

National Taxpayer Advocate

2013 ANNUAL REPORT TO CONGRESS

EXECUTIVE SUMMARY:
Preface and Highlights



YOUR VOICE AT THE IRS

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At their core,
taxpayer rights are human rights.
They are about our inherent humanity.

Particularly when
an organization is large, as is the IRS,
and has power, as does the IRS,
these rights serve as a bulwark
against the organization's tendency
to arrange things in ways that
are convenient for itself,
but actually dehumanize us.

Taxpayer rights, then, help ensure that
taxpayers are treated in a humane manner.

Nina E. Olson
Laurence Neal Woodworth
Memorial Lecture
May 9, 2013

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PREFACE: A Path to Strengthening Tax Administration and Improving Voluntary Tax Compliance

HONORABLE MEMBERS OF CONGRESS:

I respectfully submit for your consideration the National Taxpayer Advocate's 2013 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.

This report arrives at the close of a very difficult year for the IRS. It found itself mired in a scandal relating to tax-exempt organizations, resulting in the resignation or retirement of the acting Commissioner and other members of the IRS senior leadership.¹ It went through seven difficult months — from May to December — during which, under the leadership of a very able senior civil servant, it attempted to right both its operations and its reputation. During this time, it experienced a 16-day shutdown that has delayed the start of the 2014 filing season and exposed thousands of taxpayers to harm from enforcement actions initiated just before or during the shutdown.² In the midst of all this, it is a credit to the talent and professionalism of IRS employees that they managed to conduct the business of the agency as well as they have.

I submit that all of these short-term crises mask the major problem facing the IRS today — unstable and chronic underfunding that puts at risk the IRS's ability to meet its current responsibilities, much less articulate and achieve the necessary transformation to an effective, modern tax agency.

Throughout the Most Serious Problems section of this report, we recount the ways in which chronic underfunding drives the agency to develop short-term solutions that merely patch over problems and impose unnecessary burden and even harm on taxpayers. These short-term solutions also create more work for the IRS in the end, thereby wasting precious resources. As the IRS spends its resources to address problems in this *ad hoc* manner — to put fires out — it is unable to direct attention and talent to the long-term challenges it faces as it attempts to modernize. Simply put, without a stable funding stream and adequate resources to invest in the future, the IRS will fall short of fulfilling its mission to serve the U.S. taxpayer and collect revenue.

1 For a discussion of problems relating to exempt organizations, see Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*, *infra*. See also National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress (Special Report to Congress: *Political Activity and the Rights of Applicants for Tax-Exempt Status*).

2 For example, during the shutdown period, the IRS issued 3,902 levies on Social Security recipients. IRS Compliance Data Warehouse, Individual Master File (Processing Year 2013).

A Vision for the IRS in the 21st Century

A 21st century tax administration would:

- Be founded on a Taxpayer Bill of Rights and use that document as an analytical tool for its operations and initiatives.³
- Be operated on the principle that voluntary compliance is the least expensive, most effective method of collecting tax revenue.
- Recognize that modern tax administration not only involves collecting revenue but also disbursing benefits (tax expenditures) to targeted populations, including low income and business taxpayers, and it would design its activities, staffing, and training around the specific characteristics and needs of those populations.
- Be built on the understanding that only two percent of the revenue it collects comes from direct enforcement actions and that the provision of taxpayer service, assistance, and education is one of the most influential factors for maintaining voluntary compliance, particularly for the self-employed.
- Be open to emerging research that its existing enforcement approach — based on targeting large delinquencies ahead of recent delinquencies and focused on the use of liens and levies instead of timely, personal contact — may be less effective than it believes.
- Use findings from its own and the international research community to develop approaches to voluntary compliance and enforcement that incorporate behavioral, psychological, and educational approaches.
- Develop localized compliance initiatives, building on the finding that one of the most significant influences of compliance behavior is a taxpayer's networks and norms, particularly local ones.⁴
- Educate its workforce about the foundational principles of tax administration and how those principles are applied in the different aspects of their work.⁵
- Be on the cutting edge of electronic tax administration, providing taxpayers with access to their electronic accounts so they can check on filing requirements, track receipt and processing of documents they have filed, identify problems with their accounts, and resolve those problems through submissions, explanations, etc.
- Provide taxpayers with online access to all third-party information reports received by the IRS, in time for them to download or populate their return preparation software — whether government-provided, purchased from a commercial software provider or used by a commercial return preparer.⁶

³ See Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration*, *infra*.

⁴ See Volume 2: *Small Business Compliance: Further Analysis of Influential Factors*, *infra*, and National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 1-70 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

⁵ See Most Serious Problem: *Taxpayer Rights: Insufficient Education and Training About Taxpayer Rights Impairs IRS Employees' Ability to Assist Taxpayers and Protect Their Rights*, *infra*.

⁶ See Volume 2: *Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments*, *infra*.

- Provide taxpayers with face-to-face (including virtual face-to-face) and telephonic communication rather than relying solely on correspondence that generates confusion, low response rates, and re-work for the IRS.
- Develop a comprehensive suite of taxpayer service, compliance, and enforcement measures that can serve as a basis for funding decisions, while holding the IRS accountable for delivery of effective tax administration.⁷
- Lastly but most crucially, the IRS would receive the funding necessary to achieve the transformation into a 21st century tax administration and to sustain its operations at that level.⁸

In short, what taxpayers need and deserve is the transformation of the IRS from a traditional enforcement-focused tax agency to a forward-looking modern agency that embraces technology even as it recognizes the specific needs of taxpayers for personal assistance in their efforts to comply voluntarily with the tax laws. In this latter construct, the use of enforcement is informed by an understanding of taxpayer behavior. The overriding strategic goal for this system should be to increase and maintain voluntary compliance; all IRS activities should be designed to further that goal.

I want to make clear that I believe the IRS can make that transformation. It has many, many talented people, who know what needs to be done and would love to be able to receive the education and funding necessary to utilize the most advanced approaches for their jobs. But as we have noted since the 2006 Annual Report to Congress,⁹ the IRS has been chronically underfunded for years now, at the same time it has been required to take on more and more work, including administering benefit programs for some of the most challenging populations. In such an environment, the IRS can only solve problems *ad hoc*; undertaking transformational approaches to tax administration has seemed, unfortunately, like a luxury it has not been able to afford.

What the IRS — and by extension, U.S. taxpayers — need is for Congress, the Administration, Treasury, and the Commissioner of Internal Revenue to work together to provide the funding, vision, direction, and accountability required to enable the IRS to become an agency that we are all proud of, that we find easy to navigate and work with, and that we trust and believe is fair. This is not a luxury. This is a necessity.

In the pages that immediately follow, I discuss two areas that are foundational for this transformation: taxpayer service and collection. Throughout the rest of the report's discussion of the Most Serious Problems of taxpayers, we identify other components of tax administration that must change and modernize to be effective, and we attempt to identify the consequences to taxpayers — and the public fisc — if we fail.

A central theme of this report is that without adequate funding, the IRS will fail at its mission. But additional funding alone will not bring the IRS into the 21st century. The funding must be accompanied by a commitment to rethinking its approach to tax administration and intense self-scrutiny about how it should best deploy those resources. The IRS must be open to new approaches and research, even if it shakes traditional assumptions. We offer this discussion, and the following report, in the hope that under new leadership and with the support of Congress, the IRS will again be able to undertake this challenge.

⁷ See Volume 2: *The Service Priorities Project: Developing a Methodology for Optimizing the Delivery of Taxpayer Services*, *infra*.

⁸ See Most Serious Problem: *IRS Budget: The IRS Desperately Needs More Funding to Serve Taxpayers and Increase Voluntary Compliance*, *infra*.

⁹ See National Taxpayer Advocate 2006 Annual Report 442-457 (Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

The Case for Taxpayer Service as One of the Most Significant Influences on Voluntary Compliance

The classic economic model of compliance — that compliance depends upon the risk (or perception of risk) of being caught and the cost (punishment) if caught — does not fully explain the high compliance rate in our tax system. Research shows that other factors, such as taxpayers' attitudes about government and their perception that they are being treated fairly by the tax system, also influence taxpayer compliance decisions. Many researchers refer to these factors collectively as “tax morale.”¹⁰

In recent years, the Taxpayer Advocate Service (TAS) has explored the factors influencing taxpayer compliance decisions. In Volume 2 of this year's Annual Report, we discuss three studies that provide empirical evidence on several points:

- (7) Taxpayer service and trust are a significant factor in influencing compliance behavior and perhaps the most significant factor for self-employed taxpayers, who are subject to little information reporting and to whom the largest portion of the tax gap is attributable;¹¹
- (8) Accuracy-related penalties, a classic economic deterrent, do not increase the long-term voluntary compliance of the taxpayers against which they are assessed;¹² and
- (9) Local collection personnel outperformed remote, centralized collection personnel, but neither groups' enforcement actions had a significant impact on taxpayers' future compliance.¹³

This research suggests we need to adopt a new paradigm of tax compliance and the relationship between the IRS and the taxpayer. For example, our surveys have shown that for the most noncompliant group of taxpayers (sole proprietors), trust in the government, trust in the IRS, and trust in the tax system highly correlate with compliant behavior.¹⁴ Further analysis has found that delivery of taxpayer service is the single most influential factor for compliant behavior by this group of taxpayers.¹⁵ Thus, the new paradigm for tax administration should include a robust, well-funded, well-researched system of taxpayer services, designed to make it easier for taxpayers to comply with the laws and for noncompliant taxpayers to come into compliance.

Now, I am not suggesting that the IRS should not undertake enforcement actions. Such activity certainly has a direct effect (*i.e.*, it corrects the specific taxpayer's noncompliant behavior for the period under review) and indirect effect (economists have estimated the indirect effect of an examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment).¹⁶ But the IRS is very quick to pull out its hard core enforcement tools — and our research shows that indiscriminate use of these tools does not bring about significant long-term voluntary compliance. The goal of any compliance

10 For an introduction to the concept of tax morale, see National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-182 (*Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*).

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

12 See Volume 2: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*, *infra*.

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

14 See National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, 1-70 (*Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*).

15 See Volume 2: *Small Business Compliance: Further Analysis of Influential Factors*, *infra*. Economic deterrence, while a factor, is counterbalanced by other economic concerns, including the taxpayer's ability to stay in business.

16 Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, 35-36; Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986*, 43 NAT. TAX J., 395, 396, 405 (1990).

action is that you don't have to address that taxpayer's noncompliance over and over again, resulting in an endless loop of enforcement action. For all but the most determinedly noncompliant taxpayers, the use of "softer" tools, like timely personal contacts (whether by phone or in-person), educational notices, installment agreements, and offers in compromise, make it more likely to bring that taxpayer into future compliance even as you address the current issue.¹⁷

IRS Taxpayer Service Delivery is Deteriorating to a Point That Will Impact Voluntary Compliance.

I believe that any attempt to develop a framework for IRS service delivery should begin with a discussion of the mission of the Internal Revenue Service and how taxpayer service relates to the mission. It is universally acknowledged that the IRS is the principal organization responsible for collecting the revenues necessary to fund the numerous and diverse functions performed by the federal government, *i.e.*, that taxes are "the life blood" of government.¹⁸ As noted above, however, it should be clear that the mission of the IRS is broader than merely collecting tax revenue. In fact, with the expansion of refundable tax credits for individuals and businesses, the IRS today is a significant disburser of government payments.

There is also general agreement that the IRS is supposed to collect the *correct* amount of tax. This implies that the IRS's responsibility extends beyond ensuring that everyone pays the taxes they owe. We also have a responsibility to ensure that taxpayers do not pay *more* taxes than they owe. Further, there is general recognition that the IRS must weigh the burden it imposes on taxpayers against its mission to collect the taxes owed. For example, Congress has never funded the IRS to conduct extensive audits of every taxpayer every year. Besides being far too intrusive, this would place an unreasonable financial burden on the vast majority of honest taxpayers.

Our system is based on self-assessment, but the tax laws are so complicated (and become more so each year) that computing the correct amount of tax poses a daunting challenge for many of our citizens, and they frequently require assistance. While some can readily afford to pay for the assistance they need, tens of millions cannot. For these taxpayers, paying for tax assistance creates a significant financial burden.

Yet today, IRS-provided taxpayer service is increasingly and unacceptably limited. First, telephone calls and correspondence are the two main ways taxpayers communicate with the IRS. Yet the IRS is projecting it will answer only 61 percent of its calls this year from taxpayers seeking to speak to a live assistor. Waiting times are approaching 20 minutes for those lucky enough to get through. If you are a tax professional trying to resolve a problem for a client, you have a 20-minute wait on the line inaptly named "Practitioner Priority Service."¹⁹ Similarly, our ability to process correspondence has declined. Comparing the final week of FY 2004 with the final week of FY 2013, the backlog of taxpayer correspondence in the tax adjustments inventory jumped by 217 percent (from 348,000 to 1.1 million),²⁰ and the

17 See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 *Kans. L. Rev.* 1, 23-33 (2003). See also Her Majesty's Revenue and Customs (HMRC), *HMRC Hidden Economy Strategy and Customer Segmentation* (Nov. 2013). For a fascinating report on the results of a campaign applying this methodology to increasing compliance among electricians, see Her Majesty's Revenue and Customs, *HMRC Electricians Tax Safe Plan Research Report 260*, TNS-BMRB (April 2013).

18 *Bull v. U.S.*, 295 U.S. 247, 259 (1935).

19 IRS, Joint Operations Center, *Snapshot Reports: Product Line Detail – PPS* (week ending Sept. 30, 2013) (showing that the hold for FY 2013 on the Practitioner Priority Service telephone line was 1,183 seconds). Even worse, the hold time for the final quarter of the fiscal year was 2,221 seconds, or 37 minutes.

20 IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 30, 2004) and *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 28, 2013).

percentage of taxpayer correspondence in this inventory classified as “over-age” increased by 361 percent (from 11.5 percent to 53.0 percent of correspondence).²¹ Correspondence generally is considered over-age when it is 45 days old or older and the issue it addresses has not been resolved.²²

Second, the IRS has abandoned return preparation in its walk-in sites, which was already limited to the most vulnerable populations of taxpayers — the elderly, the disabled, and the low income. It also has shut down tax law assistance on the phones after April 15, and has significantly limited the scope of questions it is willing to answer during the filing season. Thus, in the United States today, tax preparation and filing assistance is now, for the most part, privatized. That is, for a taxpayer to comply with his or her requirement to file a tax return, the taxpayer generally must pay for assistance, pay for software, and pay for advice. This is an unprecedented change in tax administration and it is not a good one. It is particularly devastating when one considers that over 50 percent of prepared individual returns are completed by unenrolled return preparers²³ — the very preparers the IRS is now hamstrung over regulating because of pending litigation in the federal courts. So while we hash out this issue in the courts, millions of taxpayers are exposed to the risk of incompetent and even fraudulent return preparers.²⁴

In addition, millions of low and middle income taxpayers are “touched” annually by IRS programs that propose additional assessments, such as correspondence audits, math error, and automated underreporter (AUR) programs. Other programs hold refunds that IRS filters have identified as questionable or potentially fraudulent.²⁵ These proposed additional assessments and refund holds are not always correct, and taxpayers frequently need help understanding IRS notices and other communications.²⁶

Low and middle income taxpayers generally cannot afford to pay practitioners to work with the IRS to resolve these kinds of issues. They rely on IRS assistance through our various channels, such as the toll-free line, correspondence, and walk-in sites. If, as I propose in the Taxpayer Bill of Rights, we accept that these taxpayers have a *right to pay the correct amount of tax, i.e.*, that they should not pay taxes they do not actually owe, and should not be subjected to unreasonable financial (or other) burden, the IRS has an obligation to provide a reasonable level of service to help them do so. Similarly, practitioners who interface with the IRS on behalf of taxpayers require a reasonable level of service. I think we must acknowledge

21 IRS, Joint Operations Center, *Adjustments Inventory Reports: July – September Fiscal Year Comparison* (FY 2004 Through FY 2013).

22 Wage and Investment Division (W&I) FY 2012 Account Management Program Letter and Operating Guidelines (Dec. 12, 2011). In some instances, the definition of over-age varies based on factors such as the type of work, the program, the site, and inventory levels. TAS conversation with Joint Operations Center Paper Inventory Analyst (Dec. 13, 2011).

23 IRS Compliance Data Warehouse, Individual Returns Transaction File and Return Preparers and Providers Database (Tax Year 2011).

24 *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. Jan. 18, 2013), *motion to suspend injunction pending appeal denied but injunction modified* by 920 F. Supp. 2d 108 (D.D.C. Feb. 1, 2013), *appeal docketed*, No. 13-5061 (D.C. Cir. Feb. 22, 2013), *motion for stay pending appeal denied*, 111 A.F.T.R.2d (RIA) 1384 (D.D.C. Mar. 27, 2013), *oral argument*, No. 13-5061 (D.C. Cir. Sept. 24, 2013). See Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined from Continuing its Efforts to Effectively Regulate Return Preparers*, *infra*. See generally, Nina E. Olson, *More Than a “Mere” Preparer: Loving and Return Preparation*, 2013 TNT 92-13, Tax Notes Today (May 13, 2013).

25 See Most Serious Problem: *Revenue Protection: Ongoing Problems with IRS Refund Fraud Programs Harm Taxpayers by Delaying Valid Refunds*, *infra*.

26 For example, in tax year 2009, nearly 300,000 returns contained errors with dependent taxpayer identification numbers (TINs). During math error processing, the IRS disallowed over \$200 million of credits claimed on these returns, but subsequently reversed at least part of its dependent TIN math errors on 55 percent of them. Ultimately about 150,000 taxpayers had their refunds restored. On average, the IRS allowed nearly \$2,000 per return after the initial disallowance, with a delay of nearly three months. The total restored to taxpayers was about \$292 million. This amount exceeds the amount of credits that were initially disallowed, because it includes both restored credits and related tax reductions (e.g., taxpayers got the benefit of exemptions that were initially disallowed when the credits were disallowed). Furthermore, analysis of a sample of taxpayers who did not contest these assessments showed that about 40,000 taxpayers were denied refunds they were probably entitled to receive. See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, 116-120 (*Math Errors Committed on Individual Tax Returns – A Review of Math Errors Issued on Claimed Dependents*).

that service delivery is as integral to the IRS mission as collecting taxes and enforcing the tax laws, and fund it accordingly.

Automation Is Not a Complete Solution

To address ongoing budget pressures, the IRS is increasingly turning away from personal service toward automation, and it is clear that cost-effective innovations could yield improvements in taxpayer service. For example, the IRS allows taxpayers to conduct simple actions through IRS.gov. However, taxpayers cannot use the site for such tasks as:

- Correcting computational errors;
- Checking account status; or
- Obtaining prior year return information immediately.

By requiring a taxpayer to write, call, or visit a Taxpayer Assistance Center (TAC) to complete these tasks, the IRS creates a higher volume of calls, correspondence, and TAC visits, burdening taxpayers and creating additional work for itself. Moving tasks to the Internet would enable computer-savvy taxpayers to use this channel for these actions and could reduce stress on IRS walk-in, telephone and correspondence resources, allowing IRS assistors to focus on taxpayers who need and prefer the TACs, the phone or correspondence.

While automated options are an important component of a comprehensive taxpayer service strategy, the IRS cannot rely solely on these options to close gaps. As the tax code grows more complex, taxpayer issues become increasingly difficult and harder to resolve through automation. Additionally, IRS research shows that taxpayers prefer personal service for some activities, and that certain segments of the taxpaying public are unable or unwilling to use automation. In a congressionally mandated update to a Taxpayer Assistance Blueprint, the IRS stated:

[T]axpayers report they use IRS.gov most often to complete transactional tasks (*i.e.*, tasks that require minimal in-person assistance, such as obtaining a form or publication). However, when responding to a notice or obtaining payment information, taxpayers said that they are more likely to call the IRS toll-free telephone lines.... Research also suggested that age, income, and education are correlated to taxpayer behavior, and recent findings show that taxpayers with lower household incomes reported higher use of non-web-based IRS service channels than taxpayers in higher income households.... Low income, limited English proficient (LEP), and elderly taxpayers tend to report a somewhat higher preference for the TAC channel and a lower preference for the electronic channel than the majority of taxpayers as a whole.... Low income and LEP taxpayers report using the telephone channel more than the overall taxpaying population.²⁷

The IRS is Judged on Measures that Undercut Taxpayer Service

Unfortunately, many of the measures stakeholders routinely apply to the IRS do not acknowledge the importance of service delivery. Invariably, the focus is on reducing the tax gap through enforcement

²⁷ See IRS, *Annual Report to Congress: Progress on the Implementation of The Taxpayer Assistance Blueprint Five-Year Progress Report: FY 2008–FY 2012 7-8* (Apr. 22, 2013).

efforts, or improving efficiency as measured by return on investment (ROI). Each year, for example, the IRS publishes a document entitled “Enforcement and Service Results” on its website. The data is viewed with considerable interest by the tax administration community. At this writing, the FY 2012 results are the most recent posted. They contain seven pages of “Enforcement” data that show Enforcement Revenue Collected broken out by Examination, Collection, Appeals, and Document Matching; staffing for “key enforcement occupations”; audit rates for individuals overall and by income range; audit rates for various types of business entities; the number of levies, liens and seizures during the past year; and data on criminal investigations. At the end, there is just a single page of basic “Service” data. This heavy emphasis on enforcement measures relative to service delivery measures is indicative of IRS priorities, and suggests the need for a stronger commitment to providing high quality service to taxpayers.

The IRS’s service activities compete with its enforcement programs for funding. While research shows that taxpayer service contributes to voluntary compliance, measuring the direct dollar impact of service on compliance (*i.e.*, the ROI of IRS services) is at best very difficult. Thus, we recommend IRS funding be based on its *obligation* to deliver an acceptable level of service to the nation’s taxpayers rather than a return on investment approach that emphasizes enforcement at the expense of service. In other words, if we acknowledge that quality taxpayer service is a fundamental taxpayer right and an integral component of the IRS’s mission, then funding for IRS services should be based on service measures and set at a level that ensure the IRS will fulfill that right and achieve its mission.

IRS Needs Better Taxpayer Service Measures that Will Drive Better Funding and Resource Allocation Decisions

The IRS should develop and publish a comprehensive suite of service measures that can serve as the basis for funding decisions, while holding the IRS accountable for efficient and effective service delivery. Elsewhere, I have offered detailed guidelines for the creation of a portfolio of measures that would enable both the IRS and external stakeholders to evaluate the effectiveness of IRS service delivery.²⁸ These measures would also enable the IRS to identify performance gaps that could guide the creation of performance improvement goals. A principal feature of this proposed framework is the inclusion of the following types of measures for each of the IRS service delivery channels (telephone, face-to-face, electronic, correspondence):

- Access – level of service, wait time (including, where applicable, time waiting for service, and time waiting for a response).
- Customer satisfaction.
- Accuracy.
- Issue resolution – *i.e.*, did the IRS completely resolve the taxpayer’s problem(s)?

Stakeholders are also keenly interested in how well the IRS is delivering each of its major services (*e.g.*, return preparation, refund inquiries, tax law inquiries). The IRS could report select service delivery measures for each of its major service activities:

- Taxpayer awareness of the availability of the various service types by channel.

28 See IRS, *Annual Report to Congress: Progress on the Implementation of the Taxpayer Assistance Blueprint* (April 2009 to September 2010) 54-57 (May 2011).

- Customer satisfaction with each service type by channel.
- Issue resolution for each service type by channel.
- Access for Limited English Proficiency and disabled taxpayers for each service type by channel.
- Number of returns prepared by Taxpayer Assistance Centers and Volunteer Income Taxpayer Assistance programs.

In this year's annual report, we discuss a project that TAS and the Wage and Investment (W&I) Operating Division have developed to enable the IRS to identify a proper balance between automated and personal service delivery.²⁹ We are developing a ranking methodology for IRS taxpayer services that takes taxpayer needs and preferences into account. The goal of the project is to identify, from both the government perspective and the taxpayer perspective, the value of each of the major taxpayer services offered by the IRS. This approach enables the IRS to identify the core service activities that taxpayers need in order to comply with the tax laws. In the face of budget or staffing constraints, the IRS will be able to use this ranking methodology to make resource allocation decisions based on highest valued services. Moreover, by weighting the values of criteria differently, the IRS can change the ranking of a given service. For example, if we believe that our system should make a special effort to assist vulnerable taxpayer populations, we should give more weight to the "vulnerable populations" criterion in our ranking formula.

Taxpayer Service Is Not an Isolated Function But Must Be Incorporated Throughout All IRS Activities, Including Enforcement.

The goal of a comprehensive, modern taxpayer service plan should be to maintain and increase voluntary compliance. In order to achieve that goal, the IRS should stop approaching service and enforcement as separate tracks. The IRS enforcement functions, such as audit and collection, should not be excused from having to address the issue of taxpayer service. If a taxpayer makes a reporting error, for example, the enforcement functions should not only seek to assess and collect any underpayment of tax but should also educate the taxpayer to reduce the likelihood that the taxpayer will make the error again. In this way, the IRS can and should integrate service within its enforcement activities.

It is a truism that "you get what you measure." IRS enforcement functions are measured primarily by the tax dollars assessed and collected, and the audits closed, liens filed, and levies issued. These measures have the effect of telling IRS employees that enforcement activity is what counts, and taxpayer education, problem resolution, and long-term voluntary compliance do not.

To change this mindset and to bring IRS enforcement into alignment with the observation that taxpayer service is the most influential compliance factor, I provide a "report card" of measures at the end of this preface that, from the Taxpayer Advocate Service's perspective, would provide a good indication whether the IRS is treating U.S. taxpayers well and furthering voluntary compliance. Some of the measures are available today; others still need to be developed. Significantly, measures that show the impact IRS activities have on voluntary and future compliance and how effective the IRS has been in protecting taxpayer rights are missing from the IRS's current suite of measures. I encourage the IRS to work with TAS to develop these measures. In future reports, we will publish and track IRS performance on these measures.

²⁹ See Volume 2: *The Service Priorities Project: Developing a Methodology for Optimizing the Delivery of Taxpayer Services*, *infra*.

In a budget-constrained environment, the IRS tends to fall back on automated enforcement activity instead of personal contacts, regardless of whether that automated activity is productive or detrimental to voluntary compliance. In many cases, the IRS ignores its own research findings and persists in unproductive and taxpayer-harmful activity. This pattern is no more obvious than in the area of IRS Collection activities, as I discuss in the following section.

15 Years After RRA 98, The IRS Collection Operation Is Entrenched in Unproductive Methods that Do Not Promote Voluntary Compliance.

Earlier this year, the Treasury Inspector General for Tax Administration (TIGTA) released a report on *Trends in Compliance Activities Through Fiscal Year 2012*.³⁰ The report discusses the challenges the IRS is currently facing with reductions in resources available for IRS enforcement activities, and what TIGTA identified as a significant decline in enforcement revenue. In regard to the IRS Collection function, the TIGTA report notes that “new Taxpayer Delinquent Account (TDA) receipts continue to outpace closures,” and devotes a separate section to the decreases in the IRS’s use of liens, levies, and seizures.³¹ While TIGTA does not directly link the decline in enforcement revenue to the reductions in liens, levies, and seizures, these collection actions are nevertheless highlighted in the discussion of Collection’s “mixed results.”

TIGTA’s observations are strikingly similar to assessments made of the IRS Collection program shortly after the implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98). For example, in its May 2002 report titled *Impact of Compliance and Collection Program Declines on Taxpayers*, the General Accounting Office (GAO, now the Government Accountability Office) reported that IRS Collection programs showed declines in business results and staffing, concluding that “declining staff and productivity, and an emphasis on taxpayer service contributed to compliance and collection declines.”³² The GAO report also made specific mention of the IRS’s decreasing use of enforcement sanctions, noting that the number of liens, levies, and seizures “dropped precipitously” between fiscal years (FY) 1996 and 2000.³³

A commonly held perception following the implementation of RRA 98 was that the reductions in liens, levies, and seizures reflected a general decline in IRS enforcement, particularly in respect to the IRS Collection operations, and that the IRS’s new emphasis on taxpayer service was incompatible with a robust collection program. In fact, later discussions of collection program results commonly compared lien and levy activity with pre-RRA 98 levels, and increased activities in these enforcement areas were cited as improvements in IRS performance.³⁴

The IRS needs to embrace an expanded understanding of Collection “enforcement” actions.

This unfortunate focus on counting the wrong things — to the detriment of measuring performance factors that truly are important in tax administration — mitigated the positive impact that RRA 98 and the

30 TIGTA, Ref. No. 2013-30-078, *Trends in Compliance Activities Through Fiscal Year 2012* (Aug. 23, 2013). This review of nationwide compliance statistics for the IRS’s Collection and Examination function activities has been conducted annually by TIGTA since FY 2000.

31 *Id.*

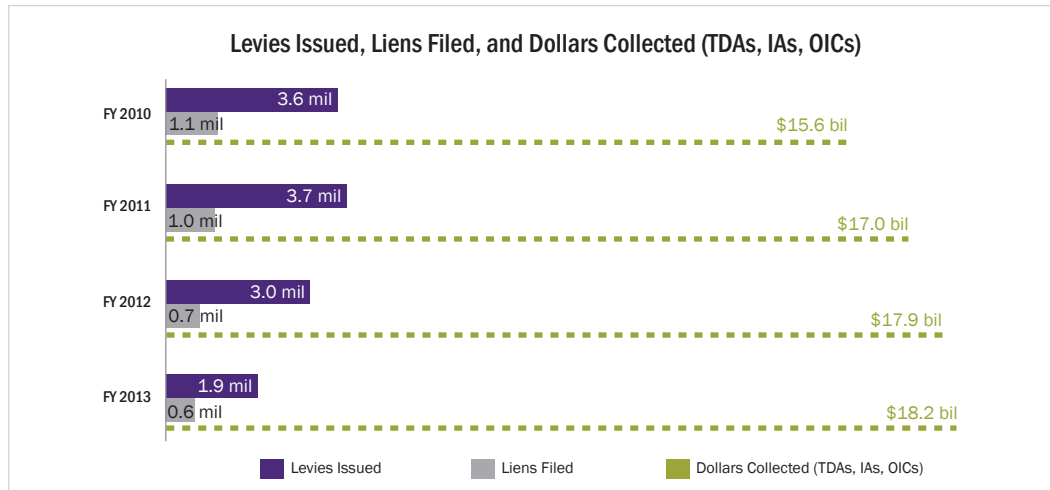
32 GAO, GAO-02-674, *Impact of Compliance and Collection Program Declines on Taxpayers* 11 (May 2002).

33 *Id.* at 12 (May 2002).

34 IRS, Statement by IRS Commissioner Mark W. Everson, *IRS Improves Enforcement and Services in 2005* (Nov. 2005). This press release noted that “In our collection activities, levies and liens have recovered to pre-RRA ‘98 levels.” (Emphasis added) IRS, Statement by IRS Commissioner Mark W. Everson, *Fiscal Year 2006 Enforcement and Service Results* (Nov. 2006). The press release noted, “Overall, some of our most common enforcement tools at the IRS also showed increases. In our collection activities, levies and liens *continue to top their 1998 levels.*” (Emphasis added)

subsequent IRS restructuring efforts might have had on the IRS Collection program. For example, the GAO report noted that between fiscal years (FY) 1996 and 2001, “cases closed declined by 36 percent, reflecting significant declines in both staff time and productivity.”³⁵ However, the report later mentions that case closures resulting in full paid accounts or installment agreements did not change for field collections and actually increased for telephone collections.³⁶ In fact, IRS data reveal that the substantial reductions in liens and levies that the IRS experienced post-RRA 98 had *no discernible impact* on the collection of delinquent revenue during this period.³⁷ Unfortunately, the IRS’s preoccupation with the volumes of lien and levy actions hampered efforts to identify the collection treatments that successfully delivered this revenue, with the aid of improved taxpayer service, *e.g.*, timely personal contacts, and more flexibility in the use of payment options such as installment agreements and offers in compromise.

In FY 2013, we see a very similar situation developing with respect to the status of the Collection program. Severe budget cuts have contributed to reductions in Collection staffing, and significant changes in IRS collection policies implemented in FY 2011 and 2012 (*i.e.*, the so-called IRS “Fresh Start Initiative”) have placed greater emphasis on more flexible collection decisions, as opposed to increased use of traditional enforcement actions. Consequently, in FY 2013, lien filings by the IRS were 45 percent less frequent than in FY 2010, and levies have been reduced by 51 percent since FY 2011. Yet, these reductions do not appear to have had *any* negative impact on revenue collections. In fact, delinquent tax dollars collected on open TDA accounts, installment agreements, and offers in compromise have actually increased by 16.3 percent from FY 2010 through FY 2013.³⁸



If history continues to repeat itself, observers soon will be pointing to the declines in liens and levies, and questioning whether the IRS enforcement programs are “broken.” To counter this cycle, I urge the IRS to

35 GAO, GAO-02-674, *Impact of Compliance and Collection Program Declines on Taxpayers* 12 (May 2002).

36 *Id.*

37 IRS Data Book 1996 to 2001. In FY 1997, the IRS reported a total yield from taxpayer delinquent accounts of \$29,913,365, while also reporting the issuance of 3,659,000 levies and the filing of 544,000 liens. In FY 2000, levy issuances had dropped to 220,000 and lien filings totaled 288,000. However, total collection yield for FY 2000 was reported as \$29,935,564 — slightly more than FY 1997. In FY 2001, after several years of reduced lien and levy activity, the IRS reported total collection yield of \$32,186,839 — an eight percent increase over FY 1997, even though the approximately 674,000 levies issued remained at only 18 percent of the FY 1997 level.

38 IRS, Collection Activity Reports, NO-5000-2, *Taxpayer Delinquent Accounts Report*; NO-5000-6, *Installment Agreement Report*; NO-5000-108, *Report of Offer in Compromise Activity* (FY 2010 to 2013).

expand the traditional definition of “enforcement” to include collection actions such as installment agreements, offers in compromise, and reminder notices that are demonstrably effective both in collecting delinquent revenue and in ensuring that delinquent taxpayers are compliant with their future tax obligations.

Critical Success Factor #1 for IRS Collection Work: Focus on the use of timely personal contacts for taxpayers who do not self-correct during the collection notice process.

A critical component of any effective and efficient collection operation is a timely, meaningful contact with the debtor, which is designed to address the full scope of the delinquency problem and expeditiously implement a realistic payment solution. In fact, an IRS research study published in FY 2012 noted, “[T]he number one action leading to case closure [in the Automated Collection System or ACS] is a telephone call with the taxpayer.”³⁹ Ironically, even though the IRS data presented in the study indicates that the majority of cases closed by ACS during the study period did not involve levy actions, and a relatively small number of levy issuances actually generated case closing actions, a key recommendation from the study was to *issue more levies*.⁴⁰

For the past several years, I have urged the IRS to review its practices involving the use of liens and levies, and rarely use these enforcement tools to *initiate* taxpayer contacts. These practices are not necessary, nor do they routinely generate productive taxpayer contacts. In fact, considering the high volume of cases not resolved by ACS, the IRS should be concerned that the reliance on “heavy-handed” enforcement may actually be discouraging taxpayers from coming forward to seek assistance from the IRS to resolve their tax debt problems. In this year’s annual report, we address concerns with the IRS’s over-reliance on automated levies as “calling cards.”⁴¹

Critical Success Factor #2 for IRS Collection Work: Meet the needs of the taxpayer by expediting the assignment of collection cases to employees who are trained and empowered to resolve them.

TIGTA has reported that IRS enforcement revenue declined by nine percent from FY 2011 to 2012, and specifically noted that dollars collected by ACS in FY 2012 declined for the first time in four years. It is interesting to note, however, that Collection enforcement yield — overall — has actually *increased* by eight percent from FY 2010 to 2013. Moreover, although Collection yield did decline by almost three percent from FY 2011 to 2012, upon closer examination, the reductions were primarily in the collection of business taxes.⁴² Remarkably, the IRS collected approximately \$602 million less in delinquent taxes withheld by employers in FY 2012 — the year the IRS opted to assign a greater percentage of these cases directly to ACS, rather than expedite their delivery to revenue officers in the field.⁴³ In fact, through FY 2013, the IRS has collected 12 percent less delinquent withholding taxes from business taxpayers than during the same period in FY 2011.⁴⁴ Conversely, collections on delinquent taxes related

39 IRS, SB/SE Research, Project DEN0181, *Automated Collection System (ACS) Closed Case Actions* 35 (Aug. 2012).

40 *Id.* For more details on this research study, see Most Serious Problem: *Collection Strategy: The Automated Collection System’s Case Selection and Processes Result in Low Collection Yields and Poor Case Resolution, Thereby Harming Taxpayers and the Public Fisc*, *infra*.

41 See Most Serious Problem: *Collection Strategy: The Automated Collection System’s Case Selection and Processes Result in Low Collection Yields And Poor Case Resolution, Thereby Harming Taxpayers and the Public Fisc*, *infra*.

42 IRS, Total Enforcement Revenue Collected (TERC) database, available at <http://cdw.web.irs.gov/EnforcementRevenueSummary.aspx> (last visited Dec. 23, 2013).

43 *Id.* In FY 2012, the IRS reported collecting \$4.371 billion in delinquent withholding taxes. In FY 2011, the IRS reported collecting \$4.973 billion in delinquent withholding taxes.

44 *Id.* In FY 2013, the IRS reported collecting \$4.366 billion in delinquent withholding taxes.

to individual income taxes have increased by 16 percent since the implementation of the “Fresh Start Initiative” in FY 2010, which involved policy changes primarily associated with income tax debts related to individuals.⁴⁵

In addition to timely interventions, another critical success factor for an effective collection operation is to ensure that cases are routinely assigned to employees who are trained and empowered to provide service that meets the specific needs of their customers. Since the implementation of RRA 98, the IRS Collection functions have strayed from this critically important concept. In this report, we discuss how IRS case assignment practices involving business-related tax delinquencies are neither efficient nor effective, and have resulted in billions of dollars of lost revenue.⁴⁶

Critical Success Factor #3 for IRS Collection Work: Provide reasonable payment solutions as early in the collecting process as possible.

Successful collection operations embrace the concept of contacting delinquent customers early, and quickly negotiating agreements for realistic payment solutions. In FY 2011, the IRS revised the collection policies governing the use of installment agreements (IA) and offers in compromise (OIC) to make it easier for more taxpayers to enter into “streamlined” payment agreements or qualify for OICs in appropriate situations. However, since the implementation of the new “streamlined” IA criteria, the number of IAs has actually *declined* by 11 percent,⁴⁷ while the IAs granted to business taxpayers have dropped by 17 percent since FY 2011.⁴⁸ The IRS collected approximately \$11.1 billion with IAs in FY 2013 — more than all other collection treatments on TDA accounts combined.⁴⁹ Yet, the IRS continues to struggle with the reality that flexible payment options represent the government’s best option to collect much of its current inventory of delinquent tax debts.

At the conclusion of FY 2013, the IRS reported over 848,000 taxpayers with TDA accounts in the Collection Queue, representing \$49.9 billion in delinquent taxes.⁵⁰ The inventory of TDA cases that the IRS reported as “shelved” stands at an all-time high of \$14.4 billion, while the overall inventory of cases reported by the IRS as “currently not collectible” included a staggering \$82.8 billion in September 2013.⁵¹ Realistically, without a more proactive approach to using IAs and OICs to resolve these accounts, the majority of this revenue will likely never be collected.

In this year’s Annual Report, we identify and discuss how existing systemic and cultural issues serve as barriers for taxpayers attempting to negotiate fair, reasonable payment solutions for tax debt problems.⁵²

45 IRS, Total Enforcement Revenue Collected (TERC) database, available at <http://cdw.web.irs.gov/EnforcementRevenueSummary.aspx> (last visited Dec. 23, 2013). In FY 2013, the IRS reported collecting \$23.575 billion on individual income tax delinquencies — a 16 percent increase over the \$20.344 billion collected in FY 2010.

46 See Most Serious Problem: *Collection Process: IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue*, *infra*. See also Volume 2: *TAS Research Study: A Comparison of Revenue Officers and The Automated Collection System In Addressing Similar Employment Tax Delinquencies*, *infra*.

47 IRS, Collection Activity Report NO-5000-6, *Installment Agreement Report* (FY 2011 to 2013).

48 *Id.*

49 *Id.*

50 IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Accounts Report* (Sept. 2013). The Collection Queue is an inventory of TDA accounts that are active, but unassigned to the ACS or CFF functions. See IRM 5.1.20.2 (May 27, 2008).

51 IRS, Collection Activity Report NO-5000-149, *Recap of Accounts Currently Not Collectible Report* (Sept. 2013).

52 See Most Serious Problem: *Collection Process: IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue*, *infra*.

Critical Success Factor #4 for IRS Collection Work: Focus enforcement efforts on the most serious compliance problems in order to maximize the benefits of available Collection resources.

In a budget environment characterized by severe cuts and limited staffing, the IRS Collection operation needs to focus its resources on programs that maximize the benefits to the government in recovering lost revenue and improving voluntary compliance. However, the improvement of case-processing efficiencies in the application of IRS compliance programs must only be accomplished along with careful consideration of taxpayer rights and taxpayer service.

For several years, I have expressed concerns with the IRS's use of automated levies.⁵³ Of particular concern are levies on Social Security retirement income, which frequently result in economic hardship for low income taxpayers, who rely on these payments to meet their necessary living expenses. The IRS continues to issue millions of these levies each year through the Federal Payment Levy Program and has not yet adequately addressed my concerns about the impact of this program on some of the most vulnerable members of our society. As a result, many taxpayers, who are currently living on income at or near poverty levels, continue to suffer undue economic and emotional harm while dealing with the IRS to resolve these levies. Most recently, the Deputy Commissioner of Services and Enforcement rescinded my Taxpayer Advocate Directive (TAD) in which I directed the IRS to protect a subset of these taxpayers.⁵⁴ In rescinding the TAD, the IRS ignores both case law and a conclusive research study showing harm to these taxpayers. Thus, in this year's annual report, I again urge the IRS to implement more safeguards into the current practices used with automated levies to prevent harm for low income taxpayers, and provide timely relief to taxpayers who have already been harmed by these enforcement actions.⁵⁵

Conclusion

This year, TAS sponsored a series of focus groups with taxpayers to ascertain their reaction to a proposed Taxpayer Bill of Rights. In these discussions, the one right that taxpayers flat out did not find credible was the *right to quality service*. When we link this observation to a finding from our 2012 survey of noncompliant sole proprietors that they believed the IRS is more interested in collecting the tax than in getting the right answer, and this year's finding that taxpayer service and trust are the most influential factors for small business compliance, one can easily conclude that taxpayer service is one of, if not the, most significant determinant for voluntary compliance and keeping noncompliance from growing. It may not bring in the hard-core noncompliant taxpayers, but it is absolutely critical to many others.

Rather than generating all sorts of automated compliance touches — including Automated Underreporter, Automated Substitute for Return, and math error notices that we later abate, which create work for ourselves and torments taxpayers unnecessarily — the IRS should explore alternative approaches to engendering compliance. What if we came up with a strategy for underreporting and nonfiling that incorporated local compliance initiatives? Working through local networks like local trade and business

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

54 Taxpayer Advocate Directive (TAD) 2012-2 (*Taxpayers Whose Incomes Are Below 250 percent of the Federal Poverty Level Set by the Department of Health and Human Services and who receive Social Security or Railroad Retirement Board Benefits Should Be Screened Out of the Federal Payment Levy Program (FPLP) regardless of unfiled returns or outstanding business debts*) (Jan. 12, 2012). See also Memorandum from John M. Dalrymple, IRS Deputy Commissioner, Services and Enforcement to Nina E. Olson, National Taxpayer Advocate, TAD 2012-2, Low Income Filter in the Federal Payment Levy Program (Dec. 20, 2013).

55 See Most Serious Problem: *Hardship Levies: Four Years After the Tax Court's Holding in Vinatieri v. Commissioner, the IRS Continues to Levy on Taxpayers it Acknowledges Are in Economic Hardship and Then Fails to Release the Levies*, *infra*.

groups, would we be more successful in promoting long-term voluntary compliance?⁵⁶ If we incorporated truly virtual face-to-face audit and collection appointments into our enforcement strategy — where the taxpayer or representative could schedule a “virtual” appointment with the IRS and communicate face-to-face in a secure virtual environment, would we achieve higher response rates, better resolutions, and more education of the taxpayer? What would happen if we required local IRS managers and enforcement personnel to go out in the community and conduct outreach? They could learn about the specific challenges taxpayers face in trying to comply with the tax laws, which would be valuable information for developing future compliance and education initiatives.

None of these things is out of reach, and except for the virtual meetings, they could be done tomorrow — for almost no expense (just a redeployment of the same resources). And the virtual technology is available — many federal agencies, including the Social Security Administration, which has the same concerns about the privacy of its proceedings, are using this technology today.

My plea to Congress, then, is to fund taxpayer service, hold enforcement accountable for a more holistic approach, ensure taxpayer rights are the framework of analysis for all IRS initiatives, and provide the appropriate funding and oversight to bring the IRS into the 21st century, both in terms of technology and more importantly in terms of its understanding of taxpayer motivations and the factors influencing compliance behavior.

We are at a crossroads. We can continue to operate as we have in the past, where success is measured by the least productive aspect of our work (enforcement). Or we can be open to the possibility that enforcement dollars, levies, and liens may not be the optimal measures of the IRS’s success in maximizing voluntary (and overall) tax compliance — and engage in an open dialogue about alternative ways to most effectively accomplish the IRS’s mission.

As we conclude a tumultuous year for the agency, I look forward to working with you to chart a better path forward, and I stand ready to assist you in any way that I can.

Respectfully submitted,



Nina E. Olson
National Taxpayer Advocate
31 December 2013

⁵⁶ Her Majesty’s Revenue and Customs (HMRC) has undertaken just such an initiative to address the “hidden economy.” See Her Majesty’s Revenue and Customs (HMRC), *HMRC Hidden Economy Strategy and Customer Segmentation* (Nov. 2013).

National Taxpayer Advocate Report Card: Measuring the IRS's Protection of Taxpayer Rights and Promotion of Voluntary Compliance

Phones	Data Available?
Number of calls	Yes
Percentage of taxpayers able to speak to live assistor (LOS) — Toll Free	Yes
Percentage of taxpayers able to speak to live assistor (LOS) — NTA Toll Free	Yes
Percentage of taxpayers able to speak to live assistor (LOS) — Practitioner Priority	Yes
Percentage of calls answered (LOS)	Yes
Average wait time to reach live assistor (speed of answer)	Yes
Accuracy — Percent of times the information given and actions taken were correct	No
Awareness of service (or utilization)	No

Correspondence	Data Available?
IMF volume	Yes
BMF volume	Yes
Average days in inventory (by unit or by IMF/BMF)	Yes
Percentage of inventory overage (by unit or by IMF/BMF)	Yes

Examination	Data Available?
<i>* All items broken out by type of exam — office, correspondence, field</i>	
No change rates	Yes
Agreed rates	Yes
Non-response rates	Yes
Percentage of cases appealed	Yes

Collection	Data Available?
Offer in Compromise: Number of Offers Submitted	Yes
Offer in Compromise: Percentage of Offers Accepted	Yes
Installment Agreements: Number of Individual & Business IAs	Yes
Streamlined Installment Agreements (ACS): Number of Individual & Business IAs	Yes
Streamlined Installment Agreements (CFf): Number of Individual & Business IAs	Yes
Number of OICs Accepted per Revenue Officer	Yes
Number of IAs Accepted per Revenue Officer	Yes
Percentage of cases in the queue or CNC	Yes
Age of delinquencies in the queue	Yes
Percentage of cases where the taxpayer is fully compliant upon closure	compute
Percentage of cases where the taxpayer is fully compliant after five years	compute

Appeals	Data Available?
Rate of appeal to Tax Court	Yes
Average number of days in Appeals to reach resolution	Yes
Customer Satisfaction of service in Appeals (Including perceptions of independence and fairness)	Yes
Tax Exempt / Government Entities	Data Available?
Employee Plans: Average age of determination requests	Yes
Exempt Org: Average age of determination requests, including average age for first read, intermediate, and full development cases	No
Toll Free LOS	Yes
Other — Apply to All Functional Areas	Data Available?
IRS Issue Resolution — Percentage of taxpayers who had their issue resolved as a result of the service they received	No
Taxpayer Issue Resolution — Percentage of taxpayers who reported their issue was resolved after receiving service	No
Wait time — Average time taxpayer spent waiting before receiving service	No
Number of complaints (by process) received by phone, by mail, or reported on social media	No
Percentage of calls/letters/issues resolved in a single 2-way communication (single call, single meeting, or single exchange of correspondence)	No
Percentage of noncompliant taxpayers (non-filers, under-reporters, or those with delinquencies) who are compliant after the IRS (or a given IRS business unit) closes their cases	Yes
Percentage of noncompliant taxpayers (non-filers, under-reporters, or those with delinquencies) who are compliant five years after the IRS (or a given IRS business unit) closes their cases	Yes
Percentage of taxpayers subject to IRS burden (e.g., received a notice from math error, AUR, ASFR, audit, collection, or had a refund delayed) who were (or may have been) compliant (i.e., those whose math error, AUR, or ASFR resulted in no net increase in tax, those with delayed refunds that were ultimately paid, those who appeared to have delinquencies but where nothing was ultimately collected)	No
Percentage of closed cases (selected at random and stratified by outcome) where the taxpayer reported that the IRS actually resolved their case and resolved it fairly	No
Average days between the due date of the return and final resolution of any liability	No

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THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

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

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

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

The issues described in the report are as follows:

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

The U.S. tax system is built on voluntary compliance. For the government, voluntary compliance is much cheaper than enforced compliance, because the government does not have to spend money to collect amounts that are voluntarily paid. Taxpayer rights are central to voluntary compliance. If taxpayers believe they are treated, or can be treated, in an arbitrary and capricious manner, they will mistrust the tax system and be less likely to comply with the laws voluntarily. If taxpayers have confidence in the fairness and integrity of the tax system, they will be more likely to comply.

There are dozens of discrete taxpayer rights scattered throughout the Internal Revenue Code, but they are not organized or presented in a coherent way. Similarly, Congress in the past has enacted several bills with the name “Taxpayer Bill of Rights,” but they, too, create discrete rights and do not articulate broad principles. Not surprisingly, in response to a survey of U.S. taxpayers conducted for TAS in 2012, less than half said they believed they have rights before the IRS, and only 11 percent said they knew what those rights are.

ANALYSIS

Many countries and states have adopted a Taxpayer Bill of Rights. Just as the U.S. Constitution’s Bill of Rights is organized and presented in a manner that U.S. citizens and the government itself can understand and respect, a Taxpayer Bill of Rights (TBOR) would serve the same function in the realm of taxation. A thematic, principle-based list of core taxpayer rights would serve as an organizing principle for tax administrators in establishing agency goals and performance measures, provide foundational principles to guide IRS employees in their dealings with taxpayers, and provide information to taxpayers to assist them in their dealings with the IRS.

The National Taxpayer Advocate views the tax system as an unwritten social contract between the government and its taxpayers; namely, taxpayers agree to report and pay the taxes they owe to enable their government to function, and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so. In recognition of this “two-way street,” the report recommends that the IRS adopt a TBOR that contains ten taxpayer rights and five taxpayer responsibilities.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS adopt a Taxpayer Bill of Rights along the lines detailed in the report; prominently display a link on the IRS.gov homepage to a taxpayer rights page; post taxpayer rights language on the business operating division pages of IRS.gov that refers to TAS, Low Income Taxpayer Clinics, and specific taxpayer rights and responsibilities and contains links to the U.S. Tax Court web page, where appropriate; require all public- and taxpayer-facing IRS sites and offices to display a poster and brochures about the Taxpayer Bill of Rights; and require all IRS operating divisions and functions when proposing initiatives, including budget initiatives, to include in their business case justifications an analysis of the proposed operation in terms of the Taxpayer Bill of Rights.

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

In fiscal terms, the mission of the IRS — to “[p]rovide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all” — trumps the missions of all other federal agencies. If the IRS lacks adequate funding to do its job effectively, the government will have fewer dollars to fund the military, social programs, and all other programs — or simply to reduce the deficit. Since fiscal year (FY) 2010, the IRS budget has been cut by nearly eight percent while inflation has risen by about six percent. As a result, the IRS has been hampered in its ability to provide “top quality service” and maintain effective enforcement. In FY 2013, the IRS could only answer 61 percent of customer service calls, and respond timely to just 47 percent of taxpayers’ letters about proposed tax adjustments. The IRS also slashed its overall training budget by a staggering 87 percent, which means the IRS not only has fewer employees than four years ago, but those who remain are less equipped to perform their jobs and to understand and respect taxpayer rights.

ANALYSIS

The combination of more work and less funding predictably has impaired the IRS’s ability both to meet taxpayer needs and to improve tax compliance. The IRS is receiving significantly more individual and business tax returns today than ten years ago, which means it must answer more taxpayer phone calls, process the additional returns, conduct compliance checks, and sometimes conduct audits or take collection actions. The IRS is also receiving substantially more phone calls. In FY 2013, nearly 20 million calls to customer service representatives went unanswered because the IRS does not have enough employees to handle them. The IRS has also had to address a huge spike in tax-related identity theft and refund fraud. The IRS assigned more than 3,000 employees to work identity theft in 2013. Because of the harm identity theft victims suffer, we believe that was the right decision, but the reassignment of so many employees meant that other work in crucial taxpayer service and enforcement areas simply could not be done.

The requirement to pay taxes is generally the most significant burden a government imposes on its citizens. The National Taxpayer Advocate believes the government has a practical and a moral obligation to make tax compliance as simple and painless as possible. The recent funding cuts have increased the compliance burden for tens of millions of taxpayers seeking assistance from the IRS by phone, by mail, and in person.

It should also be noted that the IRS is the federal government’s accounts receivable department and generates a substantially positive return on investment. In FY 2013, the IRS collected \$255 for each dollar it received in appropriated funds. It is therefore self-defeating to treat the IRS like a pure spending program in which a dollar spent is simply a dollar spent. With the IRS, a dollar spent generates many dollars in additional revenue, thereby reducing the budget deficit.

RECOMMENDATIONS

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

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

To deal with a complex, constantly changing tax law and provide taxpayers with complete and accurate service, IRS employees must receive prompt and appropriate training and education. Since fiscal year (FY) 2009, budget cuts and sequestration have led the IRS to cut its training budget by over 85 percent. The IRS has reduced its training and education programs to a bare minimum without considering the types of training employees need to perform basic job functions, protect taxpayer rights, and prevent harm and undue burden for taxpayers. Lacking appropriate training and education, employees will be unable to fulfill their mission and taxpayer service will continue to erode. Delivering timely, appropriate education and training to employees is essential to the core function of the IRS.

ANALYSIS

The IRS drastically cut its training budget to meet its required overall reductions under the Budget Control Act of 2011. Even before the sequester, however, the IRS had sharply reduced the dollars it spent on training in response to a decrease in its total operating budget since FY 2010. In FY 2013, the IRS spent less than \$250 per employee on training, as compared with \$1,450 per employee in FY 2009, a decline of more than 83 percent. The IRS also created two review boards to review training requests for recommendation to the Deputy Commissioner (Operations Support), who declined to approve over 35 percent of proposed courses. Training hours delivered to employees in key job series have been reduced as much as 89 percent since FY 2009. In FY 2009, for example, Small Business/Self-Employed division revenue officers received over 700,000 total hours of training. In FY 2013, they were given just 76,000 hours — a reduction of almost 90 percent.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS propose and Congress appropriate sufficient funding for the IRS to train its employees through the most effective means (in person, conference call, self-study, outside courses, etc.) about the subject matter they handle and protecting taxpayer rights; prioritize funding for training employees in critical job skills; request Treasury Department authorization to approve training within the Office of Management and Budget's stated guidelines; and clearly define the review boards' criteria for approving training.

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

PROBLEM

While the Internal Revenue Code guarantees certain rights to taxpayers, many taxpayers are unaware of their rights, and IRS employees do not always communicate them to taxpayers at the right times. The IRS should provide employees with an overarching, comprehensive education about taxpayer rights as well as training and guidance about how those rights apply in specific situations.

ANALYSIS

Training for many IRS employees contains only minimal instruction on taxpayer rights. For example, the 575-page training guide for newly hired tax examiners contains only six paragraphs that address discussing taxpayer rights and the audit process with taxpayers. The fiscal year 2013 continuing education schedule for the Office of Appeals includes ten Customer Satisfaction courses, nine of which are from an outside vendor and focused on customer relationships in the private sector, along with one internal course on Cultural Competence and Effective Communication. While the courses may encourage effective communication, they do not discuss taxpayer rights at all. The Internal Revenue Manual (IRM) sometimes instructs employees to ensure that they have taken a specific action to protect taxpayer rights. Often, however, the manual does not explain how an item or action, such as a statutory notice of deficiency in an audit, affects taxpayers' rights. In addition, the IRS does not adequately include taxpayer rights in its measures, such as critical job elements and case quality scores.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS include a significant segment on taxpayer rights in all future updates of training modules; require all operating divisions to include taxpayer rights measures in their Business Performance Reviews and case quality scores; update all IRM sections identified by TAS with language provided by TAS to incorporate taxpayer rights into the IRM; and require employees to provide either Publication 1, *Your Rights as a Taxpayer*, or separate publications that explain the application of taxpayer rights in particular contexts, such as examination (Publication 1-E), collection (Publication 1-C), and appeals (Publication 1-A).

**MSP
#5****Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS is Enjoined from Continuing Its Efforts to Effectively Regulate Unenrolled Preparers****PROBLEM**

In tax year 2011, unregulated tax return preparers prepared over 42 million individual returns, or more than half of all the returns handled by preparers. As preparers play a critical role in tax administration, it is essential that the IRS ensure they are competent, visible, and accountable. The IRS had instituted a program to impose minimum competency requirements, but a U.S. District Court in *Loving v. Internal Revenue Service* enjoined the IRS from enforcing the testing and continuing education elements of the program. Unless this ruling is overturned on appeal, taxpayers will continue to find themselves without meaningful IRS oversight of preparers in a world where anyone can hang out a shingle as a “tax return preparer” with no knowledge or experience needed.

ANALYSIS

Since 2002, the National Taxpayer Advocate has recommended adoption of a system to regulate return preparers. TAS has witnessed widespread problems in the tax preparation industry. Problems with return accuracy and ethical standards were substantiated by “shopping visits” the Government Accountability Office and the Treasury Inspector General for Tax Administration conducted, where auditors posed as taxpayers and visited tax preparation businesses. The National Taxpayer Advocate believes minimum competency standards are essential to protect taxpayers and improve return accuracy. Filing a tax return is not merely a ministerial act. The taxpayer is taking a position before the federal government regarding items of income, expenses, and eligibility for government benefits that are administered by the IRS. Taxpayers pay preparers for their knowledge and skills because they are uncomfortable navigating the complexity of the tax laws by themselves. Taxpayers often suffer significant consequences when a preparer is incompetent or unethical.

RECOMMENDATIONS

Until the IRS can resume testing and requiring continuing education for preparers, the National Taxpayer Advocate recommends that the IRS develop a Service-wide Return Preparer Strategy that includes the following steps: (1) offer unenrolled preparers the opportunity to earn a voluntary examination and continuing education certificate; (2) restrict the ability of unenrolled preparers to represent taxpayers in audits of returns they prepared unless they earn the certificate; (3) restrict the ability to name an unenrolled preparer as a third-party designee on Form 1040, *U.S. Individual Income Tax Return*; (4) mount a consumer protection campaign to educate taxpayers about the need to select a preparer who can demonstrate competency; (5) develop a research-driven and service-wide preparer compliance strategy similar in nature to the Earned Income Tax Credit preparer compliance strategy; and (6) recommend that Congress revise 31 U.S.C. § 330(a)(2) to make clear that the IRS has the authority to regulate unenrolled preparers.

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

PROBLEM

In general, tax-related identity theft occurs when someone uses another individual's personal identifying information to file a false tax return to obtain an unauthorized refund. For the victims, the impact can be devastating and traumatic. The IRS takes much too long to fully unwind the harm suffered by victims and issue refunds to the legitimate taxpayers. Moreover, the IRS's specialized approach to resolving identity theft requires victims to interact with multiple IRS units.

ANALYSIS

Identity theft is a devastating crime that can have a traumatic emotional impact on the victim. A person's identity is core to his or her being — when someone steals and uses your identity, it is an invasion of your person. The IRS's approach to assisting the victims ignores this important fact, and in many ways treats the victim as someone experiencing a minor inconvenience instead of a frightening personal disaster. Identity theft victims also will not receive the tax refunds they are entitled to receive until the IRS completes its handling of the case; thus, victims may suffer financial hardships when cases are not resolved quickly. The IRS should set up a centralized identity theft unit, similar to the centralized innocent spouse unit that assists taxpayers who may have been victims of domestic abuse. If the IRS believes the most efficient way to resolve identity theft issues is to involve more than 20 different units, this back-end process should be invisible to the taxpayer. As far as victims are concerned, there should be *one* IRS employee who interacts with the taxpayer. That one employee should maintain control of the taxpayer's case, including all peripheral issues stemming from the identity theft.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS designate the Identity Protection Specialized Unit as the single point of contact for identity theft victims, and for that function to assign a single employee to work with the identity theft victim until all related issues are resolved; develop a method of tracking how long it takes from the perspective of the victim to resolve cases; implement "timeliness" measures to ensure identity theft cases do not languish; and develop an identity theft database or system accessible to all functions working on cases.

**MSP
#7****HARDSHIP LEVIES: Four Years After the Tax Court’s Holding in *Vinatieri v. Commissioner*, the IRS Continues to Levy on Taxpayers it Acknowledges Are in Economic Hardship and Then Fails to Release the Levies****PROBLEM**

The IRS is required by law to release a levy that it knows is causing an economic hardship due to the financial condition of the taxpayer, and according to *Vinatieri v. Commissioner*, 133 T.C. 392 (2009), the fact that the taxpayer has unfiled returns does not justify proceeding with the levy. In 2011, despite *Vinatieri*, the IRS levied on the Social Security (SSA) and Railroad Retirement Board (RRB) benefits of nearly 67,000 taxpayers presumed to be experiencing economic hardship — taxpayers whose incomes were less than 250 percent of the federal poverty level. The IRS declined to spare accounts of almost 41,000 of these taxpayers — more than half — from the automated levy program because the taxpayers had unfiled returns. The median income of taxpayers subject to levies on their SSA or RRB in 2011 was at most about \$17,500. Thus, some of the 67,000 taxpayers whose benefits were levied upon almost surely were not merely considered low income but *below the poverty line*.

ANALYSIS

The IRS’s own research shows that it levied on the Social Security payments of taxpayers it presumed were low income solely because they had unfiled returns. The IRS changed some Internal Revenue Manual (IRM) provisions that pertain to how employees handle cases involving unfiled returns, but training materials, job aids, and quality standards still need adjusting. The IRS can determine from its own and third-party databases whether a taxpayer is likely in economic hardship before it issues a levy.

RECOMMENDATIONS

The IRS should establish quality review procedures that measure whether employees identified and considered the possibility that a taxpayer was in economic hardship before levying, and whether in those cases the employee placed the account into “currently not collectible” status rather than levying. The IRS also should develop and publish IRM guidelines describing how collection employees, on the basis of information in IRS and third-party databases, should consider the possibility a taxpayer is in economic hardship before issuing a levy.

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

PROBLEM

Unscrupulous preparers sometimes alter taxpayers' returns by inflating income, deductions, credits, or withholding without their clients' knowledge or consent, and pocket all or a portion of the inflated refund. Even though the taxpayer receives no financial gain from the fraudulent filing, he or she must still deal with the IRS in the aftermath. Return preparer misconduct is similar to identity theft, but the IRS treats victims of preparer fraud differently. When a taxpayer is victimized by identity theft, the IRS will "back out" the return filed by the perpetrator, process the true return, and pay out the refund claim. In preparer misconduct cases, the IRS has declined to provide full relief to victims, contending it would be inappropriate to issue a "second refund."

ANALYSIS

The IRS has developed interim procedures to deem a falsified return a nullity and to process the true return. However, this guidance falls short of instructing employees to issue refunds to victims of preparer fraud, which from the victim's perspective is likely the most important aspect of case resolution. Instead, the IRS tells employees to suspend action on such cases pending further guidance. The National Taxpayer Advocate believes the IRS has the legal authority to issue refunds to victims of preparer misconduct. The IRS should make these vulnerable taxpayers whole once it is established that they were not complicit in the crime, just as identity theft victims are not complicit.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS develop comprehensive guidance providing full relief to victims of return preparer misconduct, including the issuance of a refund.

**MSP
#9****EARNED INCOME TAX CREDIT: THE IRS Inappropriately Bans
Many Taxpayers from Claiming EITC****PROBLEM**

Section 32(k) of the tax code authorizes the IRS to ban a taxpayer from claiming the earned income tax credit (EITC) for two years if the IRS determines the taxpayer claimed the credit improperly due to reckless or intentional disregard of rules and regulations. This standard requires more than mere negligence on the part of the taxpayer and requires a determination of the taxpayer's state of mind. In 2011, the IRS imposed the ban on more than 5,000 taxpayers and did so contrary to IRS Chief Counsel guidance almost 40 percent of the time by banning taxpayers who simply did not respond to requests for substantiation of their claims. In a random sample of two-year ban cases, TAS found the IRS imposed the ban *automatically* 15 percent of the time, meaning no determination was made. The National Taxpayer Advocate does not support the Administration's proposal to permit the IRS to use math error authority in the context of these bans until the IRS improves its procedures to ensure its auditors impose the ban consistently with the statute. Moreover, Congress should clarify that the IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.

ANALYSIS

IRS auditors must explain and document in their work papers the reason for imposing the two-year ban, but in almost all of the cases in TAS' sample (90 percent), the work papers do not contain an adequate explanation. Managerial approval of the two-year ban is also required, but in more than two-thirds of the cases (69 percent), no managerial approval was obtained. In 62 cases in the sample (19 percent), the examiner imposed the ban solely because EITC had been disallowed in a previous year. In only ten percent of the cases were taxpayer-submitted documents clearly insufficient to prove eligibility, raising only the *possibility* that the taxpayer had the requisite state of mind to justify the two-year ban. The two-year ban is authorized only if the IRS determines the taxpayer's state of mind meets statutory criteria, but IRS procedures do not take into account the unique challenges low income taxpayers face in substantiating claimed EITC may be relevant to these taxpayers' state of mind. In fact, some Internal Revenue Manual (IRM) provisions result in the IRS punishing EITC taxpayers while they are learning these complex rules. Other IRM provisions lead to inappropriate imposition of the ban.

RECOMMENDATIONS

The IRS should immediately suspend the application of IRM provisions that permit automatic imposition of the two-year EITC ban. The IRS and Treasury should issue regulations that explain when the IRS should impose EITC bans. The IRS should work with TAS to rewrite the IRM provisions on the two-year ban to take into account what is reasonable to expect of taxpayers who claim the EITC. The National Taxpayer Advocate does not support the Treasury Department's proposal to permit the IRS to use math error authority in the context of these bans until the IRS improves its procedures to ensure auditors impose the ban consistently with the statute. Moreover, we recommend that Congress clarify that the IRS bears the burden of proving the taxpayer acted intentionally or recklessly with respect to his or her EITC claim.

**MSP
#10****INDIAN TRIBAL TAXPAYERS: Inadequate Consideration Of Their Unique Needs Causes Burdens****PROBLEM**

In filing season 2013, the IRS wrongly flagged tax returns filed by Indian tribal members as fraudulent because they shared characteristics that the IRS has identified as indicators of fraud. Although the National Taxpayer Advocate's 2008 Annual Report to Congress applauded IRS outreach to Indian Nations as exemplary, it is unclear if all IRS functions are responsive to their needs. In certain cases, IRS operating divisions remain unaware of particular characteristics and needs of Indian taxpayers, which can lead to unnecessary contact with the IRS and unwarranted audits, tax assessments, or penalties.

ANALYSIS

Indian tribes have a unique status in federal tax law. Indian taxpayers may confront IRS misunderstandings and delays relating to issues such as:

- Improper treatment of tribal distributions;
- Presumed frivolous positions;
- Misunderstanding of Native American family structure;
- Ignorance of tribal sovereignty; and
- Delays in processing certain settlement awards.

While the IRS recently issued various pieces of guidance helpful to Indian individuals, major projects remain outstanding, especially those applicable to tribal entities. The resulting uncertainty can chill tribal enterprise, distorting the tribes' economic opportunities.

RECOMMENDATIONS

The IRS should train all compliance employees about the culture and needs of Native American taxpayers, rendering assistance as required by this population, after consulting TAS; establish a cross-functional working group on issues facing Indian individuals, parallel to the IRS Indian Tribal Government (ITG) function that focuses on tribal entities; consult with the ITG function before implementing fraud filters or similar programs that could erroneously target Indian taxpayers; correct routine failure to comply with instructions from the ITG function concerning the needs of Indian taxpayers; and finalize guidance on tribal documentation of qualifying children, frivolous claim penalties, and other questions as they arise.

**MSP
#11****COLLECTION STRATEGY: The Automated Collection System's Case Selection and Processes Result in Low Collection Yields and Poor Case Resolution, Thereby Harming Taxpayers****PROBLEM**

The Automated Collection System (ACS) is a computerized inventory system that manually and systematically sends notices to taxpayers, issues liens and levies, and answers calls in an effort to resolve balance due accounts. ACS collects tax largely by offsetting taxpayers' refunds and eliminates much of its inventory by passing cases to other parts of the IRS. ACS's failure to resolve cases can be attributed in part to its counterproductive approach to working cases and the types of cases it is assigned. Rather than applying the appropriate type of contact for each taxpayer, ACS generally relies on notices of intent to levy or systematically generated levies, which are often not effective. ACS should first attempt to talk to the taxpayer by making an outgoing call or sending a notice, and then consider a levy. This strategy would reduce the risk of placing the taxpayer in economic hardship, prevent the liability from becoming too big to be resolved, and reduce the need for more extreme collection measures.

ANALYSIS

In fiscal year (FY) 2013, ACS collected \$5.4 billion on delinquent accounts, but about 47 percent of this came through automatic refund offsets, not from ACS employees' direct efforts. ACS transferred approximately three times what it collected — \$16.1 billion — in unresolved tax liabilities to other IRS collection operations. Although ACS issued 46 percent fewer levies in FY 2013 than in FY 2012, its overall collections actually increased slightly. This result is not surprising based on a TAS review of ACS cases that found about 75 percent of levies were unproductive. In addition, an IRS study showed taxpayers' rate of response to a letter was nearly three times greater than the response to a levy. Further, some types of cases are more suitable to ACS treatment than others.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that ACS better segment taxpayers, identifying which groups of taxpayers would respond best to which particular action; include a soft notice that would discuss payment options up front in its systemic procedures; send out a monthly (or no less than quarterly) notice to inform taxpayers of the tax they owe and payment options; create and properly train a core unit that can work and resolve small business cases when the field cannot take on more assignments; and require ACS assistors to present all collection alternatives to the taxpayer upfront in all cases.

**MSP
#12****COLLECTION PROCESS: IRS Collection Procedures Harm Taxpayers and Contribute to Substantial Amounts of Lost Revenue****PROBLEM**

The withholding and payment of trust fund taxes are vital components of the voluntary compliance system. Trust fund tax delinquencies can quickly become unmanageable for business taxpayers; yet the IRS provides inadequate attention and service for emerging trust fund collection cases. The IRS persists in assigning these cases to employees who are not fully equipped to resolve them. Consequently, important collection options (*e.g.*, installment agreements and offers in compromise), are exceptionally rare and are frequently not available to business taxpayers until their debts become uncollectible. The National Taxpayer Advocate is troubled by the high percentage of business taxpayers who cannot resolve their tax problems in response to IRS collection notices or contacts with the Automated Collection System (ACS) and believes the IRS could resolve many of these accounts through a more proactive, service-oriented approach.

ANALYSIS

In fiscal year 2013, 85 percent of the employment-related trust fund taxes included in collection “final” notices were not resolved in the notice process, and 78 percent of the delinquent trust fund dollars that passed through the ACS left as unresolved cases. As a result, resolutions for these collection accounts are unnecessarily delayed, increasing the risk that these taxpayers may never pay what they owe or return to compliance. At the conclusion of FY 2013, 75 percent of the trust fund cases in the IRS’s collection inventory involved more than one tax delinquency. From FY 2010 through FY 2013, the IRS has reported as uncollectible an average of \$4.2 billion per year in trust fund tax debts — or roughly 1 ½ times the amount the IRS managed to collect on these accounts, including refund offsets and installment agreements.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS reconcile assignment practices for business cases and only assign trust fund delinquencies to employees empowered to resolve them; develop and test a new “second” notice for business taxpayers, with an expanded focus on the availability of collection payment options; consider the use of “conditional” installment agreements for business taxpayers with trust fund tax debts and unfiled tax returns; issue regular collection notices to business taxpayers whose accounts have been assigned to the queue; and expand the use of existing tools to quickly address trust fund cases involving taxpayers with a history of delinquencies.

**MSP
#13****COLLECTION STATUTE EXPIRATION DATES: The IRS Lacks a Plan to Resolve Taxpayer Accounts with Extensions Exceeding its Current Policy Limits****PROBLEM**

As of December 31, 2013, 2,371 taxpayers remain subject to IRS collection action because of waivers of the applicable statutory period for collection of tax liabilities, which violate the IRS policy limit of five years. On October 30, 1991, the IRS set a limit of five years on collection statute extensions entered in connection with installment agreements (IAs) that allowed taxpayers to pay their debts over time. Before January 1, 2000 (the effective date of the IRS Restructuring and Reform Act of 1998 (RRA 98)), however, IRS collection personnel commonly solicited extensions of any collection statute beyond five years when it did not appear the taxpayer could pay before the collection statute expiration date (CSED). In connection with a directive from the National Taxpayer Advocate, the IRS and TAS worked together to investigate these CSED extensions. The majority of these lengthy CSED cases burden taxpayers, who do not appear able to pay or resolve their debts through collection alternatives. The National Taxpayer Advocate's chief concern is the IRS's failure to cancel these unreasonable CSED extensions that do not comply with current policies. The IRS has already spent over four years trying to fix this problem, and no resolution is in sight.

ANALYSIS

RRA 98 restricted CSED waivers but did not apply to waivers entered in connection with IAs. The IRS does not plan to collect almost 82 percent of taxpayers' accounts (1,939 accounts) in which it inappropriately extended the CSED beyond five years, and has placed them in currently not collectible status or in the collection queue. TAS analysis of these accounts reveals that 309 taxpayers affected by these CSEDs are deceased. More than half of the taxpayers subject to these CSED extensions owe more than \$50,000, of which almost 76 percent is attributable to accrued penalties and interest. Further, over 93 percent of these taxpayers likely defaulted on the IA entered in connection with his or her CSED waiver because the terms were unreasonable.

RECOMMENDATIONS

The National Taxpayer Advocate offers the following recommendations to provide a final resolution to all lengthy CSED accounts: by April 15, 2014, cease collection of payments on all accounts where the collection period was extended in violation of the IRS 1991 waiver policy; and by June 30, 2014, abate all such extended CSED accounts under the authority vested in the Commissioner under the Internal Revenue Code.

**MSP
#14****COLLECTION DUE PROCESS HEARINGS: Current Procedures Allow Undue Deference to Collection Function and Do Not Provide the Taxpayer a Fair and Impartial Hearing****PROBLEM**

IRS procedures for Collection Due Process (CDP) hearings deprive taxpayers of a fair and independent review of IRS collection actions. A CDP Hearing Officer must verify that the IRS followed the law and administrative procedures, and consider whether the collection action balances the need for efficient tax collection with the taxpayer's concern that the action be no more intrusive than necessary. However, Hearing Officers may overlook this balancing test and rely too heavily on the determination made by the Collection function.

ANALYSIS

Taxpayers often do not have an opportunity to work with Collection prior to a CDP hearing. Neither the Automated Collection System (ACS) nor Field Collection tracks how often employees contact taxpayers by phone or mail prior to sending CDP notices. If taxpayers do work with Collection, they often must waive their rights to a CDP hearing when accepting collection alternatives such as installment agreements for payment. IRS Office of Appeals employees do not appear to understand the purpose of CDP, and there are legitimate concerns about Appeals' independence from Collection. Among other things, Appeals lacks its own Internal Revenue Manual (IRM) guidance for CDP cases and must use the Collection IRM to evaluate collection alternatives and conduct the balancing test unique to CDP cases. Appeals does not consider the hazards of litigation in CDP cases even though the rationale for judicial review of collection actions is to provide guidance regarding when IRS actions constitute abuse of discretion. If the IRS ignores that guidance, it will harm taxpayers.

RECOMMENDATIONS

The IRS should require Collection to attempt to contact the taxpayer, preferably by phone, before issuing a CDP notice and direct the taxpayer to send his or her CDP request to Appeals instead of Collection. The IRS should consider untimely CDP requests as requests for an equivalent hearing if they qualify. If a taxpayer reaches an agreement with Collection, the IRS should not ask the taxpayer to waive the right to a CDP hearing, and Appeals should retain jurisdiction of the CDP hearing and enter into the agreement with the taxpayer. Appeals should suspend a CDP hearing when a taxpayer raises a liability issue for a non-CDP year that would be included in collection alternatives covered by the CDP hearing and allow the taxpayer to resolve these related liability issues with the appropriate IRS function. The IRS should update the Appeals IRM with a significant section on CDP hearings to provide guidance on reviewing the collection action, conducting the balancing test, and considering collection alternatives. All Appeals Officers, Settlement Officers, and Appeals Account Resolution Specialists should be required to take updated training on conducting the balancing test and applying the hazards of litigation.

**MSP
#15****EXEMPT ORGANIZATIONS: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status****PROBLEM**

The IRS Exempt Organizations (EO) function receives about 60,000 applications for exempt status each year. In addition, EO receives applications for reinstatement from organizations whose exempt status was automatically revoked for failing to file returns or Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ*, for three consecutive years. Its inventory backlog now stands at about 66,000 cases, more than the number of routine applications it usually receives in an entire year, four times the 2010 level, and more than triple the 2011 level. EO also erroneously treated thousands of organizations as no longer exempt, and programming conditions will cause more erroneous revocations in the future. Organizations affected by delays in obtaining recognition of exempt status include those that deliver human services such as food and shelter. Of public charities that report to the IRS, there are more in this category than in any other. Increased need for their assistance coincides with reductions in the amount of government funds to meet the need, especially at the state and local levels.

ANALYSIS

Since 2009, EO has notified more than half a million organizations they are no longer exempt. About 9,000 of these revocations were erroneous. Some erroneous revocations were caused by IRS programming, which calculates the three-year non-filing period that triggers automatic revocation by reference to the date the organization obtained its Employer Identification Number (EIN), rather than by reference to the effective date of its exempt status. EO intends to retain the practice of measuring the nonfiling period with reference to the EIN date. It does not inform organizations how the practice may affect them or provide for administrative review of automatic revocations.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that EO issue a letter informing organizations when the IRS proposes to treat them as having had exempt status automatically revoked and provide an opportunity to correct the condition that caused the proposed automatic revocation within 30 days; provide administrative review of organizations' concerns that the revocation would be in error; and inform organizations that EO calculates the three-year nonfiling period by reference to the date the organization obtained its EIN and advise them to contact EO if use of the EIN date will result in an erroneous revocation.

**MSP
#16****REVENUE PROTECTION: Ongoing Problems with IRS Return Integrity Programs Harm Taxpayers by Delaying Valid Refunds****PROBLEM**

The National Taxpayer Advocate identified problems as early as 2005 with IRS return integrity programs, which detect and prevent civil fraud in tax returns before the IRS issues refunds to the taxpayers. Despite improvements, problems within the IRS's return integrity strategies persist and continue to harm taxpayers. The continued failure to address these problems burdens taxpayers who file legitimate returns and are wrongly ensnared by the myriad of fraud detection filters put in place by several IRS units. The failure of these units to coordinate may result in duplicate, over-inclusive, and unnecessary filters that are not routinely reviewed for accuracy or continued necessity. With the elimination of the IRS's return integrity steering committee, problems associated with fraud detection filters will not be discussed at a servicewide level and may create additional burden.

ANALYSIS

The return integrity process is complex and multifaceted. A tax return must travel a long path with many potential roadblocks before the IRS accepts it as filed. The main goal of Integrity Verification and Operation (IVO) is to stop fraudulent refunds before they are issued by identifying potentially false returns, usually via wages or withholding reported on the return. Returns are flagged as potentially fraudulent when a computer program automatically checks to see if the return "breaks" filters put in place by the IRS to attempt to identify activity often associated with fraud. These filters resulted in 308,868 refunds being delayed due to false positives for fraudulent activity in filing season 2013. TAS has seen a continued increase in cases involving taxpayers caught in fraud filters, with receipts of IVO cases increasing over 45 percent from fiscal year (FY) 2012 to FY 2013. Problems were compounded in FY 2012 when the IRS eliminated the Pre-Refund Program Executive Steering Committee, leaving no over-arching governance of the implementation or design of revenue protection strategies or filters, inhibiting an integrated approach, and resulting in potentially duplicative or over-inclusive filters. Additional IRS programs, such as the External Leads Program, which is responsible for receiving and processing informational leads and questionable funds returned by partner financial institutions and various other sources, leave taxpayers uninformed about the status of their refunds.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS introduce an Integrated Data Retrieval System code to indicate that a refund is under investigation by the IRS under the bank leads program; reclassify the letters intended to inform taxpayers of the status of a refund caught by filters from "just destroy" to "perform further research" when they are returned as undeliverable; and reinstate the Pre-Refund Executive Steering Committee.

**MSP
#17****ACCURACY-RELATED Penalties: The IRS Assessed Penalties Improperly, Refused to Abate Them, and Still Assesses Penalties Automatically****PROBLEM**

In 2012, in a reversal of prior advice, the IRS Office of Chief Counsel determined that the IRS was not legally authorized to impose the accuracy-related penalty under Internal Revenue Code (IRC) § 6662 against taxpayers who claimed refundable credits that it had frozen (*i.e.*, not actually paid or accepted). The IRS abated almost \$143 million in penalties that it imposed against 108,774 taxpayers after June 1, 2012. Yet it declined to abate more than \$40 million in penalties that it imposed improperly against more than 46,000 taxpayers earlier, and it is still trying to collect over \$20 million of these penalties from more than 23,000 taxpayers. The IRS's failure to abate inapplicable penalties signals disrespect for the law and a disregard for taxpayer rights.

ANALYSIS

The IRS's decision not to abate inapplicable penalties illustrates its resource-driven approach to them. As we have described in prior reports, the IRS too often proposes accuracy-related penalties automatically when they might potentially apply — before performing a careful analysis of the relevant facts and circumstances — and then burdens taxpayers by requiring them to prove the penalties do not apply. For example, as part of its automated underreporter (AUR) matching program, the IRS in 2012 sent over 93,000 letters (the CP 2000) that proposed nearly \$100 million in accuracy-related penalties without first calling (or writing) the taxpayers to determine whether there was a reason for the apparent mismatches. Moreover, the IRS abated about 20 percent of the tax it assessed through AUR in FY 2012. The National Taxpayer Advocate is concerned the IRS may use the same approach to administer the new penalty applicable to erroneous claims for refund under IRC § 6676. Unlike many other penalties, this new penalty may apply even if a taxpayer has “reasonable cause” for the error. If the IRS automatically applies the new penalty to all refundable credit claims that might be erroneous (*i.e.*, before investigating), it will place a disproportionate burden on unsophisticated taxpayers who have difficulty communicating with the IRS or do not understand the relevant facts and legal rules — precisely those individuals to whom Congress frequently targets the benefits of refundable tax credits. Thus, IRC § 6676 could turn refundable credits into traps for the unwary.

RECOMMENDATIONS

The IRS should identify and abate all of the accuracy-related penalties that should not apply. It should minimize taxpayer burden when administering the IRC § 6676 penalty (*e.g.*, by not proposing it automatically) and work with the Treasury Department to support a reasonable cause exception.

**MSP
#18****ONLINE SERVICES: The IRS's Sudden Discontinuance of the Disclosure Authorization and Electronic Account Resolution Applications in E-Services Left Practitioners Without Adequate Alternatives****PROBLEM**

The IRS has a strategic goal of expanding electronic service options for its tax partners, including practitioners, who can interact with the IRS through an e-Services suite of web-based products. In early 2013, the IRS discontinued the Disclosure Authorization (DA) and Electronic Account Resolution (EAR) applications without discussing the matter with the practitioner community in advance. DA enabled practitioners to submit power of attorney and tax information authorization forms (Forms 2848 and 8821) electronically, while EAR allowed practitioners to work with the IRS electronically on account-related issues. The IRS cited low usage and increased operating costs as reasons for ending the programs. However, almost immediately after the IRS announced the decision, practitioners expressed significant concerns. The National Taxpayer Advocate believes the decision process lacked strategic planning and stakeholder engagement, and increased burden on taxpayers and their representatives.

ANALYSIS

The IRS discontinued the e-Services applications without providing practitioners with acceptable online options, despite practitioners' clear demand for more electronic services and the IRS Strategic Plan's objective to expand e-Services. Once the IRS retired the two programs, practitioners who used DA reverted to mailing or faxing their paper disclosure authorization forms to the Centralized Authorization File, which has a record of long processing times due its outdated systems. Those who used EAR must now contact the IRS through the Practitioner Priority Service (PPS). Practitioners who used PPS in fiscal year 2013 had to wait almost 20 minutes to reach a live assistor. It also is unclear whether the IRS considered the additional long-term costs of moving customers away from online services to paper and phone-based systems.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS not retire practitioner applications without soliciting comments beforehand; establish a strategic plan to identify develop, and promote viable electronic alternatives to discontinued applications prior to discontinuance; and solicit comments from users on how to improve and better market applications experiencing low usage rates.

**MSP
#19****IRS WORKER CLASSIFICATION PROGRAM: Current Procedures Cause Delays and Hardships for Businesses and Workers by Failing to Provide Determinations Timely and Not Affording Independent Review to Adverse Decisions****PROBLEM**

The classification of workers as employees or independent contractors has significant tax consequences for businesses and individuals, ranging from the allowance of expenses derived from a “trade or business” to eligibility for employee benefit or pension plans. The National Taxpayer Advocate has repeatedly called for the IRS to simplify its worker classification criteria and develop online self-help tools, but the IRS has taken little action. In addition, applicants who receive adverse classification determinations from the IRS may not automatically receive administrative appeal options, and those who do may not be afforded all the remedies offered in internal guidelines.

ANALYSIS

Firms and workers may file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, to ask the IRS whether a worker is an employee or an independent contractor. The SS-8 unit has been beset with a backlog of cases, with “overage” inventory reaching 80 percent and applicants having to wait for up to a year for a decision. The development of an electronic tool to determine classification would reduce inventory. The IRS has tried to address the backlog by streamlining procedures, but problems remain. The unit is using subjective case screening criteria that may lead to rejection of legitimate applications. And in contrast to applicants under audit, those who receive adverse SS-8 determinations may not automatically receive administrative appeal options, and those who do may not be afforded remedies like Alternative Dispute Resolution.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS adopt her previous recommendation to develop electronic tools for employers or employees to determine worker classification; increase staffing to address the inventory backlog, reduce burdens on businesses and workers and provide effective, timely classifications; allow applicants the right to an independent review of adverse determinations; provide applicants an opportunity to respond before rejecting their applications; and transition the SS-8 program from a centralized campus operation to field offices more equipped to consider subjective criteria.

MSP
#20**INTERNATIONAL TAXPAYER SERVICE: The IRS Is Taking Important Steps to Improve International Taxpayer Service Initiatives, But Sustained Effort Will Be Required to Maintain Recent Gains****PROBLEM**

U.S. citizens or resident aliens are subject to tax on their worldwide incomes and have the same general tax reporting requirements whether they live in the United States or abroad. However, the tax requirements have become so confusing and the compliance burden so great that taxpayers are giving up their U.S. citizenship in record numbers. The IRS emphasizes service to international taxpayers via IRS.gov webpages, but taxpayers still call the IRS for assistance with account-related matters because online options remain limited. The IRS is planning improvements to online service delivery, but in view of the unique communication challenges international taxpayers encounter, the IRS needs to prioritize initiatives that affect this population.

ANALYSIS

The IRS focuses on improving online services rather than telephone service for taxpayers overseas, but the persistent lack of online options means taxpayers frequently call the international call site, a *toll* number. The customer service level of service for that number declined from 78 percent to 72 percent from fiscal year (FY) 2012 to FY 2013. The IRS.gov landing page for international taxpayers received about 300,000 unique visitors in FY 2013. There were over 100,000 unique visitors to the Individual Taxpayer Identification Number (ITIN) page on average each *month*. At the same time, several basic tax forms, including both the ITIN application and Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, cannot be filed electronically. The International Individual Tax Assistance Team (IITA), created to develop international taxpayer service initiatives, has yet to be made permanent, which means there is still no ongoing IRS commitment to improve service to international taxpayers. Important details about how U.S. taxpayers living abroad can meet their obligations under the Affordable Care Act remain undeveloped.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS make IITA a permanent initiative with reporting responsibilities; prioritize the delivery of online services to international taxpayers by including initiatives affecting them in early pilot projects; make available free electronic filing of tax forms such as Form 1040NR and the ITIN application; improve the level of service for international taxpayers who call the international call site; and explore the use of voice-over-Internet-protocol and other alternative methods of telephone services that will allow the IRS to contact taxpayers, and taxpayers to contact the IRS, without paying international call rates.

**MSP
#21****INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS: ITIN
Application Procedures Burden Taxpayers and Create a Barrier to
Return Filing****PROBLEM**

In November 2012, the IRS announced permanent changes to its application procedures for Individual Taxpayer Identification Numbers (ITINs), which taxpayers who are ineligible for Social Security numbers must use to meet their filing obligations. Dependent ITIN applicants now face a substantial burden because they can no longer use a certifying acceptance agent (CAA) to certify their documents. Dependents must mail original documents or copies certified by the issuing agency, or have the documents certified at an IRS taxpayer assistance center (TAC) or at one of just four U.S. tax attaché offices overseas.

ANALYSIS

From January through October 2013, applicants filed only one million ITIN applications with returns, compared to nearly two million during the same period in 2012. During this period, ITIN applications and accompanying returns declined nearly 50 percent, while the percentage of applications rejected by the IRS soared to 50.2 percent. One explanation for these numbers is the burden caused by the new ITIN procedures. ITIN applicants report problems, including a lack of communication about why the IRS suspended or rejected an application, an inability to speak with IRS employees, a lack of notice about the status of the application, the rejection of applications with legitimate supporting documents, and lost original documents. The IRS's policy of generally accepting ITIN applications only during the filing season forces the IRS to process applications under short timelines and does not provide sufficient time to review them for potential fraud.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS allow the filing of ITIN applications throughout the taxable year with proof of a filing requirement; allow CAAs to certify a dependent applicant's documentation and send copies instead of originals or copies certified by the issuing agency; allow TAC employees to certify all identity documents (beyond passports and national identity cards) that ITIN examiners accept for primary, secondary, and dependent applicants; and require notification to a taxpayer before an ITIN expires.

**MSP
#22****OFFSHORE VOLUNTARY DISCLOSURE: The IRS Offshore
Voluntary Disclosure Program Disproportionately Burdens Those
Who Made Honest Mistakes****PROBLEM**

Since 2009, the IRS has generally required individuals who failed to report offshore income and file one or more related information returns (*e.g.*, the *Report of Foreign Bank and Financial Accounts* (FBAR)) to enter into increasingly punitive offshore voluntary disclosure (OVD) settlement programs. It generally requires “benign actors” to apply to OVD and then “opt out” before it will consider a lesser penalty. Those who opt out are subjected to audits. Because those opting out face prolonged uncertainty and the risk of even more severe penalties, some agree to pay more than they should. Moreover, IRS resources devoted to auditing and disproportionately penalizing those who come forward to correct honest mistakes are not available to address noncompliance by others who do not come forward.

ANALYSIS

In the 2009 OVD program, the median offshore penalty paid by those with the smallest accounts (\$87,145 or less) was nearly six times the tax on their unreported income. Among unrepresented taxpayers with small accounts it was nearly eight times the unpaid tax. The penalty was also disproportionately greater than the amount paid by those with the largest accounts (more than \$4.2 million) who paid a median of about three times their unreported tax. When the IRS audited taxpayers who opted out (or were removed), on average, it assessed smaller, but still severe, penalties of nearly 70 percent of the unpaid tax and interest. Given the harsh treatment the IRS applied to benign actors, others have made quiet disclosures by correcting old returns or by complying in future years without subjecting themselves to the lengthy and seemingly-unfair OVD process. Still others have not addressed FBAR compliance problems, and the IRS has not done enough to help them comply. While the IRS initiated a less punitive “streamlined” program to encourage certain nonresidents to self-correct, no similar program is available to U.S. residents. Moreover, the IRS has imposed new duplicative reporting requirements.

RECOMMENDATIONS

The IRS should expand the self-correction and settlement options available to benign actors so that they are not pressured to opt out or pay more than they should; do more to educate persons with foreign accounts (*e.g.*, recent immigrants) about the reporting requirements; consolidate and simplify guidance; and reduce duplicative reporting requirements.

**MSP
#23****REPORTING REQUIREMENTS: The Foreign Account Tax Compliance Act Has the Potential to Be Burdensome, Overly Broad, and Detrimental to Taxpayer Rights****PROBLEM**

The Foreign Account Tax Compliance Act (FATCA), which Congress enacted in 2010, fundamentally changes the reporting of foreign assets. FATCA tries to reduce revenue loss by imposing a broad range of additional reporting obligations, along with potential sanctions on U.S. taxpayers and residents, foreign entities, and withholding agents. One goal of FATCA is international data sharing with global information transparency. Questions remain, however, regarding whether such a course is advisable, whether the information being compiled is necessary and will be effectively used, whether the enforcement benefits of FATCA justify the compliance burdens and economic hardships it imposes, and whether the due process rights of taxpayers will be preserved in the process.

ANALYSIS

The IRS has not spelled out reasonable cause defenses or other relief procedures to distinguish between bad actors and benign non-filers. This lack of guidance exposes good faith non-filers to FATCA's severe penalties. Similarly, errors in collecting and reporting information on account holders by foreign financial institutions (FFIs) could cause significant difficulties for taxpayers unless the IRS develops a timely and effective mechanism for addressing such inaccurate information reporting. Additionally, although the IRS has been responsive to some comments and suggestions throughout the development of the FATCA regime, it has failed to act on advice from other well-informed stakeholders.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS issue FATCA-specific reasonable cause or similar guidance, which adopts a measured approach to the imposition of penalties with respect to benign non-filers; ensure that U.S. taxpayers and residents have a timely and effective mechanism for addressing information reporting errors of FFIs; act responsively and efficiently to implement the input of stakeholders, many of which have particular expertise that could contribute substantially to the effective implementation of FATCA; and reduce the duplicative reporting required on both Form 8938, *Statement of Foreign Financial Assets*, and the Report of Foreign Bank and Financial Accounts. The IRS should proceed with great caution as it moves forward with FATCA implementation. It should be careful to burden affected parties as little as possible, to gather only the information it will actually use, and to learn from its experiences with the Offshore Voluntary Disclosure Programs to more effectively preserve the due process rights of taxpayers.

**MSP
#24****DIGITAL CURRENCY: The IRS Should Issue Guidance to Assist Users of Digital Currency****PROBLEM**

The use of digital currencies, such as bitcoin, is growing. In the four months between July and December 2013, Bitcoin usage has increased by over 75 percent — from about 1,700 transactions per hour to over 3,000. Over the same period, the market value of bitcoins in circulation increased more than ten-fold from about \$1.1 billion to \$12.6 billion. However, the IRS has yet to issue specific guidance addressing the tax treatment or reporting requirements applicable to digital currency transactions. People who are trying to comply with these rules have complained that they are unsure about them. Thus, IRS-issued guidance would promote tax compliance, particularly among those who want to report digital currency transactions properly, and it would reduce the risk that users of digital currencies will face tax consequences that they did not anticipate.

ANALYSIS

Following a 2008 recommendation by the National Taxpayer Advocate to issue guidance on the tax treatment of the transfer of “virtual” items and currency, the IRS created a webpage that suggests existing guidance covers these transactions. However, it did not explain when the transactions are sufficiently analogous to be covered by existing rules. Unanswered questions may include:

1. When will receiving or using digital currency trigger gains and losses?
2. When will these gains and losses be taxed as ordinary income or capital gains?
3. What information reporting, withholding, backup withholding, and recordkeeping requirements apply to digital currency transactions?
4. When should digital currency holdings be reported on a *Report of Foreign Bank and Financial Accounts* (FBAR), or Form 8938, *Statement of Specified Foreign Financial Assets*?

To fill the void left by the IRS’s lack of specific guidance, taxpayers are speculating on the Internet about the answers to these questions. Some of this speculation is incorrect, incomplete, or misleading. It is the government’s responsibility to inform taxpayers about the rules they are required to follow. Moreover, the lack of clear answers to basic questions probably encourages tax avoidance.

RECOMMENDATIONS

The IRS should issue guidance that addresses the tax treatment and information reporting required in connection with digital currency transactions, including answers to the basic questions listed above.

**MSP
#25****DEFENSE OF MARRIAGE ACT: IRS, Domestic Partners, and Same-Sex Couples Need Additional Guidance**

PROBLEM

The recent Supreme Court case *United States v. Windsor* held unconstitutional the Defense of Marriage Act of 1996, which effectively had precluded federal recognition of same-sex marriage. Subsequent IRS guidance resolved certain questions for same-sex spouses anticipated by the National Taxpayer Advocate's 2012 Annual Report to Congress. While the decision and guidance resolve fundamental issues, various questions of implementation remain, while questions about the tax status of unmarried domestic or civil union partners persist.

ANALYSIS

Because of the difference between federal and state law, same-sex spouses may have to file tax returns as single at one level but as married at the other. Before *Windsor*, spouses whose state recognized their marriage would file singly for federal but jointly for state tax purposes. After *Windsor*, spouses whose state does not recognize their marriage need to file as married with the IRS while continuing to file singly with the state. IRS systems for processing amended and new returns hold potential for rejecting unusual but legitimate claims, putting them in the limbo of refund fraud processes. Meanwhile, same-sex partners in three states that ban same-sex marriage but allow domestic partnerships or civil unions still need answers to questions like the following. Is alimony after dissolution of a civil union includible by the recipient and deductible by the payer? Is community property created upon partnering with an individual of the same sex a taxable gift?

RECOMMENDATIONS

The IRS should issue formal and informal guidance for same-sex spouses to resolve questions that continue to arise, for same- and opposite-sex partners who have marital attributes under civil union or similar state law, and for IRS employees to promptly process the returns and related claims. The IRS also should review identity theft and revenue protection filters in light of common filing scenarios by same-sex spouses so the IRS does not freeze and delay refunds of legitimately married taxpayers.

LEGISLATIVE RECOMMENDATIONS

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

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

LR
#1 **Repeal the Alternative Minimum Tax**

PROBLEM

The Alternative Minimum Tax (AMT) does not achieve its original goal — to ensure that wealthy taxpayers pay at least some tax. By one projection, about 1,000 millionaires will pay no federal income tax in 2013. Those with the highest incomes are actually less likely to pay AMT than those just below them. The AMT penalizes middle income taxpayers for having children, getting married, or paying state and local taxes. The AMT is also unnecessarily complicated and burdensome, even for those who are not subject to it. Many taxpayers must fill out a lengthy form only to find they owe little or no AMT after all.

ANALYSIS

The AMT requires taxpayers to compute their taxes twice — once under the regular tax rules and again under the AMT rules. If the “tentative minimum tax” exceeds the regular tax liability, the taxpayer pays the difference as AMT. If not, he or she does not pay the AMT, and the computation seems to the taxpayer like a complete waste of time. In addition, the complexity of the AMT reduces the transparency of the tax system, making it more difficult for people to know their marginal tax rate and predict what they will owe — and when people owe more than anticipated, voluntary compliance may suffer. Even without any decline in voluntary compliance, the AMT is only projected to bring in \$25.6 billion in 2013. Thus, tax simplicity, transparency, voluntary compliance, and taxpayers who live in high-tax states or have children have become collateral damage in a battle to prevent high-income people from reducing their taxes by applying the regular tax rules enacted by Congress. If Congress does not like those rules, it should change them rather than apply an AMT.

RECOMMENDATIONS

Permanently repeal the AMT.

**LR
#2****Broaden Relief from Timeframes for Filing a Claim for Refund for Taxpayers with Physical or Mental Impairments**

PROBLEM

In 1998, Congress amended Internal Revenue Code (IRC) § 6511 by adding IRC § 6511(h), which suspends the running of the period for filing a claim for refund where a taxpayer can show that he or she was financially disabled. However, the current, narrowly tailored provision fails to protect numerous taxpayers who lack the capacity to file a refund claim. The statute requires a qualifying taxpayer to have a “medically determinable” physical or mental impairment, preventing the IRS from relying on potentially more valuable determinations, including those from licensed psychologists or clinical social workers. It also requires that the taxpayer be “unable” to manage his or her financial affairs due to a physical or mental impairment. This forces the individual making the determination to provide a global, “all or nothing” statement about the effect of the impairments. These requirements have led the IRS to dismiss otherwise compelling evidence and deny relief to taxpayers.

ANALYSIS

Requiring the determination regarding the taxpayer’s impairment to be a medical one does not always give the IRS the most accurate and useful information. A taxpayer receiving regular counseling and treatment from a licensed psychologist or a social worker could not submit a letter from either professional, even though they might be most familiar with the case, because it would not be considered a medical determination under the law. The current requirement that the taxpayer be “unable” to manage his or her financial affairs means the supporting letter must make an “all or nothing” determination. Requiring such a statement places a large burden on the individual providing the determination letter, and may unnecessarily deter professionals from doing so. Specifically, the professional may know or believe the taxpayer can manage simple, easy financial tasks, and therefore may feel barred from confidently stating that he or she was unable to manage financial affairs.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress amend IRC § 6511(h)(2)(A) to provide that an individual is financially disabled when he or she has a physical or mental impairment, determined by a licensed medical or mental health professional, which materially limits the individual’s management of his or her financial affairs.

**LR
#3****Allocate to the IRS the Burden of Proving It Properly Imposed the Two-Year Ban on Claiming the Earned Income Tax Credit****PROBLEM**

Internal Revenue Code (IRC) § 32(k) authorizes the IRS to ban a taxpayer from claiming the Earned Income Tax Credit (EITC) for two years if the IRS determines the taxpayer claimed the credit improperly due to reckless or intentional disregard of rules and regulations. The IRS often ignores the statutory requirements for imposing the ban, contravenes its own Chief Counsel guidance, and bypasses its own procedural safeguards to impose the ban. For the vulnerable population of low-income taxpayers who are otherwise eligible for EITC, inappropriately being deprived of the credit for two years is a serious burden that may be difficult to relieve. These taxpayers may be intimidated and fearful of protesting the IRS's treatment of them. They may not understand they have been wronged when the IRS imposes the ban without following the statutory requirements, and consequently they may not seek assistance they need, such as from Low Income Taxpayer Clinics. A taxpayer may petition the Tax Court for review of the IRS's determination to impose the two-year ban, but the taxpayer may have the burden of proving the IRS imposed the ban improperly.

ANALYSIS

When the IRS audits a taxpayer's return, disallows EITC, and imposes the two-year ban, it issues a statutory notice of deficiency that includes notice of the determination to impose the ban. The taxpayer may petition the Tax Court for review of the disallowed credit as well as the ban. Once in Tax Court, the taxpayer generally bears the burden of proof. Several Code provisions and Tax Court Rules shift the burden of proof to the IRS for various issues, but it is not clear which party has the burden of showing whether or not the ban was properly imposed. If the burden of proof does not shift to the IRS, the taxpayer contesting the ban must produce evidence to prove a negative (that he or she did not claim the credit due to reckless or intentional disregard of rules and regulations), a requirement that is considered unfair in certain unreported income cases.

RECOMMENDATION

Amend IRC § 32(k) to clarify that the IRS has the burden of proof when proposing to impose the two-year ban on claiming EITC. Consequently, the IRS would be required to produce evidence of the taxpayer's reckless or intentional disregard of rules and regulations and persuade the court that imposition of the ban would be appropriate.

**LR
#4****PREMIUM TAX CREDIT: Adjust the Affordability Threshold Based on Type of Coverage**

PROBLEM

Under a Treasury Regulation implementing the Affordable Care Act, an employee's family may be disqualified for the premium tax credit if the cost of self-only insurance would be affordable, even though he or she pay more for family coverage. This is because a 9.5-percent affordability threshold in the regulation refers to self-only cost — even if the employee needs family coverage.

ANALYSIS

As a logical matter, the affordability threshold creates a disjunct between a stipulated amount and the actual cost of family coverage. This should be resolved. As a practical matter, disqualification from the premium tax credit may make it harder for families to obtain health insurance.

RECOMMENDATION

Clarify that the 9.5-percent affordability threshold pertains to the applicable type of insurance, whether self-only or family coverage. The recommendation would align the rule with economic affordability.

**LR
#5****TUITION REPORTING: Allow TIN Matching by Colleges**

PROBLEM

The tax code requires colleges and universities to file information reports with the IRS reflecting tuition from students. However, the law does not permit these eligible educational institutions to verify Taxpayer Identification Numbers (TINs) with the IRS prior to filing. Unlike others who file information reports and can perfect TINs once the IRS advises them of an error, colleges and universities must rely on student information while still facing up to \$1.5 million in penalties for errors.

ANALYSIS

Existing law permits TIN matching by payors of income, who would have to do back-up withholding in the case of a payee with an inaccurate TIN. This would be inapplicable to colleges when they are not paying income to students. As a practical matter, colleges have a tuition information reporting requirement for which they need to verify TINs. A TIN may not match a student's name for various reasons, such as transposition errors or name changes.

RECOMMENDATION

To allow the IRS to alert colleges of mismatches to resolve with students prior to filing information reports, Congress should expand the TIN-matching statute for purposes of information reports on tuition.

THE MOST LITIGATED ISSUES

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer advocate to include in her Annual Report to Congress the ten tax issues most litigated in the federal courts, classified by the types of taxpayers affected. The cases we reviewed were decided during the 12-month period beginning on June 1, 2012, and ending on May 31, 2013.

SIGNIFICANT CASES

At the outset, we describe certain judicial decisions that generally do not involve any of the ten Most Litigated Issues, but nonetheless highlight important issues relevant to tax administration. This year, we discuss ten cases.

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

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties. We did not analyze these other accuracy-related penalties because during our review period of June 1, 2012, through May 31, 2013, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.

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

The deductibility of trade or business expenses has long been among the ten Most Litigated Issues in the Annual Report. We identified 134 cases involving a trade or business expense issue that were litigated between June 1, 2012, and May 31, 2013. The courts affirmed the IRS position in the vast majority (approximately 74 percent) of cases, while taxpayers fully prevailed only about two percent of the time. The remaining cases resulted in split decisions.

3. Gross Income Under IRC § 61 and Related Sections

When preparing tax returns, taxpayers must report gross income for the taxable year to determine the tax they must pay. The reporting of gross income has been among the most litigated issues in each of the National Taxpayer Advocate's Annual Report to Congress. For this report, we analyzed 117 cases decided between June 1, 2012, and May 31, 2013. The majority of cases this year involved taxpayers failing to report items of income, including some specifically mentioned in IRC § 61 such as wages, interest, dividends, and annuities.

4. Summons Enforcement Under IRC §§ 7602, 7604, and 7609

Pursuant to IRC § 7602, the IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability. To obtain this information, the IRS may serve a summons directly on the subject of the investigation or any third party who may possess relevant information. If a person summoned under section 7602 neglects or refuses to obey the summons, produce books, papers, records, or other data, or give testimony, as required by the summons, the IRS may seek enforcement of the summons in a United States district court.

A person who has a summons served on him or her may contest its legality if the government petitions to enforce it. Thus, summons enforcement cases are different from many other cases described in other Most Litigated Issues because often the government, rather than the taxpayer, initiates the litigation pertaining to summons enforcement. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons. Generally, the burden on the taxpayer to establish the illegality of the summons is heavy.

We identified 117 federal cases decided between June 1, 2012, and May 31, 2013, that included issues of IRS summons enforcement. In 80 cases, the government initiated the litigation by filing a petition to enforce the summons. In 37 cases, the taxpayer or a third party initiated the litigation by filing a motion to quash the summons. Of the 117 cases, the parties contesting the summonses prevailed fully in four cases, with two other cases resulting in split decisions. The IRS prevailed in full in the remaining 111 decisions. Of the 117 cases, 56 included a discussion of the law and interaction between the taxpayer and the government. Of these 56 cases, the parties contesting the summonses prevailed fully in four cases, with two other cases resulting in split decisions. The IRS prevailed in the remaining 50 cases.

5. Appeals From Collection Due Process Hearings Under IRC §§ 6320 and 6330

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98). CDP hearings provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a Notice of Federal Tax Lien (NFTL) or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing before the IRS issues its first levy or immediately after it files its first NFTL with respect to a particular tax liability. At the hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of the collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability. Taxpayers have the right to judicial review of Appeals' determinations if they timely request the CDP hearing and timely petition the United States Tax Court. Generally, the IRS suspends levy actions during a levy hearing and any judicial review that may follow.

Since 2003, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed in the National Taxpayer Advocate's Annual Reports to Congress. The trend continues this year, with our review of litigated issues finding 105 opinions on CDP cases during the review period of June 1, 2012, through May 31, 2013. Taxpayers prevailed in full in eight of these cases (nearly eight percent) and in part in nine others (nearly nine percent). Of the 17 opinions where taxpayers prevailed in whole or in part, seven taxpayers appeared *pro se* and ten were represented.

The cases discussed below demonstrate that CDP hearings serve an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. The Court imposed sanctions for inappropriate use of the CDP process in three of the 105 cases.

6. Failure to File Penalty Under IRC § 6651(a)(1), Failure to Pay an Amount Shown as Tax on Return Under IRC § 6651(a)(2), and Failure to Pay Estimated Tax Penalty Under IRC § 6654

We reviewed 86 decisions issued by federal courts from June 1, 2012, to May 31, 2013, regarding the additions to tax for:

- Failure to file a tax return by the due date under Internal Revenue Code (IRC) § 6651(a)(1);
- Failure to pay an amount shown as tax on a return under IRC § 6651(a)(2);
- Failure to pay estimated tax under IRC § 6654; or
- Some combination of the three.

The phrase “addition to tax” is commonly referred to as a penalty, so we will refer to these additions to tax as the failure to file penalty, the failure to pay penalty, and the estimated tax penalty. Nineteen cases involved the imposition of the estimated tax penalty in conjunction with the failure to file and failure to pay penalties, 14 involved both the failure to file and failure to pay penalties, one case involved only the estimated tax penalty, three cases involved only the failure to pay penalty, and 39 cases involved only the failure to file penalty.

The failure to file and failure to pay penalties are imposed unless the taxpayer can demonstrate that the failure is due to reasonable cause and not willful neglect. The estimated tax penalty is imposed unless the taxpayer can meet one of the statutory exceptions. In 71 out of the 86 cases, taxpayers were unable to avoid a penalty.

7. Charitable Deductions Under IRC § 170

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes for contributions of cash or other property to or for the use of charitable organizations.⁵⁷ In order to take a charitable deduction, taxpayers must contribute to a qualifying organization⁵⁸ and must substantiate contributions of \$250 or more. Litigation generally arises over one or more of these four issues:

- Whether the organization to which a donation is made is charitable;
- Whether contributed property qualifies as a charitable contribution;
- Whether the amount taken as a charitable deduction equals the fair market value of the property contributed; and
- Whether the taxpayer has substantiated the contribution.

We reviewed 40 cases decided between June 1, 2012, and May 31, 2013, with charitable deductions as a contested issue. The IRS prevailed in 32 cases, with taxpayers prevailing in five cases and with the remaining three cases resulting in split decisions. Taxpayers represented themselves (appearing *pro se*) in 18 of the 40 cases (45 percent), with one of these *pro se* cases resulting in a split decision and the IRS prevailing in the remaining 17 cases.

⁵⁷ Internal Revenue Code (IRC) § 170.

⁵⁸ To claim a charitable contribution deduction, a taxpayer must establish that a gift was made to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

8. Frivolous Issues Penalty Under IRC § 6673 and Related Appellate-Level Sanctions

From June 1, 2012, through May 31, 2013, the federal courts issued decisions in at least 34 cases involving the IRC § 6673 “frivolous issues” penalty and at least four cases involving an analogous penalty at the appellate level. These penalties may be imposed when a taxpayer maintains a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal. In many of the cases we reviewed, taxpayers escaped liability for the penalty but were warned they could face sanctions for similar conduct in the future. Nonetheless, we include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

9. Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under IRC § 7403

IRC § 7403 authorizes the United States to file a civil action in U.S. District Court against a taxpayer who has refused or neglected to pay any tax, to enforce a federal tax lien, or subject any of the delinquent taxpayer’s property to the payment of tax. We identified 33 opinions issued between June 1, 2012, and May 31, 2013, that involved civil actions to enforce liens under IRC § 7403. The IRS prevailed in 30 of these cases. The number of cases represents a 31 percent decrease from the previous year.

10. Relief from Joint and Several Liability Under IRC § 6015

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency or tax due. Joint and several liability permits the IRS to collect the entire amount due from either taxpayer.

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

We reviewed 31 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2012, and May 31, 2013. The most significant issues the courts addressed this year are the Tax Court’s scope and standard of review of claims for relief under IRC § 6015(f) and whether District Courts have jurisdiction to decide innocent spouse claims raised as a defense in a collection suit or in an interpleader suit. The Tax Court also noted how proposed guidance, if applicable, would have affected its analysis of claims for relief under IRC § 6015(f).

VOLUME 2: TAS RESEARCH AND RELATED STUDIES

1. DO ACCURACY-RELATED PENALTIES IMPROVE FUTURE REPORTING COMPLIANCE BY SCHEDULE C FILERS?

Accuracy-related penalties are intended to promote voluntary compliance. Congress has directed the IRS to develop better information concerning the effects of penalties on voluntary compliance, and it is the IRS's official policy to recommend changes when the Internal Revenue Code (IRC) or penalty administration does not effectively do so. The objective of this study was to estimate the effect of accuracy-related penalties on Schedule C filers (*i.e.*, sole proprietors) whose examinations were closed in 2007. TAS compared their subsequent compliance to a group of otherwise similarly situated “matched pairs” of taxpayers who were not penalized. TAS used Discriminant Function (or “DIF”) scores — an IRS estimate of the likelihood that an audit of the taxpayer's return would produce an adjustment — as a proxy for a taxpayer's subsequent compliance.

While all groups of Schedule C filers who were subject to an examination assessment improved their reporting compliance (as measured by reductions in their DIF scores), those subject to an accuracy-related penalty had no better subsequent reporting compliance than those who were not. Thus, accuracy-related penalties did not appear to improve reporting compliance among the Schedule C filers who were subject to them. Further, penalized taxpayers who were also subject to a default assessment or who appealed their assessment had smaller reductions in DIF scores, suggesting lower reporting compliance five years later as compared to similarly situated taxpayers who were not penalized. Similarly, those whose penalty was abated had smaller reductions in DIF scores, suggesting lower reporting compliance five years later as compared to taxpayers whose penalty was not abated.

Prior research suggests that a taxpayer's perception of the fairness of the tax law, the IRS and the government drive voluntary compliance decisions, and the findings of this study are consistent with that research. Taxpayers subject to default assessments may be more likely to feel the penalty assessment process was unfair, which may have caused lower levels of future compliance. Similarly, those who appeal may be more likely to feel that the actual result was unfair, which may have caused lower levels of future compliance. Finally, those subject to a penalty assessment that is later abated may also feel that the IRS initially sought to penalize them unfairly, potentially causing lower levels of future compliance.

These findings have a number of policy implications. First, the IRS should revise its procedures to ensure that it does not propose a penalty before exhausting efforts to communicate with a taxpayer to determine whether a penalty actually applies. By design, automated procedures — those that presume a penalty applies unless a taxpayer explains and documents why it does not — are likely to generate more default assessments and penalty abatements than other examination methods. As taxpayers who were penalized after default assessments or whose penalties were abated had smaller reductions in DIF scores, suggesting lower levels of voluntary compliance after five years than those who were not, these automated procedures may be inconsistent with the IRS's goal of promoting voluntary compliance.

Second, the IRS's Appeals function should consider doing more to objectively evaluate and then explain its determinations, particularly when it sustains a penalty. As taxpayers who were penalized after an appeal had smaller reductions in DIF scores, suggesting lower levels of compliance after five years than those

who were not penalized, it is possible that they did not perceive Appeals as fairly evaluating whether the penalty should apply. Finally, in the case of penalties that taxpayers generally regard as unfair (*e.g.*, where a reasonable cause exception does not apply or where it may be interpreted so narrowly as to, in effect, create a strict liability penalty), the IRS should consider applying a broader reasonable cause exception (or work with the Treasury Department to propose one) that is simple, fair, transparent, and easy to administer.

2. A COMPARISON OF REVENUE OFFICERS AND THE AUTOMATED COLLECTION SYSTEM IN ADDRESSING SIMILAR EMPLOYMENT TAX DELINQUENCIES

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

Direct comparisons between ACS employees and ROs present challenges, in part because ACS generally works “fresh” and comparatively low-dollar cases. Moreover, although the vast majority of all payments (including late payments) come in as a result of voluntary compliance, the IRS does not measure or compare the effect of Cff or ACS on the taxpayer’s future compliance.

In an effort to address these knowledge gaps, TAS compared the IRS’s performance in working similar types of collection cases initially assigned to an RO, ACS, or the queue. As employment tax delinquencies are a high priority for the IRS and can easily lead to future delinquencies, TAS focused on taxpayers with newly-delinquent employment tax deposit “modules” (*i.e.*, those with three or fewer delinquent quarters) that were first assigned to ACS, the queue, or Cff during 2003-2004. In an apples-to-apples comparison, TAS found:

- The Cff collected more dollars and resolved delinquencies more quickly than ACS, regardless of the size of the delinquency.
- ACS transferred more tax modules, particularly medium- and high-dollar modules (over \$1,500), to the queue and Cff, reducing the IRS’s speed and effectiveness in addressing them.
- Cff collected more on high-dollar modules initially assigned to the queue when it received them quickly. Thus, the IRS should consider limiting its use of the queue as an inventory management tool, particularly for high-dollar modules, as previously recommended by the National Taxpayer Advocate.
- Taxpayers with low-dollar modules (*i.e.*, \$1,500 or less) reduced their delinquencies by more than those with higher-dollar modules while they were in the queue.
- Taxpayers initially assigned to the queue appeared somewhat responsive to the notices they received after the initial notice stream. Thus, the IRS should consider sending additional notices to taxpayers assigned to the queue, particularly notices that emphasize payment alternatives and the impact of late payment penalties and daily compounded interest, as previously recommended by the National Taxpayer Advocate.
- IRS data suggest the IRS’s collection functions had very little success in promoting future compliance, regardless of the collection channel. It also suggests that collection employees closed about 24 percent of their cases while the taxpayers in question were falling behind on or about to fall behind on their taxes (or tax filings). Thus, both ACS and Cff should do more to resolve all compliance issues and ensure the taxpayer is able to comply in future periods before closing cases, and regularly measure and report on future compliance, as previously recommended by the National Taxpayer Advocate.

This study did not directly investigate why ROs are faster and more effective in resolving delinquencies than ACS employees, particularly on higher-dollar cases (those with modules of \$1,500 or more). However, it may be because each RO is generally expected to address the cause of the noncompliance and then resolve his or her assigned cases rather than pass them along to another collection employee or the queue. It may also be because ROs communicate with the taxpayer by visiting or making outgoing calls, and actively assist the taxpayer with collection alternatives. If so, then the IRS should either avoid assigning these cases to ACS or empower ACS employees to operate more like ROs.

For example, ACS employees should be required to make more use of outbound calls, actively assist taxpayers in using collection alternatives (*e.g.*, installment agreements and offers in compromise), and be expected to fully resolve certain types of cases (rather than pass them along to another employee or the queue). These changes would make ACS employees responsible for case outcomes. If this approach is adopted, taxpayers could work with one person who is familiar with their circumstances. However, such changes are unlikely to improve ACS's results unless ACS employees receive adequate training and authority and unless the IRS executives responsible for managing them are regularly required to measure and report on ACS's performance in these areas.

3. SMALL BUSINESS COMPLIANCE: FURTHER ANALYSIS OF INFLUENTIAL FACTORS

Problem

Because voluntary compliance by small businesses could significantly impact the tax gap, last year's Annual Report to Congress presented preliminary results from a survey of a national sample and selected community populations of sole proprietors concerning tax compliance and related socioeconomic attitudes. Reporting that trust in the government and IRS was an influential factor, the 2012 report identified correlations between questionnaire responses and tax compliance as measured for purposes of the survey. This year's report presents further analysis of the national survey.

The report also anticipated further analysis of the community survey with respect to characteristics of compliant or low-compliant populations. Responses to a set of questions in the community survey tended to link low compliance levels with social affiliations or networks associated especially with volunteering, voting, and congregations (*i.e.*, houses of worship of any denomination). This year's report explores whether low-compliance sites are located in regions where those social networks are prevalent. The report contains new analyses focusing on one state containing low-compliance sites among other sites not so classified.

Analysis

The Taxpayer Advocate Service (TAS) identified the factors underlying the survey responses, then determined whether the factors identified appear to influence taxpayer compliance behavior. We used factor analysis to identify these underlying factors. Factor analysis orders the factors it identifies based on the extent to which empirical data supports their existence. Factor analysis identified taxpayer service, which contributes to trust in government, as the highest-ranking factor. At the same time, factor analysis identified fairness and tax policy as separate factors related to trust. These findings are consistent with the 2012 report's emphasis on trust.

Factor analysis ranked norms as the second most important factor in accounting for various survey responses. Tax morale, preparers, and complexity are also important factors. Although the 2012 report could not confirm the influence of deterrence, this analysis also identifies economics, or motivations that may counter deterrence, as a distinct factor.

We used logistic regression to evaluate whether the identified factors influenced compliance behavior. The results of the logistic regressions show that norms and trust in government (specifically the taxpayer service and fairness components of trust in government) appear to have the most influence on taxpayer compliance behavior. The preparer and tax morale factors also appear to influence the compliance behavior of the subcategory of taxpayers who use preparers.

Analysis of the prevalence of social networks in low-compliant communities yielded mixed results. The region containing a concentration of low-compliant communities had some expected characteristics related to social networks. However, another area turned out to be more charitable.

The "social" nature of norms should be observable even beyond the responses to our community survey, potentially by observing characteristics of the high- and low-compliance communities or regions. Future

research could build upon the survey results by investigating social noncompliance and compliance in sites where they occur. Further investigation would relate to tax administration vis-à-vis regional traditions.

Recommendation

Our analysis confirms the importance of trust in government as reported in the preliminary results, while specifying that taxpayer service is the principal component of the trust factor. This finding lends support to the suggestion in the 2012 report that improvements in taxpayer service could increase voluntary compliance by small business proprietors.

4. THE SERVICE PRIORITIES PROJECT: DEVELOPING A METHODOLOGY FOR OPTIMIZING THE DELIVERY OF TAXPAYER SERVICES

The objective of this report is to present a set of recommendations that will guide the development and implementation of the Service Priorities Project ranking methodology. The goal of the methodology is to identify, from both the government perspective and the taxpayer perspective, the value of each taxpayer service offered by the IRS. The IRS will be able to use this ranking methodology to make resource allocation decisions that will optimize the delivery of taxpayer service activities given resource constraints. Congress will be able to use the results of this methodology to determine whether it is adequately funding core taxpayer service activities. The implementation of this approach is particularly urgent in light of today's funding environment for taxpayer service.

5. FUNDAMENTAL CHANGES TO RETURN FILING AND PROCESSING WILL ASSIST TAXPAYERS IN RETURN PREPARATION AND DECREASE IMPROPER PAYMENTS

The National Taxpayer Advocate has repeatedly written about the need to develop an accelerated information reporting system to enable the IRS to match third-party reports to return data before issuing refunds. The proposed system would benefit tax administration by protecting revenue. The government would avoid issuing erroneous funds and then chasing down the dollars through future enforcement actions. Taxpayers would benefit by avoiding enforcement and collection actions months or even years after filing the returns. Both tax administration and taxpayers would further benefit if the IRS provides taxpayers and their representatives with electronic access to their third-party data before the return filing deadline to assist in tax preparation.

The IRS acknowledged the need to develop an accelerated information reporting system in 2011 through the creation of the IRS Real Time Tax System Initiative. As part of the initiative, the IRS held two public meetings and solicited comments from a variety of impacted stakeholders, all of whom indicated general support for the proposed system. Further, the IRS promised to include the Taxpayer Advocate Service in any further development of the initiative. However, the National Taxpayer Advocate has not seen any progress since.

In this study, we evaluate various options to achieve upfront matching and enable taxpayers to access and download their third-party information into commercial tax preparation software. The evaluations consider the benefits and risks of each option and try to strike a balance to benefit all impacted stakeholders: taxpayers, the IRS, preparers, third-party report issuers, and software companies.

Ultimately, we recognize that changes to return filing and processing of this magnitude require a great deal of forethought, analysis, and stakeholder engagement. To date, the IRS has not made meaningful progress, which only delays the significant benefits we outlined above and throughout this report. Thus, we reiterate our 2009 legislative recommendation that Congress require the IRS and the Department of Treasury to prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party information reporting system. In furtherance of this issue, the National Taxpayer Advocate offers the following preliminary recommendations to develop an accelerated third-party reporting system:

Recommendation 1.1: Provide taxpayers with access to real-time transcripts of third-party data to aid in return preparation.

Recommendation 1.2: Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.

Recommendation 2.1: Develop and implement a one-year pilot to determine if the IRS can screen Form W-2 data as effectively as the Social Security Administration.

Recommendation 2.2: Eliminate the March 31 deadline for e-filed information reports. All information reports, whether e-filed or filed on paper, would be due at the end of February.

Recommendation 2.3: Minimize corrections by creating a \$50 *de minimis* threshold for corrections.

Recommendation 2.4: Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.

Recommendation 3.1: Issue direct deposit and other electronic refunds by April 30 and paper checks by May 31.

6. THE IRS PRIVATE DEBT COLLECTION PROGRAM — A COMPARISON OF PRIVATE SECTOR AND IRS COLLECTIONS WHILE WORKING PRIVATE COLLECTION AGENCY INVENTORY

In 2004, Congress passed the American Jobs Creation Act, which granted the IRS the authority to contract out collection of past due taxes to private collection agencies (PCAs). The original intent of the program was to address the buildup of potentially collectible inventory that was not being worked by the IRS. The PCAs would help collect the aging receivables in exchange for commissions based on the amounts collected.

In September 2006, the IRS began assigning taxpayer accounts to PCAs, but the PCAs' authority to work these cases was limited, given that certain actions are considered inherently governmental and therefore could not be delegated to private entities. For instance, PCAs could not determine or negotiate the amount of a taxpayer's liabilities, and the only cases PCAs could resolve were those in which the amount was not in dispute. The IRS assigned PCAs the following types of cases:

- Cases that involved an individual taxpayer with a balance due for only one tax period and \$25,000 or less due from September to December 2006; and
- Cases that involved an individual taxpayer with a balance due for one or more tax periods and \$100,000 or less due from January 2007 to February 2009.

These cases, called Potential New Inventory (PNI) accounts, fell into three categories:

1. Queue – Accounts awaiting assignment to the collection field function (CFf) but suspended (*i.e.*, not being worked);
2. Shelved – Accounts not being worked due to IRS resource limitations; and
3. Unable to contact or unable to locate (UTC/UTL) – Accounts where the IRS is not able to contact or locate the taxpayer.

The PDC program continued for nearly three years before the IRS ended it. In total, the IRS placed about \$1.8 billion (357,449 tax modules) of outstanding tax liabilities with the PCAs for collection. Upon ending the program, the IRS committed to working the tax modules recalled from the PCAs. This report examines the results the IRS obtained while working the inventory recalled from the PCAs and analyzes whether the IRS or the PCAs performed better when working the PCA inventory.

TAS compared the results for the IRS and PCAs while these entities worked the PCA Inventory. For this analysis, the IRS provided a list of all taxpayers whose accounts were assigned to a PCA, including the dates the cases were assigned to the agency and returned to the IRS. TAS used this list to determine when cases were under PCA control and when they were under IRS control.

TAS used the IRS Accounts Receivable Dollar Inventory (ARDI) to pull data on the balance owed at the time of case assignment, at six-month intervals after assignment, and at resolution for both the PCAs and the IRS. We used the IRS collection status code history file to determine when cases were resolved and what their status was when they returned to the IRS. Finally, we used the IRS Master File transaction history to determine the type and timing of payments received on the account, both while under PCA and IRS control. We broke out offset payments separately, rather than crediting them to the PCAs or IRS, since they happen automatically, rather than as a direct result of PCA or IRS collection efforts.

Because IRS worked the PCA inventory after recall, our analysis comparing IRS and PCA results while working the PCA inventory places the IRS at a significant disadvantage to the PCAs. The liabilities were older on return to the IRS and the PCAs had already had an opportunity to close the easy cases. Thus, outcomes showing superior IRS performance are conservative.

TAS used data supplied by the IRS to identify the tax modules worked by the PCAs and subsequently recalled by the IRS. The analysis does not include the tax modules for several hundred invalid taxpayer identification numbers (TINs) we found in the IRS files. In total, TAS identified 349,586 valid tax modules with tax liabilities totaling about \$1.6 billion; these are the modules included in the analysis. As discussed above, this contrasts with the \$1.8 billion (357,449 tax modules) of outstanding tax liabilities the IRS reported it placed with the PCAs for collection.

We compared PCA and IRS collections during four consecutive six-month intervals following case receipt. The IRS collected about 62 percent more than the PCAs during these two years (\$139.4 million compared to \$86.2 million collected by the PCAs).

The amount the PCAs collected fell precipitously after the first period, especially in comparison to IRS collections. This is consistent with our observation that the PCAs worked all the cases before the IRS, and had an opportunity to close the “easy” cases, *i.e.*, liabilities owed by taxpayers who responded quickly to telephone contact. The above analysis suggests that the PCAs had little success after working the easy cases. In contrast, the IRS continued to collect significant amounts throughout the two-year study period.

It is also noteworthy that the IRS collects significant amounts of money from refund offsets. We calculated that during the two-year periods under study, the IRS collected \$237,694,764 through offsets. This is more than the combined total the PCAs and IRS collected through their collection activities.

TAS study results show that the IRS was significantly more effective than the PCAs in collecting tax liabilities, collecting about 62 percent more than the PCAs during the periods under study. These results likely understate the difference in IRS and PCA effectiveness, since our analysis placed the IRS at a significant disadvantage:

- All of the cases were older when the IRS got them, and the majority were more than two years older.
- The PCAs worked the cases first and collected the easy dollars, while the IRS only got cases the PCAs had already handled.
- The total available to collect over all periods under study was higher for the PCAs.



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