

National Taxpayer Advocate

Annual Report to Congress

*2010 Annual Report to Congress*

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NATIONAL  
TAXPAYER  
ADVOCATE

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2010  
ANNUAL REPORT  
TO CONGRESS

Volume One



YOUR VOICE AT THE IRS

December 31, 2010

National Taxpayer Advocate

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ADVOCATE  
SERVICE

YOUR VOICE AT THE IRS

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*This report is dedicated*

*to*

*the hardy souls*

*who have worked actively over the years*

*for tax reform and tax simplification,*

*and to the busy majority of U.S. taxpayers*

*who are cheering for them to succeed.*

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**Honorable Members of Congress:**

I respectfully submit for your consideration the National Taxpayer Advocate's 2010 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 is my tenth Annual Report to Congress, so it seems a natural time for reflection. What has the report accomplished these last ten years? Perhaps the report's greatest contribution is to make transparent the operations of federal tax administration in the United States. We have tried to fulfill what Congress intended – an uncensored, nonpartisan perspective on the current challenges in tax administration, whether these challenges result from administrative policies and procedures or from legislation. Most notably, the Most Serious Problems section of the Annual Report to Congress discusses in considerable detail not only which problems taxpayers are encountering, but why those problems exist. We also include the IRS's response, so Members of Congress, taxpayers, and practitioners can analyze key challenges from all angles.

Even as we have spotlighted problems in tax administration and challenged the IRS and the Office of Chief Counsel to make more information and guidance available to the public, we in TAS have strived to live up to these high transparency standards ourselves. Each year we list the congressional activity that has taken place with respect to our legislative recommendations, and looking back over the years, the list is quite long.<sup>1</sup> Recently, we began to post on our website the IRS's formal responses to our annual recommendations on Most Serious Problems, and we attempt to track what has been accomplished.<sup>2</sup> We are developing procedures to post information about our year-round advocacy projects as well, so taxpayers and policymakers can see what is underway and what has been accomplished, including improvement projects undertaken jointly by the IRS and the Taxpayer Advocate Service.

The point of all this transparency is not for policymakers and commentators inside and outside the IRS to agree with us (although of course we love it when they do). Rather, we are often raising emerging issues or advocating for approaches that the IRS has not explored. Thus, the point is to begin a dialogue about what is the right answer in a given situation, and to ensure that everyone taking part in that dialogue has sufficient information with which to make up his or her own mind about the desired outcome or approach. There have certainly been times in my tenure as the National Taxpayer Advocate when the IRS has not been permitted to publicly agree with us – even though there may be private agreement – because our position conflicts with one or another Administration's position. Other times, the IRS just won't agree to something because it is content in its established ways and it is just too difficult or unsettling to think outside the box. (I see this most often in collection, as I discuss below.) I can understand the IRS reaction – the pressure to produce immediate revenue collection results may seem to weigh more heavily than the longer term

<sup>1</sup> For this year's listing of legislative activity, see the introduction to the section on Legislative Recommendations, *infra*.

<sup>2</sup> <http://www.irs.gov/advocate/article/0,,id=171153,00.html>.

benefits to be derived from carefully designed research studies and the like, but that sort of thinking means the important work required to improve long-term compliance often doesn't get done.

Having said that, when the IRS does decide to do something, and especially when it decides to work with TAS, good things can happen for taxpayers. For example, when we first proposed regulation of return preparers in 2002, the IRS vigorously opposed the concept.<sup>3</sup> It was not until Commissioner Shulman selected this issue to be one of his major initiatives that the IRS was able to work on an issue that for years it had internally recognized was vitally necessary. Once able to address it, the IRS moved swiftly to establish a regulatory approach. And because TAS was involved on a day-to-day basis in the planning and design of the initiative, we were able to ensure that our concerns were addressed and the interests of taxpayers were given priority.

So, what are the challenges that I see for the IRS over the next ten years? First, the overwhelming complexity of the Internal Revenue Code and the tax administration system that complexity has spawned. Second, the successful integration of social program and incentive delivery into the IRS's traditional revenue collection structure. Third, the movement toward greater automation at the expense of human and personal interaction with taxpayers, including the elimination of common sense, good judgment, and discretion in decision-making. Nowhere is this latter challenge seen more clearly than in the IRS's reactive, regimented approach to enforced tax collection that values numbers and checklists over truly assisting taxpayers with their devastating tax debts and helping them become voluntarily compliant taxpayers in the long term. I will briefly discuss these three challenges in reverse order.

***Automation should facilitate IRS interaction with taxpayers, not diminish it – particularly in its Examination and Collection practices.***

As the leader of over 2,000 employees who daily deal with multiple cases, issues, and tasks, multiple systems, multiple operating divisions and offices, and multiple Internal Revenue Manual (IRM) provisions and other guidance, I am the first to acknowledge that automation in today's IRS can be a sanity-saver and an absolute necessity. But for all the benefits of automation, if we do not carefully monitor how it is used, it can become a barrier instead of an aid to communicating with taxpayers and providing them assistance. For example, as we discuss in our Most Serious Problems, *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review* and *The IRS's Over-Reliance on its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Determinations*, automation can substitute for judgment and discretion, to the taxpayer's detriment. Moreover, because policies programmed into decision-tree tools are not subjected to the same rigorous internal clearance process as are policies established in the IRM, these programs can result in decisions and determinations that harm taxpayers and that IRS employees, following the law and their good judgment, would not arrive at. Finally, because the IRS does not have an adequate cadre of employees who are trained and knowledgeable in artificial intelligence and other decision sciences, the IRS's automated decision tools all too often are static and not updated often enough or accurately enough to prevent repeated mistakes.

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<sup>3</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 216 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

Automated case processing also undermines human contact in the IRS correspondence examination program<sup>4</sup> and in IRS collection activities such as lien determinations.<sup>5</sup> As we have reported for years, over 75 percent of individual audits are conducted as correspondence examinations<sup>6</sup> – which means that unless a taxpayer mails documentation timely in response to the IRS’s cryptic audit letters, the audit will just plow along on autopilot without any human being looking at the case or attempting to place an outbound phone call to the taxpayer, until the Statutory Notice of Deficiency is issued (automatically) proposing an assessment of tax. All too often the taxpayer has sent in information that the IRS has not associated with the taxpayer’s case in time to stop the issuance of the (automated) Notice of Deficiency.

Ironically, as we cover in detail in our Most Serious Problems discussing undelivered mail<sup>7</sup> and the IRS’s untimely handling of incoming taxpayer mail,<sup>8</sup> if the IRS were to apply some of the automated search, updating, and tracking tools available to it through the United States Postal Service and other entities, it would do a much better job in delivering important notices to taxpayers where they actually live, thereby increasing the chances that the taxpayer will respond timely. These tools could also free up resources currently dedicated to rework and thus enable the IRS to reach out and call the taxpayer. A little human contact and conversation can work wonders in understanding the taxpayer’s financial circumstances.

With respect to collection – we have covered this area of tax administration so much over the last ten years that the footnote containing our writings fills up nearly half a page.<sup>9</sup> Why have we focused so much on collection? Well, because collection is when taxes cease to be abstract and become personal and real for millions of taxpayers. And collection is where, if not handled appropriately, real and lasting harm can be visited upon taxpayers – destroying people’s lives and businesses. It is also where the IRS’s dedication to taxpayer rights is the most tested.<sup>10</sup>

Collection requires a delicate balancing of the government’s interest in collecting revenue and ensuring that all taxpayers pay their fair share of tax, on the one hand, and the legitimate interests of taxpayers with financial difficulties, on the other. Congress articulated this balance in a section of the tax code that directs the IRS, albeit in the context of Collection Due Process hearings, to consider whether any proposed collection action “balances the need for the efficient collection of taxes with

<sup>4</sup> See, e.g., Most Serious Problem: *The IRS’s Failure to Track and Analyze the Outcomes of Audit Reconsiderations and Inconsistent Guidance Increase Taxpayer Burden and Inflate IRS Audit Results and Cost Effectiveness Measures*, *infra*.

<sup>5</sup> See Status Update: *The IRS Has Been Slow to Address the Adverse Impact of its Lien-Filing Policies on Taxpayers and Future Tax Compliance*, *infra*; Most Serious Problem: *IRS Collection Policies Channel Taxpayers into Installment Agreements They Cannot Afford*, *infra*; and *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*, vol. 2, *infra*.

<sup>6</sup> IRS Databook FY 2009, Table 9a.

<sup>7</sup> See Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*, *infra*.

<sup>8</sup> See Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*, *infra*.

<sup>9</sup> See vol. 2, *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*, note 22, *infra*.

<sup>10</sup> We discuss the IRS’s inadequate implementation of significant taxpayer rights protections in the following Most Serious Problems: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*, *The Failure of the Office of Appeals to Adequately Document Prohibited Ex Parte Communications May Violate Taxpayer Rights and Damage the Public’s Perception of its Independence*, and *The IRS’s Failure to Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered*, *infra*.



the legitimate concern of the person that any collection be no more intrusive than necessary.”<sup>11</sup> At present, many IRS collection practices do not require much balancing. For example, IRS lien filing policies focus almost exclusively on tax collection without regard for the legitimate concern of affected persons that collection actions be no more intrusive than necessary.

Since 1999, the IRS has increased annual lien filings from 168,000 to 1,096,000, a rise of 550 percent. Lien filings can badly damage or destroy a taxpayer’s creditworthiness because they are picked up by the credit rating agencies and retained on the taxpayers’ credit reports for seven years from the date the tax liability is resolved, or longer if it is not resolved.

If lien filings were clearly correlated with substantial increases in revenue collection, one could at least understand the IRS’s position. But over the same period that the IRS has increased lien filings by 550 percent, revenue collected by the IRS’s Collection function has remained flat. Moreover, in last year’s report and in a status update this year, we have described in detail that the IRS has failed to code many payments from taxpayers against whom liens have been filed, making it impossible for the IRS to determine how much revenue its liens bring in.<sup>12</sup> In fact, the IRS must pay filing fees to local county clerks’ offices and incurs its own costs, making it questionable whether liens generate much, if any, direct revenue. By damaging taxpayers’ creditworthiness, the IRS may even be reducing long-term revenue collection.

Despite the IRS’s periodic announcements of plans to assist financially struggling taxpayers with collection problems, the IRS has refused our repeated requests to moderate its lien filing policies and to conduct in-depth research to determine their effectiveness and their impact on long-term taxpayer compliance. Although the IRS has taken a few steps in that direction during the past year, it has reached no conclusions and has continued the trend toward more lien filings despite the worst economy in at least a generation. The IRS still has no idea whether or to what extent liens contribute to the efficient collection of taxes, and it therefore still does not know whether it is balancing the need for the efficient collection of taxes with the legitimate concern of taxpayers that any collection action be no more intrusive than necessary.

Lien filing is not the only area in collection about which we are concerned. Between FY 2006 and FY 2010, the IRS’s inventory of unpaid assessments has grown almost 33 percent;<sup>13</sup> the dollars reported as “currently not collectible” (CNC) increased by 78 percent;<sup>14</sup> the number of taxpayer accounts reported as CNC increased by 73 percent;<sup>15</sup> and the dollar value of Taxpayer Delinquent

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<sup>11</sup> IRC § 6330(c)(3)(C) (cross referenced by IRC § 6320(c)).

<sup>12</sup> See Status Update: *The IRS Has Been Slow to Address the Adverse Impact of its Lien-Filing Policies on Taxpayers and Future Tax Compliance*, *infra*. See also National Taxpayer Advocate 2009 Annual Report to Congress 17 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*); and National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2., *The IRS’s Use of Notices of Federal Tax Lien (NFL)*.

<sup>13</sup> Unpaid assessments were about \$270 billion in FY 2006 and \$359 billion FY 2010. IRS, *Collection Process Study, Executive Summary 2* (Sept. 30, 2010). The data for the unpaid assessments at the conclusion of FY 2010 was provided by SB/SE in an e-mail message dated Dec. 14, 2010.

<sup>14</sup> CNC dollars were \$16.2 billion in FY 2006 and \$28.9 billion in FY 2010. IRS, *Collection Activity Reports, NO-5000-149, Recap of Accounts Currently Not Collectible Report* (Oct. 2010).

<sup>15</sup> *Id.*

Accounts (TDAs) assigned to the Collection Queue increased by 70 percent.<sup>16</sup> In FY 2010, the dollars reported as CNC by the collection Field function (CFf) were approximately 320 percent of the combined total of dollars collected on open CFf TDAs and installment agreements generated by the CFf.<sup>17</sup> Yet the IRS's enforcement budget has grown by 20 percent since FY 2006.<sup>18</sup>

Something is clearly wrong with this picture. Sadly, IRS collection practices have not evolved or entered the 21<sup>st</sup> century. As any near-retirement collection employee will tell you, and as we demonstrate throughout this report, the IRS is still approaching collection with the same one-size-fits-all approach that it used 30 or 40 years ago. Meanwhile, the taxpayer population has changed considerably over those years. Forty years ago, the Earned Income Tax Credit (EITC) did not exist. Today, over 65 million low income taxpayers are part of the tax system, many of them required to file in order to claim the EITC.<sup>19</sup> There are more self-employed taxpayers than ever, many of them in marginal businesses – with the attendant difficulties of paying estimated income and self-employment taxes.<sup>20</sup> For each of these populations, the IRS faces different challenges to bring these taxpayers into ongoing voluntary compliance, ensuring they do not dig themselves into more debt and address the tax arrears. To be a world-class 21<sup>st</sup> century tax administrator, the IRS must be flexible in its approach to tax debt, and its overriding objective must be to increase long-term voluntary compliance. In our Volume 2 discussion, *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*, we set forth a comprehensive analysis of how the IRS could reform its practices in order to achieve this goal.

***The IRS should revise its approach to social programs and incentives administered through the Code.***

Over the last decade, the Internal Revenue Code has become filled with special incentives and programs that benefit groups of individual and business taxpayers.<sup>21</sup> These provisions are known as “tax expenditures.”<sup>22</sup> They can take many forms, including deductions, credits, or preferential

<sup>16</sup> The dollar value of TDAs assigned to CFf was about \$46.2 billion at the end of FY 2010. IRS, Collection Activity Reports NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010). 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).

<sup>17</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010); IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010).

<sup>18</sup> U.S. Department of the Treasury, *Budget in Brief, Internal Revenue Service*, available at [www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS). The IRS's appropriations for “Enforcement – Exam and Collections” for FY 2006 and FY 2010 were approximately \$3.9 billion and \$4.7 billion respectively.

<sup>19</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2009). For this purpose, we consider “low income” to mean adjusted gross incomes that do not exceed 250 percent of the Federal Poverty Level. See IRC § 7526(b)(1)(B)(i). Family sizes were computed using the total number of exemptions reported on taxpayer returns.

<sup>20</sup> The number of small businesses with one to four employees has increased by 16 percent since 1993, from 2.3 million to 2.7 million. See U.S. Department of Labor, Bureau of Labor Statistics, Business Employment Dynamics data, Table G, available at [http://www.bls.gov/bdm/table\\_g.txt](http://www.bls.gov/bdm/table_g.txt).

<sup>21</sup> The Congressional Budget Office (CBO) has estimated that refundable credits will increase by approximately \$500 billion over the next ten years. Doug Elmendorf, CBO, *Federal Budget Challenges* (Apr. 20, 2009), available at <http://www.cbo.gov/ftpdocs/100xx/doc10093/04-20-Harvard.pdf> (last visited Aug. 23, 2010). From 1974 to 2004, tax expenditures more than doubled in number from 67 to 146 and tripled in size from \$243 to \$728 billion. Government Accountability Office, GAO-05-690, *Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Examined* 21-31 (Sept. 2005). Currently, there are over 170 tax expenditures worth approximately \$1.1 trillion. See Ofc. of Mgmt. & Budget, *Budget of the United States Government FY 2011, Analytical Perspectives*, Ch. 16 (Tax Expenditures), Table 16-1 at 209-13. Approximately one quarter of government spending consists of tax expenditures. See Thomas L. Hungerford, *Tax Expenditures and the Federal Budget*, at 17, Cong. Res. Serv., RL34622 (Aug. 19, 2008).

<sup>22</sup> For a detailed discussion of tax expenditures, see *Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*.

tax rates. While some are easy for the IRS to administer – they are simply a matter of using information reported on the tax return and checking it against third party information reporting – others require information to which the IRS does not have access, thereby requiring it to do extensive and intrusive auditing in order to ensure compliance. Some of these provisions are designed to assist low income populations, which present socio-economic, education, mobility, and functional and language literacy challenges. When the tax administrator is tasked with delivering benefits to this population – and charged with ensuring compliance with the eligibility rules and guarding against fraud – the IRS’s traditional revenue collection approach just doesn’t work. Something different is needed – an approach that recognizes that the IRS no longer is just a revenue collection agency but is also a benefits administrator.

As we discuss in our Most Serious Problem on the IRS mission statement, this dual mission is not an abstract concept.<sup>23</sup> Recognition that the IRS delivers significant social benefits to diverse populations (including small businesses and low income taxpayers) means that the IRS must hire employees that have program area expertise and the skillset to deal with benefits delivery rather than tax enforcement. Making the IRS’s dual mission explicit in its mission statement would also make clearer that the IRS must be properly funded to accomplish both of these tasks well; it cannot do them both by simply robbing tax enforcement to pay for new incentive programs. The urgency for this recognition is nowhere more apparent than in the challenge the IRS faces in successfully fulfilling its role in health care reform, which we describe in Volume 2, *The Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform*. The IRS can do this, but it will need a different type of employee to deliver this program – one with a social service background, not just more revenue agents or revenue officers – and it will require sufficient resources.

### ***The time for tax reform and tax simplification is now.***

What is left to be said about tax reform and simplification? We all know we need it. I will not outline here the stunning statistics about the hours and costs required of each taxpayer to deal with his or her taxes, nor will I discuss the major industry of return preparation that has grown up around this complex tax code. Our number one most serious problem and number one legislative recommendation go into the data in detail and provide a good sense of what tax complexity does to each and every one of our lives.<sup>24</sup> It is not good.

But if we all agree that tax reform is necessary, why hasn’t it happened? Well, our answer to this question is that we are all unwilling to acknowledge the strong vested interests each of us has in the current structure. Tax complexity doesn’t occur just because of “big money” special interests. It occurs because of the tax provisions that benefit each one of us. We are the special interests. And until we acknowledge that, tax reform discussions will deteriorate into shouting matches and finger pointing about cutting “their” special tax breaks and not “ours.”

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<sup>23</sup> See Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs, infra*.

<sup>24</sup> See Most Serious Problem: *The Time for Tax Reform is Now, infra*; and Legislative Recommendation: *Enact Tax Reform Now, infra*.

The road to true tax reform requires each and every one to be willing to stop protecting our own tax breaks long enough to begin a dialogue about what we want our system to look like, so we remain a vibrant nation with a tax system that is transparent to its taxpayers – one that is simpler to understand and to comply with. If we want to run business incentives or social programs through that system, then we need to have a way to evaluate those programs so we can describe to the taxpayers what is being done and how effective those programs are. In short, as we discuss in our number one Most Serious Problem and the Volume 2 piece on tax expenditures, tax reform requires great discipline and transparency about this type of spending through the code, or else we risk losing faith with our taxpayers.

As part of this dialogue about tax reform, we must remember why we have taxes in the first place: The federal government raises funds to provide protection and services to its citizens and residents primarily through taxes. We can all have different visions about the types and scope of government protection and services we want. But the fact is, without taxes, the government can do nothing for its citizens.

So let us start this dialogue with the recognition that some level of taxation is necessary. As we continue that dialogue by discussing the structure of the tax system, let us also discuss the current tax system. By identifying aspects of the current system that cause complexity or excessive frustration, we can better design the new one.

To help this dialogue along, we are doing something unique, as near as we can tell, in tax administration. The Taxpayer Advocate Service is establishing a vehicle to receive taxpayers' suggestions about tax reform. Taxpayers will be able to access this site at <http://www.taxpayeradvocate.irs.gov> through our newly designed Internet site dedicated to taxpayer rights and education. We ask that taxpayers approach this with the frame of mind that everything – even the tax breaks that benefit them or their businesses personally – should be on the table. What would they be willing to give up if they knew that others are giving up their breaks and the end result would be a much simpler system – one in which the average taxpayer might be able to prepare his or her own tax return? What particular provisions of the existing tax system are especially burdensome or seem particularly unfair? So, let us know. We promise to track these suggestions and post them, periodically, thereby helping to further the cause of tax reform and tax simplification.

Respectfully submitted,



Nina E. Olson  
National Taxpayer Advocate  
31 December 2010

# National Taxpayer Advocate 2010 Annual Report to Congress

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