIONAL LEGISLATIVE RECOMMENDATION: PROVIDE THE TAX COURT WITH JURISDICTION TO REVIEW COMMUNITY PROPERTY RELIEF DETERMINATIONS UNDER IRC § 66(C)****PROBLEM**

The Tax Court lacks jurisdiction to review the IRS's determinations regarding relief from community property law under IRC § 66(c).<sup>23</sup> In contrast, the Tax Court has jurisdiction to review IRS determinations under IRC § 6015(b), (c), and (f).<sup>24</sup> Some taxpayers may, nonetheless, obtain judicial review of IRS determinations under IRC § 66 in connection with collection due process (CDP) or deficiency proceedings.<sup>25</sup>

Upon filing a lien and before filing a levy, the IRS must provide the taxpayer an opportunity for a CDP hearing, in which he or she can raise various issues including "appropriate spousal defenses" to collection.<sup>26</sup> Since a taxpayer may appeal the IRS's CDP determination to a court, he or she may be able to obtain judicial review of the IRS's community property relief determinations in such proceedings, assuming the taxpayer raised the issue of community property relief in the CDP hearing.<sup>27</sup> However, a taxpayer is not entitled to a CDP hearing in connection with a refund offset.<sup>28</sup> This means a taxpayer who is seeking community property relief under IRC § 66(c) and is only subject to a refund offset, rather than a lien or levy, may have no ability to obtain judicial review of an IRS determination under IRC § 66(c), whereas another similarly situated taxpayer may be able to obtain judicial review.<sup>29</sup>

One significant purpose of judicial review is to ensure the IRS's determinations are correct. We are not aware of any evidence that the IRS's ability to make correct determinations regarding the allocation of community income under IRC § 66(c) is superior to its ability to make correct determinations regarding the allocation of joint and several liability under IRC § 6015.

<sup>23</sup> In *Bernal v. Comm'r*, 120 T.C. 102, 107-108 (2003) the Tax Court confirmed that it did not have jurisdiction to review the IRS's determination to deny equitable relief under IRC § 66(c). While the case only involved a denial of equitable relief under IRC § 66(c), not a denial of traditional relief under IRC § 66(c), the court stated that it had jurisdiction to review IRC § 66(c) claims in a deficiency proceeding, but not in a "stand alone" proceeding, because IRC § 66 did not contain a parallel provision to § 6015, granting jurisdiction to the Tax Court to review claims under IRC § 66. See also *Christensen v. Comm'r*, T.C. Memo 2005-299.

<sup>24</sup> IRC § 6015(e)(1). As discussed above, a bill (HR 6111), which provides the Tax Court with jurisdiction to review the IRS's innocent spouse determinations under IRC § 6015(f), was signed by the President on December 20, 2006.

<sup>25</sup> See, e.g., *Beck v. Comm.*, T.C. Memo 2001-198, AOD-122827-02 (Dec. 9, 2002).

<sup>26</sup> IRC § 6330(c)(2)(A)(i); IRC § 6320.

<sup>27</sup> See IRC § 6330(d)(1).

<sup>28</sup> See, e.g., *Boyd v. Comm'r*, 124 T.C. 296 (2005); *Bullock v. Comm'r*, T.C. Memo 2003-5.

<sup>29</sup> It may be possible for a taxpayer to obtain judicial review of an IRS determination under IRC § 66 in connection with a claim for refund. However, taxpayers can not obtain judicial review of the IRS's denial of a claim for refund until the liability is paid in full. See IRC § 7422; *Flora v. U.S.* 362 U.S. 145 (1960). In addition, the taxpayer must file any claim for refund within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later. IRC § 6511(a).

**EXAMPLE**

A married couple “domiciled” in a community property state separated in February 2000, but each spouse’s earnings continued to be community property under state law until the divorce.<sup>30</sup> In early 2001, W filed a separate 2000 return, which erroneously included all of the income she earned and omitted all of H’s income. The IRS audited W’s 2000 return and determined she was liable for tax on one-half of the community income, including income earned by H after the separation. W timely requested community property relief under IRC § 66(c), but the IRS determined W did not qualify because she could not establish she did not know or have reason to know about H’s income. W may not petition the Tax Court to review the IRS’s determination under IRC § 66(c).

**RECOMMENDATION**

Provide the Tax Court with jurisdiction to review the IRS’s community property relief determinations under IRC § 66(c).

**ADDITIONAL LEGISLATIVE RECOMMENDATION: ELIMINATE THE TWO-YEAR LIMITATION PERIOD FOR TAXPAYERS SEEKING EQUITABLE RELIEF UNDER IRC § 6015 OR IRC § 66****PROBLEM**

Taxpayers must request equitable relief under IRC § 6015 or IRC § 66 within the two-year period beginning on the date of the IRS’s first collection activity against the taxpayer with respect to the liability.<sup>31</sup> In contrast, the IRS generally has ten years from the date of any assessment to collect the liability.<sup>32</sup>

The doctrine of “equitable recoupment” has sometimes been applied as a defense against tax claims that would otherwise be barred by a statute of limitations.<sup>33</sup> Equitable recoupment is a defense arising out of some feature of the transaction occurring in a different year upon which the plaintiff’s action is grounded. “Setoff” is a related defense that is also applied without regard to the statute of limitations period.<sup>34</sup> It allows one party to defend against tax claims on the basis that the other party owes amounts to it

<sup>30</sup> Which state’s law applies depends on a person’s “domicile.” See, e.g., *U.S. v. Mitchell*, 403 U.S. 190 (1971); IRM 25.18.1.2.1 (Feb. 15, 2005). A domicile is the permanent legal home the taxpayer intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. *Id.*

<sup>31</sup> The Internal Revenue Code only applies the two-year limitation to taxpayers seeking traditional relief under IRC § 6015(b) or separate liability elections under IRC § 6015(c), potentially raising an inference that the two-year limitation should not apply to requests for equitable relief under IRC § 6015(f). See IRC § 6015(b)(1)(E) (applicable to elections under IRC § 6015(b)); IRC § 6015(c)(3)(B) (applicable to elections under IRC § 6015(c)). However, the IRS applies the two-year limitation to request for equitable relief. See Rev. Proc. 2003-61, 2003-2 C.B. 296, § 4.01(3) and § 5 (applicable to equitable relief requests under both IRC § 6015(f) and IRC § 66(c)).

<sup>32</sup> IRC § 6502(a)(1).

<sup>33</sup> See, e.g., *Bull v. U.S.*, 295 U.S. 247 (1935).

<sup>34</sup> See, e.g., *Lewis v. Reynolds*, 284 U.S. 281 (1932); *Dysart v. U.S.*, 340 F.2d 624 (Ct. Cl. 1965).

attributable to the same tax year. Even if taxpayers may not use the doctrines of “equitable recoupment” or “setoff” as a defense that would allow them to obtain innocent spouse relief without regard to any time limits, these doctrines provide a logical basis for allowing taxpayers to raise innocent spouse relief as a defense to the IRS’s collection of the liability with respect to which such relief would otherwise be granted (*i.e.*, without regard to any time limits). If a taxpayer does not owe a liability by reason of the innocent spouse rules, it should not matter when he or she seeks equitable relief as long as the IRS may continue to assess or collect those very liabilities.

#### EXAMPLE

A married couple filed a joint return for 1999. H concealed some of his income and did not report it on the joint 1999 return. In 2003, the IRS assessed additional tax against the couple as a result of H’s unreported income. H ignored the assessment and concealed collection notices sent to the couple’s home, including Letter 1058(c), *Notice of Intent to Levy and Notice of Your Right to a Hearing*, addressed to W.<sup>35</sup> In 2006, more than two years after the IRS sent Letter 1058(c), W learned of the deficiency and separated from H. W is not eligible for equitable relief under IRC § 6015 because more than two years have passed since the IRS began collection activities against her.<sup>36</sup>

#### RECOMMENDATION

Provide that a taxpayer may make a request for equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities (*i.e.*, anytime before expiration of the collection statute of limitations period).<sup>37</sup>

#### ADDITIONAL LEGISLATIVE RECOMMENDATION: EXPAND AVAILABILITY OF REFUNDS TO INNOCENT SPOUSES

##### PROBLEM

If a taxpayer pays or the IRS collects a liability with respect to which the IRS ultimately grants innocent spouse relief, the IRS can only pay refunds or credit the innocent spouse’s separate account in certain limited circumstances.<sup>38</sup> The IRS is required to pay refunds to taxpayers to the extent attributable to “traditional” innocent spouse relief

<sup>35</sup> Letter 1058(c) is usually sent via certified mail, return receipt requested. See IRM 5.19.8.4 (Oct. 1, 2002). Even if sent via certified mail, the U.S. Postal Service will deliver it to anyone who receives mail at the address unless the sender pays extra for Restricted Delivery. See [http://pe.usps.com/text/dmm300/dmm300\\_landing.htm](http://pe.usps.com/text/dmm300/dmm300_landing.htm) (last visited Dec. 12, 2006).

<sup>36</sup> See IRC § 6015(b)(1)(E), (c)(3)(B); Treas. Reg. § 1.6015-5(b)(1); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5. A similarly limited period applies to requests for equitable relief under IRC § 66(c). See *id.*

<sup>37</sup> The IRS could make such a change without legislation.

<sup>38</sup> For the remainder of this discussion, we use the term “refunds” to reference both refunds and credits.

pursuant to IRC § 6015(b).<sup>39</sup> However, the IRS is not permitted to pay refunds as a result of a “separate liability election” under IRC § 6015(c).<sup>40</sup> In addition, the IRS cannot pay refunds to a taxpayer in connection with a grant of equitable relief for liabilities with respect to which the taxpayer would otherwise qualify for relief under IRC § 6015(c).<sup>41</sup> Further, the IRS can not pay refunds to a taxpayer in connection with a grant of equitable relief under IRC § 6015(f) or IRC § 66(c), unless the taxpayer can establish that he or she provided the funds for which he or she seeks a refund and: (a) In a case involving a deficiency, the payments were made pursuant to an installment agreement that the taxpayer entered into after filing a request for relief and has not defaulted on; and (b) In a case involving an underpayment of tax, the payments were not made with the joint return, were not joint payments, and were not made by the nonrequesting spouse.<sup>42</sup> In any event, the taxpayer may obtain a refund or credit only with respect to payments made within three years of the time the return was filed or two years from the time the tax was paid, whichever is later.<sup>43</sup>

Because the IRS may not issue a refund as a result of a separate liability election under IRC § 6015(c), such an election may provide little relief to the spouse who learns of his or her rights under IRC § 6015 long after collection efforts against him or her have begun. However, this “no-refund” rule was adopted only with respect to separate liability elections to prevent inappropriate use of the election to direct refunds to one spouse or the other.<sup>44</sup> These same concerns did not exist with respect to other types of innocent spouse relief where the IRS had to determine that it was inequitable not to grant relief before any refund could be paid. Presumably, the IRS would not grant equitable relief in “inappropriate” situations. If it is inequitable for the IRS to collect a liability from an innocent spouse, it is similarly inequitable for the IRS to retain amounts collected to satisfy the liability. For the same reasons, it makes no sense to withhold refunds of tax attributable to community income that the IRS has reallocated to another person pursuant to IRC § 66(c). In any event, refunds are limited to amounts paid within three years of filing the return or two years of paying the liability, whichever is

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<sup>39</sup> IRC § 6015(g)(1). A taxpayer may obtain “traditional” relief from a deficiency attributable to an erroneous item of the nonrequesting spouse on a joint return if he or she seeks relief within the requisite period, the requesting spouse did not know or have reason to know of the deficiency, and it would be “inequitable” to hold the requesting spouse liable. See IRC § 6015(b).

<sup>40</sup> IRC § 6015(g)(3); Treas. Reg. § 1.6015-3(c)(1). A “separate liability” election is a type of innocent spouse relief that, in certain circumstances, allows a taxpayer who is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for a 12-month period to elect to limit his or her liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items. IRC § 6015(c).

<sup>41</sup> Treas. Reg. § 1.6015-4(b).

<sup>42</sup> Rev. Proc. 2003-61, 2003-2 C.B. 296 4.04.

<sup>43</sup> IRC § 6511(a).

<sup>44</sup> See H. Conf. Rep. 599, 105th Cong., 2d Sess. 259 (1998) (stating that “[S]pecial rules apply to prevent the inappropriate use of the election. The separate liability election may not be used to create a refund, or to direct a refund to a particular spouse.”).



later.<sup>45</sup> To the extent refunds are unavailable even after the IRS determines it would be inequitable to collect amounts that it has already collected, the innocent spouse rules are not fulfilling their intended purpose – to address inequities resulting from joint and several liability and community property rules. Instead, they are penalizing taxpayers who voluntarily pay the IRS.

#### EXAMPLE

W received an IRS collection notice and timely requested equitable relief under IRC § 6015(f). W entered into an installment agreement to pay the amount requested by the IRS, but she had difficulty making the payments and defaulted on it. Although the IRS ultimately determined to grant W's request for relief, it would not refund any of her payments, even though they were applied to a liability the IRS later determined that it would be inequitable for her to pay.

#### RECOMMENDATION

When equitable relief is granted under IRC § 6015 or IRC § 66(c), any resulting overpayments should be refunded or credited solely to the requesting spouse's separate liability.<sup>46</sup> Taxpayers would still only be able to obtain a refund with respect to payments made within three years of filing the return or two years of paying the liability, whichever is later.<sup>47</sup>

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<sup>45</sup> IRC § 6511(a).

<sup>46</sup> The National Taxpayer Advocate made a similar recommendation in her 2001 report. See National Taxpayer Advocate 2001 Annual Report to Congress 155-165. We note that because the Code does not prohibit the IRS from paying refunds except with respect to separate liability elections, legislation is not necessarily required to implement this recommendation.

<sup>47</sup> IRC § 6511(a).

**MILITARY ISSUES****PROBLEM**

Members of the U.S. armed forces, especially those serving in designated combat zones, face special federal income tax situations and are entitled to certain tax benefits due to their service.<sup>1</sup> Increased military action and overseas deployments have highlighted how benefits designed to help U.S. troops can negatively impact these taxpayers instead. In 2005, approximately 207,000 active duty military personnel were deployed as part of Operation Iraqi Freedom and could potentially be affected by these provisions.<sup>2</sup> This does not take into account the numerous other military personnel deployed to other combat zones.

**EARNED INCOME TAX CREDIT – NONTAXABLE COMBAT PAY ELECTION**

Military personnel who receive nontaxable combat pay from their service in a designated combat zone can choose to have the IRS consider the pay as earned income for the purpose of computing the Earned Income Tax Credit (EITC).<sup>3</sup> An amendment to IRC § 32(c)(2)(B)(vi) to allow for this election was included in the Gulf Opportunity Zone Act of 2005.<sup>4</sup> However, the nontaxable combat pay election will expire after tax year 2007.

**EXAMPLE**

John and Mary are married and have one child. John is a member of the armed forces serving in a designated combat zone for the entire year. The couple's only income is John's military pay, which totals \$17,000 in nontaxable combat pay for 2005. When completing their joint tax return for tax year 2005, John and Mary make an election under IRC § 32(c)(2)(B)(vi) to have John's combat pay treated as earned income for purposes of computing the EITC. This election brings their combined earned income to \$17,000 for tax year 2005 and allows them to claim an EITC of \$2,558.<sup>5</sup> If, however, John and Mary could not elect to have John's combat pay as earned income for EITC purposes, he and Mary would not have earned income and could not claim the EITC.

<sup>1</sup> IRC § 112 excludes from gross income certain combat zone compensation of members of the Armed forces. IRC § 7508 provides a 180-day extension after departing the combat zone for filing, paying, and performing certain other tax related acts. IRC § 692 is a special provision for members of the Armed Forces who die in a combat zone. IRC § 4253(b) exempts from excise tax any telephone call from a member of the armed forces which originates from a combat zone.

<sup>2</sup> U.S. Department of Defense, *Active Duty Military Personnel Strengths by Regional Area and Country, December 31, 2005*, available at <http://siadapp.dior.whs.mil/personnel/MILITARY/history/hst1205.pdf>.

<sup>3</sup> IRC § 32(c)(2)(B)(vi).

<sup>4</sup> Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, § Stat. 26 (2005). This provision was extended in § 106 of the Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006.

<sup>5</sup> John and Mary meet all of the other requirements for claiming the EITC. See IRC § 32.

The inability to include John's nontaxable combat pay in earned income for purposes of the EITC would reduce John and Mary's EITC from \$2,558 to \$0.<sup>6</sup>

### RECOMMENDATION

Amend IRC § 32(c)(2)(B)(vi) to make permanent the provision allowing military personnel the option to include nontaxable combat pay, received for service in a designated combat zone, as earned income for the purpose of computing the EITC.<sup>7</sup>

### INCOME TAX TREATMENT OF DIFFERENTIAL PAY

Differential pay is a series of voluntary employer payments that make up the difference between the regular civilian salary of an employee called to active duty and the amount paid by the military.<sup>8</sup> These payments are not considered wages and therefore are not subject to federal income tax withholding.<sup>9</sup> However, differential pay is still considered income and must be reported on a federal tax return.<sup>10</sup> The most recent IRS guidance regarding the tax treatment of differential pay is Revenue Ruling 69-139, which concludes, using two different hypothetical examples, that differential pay is not wages.<sup>11</sup> The IRS continues to rely on Revenue Ruling 69-139 in determining the tax treatment of differential pay.<sup>12</sup>

Military reservists do not have the option of asking their civilian employer to withhold taxes from the differential pay. The only option for the taxpayer receiving differential pay is to make quarterly estimated tax payments to the IRS to avoid a substantial tax liability at the end of the year.

### EXAMPLE

Jeanette is a member of the armed forces on active duty. She is a single taxpayer with no children and is entitled to claim only the standard deduction. During tax year 2005, she receives \$25,000 in military pay plus \$25,000 in differential pay from her civilian

<sup>6</sup> If John and Mary had two or more qualifying children for purposes of the EITC, the inability to include John's nontaxable combat pay in earned income for purposes of the EITC would reduce John and Mary's EITC from \$4,262 to \$0.

<sup>7</sup> S. 1824, *A Bill to Amend the Internal Revenue Code of 1986 to Strengthen the Earned Income Tax Credit*; H.R. 5601, *To Amend the Internal Revenue Code of 1986 to Strengthen the Earned Income Tax Credit*.

<sup>8</sup> A taxpayer need not serve in a combat zone to receive differential pay.

<sup>9</sup> Rev. Rul. 69-136.

<sup>10</sup> Rev. Rul. 69-136; IRS, *Employers with Employees in a Combat Zone: Military Differential Pay*, Q-38 – 39, available at <http://www.irs.gov/newsroom/article/0,,id=129833,00.html>.

<sup>11</sup> The basis for this conclusion is that the employment relationship between the employer and the employee was terminated when the employee was called to active duty. Therefore, the differential payments are not "wages" for services performed in "employment" ... [and] therefore, are not "wages" subject to taxes imposed by the Federal Insurance Contributions Act and the Federal Unemployment Tax Act or to the Collection of Federal Income Tax at Source on Wages." Rev. Rul. 69-139.

<sup>12</sup> IRS, *Employers with Employees in a Combat Zone: Military Differential Pay*, Q-38 – 39, available at <http://www.irs.gov/newsroom/article/0,,id=129833,00.html>.

employer. Jeanette has a total of \$50,000 in gross income for tax year 2005, but the IRS only withholds tax from the \$25,000 of military pay. When she files her 2005 income tax return, Jeanette owes \$4,962 in taxes.<sup>13</sup>

#### RECOMMENDATION

Amend the Code to require a former employer to provide a taxpayer the option of having federal income tax withheld from his or her differential pay. If a taxpayer makes this election, the former employer is required to withhold federal income tax from the taxpayer's differential pay.<sup>14</sup>

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<sup>13</sup> Jeanette had gross income for 2005 of \$50,000 and withholding on the \$25,000 of military pay of \$2,159. Her total tax liability for the year is \$7,121, bringing the amount Jeanette owes to \$4,962. The calculation was made assuming the taxpayer files single, has no additional income, takes the standard deduction, is not entitled to any other deductions or credits for tax year 2006, and was not overwithheld from on the \$25,000 of military pay.

<sup>14</sup> IRC § 3402(p)(3) authorizes the Secretary to provide for withholding "from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter, if the employer and the employee, or the person making and the person receiving such other type of payment, agree to such withholding." This legislative proposal goes beyond the scope of the authority provided in § 3402(p)(3) by *mandating* withholding if the military member requests it.

## AMEND IRC § 6511 TO ALLOW REFUND CLAIMS PAST THE RSED WHEN EXCESS COLLECTION IS DUE TO IRS ERROR

### PROBLEM

The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed and does not notify the taxpayer of the excess collection. If the taxpayer does not file a refund claim within the statutorily-permitted time, the IRS will not honor the claim. Under Internal Revenue Code (IRC) § 6511(a), a taxpayer who files a claim for refund or credit of tax generally must do so no later than three years after filing the return or two years after paying the tax.

It is the IRS's position that there is no statutory authority to allow the IRS to refund the amounts improperly levied upon if the refund claim is not timely, even if the mistake is attributable solely to the IRS and the taxpayer did not learn of the error prior to the refund statute expiration date (RSED). That the levy should have been but was not timely released by the IRS does not override the mandates of IRC § 6511.

### EXAMPLE

Jane Doe is a retired widow whose sole source of income is a \$900 monthly Social Security benefit. She owns a house and a car, but has no other assets of value. In April 1999, the IRS assessed \$3,000 against a joint return filed by Ms. Doe and her deceased husband, and now seeks to recover this amount via levy. The IRS issues a continuous levy on the Social Security benefits for unpaid balances due, and the Social Security Administration transfers a portion of Ms. Doe's benefits directly to the IRS.

The underlying liability was fully paid in June 2001. However, the IRS negligently continued to levy the taxpayer's Social Security benefits until June 2004, when the IRS discovered its error. Because the IRS did not notify the taxpayer of the excess collection until June 2006 (after the RSED has lapsed), she has no way to recover the funds that the IRS improperly levied.

### RECOMMENDATION

The National Taxpayer Advocate recommends that the IRS be required to send out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged, along with a detailed breakout of the application of such payments to tax, penalties, and interest for all relevant tax years. Taxpayers receive this type of itemized statement from the IRS when they enter into an installment agreement under IRC § 61591 and from creditors in the private sector (*e.g.*, mortgage

<sup>1</sup> Section 3506 of the IRS Restructuring and Reform Act of 1998 provides that each taxpayer who has an installment agreement be given an annual statement setting forth the initial balance at the beginning of the year, the payments made during the year, and the remaining balance as of the end of the year. Pub. L. No. 105-206, 112 Stat. 685, 771-72 (1998). *See also* IRM 3.17.46.7.6.

lenders). This annual statement is necessary since taxpayers who discover errors have a limited window of time to request refunds of overpayments.

Alternatively, the National Taxpayer Advocate recommends that IRC § 6511 be amended to allow taxpayers two years from the date they learn of the excess collection to make refund claims if the excess collection is due to IRS negligence. This legislative recommendation would provide relief to taxpayers where the excess collection is due to IRS negligence.

## RECOMMENDATIONS

SECTION  
TWO

**FEDERAL OVERSIGHT OF RETIREMENT PLANS OF QUASI-GOVERNMENTAL ENTITIES****PROBLEM**

In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA), which created minimum standards for most voluntarily established employee benefit plans.<sup>1</sup> Section 2(b) of ERISA sets forth Congress' objectives in enacting the law, stating that:

[I]t is the policy of this Act to protect...the interests of participants of employee benefit plans and their beneficiaries...by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies.<sup>2</sup>

Title I of ERISA contains rules for reporting and disclosure, vesting, participation, funding, fiduciary conduct, and civil enforcement, and is administered by the Department of Labor's Employee Benefits Security Administration (EBSA, formerly the Pension and Welfare Benefits Administration).<sup>3</sup> EBSA requires administrators of private pension and welfare plans to provide participants with easily understandable summaries of their plans. These summaries are filed with EBSA, along with annual reports on the financial operations of the plans and on the bonding of persons charged with handling plan funds and assets. Plan administrators must also meet strict fiduciary responsibility standards, which the EBSA enforces.

The enforcement provisions contained in Title I of ERISA, however, are available to private-sector plan participants only. The Department of Labor has no oversight responsibility for governmental plans (defined as plans "established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof") or quasi-governmental<sup>4</sup> plans. These plans are specifically exempt from Title I of ERISA.<sup>5</sup>

The Office of Personnel Management (OPM) came into existence on January 1, 1979, and took over many of the functions of the former United States Civil Service Commission.<sup>6</sup> The duties and authority of the OPM are specified in the Civil Service Reform Act of 1978.<sup>7</sup> The OPM has statutory authority to oversee the two primary

<sup>1</sup> Pub. L. No. 93-406, 88 Stat. 829, September 2, 1974.

<sup>2</sup> 29 USC § 1001(b).

<sup>3</sup> See 29 USC § 1001.

<sup>4</sup> Quasi-governmental entities are hybrid organizations established to implement public policy functions traditionally assigned to executive departments and agencies.

<sup>5</sup> 29 USC § 1003(b)(1).

<sup>6</sup> See Executive Order 12107 of December 28, 1978 (43 FR 36037, 92 Stat. 3783).

<sup>7</sup> See 5 USC 1101.

plans providing benefits to federal employees – the Civil Service Retirement System (CSRS)<sup>8</sup> and the Federal Employees Retirement System (FERS).<sup>9</sup>

Neither EBSA nor the OPM has the statutory responsibility for oversight of retirement plans administered by quasi-governmental entities. One rationale for exempting governmental plans from federal oversight was to respect the principle of comity, by which the federal government gives deference to the laws or decisions of the states on the presumption that state courts are equally capable of addressing federal law. While this explanation may make sense for retirement plans administered by state government agencies, the principle of comity does not apply to retirement plans administered by quasi-federal governmental agencies.

#### EXAMPLE

Jane Doe has been employed by the XYZ Agency, a quasi-governmental entity, for 20 years. In May 2006, she becomes disabled and is unable to perform her duties as a receptionist. Ms. Doe timely files an application for disability benefits in accordance with the provisions of her pension plan, but the plan administrator denies the application. Ms. Doe would like to contest this decision, but the plan does not allow participants to appeal a denial of benefits.

Because the XYZ Agency is not a private entity, the Department of Labor has no jurisdiction over the administration of this plan. The OPM does not have oversight responsibility because Ms. Doe is not a participant in CSRS or FERS. And because this plan is not state-administered, there is no designated state agency with oversight authority. With no avenue for administrative relief, Ms. Doe must undertake litigation, a costly and timely endeavor, if she wishes to challenge the XYZ Agency's decision to deny her application for disability benefits.

#### RECOMMENDATION

The National Taxpayer Advocate recommends that Congress appoint a federal agency (*e.g.*, the Department of Labor's EBSA or the OPM) to maintain oversight responsibility for ensuring that quasi-governmental retirement plans carry out their fiduciary duties. This legislative recommendation would provide relief to participants in retirement plans administered by quasi-governmental entities who currently have no avenue for administrative relief when there is a dispute with the plan administrator.

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<sup>8</sup> See 5 USC 8347.

<sup>9</sup> See 5 USC 8461.



## COLLECTION DUE PROCESS AND UNECONOMICAL LEVIES

## PROBLEM

Internal Revenue Code § 6331(j) requires the IRS to conduct a thorough investigation of the status of any property or right to property which is to be levied upon and sold under IRC § 6335. This investigation shall include (1) a verification of the taxpayer's liability; (2) an analysis of whether the expenses of levy and sale would exceed the fair market value of the property at the time of the levy; (3) a determination that there is sufficient equity in the property to yield net sale proceeds to apply to the tax liability; and (4) a thorough consideration of alternative collection methods.<sup>1</sup>

Appeals Officers conducting Collection Due Process hearings under IRC § 6330 (Notice and Opportunity for Hearing Before Levy) are required to obtain verification from the IRS that that the requirements of any applicable law or administrative procedure have been met.<sup>2</sup> Moreover, in making the determination about whether the IRS may proceed with the proposed levy action, the Appeals hearing officer shall take into consideration “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.”<sup>3</sup>

Recent court decisions have held that the Appeals hearing officer need not verify that the IRS conducted the IRC § 6331(j) review prior to proposing a levy action that triggers the CDP hearing.<sup>4</sup> Courts have also held that the Appeals hearing officer is not required to take into account the uneconomical nature of the levy under the CDP “balancing” of the government's interests versus the intrusiveness of the action from the taxpayer's perspective.<sup>5</sup>

The failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action renders that hearing meaningless. The failure to investigate the economic feasibility of the levy is contrary to the oversight of IRS collection activity that Congress intended and that should be required.

<sup>1</sup> IRC § 6331(j)(2)(A)-(D).

<sup>2</sup> IRC § 6330(c)(1).

<sup>3</sup> IRC § 6330(c)(3)(C).

<sup>4</sup> In *Living Care Alternatives of Utica, Inc.*, 411 F.3d 621 (6th Cir. 2005), the court agreed with the Commissioner's reasoning that “[a]ll that the statute requires is that the IRS investigate the equity in a property prior to levying on it, not prior to the collection due process hearing.” *Id.* at 628-29. *See also, Medlock v. U.S.*, 325 F.Supp.2d 1064 (C.D. Cal. 2003), stating “According to the plain language of the relevant statutory sections [6331(f) and 6331(j)] these actions must be taken before a taxpayer's property may be levied upon by the IRS but are prematurely raised at this stage of the collection process.” *Id.* at 1079.

<sup>5</sup> “[T]here is not requirement that the government consider in its balancing analysis whether it will receive any revenue from a levy and sale, or whether the business will have to close down due to the levy and sale.” *Living Care Alternatives of Utica, Inc.*, 411 F.3d 621, 628 (6th Cir. 2005).

## RECOMMENDATIONS

SECTION  
TWO**EXAMPLE**

The taxpayer, a nursing home, sought to raise in its CDP hearing on a proposed levy action that the IRS's attempt to levy upon property would cause lienholders to levy on the property first, thereby generating no revenue for the government, since the existing debt to the senior lienholders exceeded the value of the property. The Appeals hearing officer did not require the IRS to conduct an investigation and make a determination whether there would be any net sale proceeds to apply toward tax debt, since under current case law the IRS does not have to conduct that investigation prior to the CDP hearing; nor is it an abuse of discretion for the Appeals hearing officer to consider the uneconomical nature of the levy in the CDP hearing.

**RECOMMENDATION**

Amend IRC §§ 6330(c) to clarify that the Appeals hearing officer, prior to making his determination under IRC § 6330(c)(3), must verify that the IRS conducted the required analysis under IRC § 6331(j), and must also consider that analysis in balancing the government's interest in efficient tax collection with the taxpayer's legitimate concern about the intrusiveness of the proposed levy action.