Introduction: Legislative Recommendations

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

The chart immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate proposed in her 2001 through 2009 Annual Reports to Congress.[1] 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. The following discussion details recent legislative activity incorporating proposals made by the National Taxpayer Advocate. The discussion is broken into two categories: Legislation Promoting Taxpayers' Rights and Legislation to Reduce the Tax Gap.

Legislation Promoting Taxpayers' Rights

- **Amend IRC § 6707A Penalty for Listed Transactions.** In 2008, the National Taxpayer Advocate raised concerns regarding the impact of IRC § 6707A.[2] At that time, section 6707A imposed a penalty of $100,000 per individual per year and $200,000 per entity per year for failure to make special disclosures of a "listed transaction." The penalty applies even if the taxpayer had no knowledge that the transaction was listed or questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not "listed" until years after the taxpayer entered into, and filed a return reflecting, the transaction. The National Taxpayer Advocate recommended that Congress amend IRC § 6707A so that the amount of the penalty bears a proportional relationship to the amount of any tax savings realized. This year, Congress provided relief along the lines we proposed. The Small Business Jobs Act of 2010, which was signed into law, generally sets the penalty amount as a percentage of the tax savings resulting from the transaction.[3]
- **Improve Offer in Compromise Program Accessibility.** In 2006, the National Taxpayer Advocate recommended that Congress modify IRC § 7122(c) so that taxpayers are not required to include a partial payment with certain applications to the offer in compromise (OIC) program.[4] On April 14, 2010, the House passed the Taxpayer Assistance Act of 2010, which would repeal the 20 percent down payment requirement for submissions of offers in compromise.[5]

1 An electronic version of the chart is available on the TAS website at http://www.irs.gov/advocate.
2 National Taxpayer Advocate 2008 Annual Report to Congress 414-422.
3 Pub. L. No. 111-240, § 2041 (2010).
4 National Taxpayer Advocate 2006 Annual Report to Congress 507-519.
5 H.R. 4994, 111th Cong. (2010).

- **Allow Self-Employed Taxpayers to Deduct Health Insurance Premiums.** In 2004, the National Taxpayer Advocate recommended a suite of proposals to alleviate some of the significant burdens the tax code imposes on small businesses, including a recommendation allowing self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.[6] The Small Business Jobs Act of 2010, which was signed into law in 2010, allows self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.[7]
- **Repeal or Index the Alternative Minimum Tax.** In 2003, the National Taxpayer Advocate designated the alternative minimum tax (AMT) as the most serious problem faced by taxpayers.[8] The AMT, originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions, has morphed into a second layer of taxation that increasingly affects middle-income taxpayers. In 2008, the National Taxpayer Advocate reiterated her recommendations that Congress repeal the AMT or revamp it substantially to achieve its original objective.[9] In 2010, legislation was introduced calling either for outright repeal of the AMT[10] or for the tax to be indexed for inflation.[11] In December, Congress passed legislation that included an additional two-year "patch" consisting of higher exemption amounts.[12]
- **Promote Awareness of and Access to Low Income Taxpayer Clinics (LITCs).** The National Taxpayer Advocate has repeatedly stressed the importance of LITCs and has asked the IRS to promote the services of LITCs and educate taxpayers about their existence.[13] The Taxpayer Assistance Act of 2010, passed by the House, authorizes the IRS to refer taxpayers to specific LITCs and increases the authorization for LITCs.[14] In addition, the Taxpayer Bill of Rights Act of 2010 (TBOR 2010) contains numerous LITC provisions, including increasing funding for LITCs, authorizing the promotion of LITCs, authorizing IRS employees to refer taxpayers to specific clinics, and including information about LITCs in notices of deficiency and collection due process notices.[15]
- **Provide greater protections for taxpayers using return preparers.** In 2002, the National Taxpayer Advocate recommended that Congress enact a registration, examination, certification, and enforcement program for federal tax return preparers.[16] The National Taxpayer Advocate reiterated these concerns in 2003.[17] In 2007, the National

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6 *See* National Taxpayer Advocate 2004 Annual Report to Congress 386-402; National Taxpayer Advocate 2001 Annual Report to Congress 223.

7 Pub. L. No. 111-240 (2010).

8 National Taxpayer Advocate 2004 Annual Report to Congress 5-19.

9 National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (and prior reports cited therein).

10 S. 3018, 111th Cong. (2010).

11 *See* S. 3223, 111th Cong. (2010); H.R. 5077, 111th Cong. (2010).

12 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, Pub. L. No. 111-312, § 202 (2010).

13 *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress 231-241.

14 H.R. 4994, 111th Cong. (2010).

15 S. 3215 111th Cong. (2010); H.R. 5047 111th Cong. (2010).

16 *See* National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

17 *See* National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

Taxpayer Advocate expressed her concern over the exploitation of taxpayers by preparers selling refund anticipation products[18] and urged the IRS to increase its enforcement of penalties on return preparers.[19] The National Taxpayer Advocate criticized the IRS for its lack of a servicewide return preparer strategy in her 2009 Annual Report to Congress.[20] TBOR 2010, introduced in the House and Senate, would address these concerns by explicitly authorizing the IRS to regulate federal income tax preparers, increasing preparer penalties, extending preparer penalties to preparation of OICs and financial statements, and regulating refund delivery products such as refund anticipation loans.[21] TBOR 2010 also would improve refund service for taxpayers by reducing refund delivery times and delivering tax refunds on debit cards,[22] which may lessen the incentive for taxpayers to purchase refund delivery products.

- **Strengthen taxpayer protections for the filing of federal tax liens.** In her 2009 Annual Report to Congress, the National Taxpayer Advocate recommended requiring the IRS to take certain steps prior to filing a lien.[23] Specifically, the IRS should have to review a taxpayer's information, weighing all the facts and circumstances, and make a determination that the lien will attach to property and that the benefit to the government outweighs the possible harm to the taxpayer and does not jeopardize the taxpayer's future ability to comply.[24] The Targeted Tax Lien Act of 2010 would require the IRS to take the steps we have recommended.[25] In addition, TBOR 2010 would require individualized lien determinations and supervisory review before the IRS can file a notice of federal tax lien.[26]
- **Codify a Taxpayer Bill of Rights.** The United States tax system is based on a tacit understanding between the government and its taxpayers that taxpayer protections encourage taxpayers to voluntarily comply with their tax obligations and protect them when they err. In her 2007 Annual Report to Congress, the National Taxpayer Advocate asked Congress to codify a taxpayer statement of rights in order to make explicit taxpayers' rights and responsibilities.[27] TBOR 2010, introduced in both the House and Senate, codifies a taxpayer statement of rights.[28]
- **Authorize the IRS to make *de minimis* apology payments to taxpayers.** In 2007, the National Taxpayer Advocate recommended that Congress give the IRS authority to make *de minimis* apology payments to taxpayers who had been seriously mistreated

18 *See* National Taxpayer Advocate 2007 Annual Report to Congress 83-95.

19 *See id.* at 140-155.

20 *See* National Taxpayer Advocate 2009 Annual Report to Congress 41-69 (Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*).

21 S. 3215 111th Cong. (2010); H.R. 5047 111th Cong. (2010); *see also* H.R. 4994, 111th Cong. (2010) (allowing delivery of tax refunds on credit cards).

22 *Id*.

23 *See* National Taxpayer Advocate 2009 Annual Report to Congress 358.

24 *See Id*.

25 H.R. 6439, 111th Cong. (2010).

26 S. 3215, 111th Cong. (2010); H.R. 5047 111th Cong. (2010).

27 *See* National Taxpayer Advocate 2007 Annual Report to Congress 478-489.

28 S. 3215 111th Cong. (2010); H.R. 5047 111th Cong. (2010).

by the IRS. The authority would be vested solely in the National Taxpayer Advocate and would be nondelegable. To qualify for an apology payment, a taxpayer would have to meet established criteria and each case would have to meet the definition of significant hardship contained in IRC § 7811. The Taxpayer Advocacy and Government Accountability Promotion (TAX GAP) Act of 2010, introduced in the Senate, would create a pilot program that would allow the IRS to issue an apology payment in any case where the National Taxpayer Advocate determines that the IRS has caused an excessive or undue burden on the taxpayer.[29]

Legislation to Reduce the Tax Gap

- **Require Form 1099 Reporting for Incorporated Service Providers.** As part of a 2008 legislative recommendation on worker classification, the National Taxpayer Advocate recommended that Congress require service recipients to issue Forms 1099-MISC to incorporated service providers and increase the penalties for failure to comply with the information reporting requirements. The Patient Protection and Affordable Care Act, signed into law on March 23, 2010, reflected this recommendation, eliminating a reporting exemption for payments to corporate providers of property and services.[30]
- **Eliminate the $10 minimum on interest reporting for financial institutions.** In her 2007 Annual Report to Congress, the National Taxpayer Advocate addressed the problem of the cash economy and proposed both administrative and legislative recommendations to reduce the tax gap. One recommendation was to eliminate the $10 interest threshold beneath which financial institutions are not required to file Form 1099-INT reports with the IRS.[31] The TAX GAP Act of 2010 would enact this recommendation by repealing the $10 threshold and requiring the reporting of non-interest bearing financial accounts.[32]
- **Revise Form 1040, Schedule C to break out gross receipts reported on payee statements such as Form 1099.** In the 2007 Annual Report, the National Taxpayer Advocate recommended that the IRS add a line to Schedule C so that taxpayers would separately report the amount of income reported on Forms 1099 and other income not reported on Forms 1099.[33] This change to Schedule C could improve both voluntary compliance and audit selection and efficiency. The TAX GAP Act of 2010 would require the IRS to implement this recommendation.[34]
- **Include a checkbox on business returns requiring taxpayers to verify that they filed all required Forms 1099.** In 2007, the National Taxpayer Advocate recommended that

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[29] S. 3795, 111th Cong. (2010).

[30] Pub. L. No. 111-148 § 9006 (2010). However, this Act also contained a reporting requirement for goods sold, which the National Taxpayer Advocate opposes because of the enormous burden it places on businesses. *See* Legislative Recommendation: *Repeal the Information Reporting Requirement for Purchases of Goods over $600, but Require Reporting on Corporate and Certain Other Payments, infra*.

[31] *See* National Taxpayer Advocate 2007 Annual Report to Congress 501-502.

[32] S. 3795, 111th Cong. (2010).

[33] *See* National Taxpayer Advocate 2007 Annual Report to Congress 40.

[34] S. 3795, 111th Cong. (2010).

the IRS require all businesses to answer two questions on their income tax returns: "Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business? If yes, did you file all required Forms 1099?"[35] The TAX GAP Act of 2010 would require the IRS to study whether placing a checkbox on business tax returns, or a similar indicator as discussed above, would affect voluntary compliance.[36]

- **Require voluntary withholding and backup withholding on certain payments upon request.** Previously, the National Taxpayer Advocate recommended that the IRS pursue authority for voluntary withholding agreements between independent contractors and service recipients as a mechanism to reduce the number of nonfilers, and that payors be required to commence backup withholding if they do not receive verification of a payee's TIN.[37] The TAX GAP Act of 2010 would require voluntary withholding on certain payments upon request of the payee and would require a payor to begin backup withholding if the IRS has not verified that the TIN furnished was correct.[38]

SUMMARY OF 2010 LEGISLATIVE RECOMMENDATIONS

We continue to advocate for the proposals we have made previously. In this report, we present eleven additional legislative recommendations, which are summarized below.

1. **Enact Tax Reform Now.** In the first section of this report, the National Taxpayer Advocate identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and described the sources and impact of tax law complexity. In this section of the report, the National Taxpayer Advocate recommends that Congress make fundamental tax reform a high priority and approach reform in a manner similar to zero-based budgeting. To start out, the assumption should be that all tax expenditures would be eliminated unless a compelling business case can be made that the benefits of providing a tax incentive through the code outweigh the tax-complexity challenges that special rules create. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure.

   The National Taxpayer Advocate further recommends that Congress place special emphasis on the protection of taxpayer rights and the minimization of burden. She suggests six core principles that should guide tax reform:

   1. The tax system should not "entrap" taxpayers.

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35 National Taxpayer Advocate 2007 Report to Congress 40.

36 S. 3795, 111th Cong. (2010).

37 *See* National Taxpayer Advocate 2007 Annual Report to Congress 493-494; National Taxpayer Advocate 2005 Annual Report to Congress 238-248.

38 S. 3795, 111th Cong. (2010).

2. The tax laws should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions.
3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many.
5. Where the tax laws provide for refundable credits, they should be designed in a way that the IRS can effectively administer; and
6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.

2. **Repeal the information reporting requirement for purchases of goods over $600, but require reporting on corporate and certain other payments.** Under a provision of the health care bill enacted into law in 2010, any business that purchases $600 or more of goods from a single vendor during the course of a calendar year will have to file an information report with the IRS. Generally, third-party information reporting to the IRS significantly increases compliance by the taxpayer who receives the reported amount, thus helping to reduce the tax gap. In this case, however, the National Taxpayer Advocate is concerned that the new requirement for information reporting on goods will create a widespread administrative burden that is disproportionate to the value of the information for the IRS. We therefore recommend that Congress amend IRC § 6041 to repeal the requirement for information reports with respect to purchases of goods (as well as property of any sort). However, we also recommend that Congress retain the new requirement for information reports with respect to payments to corporations for services, determinable gains, or other income.[39] In the context of reassessing this reporting provision, we further recommend that Congress consider expanding third-party information elsewhere by eliminating the $10 threshold for certain bank information reports and by pursuing certain state data.
3. **Allow taxpayers to request equitable relief under IRC §§ 6015(f) or 66(c) at any time before the period of limitations on collection expires, and allow taxpayers to raise innocent spouse relief as a defense in collection actions.** Married taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due. Spouses who live in community property states and file separate returns are generally required to report half of the community income on their separate returns. IRC §§ 6015 and 66, sometimes referred to as the "innocent spouse" rules, provide relief, including "traditional," "allocated," and "equitable" relief, from joint and several liability and from the operation of community property rules. Under IRC § 6015, both traditional and

[39] The National Taxpayer Advocate has long supported information reporting as a means to increase compliance. *See* National Taxpayer Advocate 2004 Annual Report to Congress 483; National Taxpayer Advocate 2005 Annual Report to Congress 394-396; National Taxpayer Advocate 2007 Annual Report to Congress 494-496; National Taxpayer Advocate 2008 Annual Report to Congress 388.

allocated relief claims must be made within two years after the IRS initiates collection activity with respect to the taxpayer. However, neither IRC § 6015 nor IRC § 66 requires taxpayers to request equitable relief within a specified time. Nevertheless, a Treasury regulation imposes the two-year deadline for traditional and allocated relief on taxpayers claiming IRC §6015(f) equitable relief. Additional IRS guidance imposes the same deadline for claims for equitable relief from the operation of community property rules under IRC § 66. Taxpayers who seek equitable relief after the two-year period and otherwise qualify for such relief (including those who meet the requirements of traditional or allocated relief but for missing the statutory two–year deadline specifically stated in those provisions) are harmed because relief is foreclosed in situations for which IRC § 6015(f) was intended to provide a "safety valve," *e.g.*, where the delay was due to deceit or intimidation by a joint filer. The National Taxpayer Advocate recommends that Congress amend the Code to specify that taxpayers may request equitable relief under IRC §§ 6015(f) and 66(c) at any time before the expiration of the period of limitations on collection and that taxpayers may request innocent spouse relief as a defense in collection actions.

4. **Amend IRC § 6050P to remove the 36-month nonpayment period from a list of triggering events requiring a creditor to issue a Form 1099-C.** A creditor that cancels a debt is generally required to report that amount to the IRS on Form 1099-C, *Cancellation of Debt*, and a taxpayer whose debt is canceled must generally include the amount canceled in his or her income when filing a tax return. However, current Treasury regulations create a presumption that a 36-month period in which the debtor does not make a payment is a "triggering event" that requires the creditor to issue a Form 1099-C, even where the creditor is not actually discharging the debt. Thus, the creditor may be collecting the debt even as the IRS asserts the taxpayer owes additional tax based on the reported cancellation. The National Taxpayer Advocate recommends that Congress amend IRC § 6050P to remove the 36-month regulatory "testing period" as a basis on which to issue a Form 1099-C.

5. **Amend IRC § 3402(p) to require withholding on payments made for lost earnings or profits from disasters.** In significant disasters, affected taxpayers make hundreds of thousands of claims against responsible parties under federal and state laws and receive billions of dollars in payments. A vast majority of these claim payments are compensation for lost earnings or profits resulting from the disaster. Damages for non-natural disasters are generally includible in the recipient's gross income. However, unlike the wages they replace, the payments are not subject to federal income tax withholding, nor does current law allow voluntary withholding on these payments. As a result, many disaster victims with little or no experience making quarterly estimated tax payments will face a surprise year-end tax liability that they could have avoided through withholding. This situation causes hardship to taxpayers, not only because of the taxes owed, but because of the additional penalties, interest, and IRS collection actions. The National Taxpayer Advocate recommends amending IRC § 3402(p) to make withholding mandatory for payments made for lost earnings or profits from disasters.

6. **Enact a statute of limitations to limit the retroactive effect of revocation of an organization's exempt status.** Generally, charities enjoy tax-exempt status with accompanying benefits. A charity that fails to function as described in IRC § 501(c)(3), however, may lose exempt status through an IRS process known as revocation. When this occurs, the IRS typically audits a charity to determine how it operates, then revokes its exempt status and assesses tax as of the date the requirements for exemption are not satisfied. A revocation affects exempt status, but is not an assessment of tax subject to a statute of limitation, which generally limits assessment to three years after filing of the tax return. This creates a procedural loophole through which the IRS may revoke an organization's exempt status for time-barred years (*i.e.*, those for which it cannot collect additional tax). Even if a revoked organization complies with IRS requirements and then re-applies for exempt status, certain funding sources or program qualifications may have lapsed upon revocation, impeding future operation as a charity. The National Taxpayer Advocate recommends that Congress enact a statute of limitation for revocation of exempt status, generally three years, which would run from the filing of the return for the year in question. In case of substantial omission of items from the return, the statute would run for six years, and in case of fraud, tax evasion, or non-filing of the return, the statute of limitation would not run. The time-bar would apply not only to the effective date of revocation but also to the introduction of past facts as a reason for revocation.
7. **Refine whistleblower procedures to better protect taxpayer privacy while providing necessary information to whistleblowers.** Generally, tax return information is confidential, even if the IRS finds a deficiency, unless judicial proceedings ensue. However, whistleblower claims create a loophole by allowing public disclosure of this information without the taxpayer's knowledge or consent in proceedings to which the whistleblower – but not the taxpayer – is a party. The National Taxpayer Advocate recommends that Congress amend IRC § 7623 and other applicable provisions to require redaction of third-party return information in administrative and judicial proceedings on a whistleblower claim, with an opportunity for the taxpayer to request further redactions before disclosure. The taxpayer would have a subsequent right of action for civil damages for unauthorized disclosure by the whistleblower.
8. **Revise the willfulness component of the trust fund recovery penalty.** Employers are generally required to withhold employment taxes and certain types of excise taxes, often called "trust fund" taxes, from payments to employees. IRC § 6672 provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against defined "responsible persons" when these monies are not paid as required. To establish liability for this penalty, the IRS must conclude that the failure to pay the trust fund taxes was willful. Willfulness is established if the person had knowledge of the employer's obligation to pay the taxes and knew the funds were being used for other purposes. The statute does not contain a "reasonable cause" exception, nor does it treat the delinquency differently if it was caused by a third party bad act such as mismanagement or embezzlement by an employee or third-party payor. The National Taxpayer Advocate

recommends that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS's determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations.

9. **Amend IRC § 7430 to clarify that attorney fee awards may not be retained by the government to satisfy a litigant's preexisting government debts.** IRC § 7430 provides that courts may award attorneys' fees to taxpayers who prevail against the United States in connection with the determination, collection, or refund of any tax if certain procedural requirements are met. Fee-shifting provisions like § 7430 are intended to decrease apprehension among those who feel they have been victims of unreasonable government action but who might be reluctant to challenge those actions because of the expense involved in securing representation. However, a recent Supreme Court ruling found that the attorneys' fees awarded under the Equal Access to Justice Act were payable to the litigant and thus subject to offset by the government to satisfy a litigant's preexisting but unrelated government debt. Subjecting attorney fee awards to offset for unrelated government debts of the litigant undercuts the purpose of fee-shifting statutes and creates a chilling effect on reduced fee and *pro bono* assistance. The National Taxpayer Advocate recommends that Congress amend IRC § 7430 to clarify that attorneys' fees may not be used to satisfy a litigant's preexisting government debt.

10. **Allow small business corporations to elect to be treated as S corporations by checking a box on a timely filed return.** Small business corporations may elect to be treated as flow-through entities by submitting Form 2553, *Election by a Small Business Corporation*, on or before the 15th day of the third month of its first taxable year. However, the due date for an S corporation to file Form 1120S, *U.S. Income Tax Return for an S Corporation*, is the 15th day of the third month after the end of its taxable year. Consequently, many taxpayers overlook the requirement to submit Form 2553, subjecting themselves to serious tax consequences that include taxation at the corporate level and rendering shareholders unable to deduct operating losses on their individual tax returns. The National Taxpayer Advocate recommends that Congress amend IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its first timely filed (including extensions) Form 1120S.

11. **Enact a Federal Agency External Ombudsman Act to protect future federal ombudsmen.** The external ombudsman function in the federal government expands yearly through both legislation and individual agency initiatives. However, these new offices often lack the basic structure and protections necessary to succeed in their varying ombuds roles. A Federal Agency External Ombudsmen Act would provide, at minimum, a basic structure and set of protections to each new ombudsman. The National Taxpayer Advocate recommends that Congress enact a Federal Agency External Ombudsmen Act to ensure protections to and create uniformity among all future federal external ombudsmen.

National Taxpayer Advocate Legislative Recommendations with Congressional Action

Alternative Minimum Tax (AMT)				
Repeal the Individual AMT National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385; National Taxpayer Advocate 2008 Annual Report to Congress 356-362.	Repeal the AMT outright.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3018	Wyden	2/23/2010	Referred to the Finance Committee
	HR 240	Garrett	1/7/2009	Referred to the Ways & Means Committee
	HR 782	Paul	1/28/2009	Referred to the Ways & Means Committee
	S 932	Shelby	4/30/2009	Referred to the Finance Committee
Legislative Activity 110th Congress	S 55	Baucus	1/4/2007	Referred to the Finance Committee
	S 14	Kyl	4/17/2007	Referred to the Finance Committee
	S 1040	Shelby	3/29/2007	Referred to the Finance Committee
	HR 1365	English	3/7/2007	Referred to the Ways & Means Committee
	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
	HR 3970	Rangel	10/25/2007	Referred to the Ways & Means Committee
	S 2293	Lott	11/1/2007	Placed on the Senate Legislative Calendar under General Orders. Calendar No. 464
Legislative Activity 109th Congress	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 437	English	2/6/2001	Referred to the Ways & Means Committee
	S 616	Hutchison	3/26/2002	Referred to the Finance Committee
	HR 5166	Portman	7/18/2002	Referred to the Ways & Means Committee
Index AMT for Inflation National Taxpayer Advocate 2001 Annual Report to Congress 82-100.	If full repeal of the individual AMT is not possible, it should be indexed for inflation.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3223	McConnell	9/13/2010	Placed on the Senate Calendar
	HR 5077	Hall	4/20/2010	Referred to the Ways & Means Committee
	HR 719	Lee	1/27//2009	Referred to the Ways & Means Committee
	S 722	Baucus	3/26/2009	Referred to the Finance Committee
Legislative Activity 110th Congress	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee

Legislative Activity 109th Congress	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	12/7/2005–Passed the House; 12/13/2005–Placed on the Senate Legislative Calendar
Legislative Activity 108th Congress	HR 22	Houghton	1/7/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 5505	Houghton	10/1/2002	Referred to the Ways & Means Committee
Eliminate Several Adjustments for Individual AMT National Taxpayer Advocate 2001 Annual Report to Congress 82-100.	Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual AMT purposes.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	S 102	Kerry	1/4/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1861	Harkin	10/7/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 1939	Neal	5/12/2003	Referred to the Ways & Means Committee
Private Debt Collection (PDC)				
Repeal PDC Provisions National Taxpayer Advocate 2006 Annual Report to Congress 458-462.	Repeal IRC § 6306, thereby terminating the PDC initiative.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	HR 796	Lewis	2/3/2009	Referred to the Ways & Means Committee
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	S 335	Dorgan	1/18/2007	Referred to the Finance Committee
	HR 695	Van Hollen	1/24/2007	Referred to the Ways & Means Committee
	HR 3056	Rangel	7/17/2007	10/10/2007-Passed the House; 10/15/2007 Referred to the Finance Committee
Tax Preparation and Low Income Taxpayer Clinics (LITC)				
Matching Grants for LITC for Return Preparation National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.	Create a grant program for return preparation similar to the LITC grant program. The program should be designed to avoid competition with VITA and should support the IRS's goal (and need) to have returns electronically filed.			
Legislative Activity 111th Congress	**Pub. L. No. 111-117, Div. C, Title I, 123 Stat. 3034, 3163 (2009).**			
Legislative Activity 110th Congress	**Pub. L. No. 110-161, Div. D, Title I, 121 Stat. 1975, 1976 (2007).**			
	Bill Number	**Sponsor**	**Date**	**Status**
	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
	S 1967	Clinton	8/2/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614

Legislative Activity 108th Congress	S 476	Grassley	2/27/2003	Referred to the Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–Passed the House with an amendment; referred to the Senate
	HR 3991	Houghton	3/19/2001	Referred to the Ways & Means Committee
	HR 7	Baucus	7/16/2002	Reported by Chairman Baucus with an amendment; referred to the Finance Committee

Regulation of Income Tax Return Preparers

National Taxpayer Advocate 2002 Annual Report to Congress 216-230;
National Taxpayer Advocate 2003 Annual Report to Congress 270-301;
National Taxpayer Advocate 2007 Annual Report to Congress 83-95 & 140-155;
National Taxpayer Advocate 2008 Annual Report to Congress 423-426;
National Taxpayer Advocate 2009 Annual Report to Congress 41-69.

Create an effective oversight and penalty regime for return preparers by taking the following steps:
- Enact a registration, examination, certification, and enforcement program for federal tax return preparers;
- Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight;
- Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and
- Require the IRS to take steps within its existing administrative authority, including requiring a check-box on all returns in which preparers would enter their category of return preparer (*i.e.*, attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.

	Bill Number	Sponsor	Date	Status
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee
Legislative Activity 110th Congress	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Referrals to LITCs

National Taxpayer Advocate 2007 Annual Report to Congress 551-553.

Amend IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance.

	Bill Number	Sponsor	Date	Status
Legislative Activity 111th Congress	HR 4994	Lewis	4/13/2010	Referred to the Ways & Means Committee
	S 3215	Bingaman	4/15/2010	Referred to the Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
Public Awareness Campaign on Registration Requirements National Taxpayer Advocate 2002 Annual Report to Congress 216-230.	Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee
Legislative Activity 110th Congress	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with S. Rep. No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Increase Preparer Penalties National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 4318	Crowley/ Ramstad	12/6/2007	Referred to the Ways & Means Committee
	S 2851	Bunning	4/14/2008	Referred to the Finance Committee
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006–Placed on Senate Legislative Calendar under General Orders; Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S 882
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Refund Delivery Options National Taxpayer Advocates 2008 Report to Congress 427 - 441.	Direct the Department of the Treasury and the IRS to (1) minimize refund turnaround times; (2) implement a Revenue Protection Indicator; (3) develop a program to enable unbanked taxpayers to receive refunds on stored value cards (SVCs); and (4) conduct a public awareness campaign to disseminate accurate information about refund delivery options.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Ways & Means Committee
	HR 5047	Becerra	4/15/2010	Referred to the Senate Finance Committee
	HR 4994	Lewis	4/13/2010	Referred to the Ways & Means Committee
Small Business Issues				
Health Insurance Deduction/Self-Employed Individuals National Taxpayer Advocate 2001 Annual Report to Congress 223. National Taxpayer Advocate 2008 Annual Report to Congress 388-389.	Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.			
Legislative Activity 111th Congress	**Pub. L. No. 111-124, § 2041 STAT 2560 (2010).**			
	Bill Number	**Sponsor**	**Date**	**Status**
	S725	Bingaman	3/26/2009	Referred to the Finance Committee
	HR 1470	Kind	3/12/2009	Referred to the Ways & Means Committee
Legislative Activity 110th Congress	S 2239	Bingaman	10/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 663	Bingaman	3/17/2005	Referred to the Finance Committee
	S 3857	Smith	9/16/2006	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	S 2130	Bingaman	4/15/2002	Referred to the Finance Committee
Married Couples as Business Co-owners National Taxpayer Advocate 2002 Annual Report to Congress 172-184.	Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of sub-chapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.			
Legislative Activity 110th Congress	**Pub.L. No. 110-28, Title VIII, § 8215, 121 Stat. 193, 194 (2007).**			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in Senate, with an amendment
	S 842	Kerry	4/9/2003	Referred to the Finance Committee
	HR 1640	Udall	4/3/2003	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
Income Averaging for Commercial Fishermen National Taxpayer Advocate 2001 Annual Report to Congress 226.	Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers.			
Legislative Activity 108th Congress	**Pub. L. No. 108-357, § 314, 118 Stat. 1468, 1469 (2004).**			
Election to be treated as an S Corporation National Taxpayer Advocate 2004 Annual Report to Congress 390-393.	Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, *U.S. Income Tax Return for an S Corporation*.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Regulation of Payroll Tax Deposits Agents National Taxpayer Advocate 2004 Annual Report to Congress 394-399.	Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	S 1773	Snowe	7/12/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 3583	Snowe	6/27/2006	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614
Tax Gap Provisions				
Corporate Information Reporting National Taxpayer Advocate 2008 Annual Report to Congress 388.	Require businesses that pay $600 or more during the year to non-corporate and corporate service providers to file an information report with each provider and with the IRS. Information reporting already is required on payments for services to non-corporate providers. This applies to payments made after December 31, 2011.			
	Bill Number	Sponsor	Date	Status
Legislative Activity 111th Congress	S 1796	Baucus	10/19/2009	10/19/2009 Placed on Senate Legislative Calendar under General Orders. Calendar No. 184
Reporting on Customer's Basis in Security Transaction National Taxpayer Advocate 2005 Annual Report to Congress 433-441.	Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.			
Legislative Activity 110th Congress	**Pub. L. No. 110-343, § 403, 121 Stat. 3854, 3855 (2008).**			
	Bill Number	**Sponsor**	**Date**	**Status**
	HR 878	Emanuel	2/7/2007	Referred to the Ways & Means Committee
	S 601	Bayh	2/14/2007	Referred to the Finance Committee
	S 1111	Wyden	4/16/2007	Referred to the Finance Committee
	HR 2147	Emanuel	5/3/2007	Referred to the Ways & Means Committee
	HR 3996 PCS	Rangel	10/30/2007	11/14/2007–Placed on the Senate Calendar; became Pub. L. No. 110-166 (2007) without this provision
Legislative Activity 109th Congress	S 2414	Bayh	3/14/2006	Referred to the Finance Committee
	HR 5176	Emanual	4/25/2006	Referred to the Ways & Means Committee
	HR 5367	Emanual	5/11/2006	Referred to the Ways & Means Committee
IRS Promote Estimated Tax Payments Through the Electronic Federal Tax Payment System (EFTPS) National Taxpayer Advocate 2005 Annual Report to Congress 381-396.	Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614
Study of Use of Voluntary Withholding Agreements National Taxpayer Advocate 2004 Annual Report to Congress 478-489; National Taxpayer Advocate 2005 Annual Report to Congress 381-396.	Amend IRC § 3402(p)(3) to specifically authorize voluntary withholdings agreements between independent contractors and service-recipients as defined in IRC § 6041A(a)(1).			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336. 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614
Require Form 1099 Reporting for Incorporated Service Providers National Taxpayer Advocate 2007 Report to Congress 494-496.	Require service recipients to issue Forms 1099-MISC to incorporated service providers and increase the penalties for failure to comply with the information reporting requirements.			
Legislative Activity 111th Congress	**Pub. L No. 111-148 § 9006 (2010).** However, this Act also contains a reporting requirement for goods sold, which the National Taxpayer Advocate opposes because of the enormous burden it places on businesses. See Legislative Recommendation: Repeal the Information Reporting Requirement for Purchases of Goods over $600, but Require Reporting on Corporate and Certain Other Payments, infra.			
Require Financial Institutions to Report All Accounts to the IRS by Eliminating the $10 Threshold on Interest Reporting National Taxpayer Advocate 2007 Report to Congress 501–502.	Eliminate the $10 interest threshold beneath which financial institutions are not required to file Form 1099-INT reports with the IRS.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Senate Finance Committee
Revise Form 1040, Schedule C to break out gross receipts reported on payee statements such as Form 1099 National Taxpayer Advocate 2007 Report to Congress 40.	Administrative recommendation that the IRS add a line to Schedule C so that taxpayers would separately report the amount of income reported to them on Forms 1099 and other income not reported on Forms 1099. If enacted by statute, the IRS would be required to implement this recommendation.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Finance Committee
Include a Checkbox on Business Returns Requiring Taxpayers to Verify that they Filed all Required Forms 1099 National Taxpayer Advocate 2007 Report to Congress 40.	Administrative recommendation that the IRS require all businesses to answer two questions on their income tax returns: "Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business?" and "If yes, did you file all required Forms 1099?" S. 3795 would require the IRS to study whether placing a checkbox or similar indicator on business tax returns would affect voluntary compliance.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Finance Committee
Authorize Voluntary Withholding Upon Request National Taxpayer Advocate 2007 Report to Congress 493–494.	Authorize voluntary withholding agreements between independent contractors and service recipients.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Finance Committee
Require Backup Withholding on Certain When TINs Cannot Be Validated National Taxpayer Advocate 2005 Report to Congress 238–248.	Administrative recommendation that the IRS require payors to commence backup withholding if they do not receive verification of a payee's TIN. (S. 3795 would require voluntary withholding on certain payments.)			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Finance Committee
Taxpayer Bill of Rights and *De Minimis* "Apology" Payments				
Taxpayer Bill of Rights National Taxpayer Advocate 2007 Report to Congress 486-489.	Enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Ways & Means Committee
	HR 5047	Becerra	4/15/2010	Referred to the Senate Finance Committee
Legislative Activity 110th Congress	HR 5716	Becerra	4/8/2008	Referred to the Ways & Means Committee
***De Minimis* "Apology" Payments** National Taxpayer Advocates 2007 Report to Congress 490.	Grant the National Taxpayer Advocate the discretionary, nondelegable authority to provide *de minimis* compensation to taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer and the taxpayer meets the IRC § 7811 definition of significant hardship.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3795	Carper	9/16/2010	Referred to the Finance Committee
Simplify the Tax Treatment of Cancellation of Debt Income				
Simplify the Tax Treatment of Cancellation of Debt Income National Taxpayer Advocate 2008 Report to Congress 391-396.	Enact one of several proposed alternatives to remove taxpayers with modest amounts of debt cancellation from the cancellation of debt income regime.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	HR 4561	Lewis	2/2/2010	Referred to the Ways & Means Committee
Joint and Several Liability				
Tax Court Review of Request for Equitable Innocent Spouse Relief National Taxpayer Advocate 2001 Annual Report to Congress 128-165.	Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.			
Legislative Activity 109th Congress	**Pub. L. No. 109-432, § 408, 120 Stat. 3061, 3062 (2006).**			
Collection Issues				
Improve Offer In Compromise Program Accessibility National Taxpayer Advocate 2006 Annual Report to Congress 507-519.	Repeal the partial payment requirement, or if repeal is not possible, (1) provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an offer without considering it on the merits; (2) reduce the partial payment to 20 percent of current income and liquid assets that could be disposed of immediately without significant cost; and (3) create an economic hardship exception to the requirement.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	HR 4994	Lewis	4/13/2010	Referred to the Ways & Means Committee
	HR 2342	Lewis	5/12/2009	Referred to the Ways & Means Committee

Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens 2009 National Taxpayer Advocate Report to Congress 357-364.	Provide clear and specific guidance about the factors the IRS must consider when filing a Notice of Federal Tax Lien (NFTL) and amend the Fair Credit Reporting Act to set specific timeframes for reporting derogatory tax lien information on credit reports.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee
	HR 6439	Hastings	11/18/2010	Referred to the Ways & Means Committee
Return of Levy or Sale Proceeds National Taxpayer Advocate 2001 Annual Report to Congress 202-214.	Amend IRC § 6343(b) to extend the period of time within which a third party can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321 RS	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in House
	HR 586	Lewis	2/13/2001	4/18/02–Passed the House with an amendment; referred to the Senate
Reinstatement of Retirement Accounts National Taxpayer Advocate 2001 Annual Report to Congress 202-214.	Amend the following IRC sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343: ◆ § 401 – Qualified Pension, Profit Sharing, Keogh, and Stock Bonus Plans ◆ § 408 – Individual Retirement Account, and SEP-Individual Retirement Account ◆ § 408A – Roth Individual Retirement Account			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
	HR 1677	Rangel	3/26/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title with written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated in H.R. 1528 through an amendment and HR 1528 passed in lieu of S 882

	Bill Number	Sponsor	Date	Status
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–Passed the House with an amendment; referred to Senate
	HR 3991	Houghton	3/19/2002	Defeated in the House
Consolidation of Appeals of Collection Due Process (CDP) Determinations				
National Taxpayer Advocate 2004 Annual Report to Congress 451-470.	Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.			
Legislative Activity 109th Congress	**Pub. L. No. 109-280, § 855, 120 Stat. 1019 (2006).**			
Partial Payment Installment Agreements				
National Taxpayer Advocate 2001 Annual Report to Congress 210-214.	Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the IRS.			
Legislative Activity 108th Congress	**Pub. L. No. 108-357, § 833, 118 Stat. 1589-1592 (2004).**			
Penalties and Interest				
Interest Rate and Failure to Pay Penalty				
National Taxpayer Advocate 2001 Annual Report to Congress 179-182.	Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Interest Abatement on Erroneous Refunds				
National Taxpayer Advocate 2001 Annual Report to Congress 183-187.	Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 109th Congress	HR 726	Sanchez	2/9/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
First Time Penalty Waiver				
National Taxpayer Advocate 2001 Annual Report to Congress 188-192.	Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	Defeated in the House
Federal Tax Deposit (FTD) Avoidance Penalty				
National Taxpayer Advocate 2001 Annual Report to Congress 222.	Reduce the maximum FTD penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the IRC.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	S 1321RS	Santorum	6/28/2005	9/15/2006–The Finance Committee. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/2002–Passed the House with an amendment; referred to the Senate
	HR 3991	Houghton	3/19/2002	Defeated in the House
Family Issues				
Uniform Definition of a Qualifying Child National Taxpayer Advocate 2001 Annual Report to Congress 78-100.	Create a uniform definition of "qualifying child" applicable to tax provisions relating to children and family status.			
Legislative Activity 108th Congress	**Pub. L. No. 108-311, § 201, 118 Stat. 1169-1175 (2004).**			
Means Tested Public Assistance Benefits National Taxpayer Advocate 2001 Annual Report to Congress 76-127.	Amend the IRC §§ 152, 2(b) and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or "not married" status.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Credits for the Elderly or the Permanently Disabled National Taxpayer Advocate 2001 Annual Report to Congress 218-219.	Amend IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 107th Congress	S 2131	Bingaman	4/15/2002	Referred to the Finance Committee
Electronic Filing Issues				
Direct Filing Portal National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Amend IRC § 6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	S 1074	Akaka	3/29/2007	Referred to the Finance Committee
	HR 5801	Lampson	4/15/2008	Referred to the Ways & Means Committee
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006–Referred to the Finance Committee; Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title; with written report No. 109-336 9/15/2006–Placed on the Senate Legislative Calendar under General Orders; Calendar No. 614

Free Electronic Filing For All Taxpayers National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Revise IRC § 6011(f) to provide that the Secretary shall make electronic return preparation and electronic filing available without charge to all individual taxpayers.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	S 2861	Schumer	4/15/2008	Referred to the Finance Committee
Office of the National Taxpayer Advocate				
Confidentiality of Taxpayer Communications National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the IRC, Local Taxpayer Advocates have the discretion to withhold from the IRS the fact that a taxpayer contacted the Taxpayer Advocate Service or any information provided by a taxpayer to TAS.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Access to Independent Legal Counsel National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Taxpayer Advocate Directive National Taxpayer Advocate 2002 Report to Congress 419-422.	Amended IRC § 7811 to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 111th Congress	S 3215	Bingaman	4/15/2010	Referred to the Senate Finance Committee
	HR 5047	Becerra	4/15/2010	Referred to the Ways & Means Committee
Other Issues				
Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact National Taxpayer Advocate 2008 Annual Report to Congress 419-422.	Modify IRC § 6707A to ameliorate unconscionable impact. Section 6707A of the IRC imposes a penalty of $100,000 per individual per year and $200,000 per entity per year for failure to make special disclosures of a "listed transaction."			
Legislative Activity 111th Congress	**Pub. L. No. 111-124, § 2041 Stat 2560 (2010).**			
	Bill Number	**Sponsor**	**Date**	**Status**
	S 2771	Baucus	11/16/2009	Referred to the Finance Committee
	HR 4068	Lewis	11/16/2009	Referred to the Ways & Means Committee
	S 2917	Baucus	12/18/2009	Referred to the Finance Committee
Disclosure Regarding Suicide Threats National Taxpayer Advocate 2001 Annual Report to Congress 227.	Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	5/19/2004–Passed/agreed to in the Senate, with an amendment
	S 882	Baucus	4/10/2003	5/19/2004–S 882 was incorporated in HR 1528 through an amendment and HR 1528 passed in lieu of S 882
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Attorney Fees National Taxpayer Advocate 2002 Annual Report to Congress 161-171.	Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees "above the line." Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.			
Legislative Activity 108th Congress	**Pub. L. No. 108-357, § 703, 118 Stat. 1546-1548 (2004).**			
Attainment of Age Definition National Taxpayer Advocate 2003 Annual Report to Congress 308-311.	Amend IRC § 7701 by adding a new subsection as follows: "Attainment of Age. An individual attains the next age on the anniversary of his date of birth."			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 108th Congress	HR 4841	Burns	7/15/2004	7/21/2004–Passed the House; 7/22/2004–Received in the Senate
Home-Based Service Workers (HBSW) National Taxpayer Advocate 2001 Annual Report to Congress 193-201.	Amend IRC § 3121(d) to clarify that HBSWs are employees rather than independent contractors.			
	Bill Number	**Sponsor**	**Date**	**Status**
Legislative Activity 110th Congress	HR 5719	Rangel	4/16/2008	Referred to the Finance Committee
Legislative Activity 107th Congress	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

LR #1

Enact Tax Reform Now

PROBLEM

In the first section of this report, the National Taxpayer Advocate identified the complexity of the Internal Revenue Code as the most serious problem facing taxpayers. We described the sources and impact of complexity as well as some of the key obstacles to achieving fundamental reform.[1] In this section, we offer some principles and proposals to streamline the tax code.

RECOMMENDATIONS

As a threshold matter, we note that the terms "tax reform" and "tax simplification" are not necessarily synonymous. The term "reform" suggests a more fundamental revision of the tax code, and in theory, the code could be "reformed" in a way that adds complexity. By contrast, the term "simplification" suggests reducing complexity but does not necessarily imply a comprehensive revision. Simplifying discrete provisions that are particularly confusing for large numbers of taxpayers would fit within this definition.

In the first section of this report, we described the magnitude of the burden the existing tax code imposes. Overall compliance consumes an estimated 6.1 billion hours a year – the equivalent of more than three million full-time workers. The monetary compliance burden for the median taxpayer (as measured by income) comes to more than $250 a year. The tax code has grown so long that no one can even determine how long it is, with one measurement suggesting it has reached 3.8 million words.

We further discuss the breadth of "tax expenditures," a term that generally encompasses any reduction in revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.[2] Tax expenditures now total about $1.1 trillion a year. As compared with about 138 million individual tax returns filed in 2010,[3] that translates to an average reduction in tax per return of about $8,000.[4] Moreover, tax is computed as a percentage of income. Therefore, for example, a taxpayer who pays a 25 percent tax rate may be benefiting from deductions or exclusions from income worth $32,000 (*i.e.,* a reduction in taxable income of $32,000 produces a reduction

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1 *See* Most Serious Problem, *The Time for Tax Reform Is Now, supra*.

2 Congressional Budget and Impoundment Control Act, Pub. L. No. 93-344, § 3(3) (1974).

3 *See* IRS 2010 Filing Season Statistics *at* http://www.irs.gov/newsroom/article/0,,id=220953,00.html (last visited Dec. 27, 2010).

4 Tax expenditures have interactive effects, so if all tax expenditures were simultaneously eliminated, the change in revenue would likely be somewhat less than $1.1 trillion. Accordingly, the average tax reduction per taxpayer could be somewhat less than $8,000. Nevertheless, this total represents a reasonable approximation and is used for illustrative purposes in this report. *See* Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, Amer. Soc. Sci. Assoc'n (New Orleans, La., Jan. 5, 2008) 3, shorter version published in 98 *Amer. Econ. Rev*. 79 (2008) (stating that despite interaction effects, "commentators have added up tax expenditures to make general statements about their magnitude").

in tax of $8,000 when the tax rate is 25 percent).[5] Few taxpayers recognize the extent of tax expenditures, but because the system is so complex, many suspect that well-advised taxpayers are taking advantage of loopholes while they themselves are paying full freight. Some likely feel justified in "fudging" on their taxes to right the perceived unfairness. This suspicion and cynicism are not good for the tax system, nor for tax compliance. Indeed, among taxpayers who have a choice about reporting their income, compliance rates are well under 50 percent.[6]

For these reasons, the National Taxpayer Advocate has become convinced that fundamental tax reform – not merely *ad hoc* simplification – is required. However, the National Taxpayer Advocate has previously offered numerous simplification proposals that still have merit and should be considered as part of an overall tax reform effort. Below we suggest several fundamental principles that should help guide tax reform and then summarize notable simplification recommendations from past reports.

General Principles

In attempting to reform the tax code, a threshold challenge that the new Congress will face is balancing tax administration considerations with other policy objectives. From a tax administration perspective, tax expenditures are to be avoided. The rationale is simple: Every exclusion, deduction, credit, or other deviation from the general concept of taxing total income at a specified rate of tax introduces complexity into the tax code.

At the same time, we recognize that competing policy objectives exist. For example, the mortgage interest deduction arose from the desire to encourage home ownership; the exclusions for retirement plan contributions and employer contributions for health insurance are designed to increase retirement savings rates and health insurance coverage, respectively; the deduction for charitable contributions aims to encourage taxpayers to support organizations that seek to advance the common good; the earned income tax credit (EITC) seeks to promote work and raise low income families out of poverty. The evidence is mixed concerning the extent to which these tax incentives encourage more of the behavior they seek to induce,[7] and some of these objectives may be better accomplished through direct expenditures rather than through tax expenditures. Still, tax expenditures are generally motivated by legitimate policy objectives, so Congress must carefully balance the tax administration interests of simplification against other policy priorities.

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5 Tax expenditures are discussed in more detail elsewhere in this report. *See* Most Serious Problem: *The Time for Tax Reform Is Now, supra, and Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*). These sections note that the largest tax expenditures include the exclusion for employer-provided health care, the exclusion for retirement plan contributions and earnings, and the mortgage interest deduction for owner-occupied housing.

6 IRS studies show that non-farm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent. *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at http://www.irs.gov/newsroom/article/0,,id=154496,00.html). As low as these rates are, they would be even lower if not for the fact that some of this income is reported to the IRS by third parties.

7 For a more complete discussion, see *Evaluate the Administration of Tax Expenditures*, vol. 2, *infra*.

Our suggestion is to approach tax reform in a manner similar to zero-based budgeting. To start the discussion, the assumption should be that all tax expenditures would be eliminated. Then a tax benefit would be added back only if a compelling business case can be made that the benefits of providing the benefit through the tax code outweigh the tax-complexity challenges it creates. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.[8]

The immediate elimination of certain tax benefits could cause hardships for individuals or businesses where established pricing or conduct is based on those provisions. For example, homeowners paid a purchase price that took into account the federal subsidy provided through the mortgage interest deduction. Sudden elimination of that deduction would cause the value of existing homes to drop substantially. If Congress decides to eliminate tax incentives in situations like this, transitional relief should be provided.

This approach, at a conceptual level, is similar to two other proposals presented during the past year. In December 2010, the National Commission on Fiscal Responsibility and Reform issued a report that, among other things, also recommended a zero-based budgeting approach to tax reform.[9] In February 2010, Senators Wyden and Gregg introduced legislation that would substantially revamp the tax code.[10] While we do not endorse specific proposals, we think both are thoughtful and worthy starting points.

In addition to suggesting a zero-based budgeting approach to tax reform, we believe the protection of taxpayer rights and minimization of taxpayer burden should be emphasized along with the IRS's ability to administer the law. Toward those ends, we suggest six core principles that should help guide the development of tax reform legislation:

1. The tax system should not "entrap" taxpayers.
2. The tax laws should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions.

Legislative Recommendations

8 The National Taxpayer Advocate has previously discussed design elements that should be considered when running social benefit programs through the tax code. *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, *Running Social Programs through the Tax System*.

9 *See* National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 28-34 (Dec. 2010) *at* http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform. The mandate of the commission was to address the nation's long-term fiscal challenges, and as a result, its tax reform recommendations are partly designed to increase revenue. It is beyond the mission of the National Taxpayer Advocate to take a position on these broader fiscal issues. However, we note that the question of whether and to what extent to raise revenue is extremely contentious, and we are concerned that the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, we suggest it may be more productive for Congress to consider these issues in two steps. First, Congress could enact systemic reforms to the tax code on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates accordingly.

10 Bipartisan Tax Fairness and Simplification Act, S. 3018, 111 Cong. (2010).

3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many.
5. Where the tax laws provide for refundable credits, they should be designed in a way that the IRS can effectively administer.
6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.[11]

Finally, we offer one recommendation that, while not a general principle, would help make taxpayers more aware of the connection between the taxes they pay and the benefits they receive. We recommend that Congress direct the IRS to provide each taxpayer with a "taxpayer receipt" presenting a general breakdown of how federal dollars are spent.

One commentator has noted:

> Sending taxpayers a one-page summary of Federal spending is a big step toward a more rational discussion of debt and deficits. Polls show Americans think over 50 percent of the Federal budget is wasted; liberals think it all goes to wars, conservatives think it all goes to welfare and foreign aid. If people knew that half the budget goes to Social Security, Medicare, Medicaid and interest on the debt, everyone would recognize the need for tough choices on taxes and spending.[12]

From a tax administration standpoint, we believe better awareness of how our tax dollars are spent would increase the sense that "we're all in this together" and potentially improve attitudes toward tax compliance.[13]

Simplification Proposals

Over the past decade, this office has made numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of structural tax reform in mind, they should be considered as part of an overall tax reform process.

Repeal the Alternative Minimum Tax (AMT) for Individuals. Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively

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11 The National Taxpayer Advocate previously articulated these principles in a presentation to the President's Advisory Panel on Federal Tax Reform. *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate), *at* http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Key Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

12 Comment of Steve Novick, posted on website of Senator Ron Wyden *at* http://wyden.senate.gov/imo/media/doc/statements.pdf.

13 A "taxpayer receipt" would be relatively easy to generate. The IRS already provides a high-level breakdown of federal spending in the Form 1040 instructions booklet. *See* Form 1040 Instructions (2009), at 100. This information could be provided in somewhat more detail and mailed or provided electronically to each taxpayer. Third Way, a liberal advocacy group, has promoted the idea, and the Tax Foundation, a conservative group, has supported it. *See* Laura Saunders, *Tracking Your Federal Tax Dollars*, Wall Street Journal, Nov. 6, 2010, *at* http://online.wsj.com/article/SB100014240527487045064045 75592900454547226.html?KEYWORDS=%22taxpayer+receipt%22.

requires taxpayers to compute their taxes twice – once under the regular tax rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing "double taxation" at the federal and state levels), but the AMT rules disallow those deductions. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate has recommended that the AMT be repealed. Moreover, we note that if tax expenditures are substantially reduced, the AMT would be rendered largely irrelevant.[14]

Consolidate the Family Status Provisions. Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the tax code's family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the EITC, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. The National Taxpayer Advocate has recommended that, as part of a comprehensive reform of the tax code's tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.[15]

Improve Other Provisions Relating to Taxation of the Family Unit. The tax code currently imposes "joint and several liability" on married persons who file a joint federal income tax return. This concept dates back to the early years of the income tax when a husband was typically the sole wage earner for the family unit. Today, husbands and wives often have separate assets and incomes that they do not equally control. Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse's income, at least in cases where he or she does not know about the income of the other spouse and does not

Legislative Recommendations

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[14] The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony since 2001. *See* National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); *see also Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (March 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

[15] *See* National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

significantly benefit from it, Congress has enacted relief rules. However, these relief rules are complex, do not always produce the right result, and impose a large burden on the "innocent spouse" to prove his or her case. The National Taxpayer Advocate has recommended several steps to improve equity and simplify the rules, including eliminating joint and several liability for joint filers.[16]

The "kiddie tax" rules are another family-related area of taxation that create significant burden for some taxpayers. The tax code currently taxes a minor child's unearned income above a certain threshold at the parent's tax rate. The parent must decide whether to file a separate return for the child or include the child's income on the parent's own return. The calculations required to determine which option is preferable in a particular case are complex. Moreover, if the child's parents are separated, additional complications arise. If a custodial parent has been designated, the child's income must be included on that parent's return. If no custodial parent has been designated, the law requires the tax to be computed by reference to the return of the parent with the greater taxable income. During a divorce proceeding, however, spouses sometimes conceal their assets or income from the other spouse, making compliance with these rules impractical. The National Taxpayer Advocate has recommended that the unearned income of minor children above a specified threshold be taxed at a higher rate and that the link between the computation of the child's tax liability and the parent's tax return be severed.[17]

Consolidate Education Savings Tax Incentives. The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. However, taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. The National Taxpayer Advocate has recommended that Congress consolidate incentives and harmonize definitions and other terms to the extent possible.[18]

Consolidate Retirement Savings Tax Incentives. The tax code contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education incentives, the large number of options and lack of common definitions and terms can

16 *See* National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*); *see also* National Taxpayer Advocate 2001 Annual Report to Congress 128-165 (Legislative Recommendation: *Joint and Several Liability*).

17 *See* National Taxpayer Advocate 2002 Annual Report to Congress 231-242 (Legislative Recommendation: *Children's Income*).

18 *See* National Taxpayer Advocate 2008 Annual Report to Congress 370-372 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).

preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate has recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.[19]

Simplify Worker Classification Determinations to Minimize Employee-versus-Independent Contractor Disputes. The complexity of, and ambiguities in, the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay and withhold employment tax, withhold income tax, and provide benefits with respect to employees. Consequently, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as contractors if the employer does withhold taxes or report the payments for employees to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate has recommended that Congress (1) replace § 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes and require the Secretary to issue associated guidance, including guidance with specific industry focus; (2) direct the IRS to develop an electronic tool to determine worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.[20]

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets. The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and may even reduce tax compliance. The National

Legislative Recommendations

19 *See* National Taxpayer Advocate 2008 Annual Report to Congress 373-374 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

20 *See id.* at 375-390 (Legislative Recommendation: *Worker Classification*).

Taxpayer Advocate has suggested several ways for Congress to reduce or eliminate the procedural incentives to enact temporary tax provisions.[21]

Eliminate (or Simplify) Phase-Outs. More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. Moreover, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate has recommended that Congress repeal phase-outs or at least reassess them individually to ensure that they are necessary to accomplish their intended objective.[22]

Streamline the Penalty Regime. The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate has recommended that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommended 11 steps that could be taken immediately.[23]

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21 *See* National Taxpayer Advocate 2008 Annual Report to Congress at 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

22 *See id*. at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*).

23 *See* National Taxpayer Advocate 2008 Annual Report to Congress 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*, and vol. 2 (Research Study: *A Framework for Reforming the Penalty Regime*).

LR #2 Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments

PROBLEM

In 2012, a business that purchases $600 or more worth of goods from a single vendor will have to start collecting data for an information report reflecting the aggregate purchase price associated with the vendor's Taxpayer Identification Number (TIN) for filing with the IRS, with a copy to the vendor.[1] The intent of this provision may have been to capture income unreported by vendors or to verify deductions claimed by purchasers. However, if it was the former, the resulting burden appears excessive with respect to the affected portion of the tax gap, and if it was the latter, the legislated mechanism unnecessarily involves a third party. In any case, more efficient means of obtaining data are available.

EXAMPLE

ABC Associates, a non-profit service organization, purchases paper, pens, toner cartridges, and other office supplies from the local XYZ Office Supply, Inc., a big box retailer, aggregating to $700 for 2012. ABC, which had to track all of its purchases by vendor to identify those receiving at least $600, must solicit XYZ's TIN to prepare Form 1099-MISC, *Miscellaneous Income*, reporting the gross purchase amount to the IRS by February 28, 2013. ABC must also provide a copy of the Form 1099-MISC to XYZ by January 31, 2013, when all other similarly situated business customers must also report to XYZ.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 6041 to repeal the requirement for information reports on purchases of goods (as well as property of any sort). Retain the new requirement for information reports on payments to corporations for services, determinable gains, or other income. Expand third-party data by eliminating the $10 threshold for certain bank information reports and by pursuing certain state data.

PRESENT LAW

Generally, aggregate annual payments of $600 or more to a payee for services, determinable gains, or other income, made in the course of a trade or business, are subject to information reporting.[2] Under a longstanding regulatory exception that was repealed by a provision in the Patient Protection and Affordable Care Act of 2010, payments to a corporation before

1 *See* Internal Revenue Code (IRC) § 6041 as amended by the Patient Protection and Affordable Care Act of 2010 (PPACA), Pub. L. No. 111-148, Title IX, Subtitle A, § 9006 (2010).

2 In addition to compensation for services, the information report requirement covers interest, "rents, royalties, annuities, pensions, and other gains, profits, and income." Treas. Reg. § 1.6041-1(a)(1)(i)(B); *see also* IRC § 6041A.

2012 generally were exempt from information reporting.[3] Further, PPACA made gross purchase amounts for goods (as well as property of any sort) reportable after 2011.[4]

Information reports are also required for annual payments of interest aggregating to $10 or more to a payee, generally on Form 1099-INT, *Interest Income*.[5] As a matter of data-sharing, the taxpayer privacy law permits the IRS to disclose return information to state tax agencies subject to safeguards.[6] Federal tax law generally does not govern state tax agencies' data or IRS use of those data.

REASONS FOR CHANGE

Generally, third-party information reporting to the IRS significantly increases compliance by the taxpayer who receives the reported amount, thus helping to reduce the tax gap. However, the new requirement for information reporting on goods will create a widespread administrative burden that is disproportionate to the value of the information for the IRS. The National Taxpayer Advocate's Fiscal Year 2011 Objectives Report to Congress discusses the burdens, starting with TIN collection and recordkeeping, followed by paper or electronic filing, and culminating in matching or mismatching, with potential penalties, at the IRS. Additionally, this PPACA requirement could have distortionary economic effects to the extent that purchasers may favor large vendors with recordkeeping capacity.[7]

Because purchases of goods are so common, small businesses and even non-profit organizations (totaling over 38 million with other affected entities)[8] will not escape the burden of filing paper information reports if they are not required to file electronically.[9] Nor would raising the threshold amount alleviate the burden because tabulation of all purchases by vendor TIN would still be necessary to determine if the threshold is reached. Exemption of a defined class of small businesses could relieve that burden but would introduce a tax-based distortion into decisions on business size. Ultimately, exemptions from information reporting limit the accuracy of data for IRS research purposes.

Meanwhile, the utility to tax administration of gross purchase amounts is unclear. Even if these amounts are reported, they represent only a first step in determining vendor income which, for instance, may be reduced by the cost of goods sold. On the other hand, if a provision is necessary to verify deductions by a purchaser, a requirement of a particular form

3 *See* Treas. Reg. § 1.6041-3(p)(1).

4 Treas. Reg. § 1.6041-3(c) excepts payments for merchandise. Rev. Rul. 81-232, 1981-2 C.B. 231, indicates that a payment for merchandise incidental to a service is included in the reportable amount. *But see* Rev. Proc. 2004-43, 2004-2 C.B. 124 (allowing certain payers to rely on merchant category codes to determine reportability).

5 *See* IRC § 6049.

6 *See* IRC § 6103(d)(1), (p)(8).

7 *See* National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress 9-13.

8 *See Id*. at 10.

9 *See* IRC § 6011(e)(2)(A); Treas. Reg. § 301.6011-2 (applying e-filing to 250 or more returns).

of receipt could accomplish this goal without impinging on the vendor.[10] Finally, third-party data can be enhanced by other recommendations, such as those on bank account reporting and state data matching, that do not impose significant administrative burdens on business taxpayers and use data the IRS has already collected.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate has long supported information reporting as a means to increase compliance.[11] In particular, the corporate exception is outmoded now that a significant number of businesses, including small businesses, are incorporated.[12] At the same time, repeal of the corporate exception relieves payers of the burden of investigating whether a merchant is incorporated or takes another organizational form. Even if a corporation's fiscal year results in a mismatch with calendar year information reporting, itemization of monthly amounts can achieve reconciliation.[13] Consequently, the National Taxpayer Advocate recommends retention of the PPACA provision that repealed the regulatory exception to information reporting on payments to corporations.

At the same time, the information reporting law and regulations distinguish in various places between determinable gains that represent income and other amounts that may be misleading.[14] Given the limited utility of gross purchase amounts for tax administration coupled with the mass burden required to collect the information, the National Taxpayer Advocate recommends repeal of the recently enacted requirement.

To enhance information reporting, the National Taxpayer Advocate has recommended elimination of the $10 threshold for interest reporting by modifying the requirement to encompass deposits.[15] Not only would this step reduce sorting burden for payers, but it effectively would apprise the IRS of the existence of all accounts, even those that do not bear interest, potentially deterring taxpayers from underreporting amounts deposited, and leading to greater accuracy by the IRS in selecting returns for audit.[16]

If further relevant programs are to be considered, the National Taxpayer Advocate has recommended that the IRS expand matching of reported gross receipts with state sales tax

10 *See* IRC § 170(f)(8), (f)(17) (requiring a particular form of receipt – even for cash transactions in any amount – for charitable deductions).

11 *See* National Taxpayer Advocate 2004 Annual Report to Congress 483; National Taxpayer Advocate 2005 Annual Report to Congress 394-396; National Taxpayer Advocate 2007 Annual Report to Congress 494-496; National Taxpayer Advocate 2008 Annual Report to Congress 388.

12 In fact, the majority of corporate taxpayers are S corporations. In 2009, S corporations filed 4.5 million returns, compared with 2.5 million returns filed by other corporations. *See* IRS *Data Book* (2009) Table 2 at 4.

13 *See* Treas. Reg. § 1.6050W-1(h)(2)(ii)(B), 75 Fed. Reg. 49,833 (Aug. 16, 2010) (requiring monthly amounts on information reports of gross purchases by credit and debit card).

14 *See* IRC § 6041(a); Treas. Reg. § 1.6041-3 (excepting from information reports payment for merchandise, excludable payments for services abroad, deductible employee expense reimbursements, certain excludable interest, payments to certain tax-exempt entities, etc.).

15 *See* National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, § 1, 16.

16 *See* Taxpayer Advocacy and Government Accountability Promotion Bill, S. 3795, 111th Cong., 2nd Sess. § 106 (2010) (containing provisions that would repeal the $10 threshold while requiring information reports on non-interest bearing deposits, which potentially could be reported in a similar form with $0 interest).

and other data to identify unreported income.[17] The success of these efforts so far may indicate that it is time to formalize these programs.[18]

17 *See* National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, § 1, 17-18.

18 *See* National Taxpayer Advocate 2009 Annual Report to Congress 174.

LR #3 Allow Taxpayers to Request Equitable Relief Under Internal Revenue Code Section 6015(f) or 66(c) at Any Time Before Expiration of the Period of Limitations on Collection and to Raise Innocent Spouse Relief as a Defense in Collection Actions

PROBLEMS

Married taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due.[1] Spouses who live in community property states and file separate returns are generally required to report half of the community income on their separate returns.[2] Internal Revenue Code (IRC) §§ 6015 and 66, sometimes referred to as the "innocent spouse" rules, provide relief from joint and several liability and from the operation of community property rules. In addition to providing for relief in specific circumstances as described in subsections 6015(b), 6015(c), and 66(c), each statute grants the IRS the authority to establish procedures for relieving a spouse of liability when, in consideration of all the facts and circumstances, it would be inequitable to hold the spouse liable. These latter provisions are known as "equitable relief." Neither IRC § 6015 nor IRC § 66 requires taxpayers to request equitable relief within a specified time. However, a Treasury regulation provides that a taxpayer must request equitable relief from liability arising from a joint return under IRC § 6015(f) within two years after the IRS initiates collection activity with respect to the taxpayer.[3] Additional IRS guidance imposes the same deadline for claims for equitable relief from the operation of community property rules under IRC § 66.[4] Taxpayers who seek relief after the two-year period are harmed because relief is foreclosed in situations for which IRC § 6015(f) was intended to provide a "safety valve," *e.g.*, where the delay was due to deceit or intimidation by a joint filer.[5] The U.S. Tax Court recently held the regulation invalid, and although the decision was reversed by the U.S. Court of Appeals for the Seventh Circuit,[6] the Tax Court adheres to its position in cases appealable to other Courts of Appeals.[7] The IRS maintains that the regulation is a valid interpretation of IRC § 6015(f) and has appealed the issue to other Courts of Appeal.[8] As discussed in detail in Volume

1 Internal Revenue Code (IRC) § 6013(d)(3); Rev. Proc. 2003-61, 2003-2 C.B. 296.

2 *Poe v. Seaborn*, 282 U.S. 101 (1930).

3 Treas. Reg. § 1.6015-5(b)(1) .

4 Rev. Proc. 2000-15, §§ 4.01(3) and 5, 2000-1 C.B. at 448, 449, *superseded by* Rev. Proc. 2003-61, §§ 4.01(3) and 5, 2003-2 C.B. at 297, 299.

5 As the Tax Court noted in *Hall v. Comm'r*, 135 T.C. No. 19, slip op. at 12 (Sept. 22, 2010), "application of the 2-year limits in subsections (b) and (c) makes subsection (f) ineffective in situations where an innocent spouse is unaware of the need to or unable to contact the IRS for some of the very reasons that Congress considered in enacting section 6015. For example, a spouse is sometimes subject to abuse by a partner. The abuse can take many forms. Where a spouse is prevented from acting by fear, intimidation, or fraud, an administrative procedural hurdle would eliminate consideration of relief by the IRS. The Secretary did not allow any exception even for extreme cases, but rather adopted a strict time bar that requires the IRS to deny relief without any consideration of the facts and circumstances."

6 *Lantz v. Comm'r*, 132 T.C. 131 (2009), *reversed and remanded by* 607 F.3d 479 (7th Cir. 2010).

7 *See Hall v. Comm'r*, 135 T.C. No. 19 (Sept. 22, 2010).

8 *E.g., Mannella v. Comm'r*, 132 T.C. 196 (2009), *appeal docketed*, No. 07-175310 (3rd Cir. Jan. 25, 2010); *Coulter v. Comm'r*, Tax Court Docket No. 1003-09, *appeal docketed*, No. 10-680 (2d Cir. Feb. 24, 2010); *Buckner v. Comm'r*, Tax Court Docket No. 12153-09, *appeal docketed*, No.10-2056 (6th Cir. Aug. 18, 2010); *Jones v. Comm'r*, Tax Court Docket No. 17359-08, *appeal docketed*, No. 10-1985 (4th Cir. Aug. 30, 2010).

2 of this report, the National Taxpayer Advocate believes that the language and legislative and administrative history of IRC § 6015 and its predecessor IRC § 6013(e) make clear that Congress did not intend to limit claims for equitable relief to a two-year window.[9] While the courts will ultimately settle this question, in the meantime, taxpayers are harmed by both the IRS's continued enforcement of the two-year rule and the uncertainty in the law. Therefore, the National Taxpayer Advocate recommends that Congress explicitly state that a taxpayer may raise a claim for relief under IRC § 6015(f) and § 66(c) at any time before the statutory period for collecting the tax expires.

EXAMPLE 1

In *Lantz v. Commissioner*,[10] Mrs. Lantz's spouse, Dr. Chentnik, had income from Medicare fraud that he did not report when he prepared the couple's 1999 joint return. Mrs. Lantz was unaware of the fraud and relied on her husband to resolve the tax issue that arose when it was discovered. In his correspondence with the IRS, Dr. Chentnik, who was incarcerated at the time, characterized Mrs. Lantz as an innocent spouse and asked that the IRS send him the appropriate forms so he could claim innocent spouse relief on behalf of Mrs. Lantz. Dr. Chentnik died in a halfway house without requesting relief on Mrs. Lantz's behalf or informing her that he had not requested innocent spouse relief. When Mrs. Lantz requested equitable relief under IRC § 6015(f), the IRS denied her claim because she had not requested relief within two years of the first collection activity. The IRS concedes that Mrs. Lantz would be entitled to relief under IRC § 6015(f) if her claim had been timely filed.

In addition to the problem of the two-year rule, the National Taxpayer Advocate has identified a disturbing trend of restricting a taxpayer's ability to raise IRC § 6015 as a defense in collection suits in district court.[11] This development continues to harm taxpayers.[12]

EXAMPLE 2

A taxpayer ("W"), whose English proficiency was extremely limited, filed jointly with her husband ("H") in 1985 and 1986.[13] Unbeknownst to W, H had income from his sole proprietorship, which he used to support his mistress. The IRS discovered the income and assessed a total of $35,000 in taxes and penalties for the two years. H hid from W all notices pertaining to the tax assessment and collection efforts. Years later, after H abandoned his wife and family and fled the country, the United States reduced the liens to judgment.

9 For a more detailed discussion of this topic and recommendation, see *Unlimit Innocent Spouse Equitable Relief*, vol. 2, *infra*.

10 132 T.C. 131 (2009), *reversed and remanded by* 607 F.3d 479 (7th Cir. 2010).

11 *See* National Taxpayer Advocate 2007 Annual Report to Congress 631; National Taxpayer Advocate 2008 Annual Report to Congress 524; National Taxpayer Advocate 2009 Annual Report to Congress 487.

12 *See* Most Litigated Issue, *Relief from Joint and Several Liability Under Internal Revenue Code Section 6015, infra.*

13 This example is generally based on a case in which the National Taxpayer Advocate, when she was Executive Director of the Community Tax Law Project in Richmond, Virginia, served as the taxpayer's representative.

W learned about the tax liability when the IRS offset her Earned Income Tax Credit refund and about the judgment when she attempted to refinance her home. When W sought innocent spouse relief, more than two years had elapsed since the IRS's first collection activity. In 1997, almost ten years after the IRS assessed the tax and initiated collection activity, the IRS abated the tax against W and refunded all amounts collected from her as permitted under IRC § 6511(b)(2)(B).[14] Under these facts today, W would be ineligible for innocent spouse relief under IRC § 6015(b) or (c) because she did not submit her claim within the *statutory* two-year period, and would be barred from IRC § 6015(f) relief by the *regulation's* two-year limit.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress amend IRC §§ 6015 and 66 to specify that:

1. Effective with respect to any liability for tax arising after the date of enactment and any liability for tax arising on or before such date but remaining unpaid as of such date, taxpayers may request equitable relief at any time before expiration of the period of limitations on collection,[15] regardless of whether the taxpayer previously received a final administrative determination denying as untimely a request for equitable relief for the same tax year or meaningfully participated in a prior proceeding in which equitable relief for the same tax year was denied as untimely; and
2. Taxpayers may raise innocent spouse relief as a defense in a proceeding brought under any provision of title 26 (including §§ 6213, 6320, 6330, 7402, and 7403) or any case under title 11 of the United States Code.

CURRENT LAW

IRC § 6015(f) and the flush language of IRC § 66(c), in identical terms, provide for equitable relief where "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)." IRC § 6015 (e)(1)(A) provides that an individual who seeks relief from joint liability may, "in addition to any other remedy provided by law" petition the Tax Court to determine the

14 If a claim for credit or refund is filed within two years of a payment on the underlying tax liability (but not within three years of a return filing), IRC § 6511(b)(2)(B) limits the credit or refund to amounts paid during the two years immediately preceding the claim.

15 *See* IRC § 6502.

appropriate relief available. Other statutory provisions and judicial precedent make clear that taxpayers may raise IRC § 6015 relief in a variety of contexts.[16]

REASONS FOR CHANGE

As discussed in greater detail in Volume 2 of this report, innocent spouse relief was first enacted in 1971 and was revised in 1984, but prior to 1998 the innocent spouse provisions did not contain a statute of limitations.[17] From 1971 until 1998, nothing impeded the IRS from considering claims for relief under IRC § 6013(e) at any time before expiration of the statutory period of limitations on collection, generally ten years after the date the tax is assessed.[18] The innocent spouse provisions were revised as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[19] because, according to the Senate Committee on Finance, "the innocent spouse provisions of present law are inadequate."[20] While statutory limitation periods were explicitly stated for relief under IRC § 6015 (b) and (c), RRA 98 was silent as to the time limit within which taxpayers must request equitable relief, thereby implicitly retaining for IRC § 6015(f) relief the general statute of limitation period for collection actions.[21]

Equitable relief under IRC §6015(f) is "a safety-valve provision for innocent spouses who fall through cracks in (b) or (c)."[22] In hearings that preceded enactment of RRA 98, witnesses who were ineligible for relief under IRC § 6013(e) described to the Senate Committee on Finance how (1) they had not learned of the underlying assessment because their spouses hid IRS notices or (2) they were unaware that the tax had not been paid because their

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16 *See* IRC §§ 6320(c) and 6330(c)(2)(A)(i) (pertaining to collection due process proceedings); IRC § 6213 and *Corson v. Comm'r*, 114 T.C. 354, 363 (2000) (pertaining to deficiency proceedings); 11 U.S.C.§ 505(a) (pertaining to bankruptcy proceedings); and IRC § 7422 (pertaining to refund suits). *See also Pollock v. Comm'r*, 132 T.C. 21 (2009). In *Pollock*, the United States filed a collection suit seeking to foreclose its lien on the residence of the putative innocent spouse. The district court stayed the proceedings to permit the taxpayer to file a petition for relief in the Tax Court. In holding that the doctrine of equitable tolling did not apply to the 90-day period for filing a Tax Court petition, the court noted that "Perhaps not all hope is lost – the Commissioner conceded at oral argument that if [the taxpayer] filed a refund action in District Court after her home was seized and sold, [the taxpayer] could try to make her case that she is an innocent spouse." 132 T.C. at 37 n. 21. The Tax Court had earlier held in *Thurner v. Comm'r* that *res judicata* barred the taxpayer from raising IRC § 6015 as a defense in the Tax Court proceeding because the taxpayer could have raised IRC § 6015 as a defense in a prior collection suit. 121 T.C. 43 (2003).

17 *See* Pub. L. No. 91-679 (adding IRC § 6013(e)); Pub. L. No. 98-369, sec. § 424, 98 Stat. 801 (1984) (expanding the class of understatements for which innocent spouse relief was available).

18 IRC § 6502(a). However, if a court proceeding to collect the tax is brought, such as a suit to reduce a tax liability to judgment, the period of limitations on collection is extended. Therefore, the period of limitations on collection could exceed ten years and a claim for innocent spouse relief would be valid at any point during that time.

19 Pub. L. No.105-206, sec. 3201(a), (b), 112 Stat. 685 at 734, 739.

20 S. Rep. 105-174, accompanying H.R. 2676 (enacted as RRA 98), 105th Cong., 2nd Sess. (1998) at 55.

21 *See General Motors Corp. v. U.S.*, 496 U.S. 530, 538 (1990); *Russello v. U.S.*, 464 U.S. 16, 23 (1983) (stating "where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion").

22 *Lantz v. Comm'r*, 607 F.3d 479 at 484 (7th Cir.2010). As the conference report accompanying H.R. 2676 (enacted as RRA 98) stated, "The conferees do not intend to limit the use of the Secretary's authority to provide equitable relief to situations where tax is shown on a return but not paid. The conferees intend that such authority be used where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return. The conferees intend that relief be available where there is both an understatement and an underpayment of tax." H.R. Conf. Rep. No. 105-599, 105th Cong., 2nd Sess. 254-255 (1998).

spouses had assured them it had been taken care of. Several of the witnesses learned about the tax debt many years after assessment and the initiation of collection activity.[23]

The IRS, by subjecting § 6015(f) claims to the same new limitations period as claims under (b) and (c), tightens the safety valve Congress provided. Moreover, the equitable relief provisions were part of a statutory scheme intended to address the perceived inadequacy of prior law; delay in claiming equitable relief may arise because of the very circumstances for which Congress intended to provide relief.[24] If not for the IRS's interpretation of the time limits for claiming equitable relief, which the Tax Court held was invalid, changes to the statutes would be unnecessary. However, because taxpayers are being harmed while this issue is litigated in the courts, the National Taxpayer Advocate recommends that Congress act to reaffirm the availability of the safety valve without the time limit imposed by the regulation.[25]

Although statutory provisions and judicial precedent make clear that taxpayers may raise IRC § 6015 in a variety of contexts,[26] taxpayers are harmed when district courts refuse to consider their innocent spouse claims as a defense in collection suits.[27] The National Taxpayer Advocate first identified this disturbing trend in 2007, and the Taxpayer Advocate Service continues to see this issue from time to time.[28] Therefore, Congress should clarify that the defense can be raised in all proceedings brought under any provisions of title 26 of the United States Code, including an action under IRC § 7402 to reduce federal tax assessments to judgment and a suit under IRC § 7403 to foreclose a tax lien on real property, or any case under title 11.

EXPLANATION OF RECOMMENDATION

The first recommendation would specify that taxpayers may request equitable relief without regard to the time that elapses between the commencement of collection activity and the request for relief. As long as the period of limitations for collection of the liability remains open, taxpayers may request innocent spouse relief with respect to deficiencies

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23 Sen. Comm. on Finance, *IRS Restructuring Hearings*, 105th Cong., 2nd Sess. (Jan. 28-29; Feb. 5, 11 & 25, 1998).

24 *See Unlimit Innocent Spouse Equitable Relief*, vol. 2, *infra*, for a discussion of the similarity between innocent spouse cases described in 1998 congressional testimony and recent cases in which relief was denied because the claim was untimely.

25 The National Taxpayer Advocate previously recommended making it explicit that a taxpayer may request equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities (*i.e.*, any time before expiration of the statute of limitations on collection). National Taxpayer Advocate 2006 Annual Report to Congress 540 (Legislative Recommendation: *Eliminate the Two-Year Limitation Period for Taxpayers Seeking Equitable Relief Under IRC § 6015 or § 66*).

26 See note 16, *supra*.

27 *See, e.g., U.S. v. Wallace*, 105 A.F.T.R.2d 2827 (S.D. Ohio Apr. 28, 2010), *adopted by* 105 A.F.T.R.2d (RIA) 2831 (S.D. Ohio June 8, 2010); *U.S. v. Pollock*, No. 06-80903 (S.D. Fla. filed Sept. 27, 2006); *U.S. v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007); *U.S. v. Bucy*, 100 A.F.T.R.2d (RIA) 6666 (S.D. W. Va. 2007); *U.S. v. Cawog*, 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. 2007); *U.S. v. Feda*, 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006).

28 The National Taxpayer Advocate twice recommended that legislation clarify that taxpayers may raise relief under IRC §§ 6015 and 66 as a defense in collection actions. National Taxpayer Advocate 2007 Annual Report to Congress 549; National Taxpayer Advocate 2009 Annual Report to Congress 378. For a discussion of *U.S. v. Wallace*, a case in which the issue arose this year, see Most Litigated Issue: *Relief from Joint and Several Liability Under Internal Revenue Code Section 6015, supra*.

and underpayments. The provision should be effective with respect to any liability for tax arising after the date of enactment and any liability for tax arising on or before such date but remaining unpaid as of such date.[29] Additionally, allowing taxpayers whose requests for equitable relief were previously denied as untimely to obtain relief, in light of removal of the two-year period, would require careful drafting of the effective date in order to extend relief to taxpayers who were previously denied equitable relief solely because the claim was made more than two years after collection activity commenced, as long as the period of limitations on collection has not expired. In the case of credits or refunds, taxpayers would still be subject to the general requirements and time limitations found in IRC § 6511. This recommendation would be consistent with Congress' intent in enacting the innocent spouse rules, would correct the IRS's misinterpretation of the statutes, and would avert a potential conflict among the Courts of Appeals. The second recommendation would clarify that, consistent with the statutory language of IRC § 6015 and other statutory and judicial provisions, taxpayers may raise IRC § 6015 as a defense in district court collection suits. This recommendation would avert further confusion as to whether the defense is allowed in district court collection suits, and would provide uniformity among district courts.

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29 The effective date of IRC § 6015 as originally enacted was identical, applying to "any liability for tax arising after the date of the enactment of this Act and any liability for tax arising on or before such date but remaining unpaid as of such date." Pub. L. No. 105-206, sec. 3201(g)(1), 112 Stat. 685 at 740. Moreover, when IRC § 6015 was amended in 2006 to clarify that the Tax Court has jurisdiction to review "stand alone" cases under IRC § 6015(f) (*i.e.*, petitions filed in response to a notice of determination, or after the claim has been pending for more than six months, where no deficiency has been asserted), the effective date of the amendment was similar, applying "with respect to liability for taxes arising or remaining unpaid on or after the date of the enactment of this Act." Pub. L. No. 109-432, sec. 408(c), 120 Stat. 2922, 3062.

LR #4

Remove the 36-Month "Testing Period" that May Trigger Cancellation of Debt Reporting[1]

PROBLEM

A creditor that cancels a debt is generally required to report that amount to the IRS on Form 1099-C, *Cancellation of Debt*, and a taxpayer whose debt is canceled must generally include the amount canceled in his or her income when filing a tax return.[2] An exception to this general rule applies if the taxpayer was insolvent when the debt was canceled. As discussed in greater detail elsewhere in this report,[3] creditors issued Forms 1099-C to record numbers of taxpayers in recent years.[4] However, under Treasury regulations, a creditor may legitimately issue a Form 1099-C even though it is not actually discharging a debt.[5] Thus, a creditor can collect the debt even as the IRS proposes additional tax due to the reported cancellation of the same debt.

EXAMPLE

D incurred a debt in December 2006, but because she was unemployed did not make any payments for 36 months. In January 2010, D's creditor issued a Form 1099-C, as permitted by the applicable Treasury regulations, which do not prohibit a creditor from continuing to collect the debt even after issuing the form. The creditor continued to collect the debt. D did not report the "canceled" debt on her 2009 tax return. The IRS's automated document matching system identified a discrepancy between the amount D's creditor reported on Form 1099-C and the amount of canceled debt D reported on her return, and issued a Notice CP 2000, in which it proposed to increase D's tax liability based on the discrepancy.[6]

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 6050P to repeal the 36-month regulatory "testing period" as a basis on which to issue a Form 1099-C.

1 For a more detailed discussion of this topic and recommendation, see Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

2 Internal Revenue Code (IRC) §§ 61(a)(12), 6050P(a). Treas. Reg. §1.6050P-1(a) requires creditors that discharge an indebtedness of at least $600 during any calendar year to file a Form 1099-C information return with the IRS.

3 Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

4 Almost half the taxpayers who were issued a Form 1099-C in 2008 were low income, and in addition to facing additional tax on "canceled" debt, they faced losing earned income tax credits (EITC). *See* Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

5 Treas. Reg. § 1.6050P-1(a)(1). Moreover, a creditor may threaten to issue a Form 1099-C as a means of pressuring a debtor to pay. *See* Jacob Barron, *Leveraging Uncle Sam, Getting the Threat of the IRS Behind Your Collection Effort*, National Association of Credit Management, *Business Credit*, June 2008.

6 The Notice CP 2000 is the first step toward assessment of the tax and in this sense is an enforcement measure. The IRS issued 214,858 Notices CP 2000 in 2007 and TAS analyzed a random sample of 316 taxpayers to whom they were issued (TAS Notice CP 2000 sample). The Notice CP 2000 was issued *solely* on the basis of a Form 1099-C to 71 taxpayers in the Notice CP 2000 sample. *See* Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

CURRENT LAW

IRC § 61(a)(12) provides that a taxpayer's gross income includes income from the discharge of indebtedness. Whether a creditor has forgiven a debt is a question of fact.[7] Prior to 1993, the Code did not require lenders to file information returns with respect to discharged debts.[8] IRC § 6050P was enacted in 1993 in part "to encourage taxpayer compliance with respect to discharged indebtedness" and "to enhance the ability of the IRS to enforce the discharge of indebtedness rules."[9] Section 6050P requires certain financial entities to report to the IRS discharges of indebtedness of $600 or more during any calendar year, and to provide a copy of the report to the person whose debt was discharged.[10] Congress did "not intend that this provision alter the present law determination of when a discharge of indebtedness occurs under section 61(a)(12)."[11] While a creditor's failure to report canceled debt was made subject to a penalty,[12] there is no penalty for issuing a Form 1099-C when a debt was not actually canceled.

Temporary regulations under IRC § 6050P issued in 1993 provided, in relevant part, "For purposes of this section, indebtedness will be considered discharged upon the occurrence of an identifiable event indicating that the indebtedness will never have to be paid by the debtor, *taking into account all the facts and circumstances*"[13] (emphasis added). A creditor's collection efforts were one of the facts and circumstances to be taken into account in determining whether a discharge occurred.[14] Commentators objected to the facts and circumstances test of the proposed regulation because "creditors do not have the resources to weigh all the facts and circumstances in order to determine whether a debt will never have to be repaid by the debtor."[15]

In response to comments and testimony, the final regulations provide that indebtedness is considered discharged, and reporting is required, *only* upon the occurrence of specified identifiable events. The facts and circumstances test, which tied the actual discharge of debt with the creditor's reporting obligation, was discarded. A discharge of indebtedness is now "deemed" to have occurred if (and only if) an identifiable event has occurred, "whether or not an actual discharge of indebtedness has occurred."[16] As explained below, a creditor's

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7 *Carl T. Miller Trust v. Comm'r*, 76 T.C. 191, 195 (1981); *Cozzi v. Comm'r*, 88 T.C. 435, 445 (1987).

8 IRC § 6050J, however, required lenders to report foreclosures or other acquisitions of property in satisfaction of a debt secured by the property, and such events may effect a discharge of indebtedness.

9 H.R. Rep. No. 103-111, at 758 (1993) *reprinted in* 1993 U.S.C.C.A.N. 378, 989.

10 IRC § 6050P(a), (b), (d). Treas. Reg. §1.6050P-1(a) designates Form 1099-C as the appropriate information return.

11 H.R. Rep. No. 103-213, at 672 (1993)(Conf. Rep.) *reprinted in* 1993 U.S.C.C.A.N. 1088, 1361.

12 *See* IRC §§ 6721-6723, 6724(d)(1)(B)(ix), (d)(2)(Q).

13 Treas. Reg. § 1.6050P-1T(b)(1), 58 Fed. Reg. 68301-01, 1994-1 C.B. 286. The temporary regulations included a nonexclusive list of three identifiable events: discharge of the debt in bankruptcy; an agreement between the creditor and debtor to discharge the indebtedness; and cancellation by operation of law such as the expiration of the statute of limitations for collection of the debt.

14 Treas. Reg. § 1.6050P-1T(b)(2)(C), 58 Fed. Reg. 68301-01, 1994-1 C.B. 286.

15 *See* Information Reporting for Discharges of Indebtedness, Explanation of Revisions and Summary of Comments, 61 Fed. Reg. 262, 1996-1 C.B. 298.

16 Treas. Reg. § 1.6050P-1(a). The only exception is that a creditor may, at its discretion, report an actual discharge of indebtedness that occurs before an identifiable event occurs. Treas. Reg. § 1.6050P-1(b)(3).

continued collection activity is relevant only where *the creditor* wishes to rebut a presumption that a debt has been canceled.

The IRC § 6050P regulations now specify eight identifiable events that trigger the creditor's obligation to report canceled debt. Seven identifiable events describe circumstances in which the creditor cannot, or clearly intends not to, collect the debt.[17] However, the mere passage of time (generally 36 months, referred to as a "testing period") with no payment from the debtor creates a presumption that an identifiable event triggering the creditor's reporting obligation has occurred.[18] Thus, a creditor, by issuing a Form 1099-C after 36 months of nonpayment, avoids any penalty for failing to comply with its reporting obligations, and is still free to collect the debt.[19] If, on the other hand, the creditor *fails* to issue a Form 1099-C after 36 months of nonpayment, to avoid liability for a penalty it must overcome a presumption that an identifiable event occurred.[20] Regardless of the identifiable event that triggered issuance of the Form 1099-C, if the taxpayer does not report the amount shown on a Form 1099-C on a return, he or she may receive a Notice CP 2000, *Notice Proposing Adjustments to Income, Payments, or Credits*, which is the IRS's first step toward assessing the tax.[21]

REASONS FOR CHANGE

The regulations under IRC § 6050P, by divorcing the creditor's reporting obligation from the question of whether a debt has been discharged and providing for a 36-month nonpayment period as an identifiable event, create an incentive for creditors to issue Forms 1099-C when they are *not* cancelling debts. This may activate IRS compliance resources even

17 These seven identifiable events are: (1) a discharge in bankruptcy; (2) cancellation in the context of asset transfers in corporate reorganizations pursuant to bankruptcy; (3) expiration of the statute of limitations if the debtor's affirmative statute of limitations defense is upheld in a final judgment or decision of a judicial proceeding, and the period for appealing the judgment or decision has expired; (4) cancellation pursuant to an election of foreclosure remedies that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness; (5) cancellation that renders a debt unenforceable pursuant to a probate or similar proceeding; (6) discharge pursuant to an agreement between the creditor and the debtor; or (7) discharge pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge the debt. Treas. Reg. § 1.6050P-1(b)(2)(i)(A)-(G).

18 Treas. Reg. § 1.6050P-1(b)(2)(i)(H). Treas. Reg. § 1.6050P-1(b)(2)(iv) defines a "testing period," generally 36 months, and provides that if the testing period expires without payment by the debtor, a presumption arises that an identifiable event has occurred. This provision does not apply to all creditors, but rather to "applicable financial entities" as described in IRC § 6050P(c)(2)(A) through (C). Such entities generally include banks, credit unions, their regulated subsidiaries, and Federal executive agencies such as the Federal Deposit Insurance Corporation and the National Credit Union Administration.

19 Because Form 1099-C does not require an issuer to indicate the basis on which it is issuing the form, the number of forms that are triggered by the 36-month testing period is unknown. However, as one representative of the American Bankers Association noted at the hearing on the final IRC § 6050P regulations, "banks and other institutions almost never entirely give up on an uncollected debt." BNA Banking Daily, *Discharge Rules: Witnesses Call for Narrower View of Indebted; Say IRS Proposal Burdensome*, Mar. 31, 1994. Therefore, we would expect that the 36-month testing period accounts for a substantial number of Forms 1099-C. The National Taxpayer Advocate recommends that the Form 1099-C be revised to capture this information. *See* Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

20 The regulatory framework gives creditors an incentive to issue a Form 1099-C even though they are *not* canceling a debt, yet a state court, in a subsequent collection action, may view the Form 1099-C as *prima facie* evidence that the debt *was* actually canceled. See, *e.g.*, *CoBiz Financial v. CF Homes*, No. 09-0711, slip op. at 6 (Ariz. Ct. App. Nov. 23, 2010) *available at* http://www.cofad1.state.az.us/memod/CV/CV090711.pdf, in which the Arizona Court of Appeals held that a Form 1099-C was *prima facie* evidence that the issuer had discharged the debt.

21 See National Taxpayer Advocate 2008 Annual Report to Congress 47 for a description of the IRS's Automated Underreporter program, which matches a Form 1099-C against the taxpayer's return. *See also* Internal Revenue Manual (IRM) 4.19.3.7.19.1 (Oct. 15, 2008).

though there has been no taxable event, and may place taxpayers in the position of facing collection activity by the creditor to collect the debt and simultaneous enforcement action by the IRS with respect to tax it believes is owed due to cancellation of the same debt.

EXPLANATION OF RECOMMENDATION

The rules pertaining to cancellation of debt are complex and counterintuitive to most taxpayers. As discussed in greater detail earlier in this report, according to a Taxpayer Advocate Service (TAS) sample of taxpayers who were issued a Notice CP 2000, many may have been eligible to exclude canceled debt from income because they were insolvent. However, many taxpayers simply agreed with the adjustment proposed in the CP 2000 or notice of deficiency, or did not respond at all, which indicates that they were not aware of the insolvency exception.[22] Because taxpayers are even less likely to appreciate that expiration of the 36-month testing period may have triggered issuance of the Form 1099-C (rather than a creditor cancelling their debt) they may inappropriately pay additional tax and lose the EITC.

Third-party reporting by means of Form 1099-C could usefully direct taxpayers' attention to the general rule that canceled debt is includible in income. But where the reporting rules burden taxpayers without reliably signaling a taxable event, they become counterproductive. Removing the 36-month testing period as an identifiable event would benefit taxpayers and conserve IRS resources.

22 Most Serious Problem: *Third-Party Reporting of Cancellation-of-Debt Events is not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers, supra.*

LR #5

Amend Internal Revenue Code Section 3402(p) to Allow Voluntary Withholding on Payments Made for Lost Earnings or Profits from Disasters

PROBLEM

In significant disasters, affected taxpayers make hundreds of thousands of claims against the responsible parties under federal and state laws and receive billions of dollars in payments.[1] A vast majority of these claim payments are for lost earnings or profits resulting from the disaster.[2] Taxpayers rely on these payments to make up for their lost income. Some rely on them just to survive.

Damages for non-natural disasters are generally includible in the recipient's gross income.[3] Unlike the wages they may replace, the claim payments are not subject to federal income tax withholding; nor does current law provide for voluntary withholding on these payments.[4] Thus, the only way for payment recipients to satisfy their quarterly tax obligations is through the estimated tax payment process. However, many disaster victims with little or no experience making quarterly estimated tax payments will not make the required deposits and will face a surprise year-end tax liability that could have been avoided through withholding. This situation causes hardship to taxpayers, not only because of the taxes owed, but also because of the penalties, interest, and potential IRS collection efforts. Without a withholding mechanism, taxpayers may face an "IRS disaster" that could rival the personal economic damage caused by the disaster they just survived.

EXAMPLE

On April 20, 2010, BP Plc's Deepwater Horizon drilling rig exploded in the Gulf of Mexico, exposing a tapped well that began leaking up to 60,000 barrels of crude oil per day. This quickly became the worst oil spill in U.S. history.[5] The President did not pronounce the spill a federally-declared disaster pursuant to the Stafford Act.[6]

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1 *E.g.*, as of November 20, 2010, BP Plc (BP) and the Gulf Coast Claims Facility (GCCF) received claims from 565,483 claimants for damages from the 2010 Deepwater Horizon incident and paid $2,351,075,419 in claims. *See* BP Plc, *Summary of BP Claims Statistics* (Aug. 23, 2010); Gulf Coast Claims Facility, *GCCF Program Statistics – Overall Summary* 1 (Nov. 20, 2010). BP and GCCF data are combined since GCCF took over claims administration from BP on August 23, 2010. BP continues to be responsible for all damages.

2 Of all claims made due to the Gulf oil spill since August 23, 2010, 89.63 percent were for lost earnings or profits. Of all claims paid, 99.96 percent were for lost earnings or profits. Data are for individuals and businesses combined. Gulf Coast Claims Facility, *GCCF Program Statistics – Overall Summary* 4 (Nov. 20, 2010).

3 *See* Internal Revenue Code (IRC) § 61(a); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). IRC § 139 exempts payments from gross income if an incident is a federally-declared disaster under the Stafford Act. Most non-natural disasters are not federally-declared disasters.

4 *See* IRC § 3402(p) *et seq.*

5 ADM Robert J. Papp, USCG, *Shipmates 5 - Honor Our Profession*, ALCOAST 308/10 (June 12, 2010) ("What started out on April 20, 2010, as a search and rescue operation … has evolved into the largest offshore oil spill in U.S. history.").

6 See the Robert T. Stafford Disaster Relief and Emergency Assistance Act, P.L. No. 93-288, as amended, 42 U.S.C. §§ 5121-5206 (Stafford Act), and implementing regulations in 44 C.F.R. §§ 206.31-206.48. To trigger provisions of the Stafford Act, the governor of an affected state must request that the President declare a major disaster. 42 U.S.C. § 5170. To date, no governor has made such a request for the Gulf oil spill.

Almost immediately, taxpayers whose livelihoods were damaged by the oil spill began making claims against BP. As of November 20, 2010, BP paid $2.4 billion on approximately 565,000 claims.[7] About 48 percent of payments went to individuals for lost earnings or profits.[8] In other words, almost one-half of all claimants will have to include the payments in their individual gross incomes for tax year 2010, and none of these payments are subject to income tax withholding.[9]

The average initial payment per individual claimant for lost earnings or profits was $9,269.[10] Given a 15 percent marginal tax rate, the average individual taxpayer might have a $1,390 "tax surprise" for 2010.[11] Had the disaster not occurred, the taxpayer's employer would have withheld income tax from the taxpayer's wages. However, current law does not require the payor of these types of payments to withhold income taxes. Instead, disaster victims must utilize the process of estimating and paying taxes in advance. This can be overly burdensome to a taxpayer whose focus is on daily survival.

Based on this data, about a quarter of a million individual taxpayers may have a "tax surprise" for 2010.[12] If taxpayers cannot afford to pay the tax, current law will require the IRS to assess penalties and interest that can quickly double the amount due.[13] Many taxpayers may also be subject to IRS collection efforts.

RECOMMENDATION

The National Taxpayer Advocate recommends Congress amend IRC § 3402(p) to require withholding of income taxes from payments made pursuant to claims for lost earnings or profits that result from an event designated by the Secretary of Treasury to be a disaster, regardless of whether that event is declared a disaster by the President pursuant to the Stafford Act, unless the recipient expressly opts out of such withholding at the time of payment.

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7 BP Plc, *Summary of BP Claims Statistics* (Aug. 23, 2010); *GCCF Program Statistics – Overall Summary* 1 (Nov. 20, 2010).

8 Of the $2.4 billion paid to date, $1.1 billion was paid to individuals for lost earnings or profits. *Summary of BP Claims Statistics* (Aug. 23, 2010); *GCCF Program Statistics – Overall Summary* 1 (Nov. 20, 2010).

9 Business claimants must also include payments for lost earnings or profits in their gross incomes, although some will have expenses and losses to offset some of the tax liability.

10 Total amount paid to individuals divided by the number of claims by individuals. *GCCF Program Statistics – Overall Summary* 2 (Nov. 20, 2010).

11 This is a conservative estimate since claims paid in 2010 represent initial Emergency Assistance Claims only. BP/GCCF expects to make final payments in 2011 and 2012 for all legal claims an individual may have against BP for the oil spill. As a result, the final payments should be significantly more than amounts paid in 2010. In other words, we can expect larger surprise tax liabilities in the future without a statutory withholding mechanism. Some self-employed taxpayers may owe an additional tax.

12 Total claims paid as of November 20, 2010 (565,483) times 48 percent equals 271,432.

13 *See, e.g.*, IRC §§ 6651(a) (delinquency penalties), 6601(a) (interest on underpaid tax).

PRESENT LAW

Payments for lost earnings or profits are generally includible in the recipient's income (*i.e.*, subject to income tax).[14] If a disaster becomes a federally-declared disaster under the Stafford Act, these payments are excluded from the recipient's income.[15] However, if a payment is not excluded from income by reason of being related to a federally-declared disaster, and thus, is includible in income, the law does not require the payor to withhold federal income taxes.

Under IRC § 3402(p)(3)(B), the Secretary is authorized to provide regulations for income tax withholding from any payment with respect to which the Secretary finds that withholding would be appropriate, if the person making such payment and the person receiving such payment agree to such withholding. In other words, the Secretary can determine that voluntary withholding is *permitted*, but only pursuant to an enacting regulation, which currently does not exist for IRC § 3402(p)(3)(B). Further, IRC § 3402(p)(3)(B) permits voluntary withholding only if *both* the payee and the payor agree to it. This means that even if an enacting regulation were in place for IRC § 3402(p)(3)(B), a payor could still legally refuse to withhold any income tax even if the taxpayer elected withholding.

REASONS FOR CHANGE

One purpose of tax withholding is to assist the government in securing needed revenue without having to inefficiently resort to levies after assessments.[16] This recommendation will improve taxpayer compliance and the timing of receipts to the federal government. Withholding can also assist taxpayers in ameliorating their annual lump-sum tax payments. Taxpayers who find it burdensome to make quarterly estimated tax payments may find it more convenient to have federal income taxes withheld at the time the payment is made.

Although IRC § 3402(p)(3)(B) currently authorizes the Secretary to permit voluntary withholding by regulation if both parties agree, the payor could legally refuse to enter into a voluntary withholding arrangement even if the IRS publishes a regulation. To get around this regulatory void, the IRS in past disasters encouraged payors to establish estimated tax payment mechanisms in which taxpayers authorize payors to "withhold" a certain amount and pay it to the IRS to be applied toward any tax due.[17] Taxpayer participation in this

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[14] *See* IRC § 61(a); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *see also* Internal Revenue Service, Press Release (June 25, 2010), *available at* http://www.irs.gov/newsroom/article/0,,id=224886,00.html.

[15] IRC § 139.

[16] *See United States v. American Friends Service Committee,* 419 U.S. 7, 10 n.6 (1974), *citing* H. R. Rep. No. 268, 78th Cong., 1st Sess., 1-2 (1943); S. Rep. No. 221, 78th Cong., 1st Sess., 1 (1943).

[17] *See, e.g.*, IRS Letter 4429 (Nov. 2008) (advising taxpayers who received punitive damages from the *Exxon Valdez* oil spill to make estimated tax payments on their own or request a voluntary withholding agreement with the Exxon Qualified Settlement Fund).

workaround was low and some payors refused to create the mechanism.[18] This resulted in a number of "tax surprises" for taxpayers.[19]

Congress should amend IRC § 3402(p) to require ten percent withholding on payments of lost earnings or profits due to a disaster, unless taxpayers expressly elect to opt out at the time of payment. The provision would be for disasters declared by the Secretary specifically for income tax withholding purposes.[20] This will decrease the time necessary to authorize withholding since the Secretary can trigger the provision by declaration.

The Deepwater Horizon oil spill shows just how many taxpayers might find a "tax surprise" waiting for them on April 15 without an opt out withholding provision. These unexpected tax liabilities, and the ensuing penalties, interest, and potential IRS collection efforts, are easily avoidable if the payor is required to withhold income tax when making the payment. Even if a ten percent withholding is less than the total tax due, the withholding will reduce the outstanding tax liability at the end of the year. An opt-out provision will also increase taxpayer participation in withholding. Although some taxpayers will opt out of withholding, many will choose the path of least resistance and be subject to withholding.

The Gulf oil spill is not the first non-natural disaster to affect U.S. taxpayers,[21] and it will certainly not be the last.[22] By modifying the tax code now to require withholding, Congress could protect taxpayers from an "IRS disaster" before the next actual disaster strikes.

EXPLANATION OF RECOMMENDATION

This recommendation will authorize the Secretary of Treasury to declare a disaster for income tax withholding purposes, even if the incident is not a federally-declared disaster under the Stafford Act. The recommendation requires the payor of lost earnings or profits resulting from the disaster to withhold federal income tax from payments at a ten percent rate unless the recipient opts out of withholding at the time of payment. Treasury regulations may also specify additional withholding rates.

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18 Only seven percent of taxpayers who received damages from the *Exxon Valdez* settlement opted to participate in the estimated tax payment mechanism. E-mail from the Exxon Qualified Settlement Fund administrator dated June 6, 2008 (on file with TAS).

19 Out of the 25,000 claimants in the *Exxon Valdez* settlement, only 1,800 participated in the estimated tax election. This means over 23,000 may have owed additional tax without the benefit of withholding or estimated payments. E-mail from IRS Office of Chief Counsel dated June 6, 2008 (on file with TAS).

20 *Cf.* 13 CFR § 123.3, authorized under the Small Business Act, 15 U.S.C. § 636(b), (c), and (f). This allows the Small Business Administration (SBA) to declare a disaster for purposes of granting SBA disaster loans notwithstanding the Stafford Act.

21 *E.g.*, the *Exxon Valdez* oil spill of 1989.

22 The gas pipe explosion in San Bruno, California, is an example of a non-natural disaster that may not be as far-reaching as the Gulf oil spill, but could create just as much economic harm to individual taxpayers if there is no withholding on damage payments. As of September 16, 2010, California Governor Arnold Schwarzenegger asked the responsible party, Pacific Gas and Electric, to create a $100 million fund for victims, including the 271 people displaced by the explosion. *See Answers Promised: Schwarzenegger Tours San Bruno Disaster Site*, The Daily Journal (Sep. 16, 2010), *available at* http://www.smdailyjournal.com/article_preview.php?id=141268.

LR #6 Enact a Statute of Limitations to Limit the Retroactive Effect of Revocation of an Organization's Exempt Status

PROBLEM

Generally, charities enjoy tax-exempt status with accompanying benefits.[1] A charity that fails to function as described in Internal Revenue Code (IRC) § 501(c)(3) may lose exempt status through an IRS process known as revocation. Typically, the IRS audits a charity to determine compliance, and then revokes exempt status and assesses tax as of the date the requirements for exemption are not satisfied.[2] Although assessment is subject to the general three-year statute of limitation,[3] no statute of limitation governs revocation.[4] This creates a procedural asymmetry through which the IRS may revoke an organization's exempt status even for time-barred years, *i.e.*, those for which it cannot collect additional tax.[5] Even if a revoked organization complies with IRS instructions to change its organization or operations and then re-applies for exempt status, certain funding sources or program qualifications may have lapsed upon revocation, impeding future operation as a charity.

EXAMPLE

In Year 1, charitable organization O applies for exempt status, which the IRS recognizes. O functions through a state program that requires maintenance of IRC § 501(c)(3) status. In Year 10, the IRS opens an audit of Years 6, 7 and 8, pending which O agrees to extend the statutory period of limitation on assessment of tax. Meanwhile, O acts on advice from the state program to remedy certain conduct that caused concern in prior years. In Year 11, the IRS discovers a pattern of questionable conduct dating back to Years 4 and 5 and proposes to revoke O's exempt status, but O appeals and extends the period of limitation until Year 12. In Year 12, the IRS issues a final notice of revocation. Already, assessment on Years 4 and 5 is time-barred, yet the IRS assesses a deficiency in tax for Years 6 through 11. O protests to no avail that its activities in Year 9 and later are not accurately characterized

1 IRC § 501(c)(3) exempt organizations are referred to as 'charities' . . . even though it is only one of several adjectives used in § 501(c)(3), partly because 'charitable' is the residual category used to classify these groups when they do not fit under any of the other adjectives, and partly because the Supreme Court has held that all § 501(c)(3) groups must conform to certain fundamental common-law charitable criteria." John Simon, Harvey Dale, and Laura Chisholm, *The Federal Tax Treatment of Charitable Organizations*, in The Nonprofit Sector: A Research Handbook 2nd ed. (New Haven, Conn.: Yale Univ. Press, 2006) 267, 268; *see Bob Jones Univ. v. U.S.*, 461 U.S. 574 (1983).

2 When there has been a material change inconsistent with exemption in the character, purpose, or operation of a charity, revocation ordinarily will take effect as of the date of such material change. Rev. Proc. 2010-9, § 12.01(1), 2010-1 C.B. 258, 268. In 2009, the IRS examined almost 4,000 exempt organization returns and revoked the exempt status of 44 charities. *See* IRS Pub. 55, *Data Book* (2009), Table 13; Ann. 2009-90, 2009-2 C.B. 1010 (revoking the exempt status of one charity); Ann. 2009-86, 2009-2 C.B. 759 (revoking two charities); Ann. 2009-80, 2009-2 C.B. 646 (two); Ann. 2009-78, 2009-2 C.B. 594 (one); Ann. 2009-72, 2009-2 C.B. 500 (one); Ann. 2009-66, 2009-2 C.B. 364 (two); Ann. 2009-64, 2009-2 C.B. 319 (four); Ann. 2009-61, 2009-2 C.B. 246 (twenty-eight); Ann. 2009-60, 2009-2 C.B. 166 (three).

3 *See* IRC § 6501.

4 *Cf.* Internal Revenue Manual (IRM) 4.75.13.5.3.1(4) (stating in "most instances the examiner will not expand the examination to a prior year if the statute of limitations for the assessment of tax has expired").

5 *See, e.g.*, *John Marshall Law School v. U.S.*, 48 A.F.T.R.2d 81-5340 (Ct. Cl. Trial Div. 1981), *aff'd per curiam* 228 Ct. Cl. 902 (1981) (revoking closed years without contest); *Anclote Psychiatric Center v. Comm'r*, T.C. Memo. 1998-273, *aff'd without written opinion* 190 F.3d 541 (11th Cir. 1999) (revoking closed year without contest).

by an audit of Years 4 through 8. Even if O applies for relief from retroactive effect,[6] upon revocation O can no longer conduct certain activities that would allow it to survive as a charity.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact a statute of limitation for revocation of exempt status, generally for three years, that would run from the filing of the return for the year in question. As under current law, in case of substantial omission of items from the return, the statute would run for six years, but in case of fraud, tax evasion, or non-filing of the return, the statute of limitation would not run.[7] The time-bar would apply not only to the effective date of revocation but also to the introduction of past facts from closed years as a reason for revocation. Statutory certainty regarding the period in issue would help to align revocation with assessment.

PRESENT LAW

Generally, the IRS may determine whether an organization is exempt from taxation of its income as described in IRC § 401(a), or 501(c) or (d).[8] In particular, IRC § 501(c)(3) organizations apply to the IRS on Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*.[9] Thereafter, charities (along with other exempt organizations) annually file Form 990, *Return of Organization Exempt from Income Tax*.[10]

A revocation affects exempt status, but is not an assessment of tax subject to a statute of limitation, which generally forecloses assessment three years after filing of the tax return.[11] The period extends to six years in cases of substantial omission from a return exceeding 25 percent of gross income or of tax in case of certain charity excises.[12] No period of limitation would apply in the case of a false or fraudulent return, willful attempt to evade tax, or

6 *See* IRC § 7805(b)(8); Rev. Proc. 2010-4 § 13.09, 2010-01 I.R.B. 122, 152.

7 *Cf.* IRC § 6501(c), (e).

8 *See* IRC § 501(a). In 2009, there were almost a million employee plans as described in IRC § 401(a) and approximately 1.8 million organizations as described in IRC § 501(c) and (d), 1.2 million of which fell under IRC § 501(c)(3). *See* IRS Pub. 55, Data Book (2009), Tables 13 & 25.

9 *See* IRC § 508; Treas. Reg. § 1.508-1(a)(1), (a)(2). Generally, the IRS recognizes exemption as of the date a charity was organized as long as it filed Form 1023 within 27 months. *See* Treas. Reg. § 301.9100-2(a)(2)(iv).

10 *See* IRC § 6033; Treas. Reg. § 1.6033-2. For 2010, exempt organizations with gross receipts normally less than $200,000 or total assets less than $500,000 may file Form 990-EZ. Pursuant to the charity reform subtitle of the Pension Protection Act of 2006, very small charities have to file a Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ*, to apprise the IRS of their ongoing existence. *See* Pub. L. No. 109-280, § 1223, 120 Stat. 780, 1090 (adding IRC § 6033(i) & (j)). However, submission of this e-Postcard is not considered the filing of a complete return that would start the period of limitations. *See* Treas. Reg. § 1.6033-6(c)(4). Failure to file a required Form 990-N for three consecutive years automatically results in revocation of exempt status. *See* IRC § 6033(j).

11 *See* IRC § 6501(g)(2) (indicating for limitation purposes that Form 990 is the return of a charity that determined in good faith that it is an exempt organization).

12 *See* IRC § 6501(e).

non-filing of a return.[13] If the IRS determines a charity is not "described in" IRC § 501(c)(3), an unwitting donor who claims a charitable deduction would be held harmless until announcement of revocation.[14]

The requirements to apply for exempt status and file annual returns do not apply to churches or certain related religious organizations.[15] If it plans to audit a church, the IRS must provide notice of a so-called church tax examination, which initially is limited to "tax status or liability" for the three most recent years before the examination notice date. If the IRS determines the church was not exempt for this period and did not file a return, the examination may extend back to six years before the notice date. These three- and six-year periods in the regulations correspond to periods of limitation on assessment prescribed by the church tax examination statute.[16]

An organization whose tax-exempt status is revoked may come into compliance with IRS requirements and then re-apply for exemption. Nevertheless, certain funding sources or program qualifications may have lapsed upon revocation, which would impede future operation as a charity.

REASONS FOR CHANGE

Exempt status generates numerous benefits, such as qualification for certain bond financing or participation in certain programs, which potentially could affect third parties such as bondholders or beneficiaries.[17] Additional benefits of § 501(c)(3) exempt status may include deductibility of charitable contributions for federal income, estate, and gift tax purposes,[18] effectively favorable status as a grantee of a private foundation,[19] and numerous non-tax benefits such as preferred postal rates.[20] Given the far-reaching impact of these benefits on both charities and third parties such as beneficiaries or donors, equally far-reaching consequences follow revocation, to which procedural safeguards should apply. Current law, however, lacks a fundamental safeguard in the form of a statute of limitation on revocation.[21]

13 *See* IRC § 6501(c).

14 *See* Rev. Proc. 82-39, 1982-2 C.B. 759. Further, IRC § 170 contribution deductions would continue to be allowed if a charity pursues judicial relief. *See* IRC § 7428(c).

15 *See* IRC §§ 508(c)(1)(A), 6033(c)(3)(A)(i).

16 *See* IRC § 7611; Treas. Reg. § 301.7611-1, A-15.

17 *See* Elizabeth Mills, *IRS Takes Hard Line on Section 501(c)(3) Bonds and Exempt Status*, Journal of Taxation of Exempt Organizations (July-Aug. 2001).

18 *See* IRC §§ 170(c), 2055(a), 2522(a).

19 *See* IRC § 4945(d)(4).

20 *See* 39 CFR § 111.1; Domestic Mail Man. 703 (1.0).

21 The Supreme Court long has observed that statutes of limitation are vital to the welfare of society, stimulating activity, punishing negligence, and protecting parties from the prosecution of stale claims, when, by loss of evidence from death of some witnesses, and the imperfect recollection of others, or the destruction of documents, it might be impossible to establish the truth. *See United States v. Oregon Lumber Co*., 260 U.S. 290, 299-300 (1922).

In tax administration, a statute of limitation on revocation would maximize audit efficiency while minimizing taxpayer burden. Generally, the IRS receives notice of a charity's claim to exempt status upon organization and annually thereafter, so it would not be the case that the IRS lacks timely notice of the charity's claim.[22] The law precludes assessment of tax for closed years, for which donor deductions would be allowed, so it is unclear whose interests could be protected by an indefinite period for revocation.[23] Even if a charity acted improperly, revocation for time-barred years would yield no return on investment in terms of tax administration. Yet revocation for closed years (*i.e.*, those for which the period of limitation on assessment has expired) creates substantial uncertainty, and could impair a charity's ability to function and ultimately reform, which would serve the interest of tax administration.

While tax exemption should lapse whenever a charitable organization ceases to operate exclusively for a public rather than a private interest or otherwise fails to fulfill the requirements,[24] an organization that has transgressed may reform. Unless egregious operation warrants expeditious revocation, the IRS, pending reform, can obtain an agreement to extend the applicable limitation period. If a closing agreement ensues, public disclosure of reform actions can even be a condition of the agreement. Thus, charitable reform can proceed in harmony with the public interest in exempt operation. Otherwise, a revoked yet reformed charity would have to re-apply for exempt status, creating a tax administration burden that hinders future exempt operation. By limiting this scenario to open years, the recommendation would help make tax administration more efficient.

EXPLANATION OF RECOMMENDATION

Under the recommendation, a limitation period on revocations of charitable exemption generally would run concurrently with the existing period of limitation on assessment. Thus, revocation potentially may occur for up to three, or in case of substantial omission, six years following the filing of a return.[25] As under current law, no period of limitation on revocation would apply in cases of fraud, tax evasion, or non-filing.

This recommendation would apply in addition to the statute of limitation on assessment. Thus, assessment for a revoked period four, five, or six years ago would be time-barred except in case of substantial omission, fraud, or tax evasion.

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22 As noted above, the IRS uses Forms 1023 and 990 to collect information about a charity's initial and ongoing organization and operation.

23 *See* Rev. Proc. 82-39, § 3.01 (stating "contributions made to the organization by persons unaware of the change in the status of the organization generally will be considered allowable if made on or before the date of an appropriate public announcement").

24 *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); *Bob Jones Univ.*, 461 U.S. at 591 (stating "[c]haritable exemptions are justified on the basis that the exempt entity confers a public benefit – a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues").

25 In this case, substantial omission may be interpreted to encompass unreported material change in organization or operation. In the case of a very small charity electronically filing a Form 990-N or *e-Postcard* rather than a return as such, the period would run from the electronic submission. Currently, the statute of limitation would not run when a return was not filed even if not required. *See* Rev. Rul. 71-55, 1971-1 C.B. 403.

Moreover, revocation could not proceed from failure to satisfy an exemption requirement in a year closed under the recommendation. Finally, the recommendation would not supersede the more specific church tax examination statute of limitation.

Theoretically, periods of limitation could be imposed by regulation, but the one that applies limitations in the case of church tax examinations closely parallels the statutory terms. Accordingly, the National Taxpayer Advocate recommends enactment of a statute of limitation on exempt charity revocations.

LR #7

Protect Taxpayer Privacy in Whistleblower Cases

PROBLEM

Generally, tax return information is confidential, even if the IRS finds a deficiency, unless judicial proceedings ensue or other exceptions apply. However, a significant gap in the case of a whistleblower claim, of which there are a significant number,[1] allows public disclosure of this return information without the taxpayer's knowledge or consent in proceedings to which the taxpayer is not a party.

EXAMPLE

An individual, W, believed that an acquaintance, T, was committing federal tax fraud. W filed a whistleblower claim reporting this belief to the Whistleblower Office (WO) within the IRS. After reviewing the claim, the WO sent a letter to W stating that his information did not lead to a federal tax issue upon which the IRS will take action. W disagreed with the IRS's finding through an administrative proceeding, filing a petition for review by the U.S. Tax Court. These administrative and judicial proceedings included a discussion of facts relevant to W's claim, including T's name, gross income, and other return information. Even though T was not a party to W's case, the Tax Court published an opinion discussing T's return information.[2]

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 7623 or other applicable provisions to require redaction of third-party return information in administrative and judicial proceedings relating to a whistleblower claim, with an opportunity for the taxpayer to request further redactions before disclosure. The taxpayer would have a subsequent right of action for civil damages for unauthorized disclosure by the whistleblower.

PRESENT LAW

Generally, tax returns and return information are confidential,[3] with sanctions stating that it "shall be unlawful" for IRS employees or certain other persons to make an unauthorized disclosure.[4] Additionally, a taxpayer who is the subject of an unauthorized disclosure has a right to bring an action within two years for civil damages against a knowingly or

1 In the last reported year, the IRS received 460 whistleblower submissions that appeared to meet the threshold of $2 million in dispute under Internal Revenue Code (IRC) § 7623(b) (allowing appeal to Tax Court), relating to 1,941 taxpayers. *See* IRS Whistleblower Office, *Annual Report to Congress on the Use of Section 7623* (FY 2009) at 5. Additionally, there were 5,678 cases received under IRC § 7623(a) (not applying the $2 million threshold). *See Annual Report*, Table 2 at 8.

2 *See, e.g., Cooper v. Comm'r*, 135 T.C. No. 4 (July 8, 2010).

3 *See* IRC § 6103(a).

4 *See* IRC § 7213 (up to $5,000 or 5 years imprisonment).

negligently responsible person in the amount of $1,000 or, if applicable, actual and punitive damages, costs, and attorney fees.[5]

However, there are statutory exceptions that authorize disclosure. In an administrative or judicial tax proceeding pertaining to tax administration that concerns the treatment of an item on a third party's return, disclosure of relevant return information is authorized.[6] Disclosure in a proceeding before the public (including a person who is not a government employee) can render return information public.[7] These exceptions may apply to the case of a whistleblower.

On the date the claim for award is received from the IRS by the WO after the IRS has taken action against a taxpayer, the WO begins an "administrative proceeding" to review the whistleblower's contribution to the IRS action against the taxpayer and to determine an award to the whistleblower based on that contribution.[8] The extent of disclosure to the whistleblower depends on how much of the third-party taxpayer's return information is relevant to the proceeding for determination of an award by the WO. Necessary disclosures comprise facts sufficient for a whistleblower to understand the basis of the WO's decision on the claim. A Sample Preliminary Award Report and Sample Determination Letter developed by the WO appear to contemplate disclosure of the type of transaction, industry, dates, amounts, tax positions, audit history, and other return information of the third party.[9] At the same time, the WO has issued a Confidentiality Agreement imposing confidentiality of return information on the whistleblower as a condition of participation "in the administrative proceeding leading to the determination of an award by the" WO and pointing to potential re-disclosure as a negative factor in award determination.[10] As a practical matter, this factor would be ineffective after payment.

Current law does not specifically protect the confidentiality of a taxpayer who is the subject of a whistleblower claim, but aspects of existing rules may be instructive. In the case of a criminal or civil judicial proceeding, disclosures in open court are generally in the public domain. Unlike litigation in which the taxpayer as a party could request certain redactions from the record,[11] whistleblower litigation does not include the taxpayer as a party, even though this is also litigation subject to public observation. Although a third-party taxpayer would not be a party in a whistleblower case,[12] the Tax Court has allowed third parties to

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5 *See* IRC § 7431.

6 *See* IRC § 6103(h)(4); Internal Revenue Manual (IRM) 11.3.22.19.

7 *See Lampert v. U.S.*, 854 F.2d 335, 337 (9th Cir. 1988) (stating "once return information is disclosed in court, such information is no longer confidential, the taxpayer loses any privacy interests in that information") *cert. den'd* 490 U.S. 1034 (1989). After disclosures authorized by § 6103(c), (k)(6), or (e), restrictions do not apply. *See* Rev. Rul. 2004-53, 2004-1 C.B. 1026.

8 *See* IRM 25.2.2.8(1). This administrative proceeding may follow referral of the whistleblower claim to an IRS subject-matter expert "to determine whether it may materially contribute to the identification, development or resolution of taxpayer liability or collection issues." IRM 27.2.2.7(5).

9 *See* IRM Exhs. 25.2.2-11, -12.

10 *See* IRM Exh. 25.2.2-10.

11 *See, e.g.*, T.C. Rule 27 (allowing redaction for good cause in certain cases); Fed. R. Crim. Proc. 49.1 (allowing redaction for good cause in certain cases).

12 IRC § 7623(b)(4) grants the Tax Court jurisdiction over appeal of a whistleblower award determination.

intervene to protect an otherwise unrepresented interest.[13] Additionally, the tax law authorizes the Tax Court to "make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information," and Tax Court rules allow a request for redaction of information for good cause or a protective order over a trade secret or other information that justice requires to protect a person from embarrassment.[14] The Tax Court rules leave much to the discretion of the judge.

In the case of a Private Letter Ruling (PLR) issued upon taxpayer request, the tax law essentially requires public release, but requires redaction of names, addresses, identifying details, trade secrets, commercial or financial information, and information that if disclosed "would constitute a clearly unwarranted invasion of personal privacy."[15] Moreover, the taxpayer receives "notice of intention to disclose" and an administrative opportunity to request additional or fewer disclosures, with confidential judicial review in the Tax Court.[16]

REASONS FOR CHANGE

Disclosure of third-party tax return information in a whistleblower case is a significant gap in the taxpayer privacy rules and could subject a taxpayer to unwarranted exposure or potentially attract claims for the purpose of exposure. This scenario could detract from the mission of the IRS and Tax Court. Beyond minimal disclosure sufficient for transparent judicial review, it is unclear that disclosure of return information in whistleblower litigation would achieve a particular public interest.[17] On the contrary, a taxpayer's privacy interest generally should not be compromised without consent, which is implicit in civil litigation initiated to contest a tax deficiency or obtain a refund, but not in whistleblower litigation. In the criminal context, considerable procedural protections leading up to a criminal charge and trial that discloses return information, coupled with the significant public interest in obedience to criminal laws, take the place of taxpayer consent.[18] While a whistleblower has an interest in knowing that the IRS correctly determined an award based on information provided, it is unclear to what extent third-party disclosure is necessary to adjudicate a whistleblower claim. The National Taxpayer Advocate has long championed taxpayer privacy rights,[19] which may be unjustifiably abridged here unless explicit protections are enacted.

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13 *See Estate of Smith v. Comm'r*, 77 T.C. 326, 334 (1981); *Central Union Trust Co. v. Comm'r*, 18 B.T.A. 300, 303 (1929).

14 *See* I.R.C. § 7461(b)(1); T.C. Rules 27, 103.

15 *See* IRC § 6110.

16 *See* IRC § 6110(f)(3); Treas. Reg. § 301.6110-5; T.C. Rule 220 *et seq*.

17 For oversight, the WO is mandated to deliver to Congress an annual report, which contains aggregate information. *See* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 406(c) (containing an "off-Code" provision that does not override IRC § 6103(a), which precludes IRS disclosures except as authorized in Tit. 26); IRM 25.2.2.14. If Congress needs return information, generally the tax-writing committees can obtain it under IRC § 6103(f).

18 Even in a criminal trial, a taxpayer as a party could make a motion to protect private information. *See* Fed. R. Crim. Proc. 49.1. A distinct anomaly in a whistleblower case is that, unlike in a criminal or civil tax case, the taxpayer whose return information is disclosed is a third party.

19 *See* National Taxpayer Advocate 2003 Annual Report to Congress 232.

EXPLANATION OF RECOMMENDATION

Legislation would require redaction of the administrative record and any judicial review of a whistleblower proceeding to protect names, addresses, identifying details, trade secrets, commercial or financial information, and information that if disclosed "would constitute a clearly unwarranted invasion of personal privacy" of the third-party taxpayer.[20] Since the whistleblower already knows the identity of the taxpayer, designating the taxpayer by an initial, as in the case of a PLR, should pose no impediment to due process for the whistleblower. With respect to identifying details and other return information, such as dates and income amounts, there may be an exercise of discretion to protect taxpayer confidentiality while affording a full and fair hearing to the whistleblower. Consequently, a confidential administrative and judicial process, beginning with "notice of intention to disclose" to the taxpayer, legislatively designated as a party, would be available separately concerning redaction, but not regarding the merits of the whistleblower claim.

Subsequently, the whistleblower could disclose return information only in judicial or congressional review of the claim.[21] The taxpayer would have a legislatively established right to bring a civil action against the whistleblower within two years of an unauthorized disclosure of return information obtained in the course of an administrative or judicial proceeding, for an amount not less than $1,000, or actual economic damages, including costs and attorney fees.

20 *See* IRC § 6110(c)(5).

21 A whistleblower's disclosure of properly obtained return information to the tax-writing committees of Congress would not be considered to be unauthorized. *See* IRC § 6103(f)(5).

LR #8

Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continue Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act

PROBLEM

Employers are generally required to withhold employment taxes, income tax, and certain types of excise taxes, often referred to as the "trust fund" taxes, from payments to employees.[1] Internal Revenue Code (IRC) § 6672 provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against those deemed responsible persons when these monies are not paid as required.[2] To establish liability under IRC § 6672, the IRS must conclude a person was responsible for withholding and paying over to the IRS payroll taxes and that the failure to do so was willful.[3] The willfulness component of the statute is satisfied if the person had knowledge of the employer's obligation to pay withholding taxes and knew the funds were being used for other purposes.[4] The statute does not contain a reasonable cause exception.[5]

The United States Supreme Court has limited the application of the penalty in cases where a financially troubled company changed ownership and an individual became a responsible person after the liability accrued,[6] to provide the company with "minimum working capital .... to maintain operations and avoid liquidation of the business."[7] However, courts have adopted a rather "harsh" interpretation of the willfulness component of the statute in situations where there was no change in ownership.[8] To avoid TFRP liability, a responsible person must use all available funds to pay off back trust fund taxes and cannot use any

1 *See generally* IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, *see, e.g.*, IRC §§ 4251; 4261; 4271. IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. These taxes are often referred to as the "trust fund" taxes.

2 "Responsible person" is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes, but willfully fails to do so. IRC §§ 6671(b) and 6672(a). *See also Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

3 IRC § 6672 applies to taxes collected and paid over by a third party. It does not apply to taxes directly imposed on the person or entity required to pay them, *e.g.*, it does not apply to the employer's share of FICA or FUTA. IRC §§ 3101 and 3301.

4 *See Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). A person has acted with willfulness if his or her actions were voluntary, conscious, and intentional as opposed to being merely negligent.

5 There is a split in circuits on this issue. While most circuits reject the contention that reasonable cause or justifiable excuse plays a part in determining whether the responsible party's actions are willful, the U.S. Court of Appeals for the Fifth Circuit held that, in very limited circumstances, reasonable cause could have an effect on a willfulness determination. *See Harrington v. U.S.*, 504 F.2d 1306 (1st Cir. 1974); *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970); *Olsen v. U.S.*, 952 F.2d 236 (8th Cir. 1991); *Bloom v. U.S.*, 272 F.2d 215 (9th Cir. 1959). *Cf. Newsome v. U.S.*, 431 F.2d 742 (5th Cir. 1970); *McCarty v. U.S.*, 194 Ct. Cl. 42 (1971).

6 *Slodov v. U.S.*, 436 U.S. 238 (1978) (holding that the individual's conduct was not willful when he used after-acquired funds for operating expenses of the business).

7 *In re Rossiter*, 167 B.R. 919 (C.D. Cal. 1994) (applying *Slodov* analysis).

8 *See, e.g.*, *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997); *Phillips v. U.S.*, 73 F.3d 939, 943 (9th Cir. 1996). *See also* Corrie Lynn Lyle, *The Wrath of IRC § 6672: The Renewed Call for Change – Is Anyone Listening? If You Are a Corporate Official, You Had Better Be*, 74 S. Cal. L. Rev. 1133 (May 2001).

portion of after-acquired funds as a working capital to pay current operating expenses, even if it may result in liquidation of the business.[9] This outcome does not change if the delinquency was caused by a third party bad act, such as mismanagement or embezzlement, by an employee or by a third party payer.[10] Because the assessment of the TFRP can have disastrous economic consequences on those deemed responsible, this rule provides a disincentive for keeping financially struggling businesses afloat by paying businesses' operating expenses and current employment tax liabilities, while repaying past delinquencies in installments.

EXAMPLE

A small construction business incurred a payroll tax liability of about $500,000 as a result of embezzlement by a trusted company controller. As soon as the company's management became aware of the delinquency, it contacted the IRS and arranged to pay past taxes in installments while being current with payment and filing obligations. To keep the business a going concern and generate income to repay the past delinquencies, the management continued to pay current operational expenses, including rent, accounts receivable, suppliers, etc. Although the controller admitted his guilt and was subsequently convicted, the amount of restitution did not cover the accrued delinquencies, nor did the company's business insurance cover the amount embezzled. The IRS assessed TFRPs against corporate officers and filed notices of federal tax lien against their personal assets.[11] As a result, the company lost its line of credit, which was dependent on the creditworthiness of its officers and shareholders. The company went out of business, leaving 15 people, including the officers, unemployed. Although the officers liquidated the remaining assets, the proceeds were insufficient to pay off the liability, and the IRS acted to enforce federal tax liens against the officers' homes.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS's determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations.

9 Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors. *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821 (1970); *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Stettler v. U.S.*, 98-1 U.S.T.C. ¶ 50,136 (10th Cir. 1998); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987).

10 *See, e.g., Anuforo v. Comm'r*, 614 F.3d 799 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). *See also Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir 1979); *Garsky v U.S.*, 600 F.2d 86 (7th Cir. 1979). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers;* Legislative Recommendation: *Taxpayer Protection from Third Party Payer Failures*).

11 The IRS's policy is not to pursue the TFRP so long as there is an installment agreement (IA) in place with the business, unless there are statute of limitations issues or a default on IA is entered. IRS Policy statement 5-14, IRM 1.2.14.1.3(8) (June 9, 2003).

PRESENT LAW

IRC § 6672 imposes a penalty on any person required to collect, truthfully account for, and pay over any tax imposed under the Code where that person willfully fails to do so, or willfully attempts to evade tax. This is referred to as a trust fund recovery penalty, which is also called the 100 percent penalty because the amount is equal to 100 percent of the trust fund taxes evaded, not collected, or not accounted for and paid over.[12] Trust fund taxes include employment taxes, income tax withheld from employees' wages, and certain types of excise taxes.[13] To establish liability under IRC § 6672, the IRS must conclude a person was responsible for withholding and paying over to the IRS payroll taxes and that the failure to do so was willful.[14] The determination of whether a person was responsible for withholding and paying payroll taxes depends on the individual's status, duty, and authority in the context of the business.[15]

The willfulness component of the statute is satisfied if the person had knowledge of the employer's obligation to pay withholding taxes and knew the funds were being used for other purposes.[16] Willfulness does not require specific criminal intent or evil motive.[17] The courts apply these general standards to determine whether a responsible person acted willfully:

- **Deliberate choice** – Willfulness exists where the responsible person makes the deliberate choice to pay withholding taxes to other creditors, instead of paying the taxes over to the IRS;[18]
- **Knowledge of nonpayment of taxes** – Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors;[19] and
- **Reckless disregard** – Willfulness exists where the responsible person acts with a reckless disregard of a known or obvious risk that withholding taxes will not be remitted,

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12 IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. The IRS is required to credit the employees for the withheld taxes even if the employer fails to remit them. IRC § 31(a). *See also Slodov v. U.S.*, 436 U.S. 238 (1978).

13 *See generally* IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, *see, e.g.*, IRC §§ 4251, 4261, 4271.

14 "Responsible person" is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes, but willfully fails to do so. IRC §§ 6671(b) and 6672(a). *See also Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

15 *Thiboudeau v. U.S.*, 828 F.2d 1499 (11th Cir. 1987), *cert. denied*, 506 U.S. 1050 (1993); *George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987).

16 *See Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). A person has acted with willfulness if his or her actions were voluntary, conscious, and intentional as opposed to being merely negligent. *See also Kalb v. U.S.*, 505 F.2d 506, 511 (2d Cir. 1974).

17 *See, e.g., Thomas v. U.S.*, 41 F.3d 1109 (7th Cir. 1994).

18 *See Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.3d 1151 (5th Cir. 1979).

19 *See, e.g., Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Stettler v. U.S.*, 98-1 U.S.T.C. ¶ 50,136 (10th Cir. 1998); *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied* 400 U.S. 821 (1970); *Thosteson v U.S.*, 331 F.3d 1294 (11th Cir. 2003), *cert. denied,* 540 U.S. 1105 (2004).

> including failing to investigate or correct mismanagement after being notified that withholding taxes have not been paid.[20]

The statute does not contain a reasonable cause exception.[21] In *Slodov v. U.S.*, the Supreme Court addressed liability of a successor, and limited the application of the penalty in cases where a financially troubled company changes ownership and an individual becomes a responsible person after the delinquency and change of ownership occurred.[22] The court held that the individual's conduct was not willful when he used after-acquired funds for operating expenses of the business after the liability accrued.[23] The reasoning of *Slodov* also applies to individuals who become responsible persons after the taxes accrue, even if no ownership change has occurred.[24] However, to avoid personal liability for past delinquencies, a person deemed responsible must use all unencumbered funds to pay the back taxes after he or she obtains knowledge of a trust fund tax delinquency.[25] This duty extends not only to funds available at the time the responsible person becomes aware of the delinquency, but also to any funds acquired thereafter regardless of why the delinquency occurred.[26]

REASONS FOR CHANGE

As a result of the courts' interpretation of the willfulness component of the statute, in situations where no changes in ownership occurs, the responsible person must use all available funds to pay the delinquency and cannot use any of the funds to pay operating expenses of the business to avoid personal liability for TFRP. This outcome does not change if the delinquency resulted from a third party bad act, such as mismanagement, embezzlement by a trusted employee, or by a third party payer.[27] The taxpayer's willfulness is generally established if he or she pays other creditors instead of paying the IRS after finding out about the embezzlement, even if those payments are made in an effort to keep the business

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20 *See, e.g., George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Denbo v. U.S.*, 988 F.2d 1029 (10th Cir. 1993); *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *Godfrey v. U.S.*, 748 F.2d 1568 (Fed. Cir. 1984); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979).

21 There is a split in circuits on this issue. While most circuits reject the contention that reasonable cause or justifiable excuse plays a part in determining whether the responsible party's actions are willful, the U.S. Court of Appeals for the Fifth Circuit held that, in very limited circumstances, reasonable cause could have an effect on a willfulness determination. *See Harrington v. U.S.*, 504 F.2d 1306 (1st Cir. 1974); *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970); *Olsen v. U.S.*, 952 F.2d 236 (8th Cir. 1991); *Bloom v. U.S.*, 272 F.2d 215 (9th Cir. 1959). *Cf. Newsome v. U.S.*, 431 F.2d 742 (5th Cir. 1970); *McCarty v. U.S.*, 194 Ct. Cl. 42 (1971).

22 *Slodov v. U.S.*, 436 U.S. 238 (1978).

23 *Id.*

24 *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir 1979).

25 *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821 (1970) (the responsible party knew those taxes were due but nevertheless wrote checks to other creditors and suppliers); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987); *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979). Encumbered funds are money that the taxpayer is legally obligated to use for a purpose other than satisfying the preexisting tax liability. The claim of the other creditor must be superior to the IRS. *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997).

26 *Garsky v. U.S.*, 600 F.2d 86 (7th Cir. 1979); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997). Even if money intended for payment of taxes was embezzled, the responsible party remains liable for the penalty. *Anuforo v. Comm'r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010). *See also Purcell v. U.S.*, 1 F.3d 932 (9th Cir. 1993); *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997).

27 *Anuforo v. Comm'r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). *See also* National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; Legislative Recommendation: *Taxpayer Protection from Third Party Payer Failures*).

going. Thus, during a period of financial hardship, a responsible person must always continue to repay back taxes even when funds to operate the business are not available.[28]

Courts and legal scholars have commented that the current judicial interpretation of willfulness is "harsh," "draconian," and "somewhat counterintuitive," and advocated for change in the statute.[29] This interpretation appears to cause unjust results when a responsible person of a struggling business tries to resolve past tax delinquency, which resulted from an intervening bad act, and agrees to repay the liability in installments instead of liquidating the business.[30]

In the context of a buyout of a struggling company, the Supreme Court in *Slodov* commented that although the IRS "encourage[s] the responsible person to continue operation with the hope of receiving the payment of back taxes, if the attempt fails and the taxes remain unpaid, the IRS insists that the § 6672 personal liability penalty attached upon payment of the first dollar to a supplier."[31] The court also stated that a responsible person has no obligation to liquidate business assets and refused to construe IRC § 6672 to discourage changes of ownership and management of financially troubled companies.[32] In the same context, another court noted that the financially struggling business should be allowed "minimum working capital .... to maintain operations and avoid liquidation of the business."[33]

This reasoning is equally applicable to a financially struggling business that became a victim of a third party bad act. It is in the best interests of the government to encourage business owners to continue in business and pay off the delinquencies in installments rather than liquidate and lay off employees. Because current judicial interpretation of the TFRP willfulness component effectively requires a business owner to stop operating a business and pay all available cash to the IRS, the government may be forced to make outlays in the form of unemployment benefits, food stamps, and the like to the business owner and the laid-off employees. Thus, the strict application of the TFRP willfulness component has the potential to destroy the taxpayer's business, financially damage the taxpayer's family, and simultaneously reduce future federal revenue.

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28 *See, e.g., Sorenson v. U.S.*, 521 F.2d 325, 327 (9th Cir. 1975).

29 *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997); *Phillips v. U.S.*, 73 F.3d 939, 943 (9th Cir. 1996). *See also* Corrie Lynn Lyle, *The Wrath of IRC § 6672: The Renewed Call for Change – Is Anyone Listening? If You Are a Corporate Official, You Had Better Be*, 74 S. Cal. L. Rev. 1133 (May 2001).

30 For example, in *Baimbridge v. United States* the potentially responsible person attempted to address the willfulness component of the TFRP liability test by arguing that the corporation had entered into an installment agreement for the repayment of the delinquent tax, and therefore, the IRS should be estopped from assessing the penalties because it was fully aware that the business was going to continue operation and satisfy non-IRS creditors. *Baimbridge v. U.S.*, 335 F. Supp. 2d 1084 (S.D. Cal. 2004). The court noted "that serious injustice may result from a penalty assessment being predicated on non-IRS payments which were contemplated by the installment agreement" and denied the IRS's motion for summary judgment on the issue of willfulness, thereby requiring the parties to go to trial.

31 436 U.S. at 252.

32 *Slodov v. U.S.*, 436 U.S. 238 (1978).

33 *In re Rossiter*, 167 B.R. 919 (C.D. Cal. 1994).

EXPLANATION OF RECOMMENDATION

Because courts strictly interpret the willfulness prong of the TFRP, persons deemed responsible are required to use all available funds to pay a tax delinquency after they obtain knowledge of the delinquency, regardless of the reasons why the delinquency occurred. The National Taxpayer Advocate recommends amending IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful, if the delinquent business: (1) makes payment arrangements to satisfy the liability based upon IRS's determination of minimal working capital needs of the business, and (2) remains current with payment and filing obligations.[34]

This legislative change will provide for uniform treatment of similarly situated taxpayers in the context of a financially struggling business, both when change of ownership occurs and when the liability accrues due to an intervening bad act. It will also encourage a responsible person to continue operation of the business and enter into payment arrangements with the IRS on behalf of the business, rather then resign after obtaining knowledge about the liability. This legislative change would not relieve from liability responsible persons who caused the delinquency to accrue.

In addition, the National Taxpayer Advocate recommends that the IRS be given authority to determine minimal working capital needs of a financially struggling business. Similar to the IRC § 7122(d)(2) requirement for allowable living expenses analysis, the IRS should base its determination of minimal working capital needs on a thorough analysis of all facts and circumstances of each taxpayer and ensure that its determination will not leave the taxpayer without adequate funds to meet its basic operating expenses, including current and future tax obligations.[35]

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34 Multiple persons may be responsible for TFRP. Therefore, responsible persons who did not apply for a relief under this provision will remain liable for TFRP under current law.

35 In 1995, the IRS developed and implemented the allowable living expenses (ALE) approach to determining an individual taxpayer's financial ability to pay delinquent taxes, which serve as the basis for various collection alternatives, such as installment agreements, CNC determinations, and offers-in-compromise. The IRS Restructuring and Reform Act of 1998 also requires the IRS to prescribe guidelines to determine whether to accept an offer in compromise, which in essence codified the IRS's use of the ALE, Pub. L. No. 105-206, § 3462(a) (1998) (codified at IRC § 7122(d)(2)). The ALE standards are not applicable to corporations, partnerships, LLCs, where the LLC is identified as the liable taxpayer, or any Business MasterFile expenses. IRM 5.15.1.7 (Oct. 2, 2009).

LR #9

Designate that Attorneys' Fees Awarded Pursuant to Internal Revenue Code Section 7430 Are Ineligible for Offset to Satisfy a Litigant's Preexisting Government Debts

PROBLEM

The Internal Revenue Code (IRC) provides that courts may award attorneys' fees to taxpayers who prevail against the United States in connection with the determination, collection, or refund of any tax if certain procedural requirements are met.[1] IRC § 7430 generally permits the prevailing party to be awarded a judgment for reasonable administrative and litigation costs paid or incurred.[2] Fee-shifting provisions like IRC § 7430 are intended to decrease apprehension among those who feel they have been victims of unreasonable government action but who might be reluctant to seek review of or defend against those actions because of the expense involved in securing representation to pursue such a claim. Fee-shifting statutes also support the public policy of encouraging qualified representatives to offer *pro bono* assistance to indigent litigants.[3]

Awards of attorneys' fees under IRC § 7430 may be negatively affected by a recent ruling of the United States Supreme Court. The Court's holding in *Astrue v. Ratliff*[4] calls into question some existing case law, and may result in attorneys' fees awards being offset by the government to satisfy a litigant's preexisting government debt. The Court held that attorneys' fees awards paid under the Equal Access to Justice Act (EAJA) were payable directly to the litigant, rather than to the litigant's attorney, thereby making the award subject to administrative offset. The case may impact IRC § 7430 because the fee shifting statute under the EAJA and IRC § 7430 both contain identical language, providing for an award of fees to a "prevailing party."

EXAMPLE

The IRS issues a statutory notice of deficiency to a taxpayer. The taxpayer disagrees with the proposed deficiency and exhausts all administrative procedures and remedies, but is ultimately unsuccessful and must petition the U.S. Tax Court to hear the case. The taxpayer seeks representation before the Court, but is indigent and approaches an attorney about taking the case on a *pro bono* basis. The attorney is aware of a recent ruling that is controlling precedent in the taxpayer's jurisdiction and would support an argument that the government's position is not substantially justified.

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1 IRC § 7430. Under the general provisions of § 7430, a taxpayer will not be awarded attorneys' fees if: i) the government establishes that its position was substantially justified; ii) the taxpayer fails to meet the statutory net worth requirement; iii) the taxpayer does not exhaust administrative remedies; or iv) the taxpayer protracts the administrative or judicial proceedings.

2 IRC § 7430(a).

3 IRC § 7430(c)(3)(B).

4 *Astrue v. Ratliff*, 130 S. Ct. 2521 (2010). *See also* 28 U.S.C. § 2412(d).

The attorney is a struggling solo practitioner, and has limited time to handle reduced fee cases, but feels strongly that the government's position is not substantially justified, and so determines that an award of attorneys' fees under IRC § 7430(c)(3)(A) may be obtainable upon achieving a successful result in the taxpayer's case. Prior to taking the case, the attorney determines that the taxpayer owes the government an unrelated social security debt from two years prior. Even if the taxpayer wins his case, and the court awards attorneys' fees, any fee award may be subject to offset against the taxpayer's social security debt. Now if the attorney wishes to have even the possibility of receiving fees, she is faced with the difficult choice of handling the taxpayer's tax controversy issue to her personal detriment, or telling the taxpayer she cannot provide representation.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 7430 to declare that attorneys' fees are ineligible for offset to satisfy a litigant's pre-existing federal government debt.

PRESENT LAW

Litigants who prevail in a suit against the IRS are able to move for an award of attorneys' fees under IRC § 7430. In order to determine if an attorneys' fee award is merited, the standard typically applied is whether the government's position was substantially justified.[5]

In 1996, Congress passed the Debt Collection Improvement Act (DCIA),[6] and subsequently amended it in 1999 to include a provision establishing the Treasury Department's Offset Program (TOP).[7] The TOP provides for offsetting of certain federal government payments to satisfy other federal government debt owed by an individual. Congress's purpose in enacting the DCIA was to "maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and the use of all appropriate collection tools."[8] At the time of the DCIA's enactment, some agencies had a regular practice of paying fee awards directly to the attorney, rather than the prevailing party. However, in 2005 the Treasury Department extended the offset program to cover miscellaneous federal payments, including attorneys' fees awards.[9] Some precedent existed at that time holding that attorneys' fees awards under IRC § 7430 could not be offset against debts owed to the government by the taxpayer; the attorney was viewed as the real party in interest, while

5 In order to be eligible for an award of attorneys' fees, taxpayers must also meet other criteria. The taxpayer must fall within a statutory net worth requirement, all administrative remedies must be exhausted, and the taxpayer must not protract administrative or judicial proceedings.

6 Pub. L. No. 104-134, 110 Stat. 1321, 358 (1996).

7 *See* Internal Revenue Manual 21.4.6.4(1) (Oct. 1, 2009).

8 Pub. L. No. 104-134, § 31001(b)(1), 110 Stat. 1321, 358 (1996).

9 Centralized Offset of Federal Payments to Collect Nontax Debts Owed to the United States, 70 Fed. Reg. 3142-01 (Jan. 21, 2005) (codified at 31 C.F. R. pt. 285).

"the prevailing party [was] only nominally the person who receives the award."[10] Only after TOP's expansion did the Treasury universally adopt the position that attorneys' fees awards under the EAJA were appropriately considered the property of the prevailing party, and thus subject to offset to satisfy a litigant's pre-existing government debt.[11]

REASONS FOR CHANGE

Allowing attorneys' fee awards to be offset for a client's government debt impairs the legislative intent of government fee-shifting statutes. In enacting the EAJA, Congress found "that certain individuals, partnerships, corporations, and labor and other organizations may be deterred from seeking review of, or defending against, unreasonable governmental action because of the expense involved in securing the vindication of their rights in civil actions and in administrative proceedings."[12]

According to the legislative history, IRC § 7430 was designed to "deter abusive actions and overreaching by the Internal Revenue Service and [to] enable individual taxpayers to vindicate their rights regardless of their economic circumstances."[13] Reducing the likelihood of obtaining attorneys' fees will have a chilling effect on the availability of low-cost or no-cost legal services for indigent civil litigants.

As Justice Sotomayor pointed out in her concurring opinion in *Ratliff*, without Congressional intervention, "[t]he EAJA's admirable purpose will be undercut if lawyers fear that they will never actually receive attorneys' fees to which a court has determined the prevailing party is entitled. The point of an award of attorneys' fees, after all, is to enable a prevailing litigant to pay her attorney…Subjecting EAJA fee awards to administrative offset for a litigant's debts will unquestionably make it more difficult for persons of limited means to find attorneys to represent them."[14]

Since IRC § 7430 and the EAJA are similarly worded in that both provide for awards to the "prevailing party," *Ratliff* could be applied to support offsetting of awards in section 7430 cases as well.[15] Attorneys' fees awards should be designated as belonging to the litigant's representative, and unavailable for offset to satisfy a pre-existing government debt of the litigant.

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10 *Marre v. United States*, 117 F.3d 297 (5th Cir. 1997); *but see Stephens ex rel. R.E. v. Astrue*, 565 F.3d 131, 137 (4th Cir. 2009) (holding that "attorney's fees under the EAJA are payable to the claimant, not the attorney, and thus are subject to administrative offset"); *Reeves v. Astrue*, 526 F.3d 732 (11th Cir. 2008) (finding the language of the EAJA statute to unambiguously direct attorneys' fees awards to the prevailing party, rather than the party's representative, and thus subject to offset).

11 *Ratliff*, 130 S. Ct. at 2532 (J. Sotomayor, concurring) (citations omitted).

12 Pub. L. No. 96-481, § 202(a) of title II, 94 Stat. 2325 (1980).

13 *See* H.R. Rep. No. 404, 97th Cong., 2d Sess. 11 (1982).

14 *Ratliff*, 130 S. Ct. at 2530-31 (J. Sotomayor, concurring) (citations omitted).

15 Although both IRC § 7430 and the EAJA contain the phrase "prevailing party," IRC § 7430 contains a unique section specific to awards of attorneys' fees in the context of *pro bono* services. The last sentence of IRC § 7430(c)(3)(B) specifies that the "subparagraph shall apply only if such award is paid to [the representative] or [the representative's] employer." The argument can be made that this language may forestall offsetting; however, because of the important role fee-shifting provisions play in preserving the fairness of the tax system, particularly in the *pro bono* context, we believe that all attorneys' fees should be unequivocally protected from offset.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate's recommendation will ensure that a policy of the Treasury Department does not undermine an important remedy which serves to protect indigent taxpayers against unjustified IRS actions. Allowing litigants to sue the government and seek attorneys' fees eliminates the financial disincentive to challenge unreasonable government actions. Fee-shifting provisions particularly help litigants with limited means to obtain reduced fee or *pro bono* assistance. Subjecting attorneys' fees awards to offset for government debts of the litigant undercuts the purpose of fee-shifting statutes and creates a chilling effect on reduced fee and *pro bono* assistance. For instance, if an attorney becomes aware that her client owes the Government a debt which could result in an award becoming subject to offset, then the attorney is faced with a truly difficult choice; she must choose between making her own livelihood or righting a wrong for someone in need who may be unable to get relief without her assistance. Further, limiting access to an attorney will in turn increase the number of *pro se* litigants and increase the burden on the courts. Awards of attorneys' fees should be protected from offset and payable directly to the attorney providing the representation.

LR #10

Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections

PROBLEM

Small business corporations may elect to be treated as flow-through entities by submitting Form 2553, *Election by a Small Business Corporation*, on or before the 15th day of the third month of the taxable year.[1] However, the due date for an S corporation to file Form 1120S, *U.S. Income Tax Return for an S Corporation*, is the 15th day of the third month after the end of its taxable year.[2] Many taxpayers overlook this requirement, subjecting themselves to serious tax consequences that include taxation on the corporate level and the inability to deduct operating losses on shareholders' individual tax returns.[3]

Businesses that wait until the tax return filing date to make this election are deemed to have made the election for the succeeding year, and must seek retroactive relief upon a showing of reasonable cause.[4] In processing years 2008 and 2009, 81,431 and 97,823 S corporation returns could not be processed as filed because of missing or late elections, IRS errors in recognizing or processing a valid election, and an absence of effective relief procedures.[5] These unprocessed returns accounted for nearly 17 and nearly 24 percent of all new S corporation filings, respectively, for those two years.[6]

EXAMPLE

Taxpayers A and B incorporate a small car repair business on January 1, 2008, and choose to use a calendar year for tax purposes. The business does not become profitable until tax year (TY) 2010. To avoid the double taxation of corporate profits, A and B decide to operate the business as an S corporation, but overlook the requirement to file an election on Form 2553, *Election by a Small Business Corporation*, by March 15, 2008, for TY 2008. However, the business timely files its Form 1120S, *U.S. Income Tax Return for an S Corporation*, for tax year 2008. The IRS converts the Form 1120S to Form 1120, *U.S. Income Tax Return for*

1 IRC § 1362(b)(1)(B); Treas. Reg. § 1.1362-6(a)(2). In FY 2009, 4.5 million S corporation returns were filed, accounting for about 64 percent of all corporate returns. IRS, *Data Book 2009*, Table 2, 4.

2 Internal Revenue Code (IRC) §§ 6037 and 6072(b); Treas. Reg. § 1.6037-1(b); Instructions for Form 1120S, *U.S. Income Tax Return for an S Corporation* 3 (2009).

3 *See* Most Serious Problem: *S Corporation Election Process Unduly Burdens Small Businesses*, *supra*.

4 IRC § 1362(b)(3) and (b)(5). Taxpayers may seek relief under one of four revenue procedures or through a private letter ruling (PLR) request. *See* Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 97-48, 1997-2 C.B. 521. The IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under IRC § 1362 from fiscal year (FY) 2007 to FY 2009, for which the IRS charged a user fee ranging from $625 to $14,000 per request. Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010). For PLR procedures and user fees, see Rev. Proc. 2010-1, 2010-1 I.R.B. 1.

5 Business Master File (BMF) Extract from IRS Compliance Data Warehouse (CDW) for Processing Years 2007-2009 (June 2010). If there is no election on file, the return information cannot "post" to the IRS Master File, and the return becomes "unpostable."

6 Prior IRS research reports revealed approximately 20 percent of these returns remain unpostable for multiple years. IRS, Small Business/Self-Employed Division (SB/SE) Research report, *Profile Taxpayers with Unpostable Initial 1120S Returns* (May 2007).

a Corporation, where income is taxed at the corporate level, but because the business had operating losses for the year, the IRS does not assess any tax at the corporate or shareholder level and does not issue a statutory notice of deficiency (SNOD), leaving the taxpayers with the incorrect assumption that the IRS has accepted their 1120S return as filed.[7]

In 2009, the business once again timely files a Form 1120S. Upon receipt of correspondence from the IRS, the business discovers its oversight regarding Form 2553. In July 2010, the business files an election, and the IRS grants an effective date for S corporation filing as of January 1, 2011.[8]

This action creates the potential for taxation of dividend income at the shareholder level in TY 2010 upon distribution, and prevents A and B from deducting any of the business operating losses on their individual returns for 2008 and 2009. The taxpayers are directed by the IRS to amend prior year returns and are left only with the options of seeking reasonable cause relief for a late election under a Revenue Procedure or through a private letter ruling, which may cost up to $14,000. If the business does not qualify for relief under a revenue procedure and cannot afford the PLR user fee, it will not be treated as an S corporation until the 2011 tax year. The business also may be subject to certain special corporate-level taxes,[9] and carry on certain C corporation attributes such as retained earnings, that may be taxable to A and B as a dividend upon distribution, or be limited in the use of any net operating losses arising during the period it was a C corporation.[10]

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress amend IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its timely filed (including extensions) Form 1120S, *U.S. Income Tax Return for an S Corporation.*[11]

7 *See* Most Serious Problem: *S Corporation Election Process Unduly Burdens Small Businesses, supra*. If the corporation had a gain, the IRS would assess the tax on the corporate level and is required to issue a SNOD. *See also* Memorandum from Assistant Chief Counsel (Field Service) to District Counsel, Pennsylvania District, SCA 199929036 (May 20, 1999).

8 If an S corporation election is made after the 15th day of the third month of the taxable year and on or before the 15th day of the third month of the following taxable year, then the election is treated as made for the following taxable year. IRC § 1362(b)(3).

9 *See generally* IRC §§ 1374 and 1375.

10 IRC §§ 1368(c); 1374 (a) and (b)(2). IRC § 1374(b)(2) generally provides an exception, allowing certain carryover losses to be used against the built-in gains tax of § 1374(a). If the business has C corporation retained earnings and receives too much of its income in future taxable years from certain passive investment activities, its S corporation election may terminate under § 1362(d)(3).

11 The National Taxpayer Advocate reiterates her legislative recommendations from prior Annual Reports to Congress. *See* National Taxpayer Advocate 2004 Annual Report to Congress 390; National Taxpayer Advocate 2002 Annual Report to Congress 246.

LR
11

Enact a Uniform Federal Agency External Ombudsman Act

PROBLEM

The external ombudsman function in the federal government expands yearly, through legislation and individual agency initiatives. However, these new offices often lack the basic structure and protections necessary to succeed in their varying ombuds roles. A Federal Agency External Ombudsmen Act would provide, at minimum, a basic structure and set of protections to each new ombudsman.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact a Federal Agency External Ombudsmen Act to ensure protections to and create uniformity among all future federal external ombudsmen.

BACKGROUND

External ombudsmen for federal agencies serve specific public populations and fall into three distinct categories: legislative, executive, and advocate.[1] A legislative ombudsman is created by an act of Congress, receives complaints from the public, and may advocate for change to agency policy or procedure. Executive ombudsmen receive complaints from the public and may serve to hold an agency or program accountable, or work with the agency to improve specific areas. Advocate ombudsmen work on behalf of a specific population and may investigate complaints from that population in order to recommend remedies.

EXPLANATION OF RECOMMENDATION

Similar to the Inspector General Act of 1978, a Federal Agency External Ombudsmen Act would detail the general responsibilities, authorities, and duties of all federal external ombudsmen.[2] While the Inspector General Act created an Inspector General (IG) for every federal agency and specified the particular duties and requirements of individual offices, we recommend that the Federal Agency External Ombudsmen Act instead cover the general structure and function of any federal external ombudsman office. Thus, when Congress created a new federal external ombudsman, the Act would automatically be incorporated and Congress would specify the particular duties and requirements of the new office at that time. For example, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contained a section establishing the Office of the Inspector Advocate

1 American Bar Association (ABA), *Standards for the Establishment and Operation of Ombuds Offices* (Feb. 9, 2004), *available at* http://meetings.abanet.org/webupload/commupload/AL322500/newsletterpubs/115.pdf (last visited Sept. 20, 2010).

2 Inspector General Act of 1978, Pub. L. No. 95–452, 92 Stat. 1101 (1978).

in the Securities and Exchange Commission.[3] Although the general structure and duties of the new office appear similar to those of previous legislative ombudsmen, an overarching Federal Agency External Ombudsmen Act would have allowed Congress to simply incorporate the general aspects of all ombudsmen offices without the need to rewrite each provision for every new office and only legislate those aspects that are unique for each office.[4]

Crafting new legislation for the general structure and function of each new federal external ombudsman office increases the risk that a crucial function or structural element of the office—for example, one that guarantees confidentially, independence, and impartiality—may be omitted, thereby weakening the office. For example, neither the new Office of the Inspector Advocate nor the National Taxpayer Advocate statutes contain provisions for an independent budget from the parent agency.[5] Requiring the ombudsman to rely on a parent organization for funding can restrict both functional and apparent independence.

A Federal Agency External Ombudsman Act would also provide much-needed protections to ombudsmen created through agency initiatives. Currently, the structures, functions, and authorities of agency-created ombudsmen vary greatly, with the most basic protections of the confidentiality, independence, and impartiality of an ombudsman office not in effect.[6] Thus the Act should require agencies to, at a minimum, establish offices with the structures and protections provided by the Federal Agency External Ombudsman Act when creating a new ombudsman office. This requirement would ensure that the office will function in a confidential, independent, and impartial manner.

3 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

4 *See, e.g.*, IRC § 7803(c) (Office of the Taxpayer Advocate); 6 U.S.C. § 272 (Citizenship and Immigration Services Ombudsmen).

5 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act; IRC § 7803(c).

6 For a discussion of the variations between federal external ombudsmen offices, *see* National Taxpayer Advocate 2009 Annual Report to Congress vol 2, 105-127.