

AREA OF FOCUS #8 The IRS Should Reevaluate How It Develops and Uses Allowable Living Expense Standards

TAXPAYER RIGHTS IMPACTED¹

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The Creation of Allowable Living Expense Standards

The IRS Restructuring and Reform Act of 1998 (RRA 98) required the IRS to establish guidelines to determine whether a taxpayer's offer in compromise (OIC) is adequate, which in essence codified the IRS's use of the Allowable Living Expense (ALE) standards.²

In particular, IRC § 7122(d)(2)(A) mandates that the IRS “develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses.”³ Congress also instructed the IRS to analyze, on a case-by-case basis, if application of the standards to the taxpayer would be appropriate.⁴ IRS employees are required to analyze the facts of each case to determine if application of the standards is appropriate. If application of the standards results in a taxpayer not being able to provide for basic living expenses, then the standards should not be used.⁵

The resulting ALE standards have come to play a major role in analyzing taxpayers' financial situations in order to determine the best resolution in IRS collection cases.⁶ A taxpayer with a personal tax liability must prepare Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals* (CIS) in order to submit an OIC.⁷ The section of Form 433-A used to determine monthly expenses primarily relies on the ALE standards. In addition to OICs, certain installment agreements also require a prepared CIS.⁸ In some instances, the IRS requires a completed CIS prior to putting the taxpayer's liability into Currently Not Collectible (CNC) status.⁹ The National Taxpayer Advocate has

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 RRA 98, Pub. L. No. 105-206, § 3462(a) (1998) (codified at IRC § 7122(d)). In certain situations, OICs allow taxpayers to pay less than the balance due in full satisfaction of what is owed to the IRS.

3 See also Treas. Reg. § 301.7122-1(c)(2)(i).

4 IRC § 7122(d)(2)(B).

5 *Id.*

6 The IRS's ALE standards have also been adopted for other purposes. For instance, debtors filing for bankruptcy are instructed to use the IRS's ALE standards to calculate income and expenses. 11 U.S.C. § 707(b)(2). Additionally, when a debtor to a federal student loan is subject to a proposed wage garnishment, that debtor may object to the proposed garnishment by arguing it would create a financial hardship. 34 C.F.R. § 34.24(a). The debtor must provide credible documentation showing, among other things, his or her basic living expenses as established by the IRS's ALE standards. 34 C.F.R. § 34.24(e)(2).

7 Internal Revenue Manual (IRM) 5.8.5.3, *Taxpayer Submitted Documents* (Sept. 30, 2013).

8 When full payment cannot be achieved by the collection statute expiration date, but the taxpayer has some ability to pay, the IRS may consider a Partial Payment Installment Agreement (PPIA). IRM 5.14.2.1(1), *Overview* (Mar. 11, 2011). A PPIA requires a CIS. IRM 5.14.2.1.1, *Partial Pay Installment Agreement Requirements* (Sept. 19, 2014).

9 IRM 5.16.1.2.9, *Hardship* (Aug. 25, 2014). A hardship exists if the taxpayer is unable to pay basic, reasonable living expenses. *Id.* Once an account is reported as CNC, it is taken out of the active inventory for most collection action. IRM 1.2.14.1.14, *Policy Statement 5-71* (Nov. 19, 1980). See also Treas. Reg. 301.6343-1(b)(4).

previously addressed concerns with the use and application of ALE standards to individual taxpayer cases.¹⁰

The Current ALE Standards

To fulfill Congress's mandate in RRA 98, the IRS developed a system of allowable expenses, which must meet the "necessary test."¹¹ The expenses are broken down into three categories: allowable living expenses, other necessary expenses, and other conditional expenses.¹² This discussion will focus on ALEs.

There are standardized ALEs for items such as food and clothing, housing and utilities, and transportation.¹³ Expenses for food, clothing, and other miscellaneous items, as well as for out-of-pocket healthcare expenses, are based on national standards. These standards come from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey (CES).¹⁴ Taxpayers are allowed the total national standard amount for their family size without analyzing the amounts they actually spend.¹⁵

On the other hand, housing and utility expenses and transportation costs are based on local standards. Housing expenses are based on Census and BLS data by county.¹⁶ Transportation costs consist of nationwide figures for loan or lease payments, and additional amounts for operating costs broken down by Census Region and Metropolitan Statistical Area. Taxpayers are generally allowed the local standard or what they actually pay each month, whichever is less.¹⁷ Thus, the local standards serve as a cap on what taxpayers can claim. However, a deviation from application of the standards is allowed when, based on a taxpayer's facts and circumstances, such application would create an economic hardship for the taxpayer.¹⁸

10 National Taxpayer Advocate 2006 Annual Report to Congress (Most Serious Problem: *IRS Collection Payment Alternatives* 83-109); National Taxpayer Advocate 2005 Annual Report to Congress (Most Serious Problem: *Allowable Expense Standards for Collection Decisions* 270-91).

11 An expense is considered necessary if it is "necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income." IRM 5.15.1.7, *Allowable Expense Overview* (Oct. 2, 2012).

12 "Other necessary expenses" are expenses that meet the necessary expense test, and are normally allowed. This is the category which includes childcare costs, which are allowed if they are "reasonable," making them subject to an individual IRS employee's judgment, a point discussed in more detail below. Conditional expenses are expenses which may not meet the necessary expense test, but may be allowed based on the circumstances of an individual case. IRM 5.15.1.7, *Allowable Expense Overview* (Oct. 2, 2012).

13 IRM 5.15.1.7, *Allowable Expense Overview* (Oct. 2, 2012).

14 The BLS is part of the United States Department of Labor. United States Department of Labor, *About BLS*, <http://www.bls.gov/bls/infhome.htm>. Out-of-pocket healthcare expenses are based on Medical Expenditure Panel Survey data, <http://meps.ahrq.gov/mepsweb/>, which comes from the U.S. Department of Health and Human Services. IRM 5.15.1.7 (Oct. 2, 2012).

15 IRM 5.15.1.7(3), *Allowable Expense Overview* (Oct. 2, 2012). The CES program "consists of two surveys, the Quarterly Interview Survey and the Diary Survey, that provide information on the buying habits of American consumers, including data on their expenditures, income, and consumer unit (families and single consumers) characteristics." BLS, CES, <http://www.bls.gov/cex/> (last visited Sept. 9, 2015).

16 IRM 5.15.1.7(4), *Allowable Expense Overview* (Oct. 2, 2012). In addition to mortgage or rent, housing expenses include such things as utilities (gas, electricity, water, etc.), garbage removal, cable television, internet service, telephone, and cell phone.

17 IRM 5.15.1.7(4) (Oct. 2, 2012) and IRM 5.15.1.9, *Local Standards* (Nov. 17, 2014).

18 IRM 5.15.1.1(7) (Nov. 17, 2014).

Shortcomings of the Current ALE Standards

TAS believes the IRS should adopt ALE standards that are based on actual cost for an appropriate quality of living.¹⁹ As it is now, the standards are based on the average or median expenditures derived from U.S. government data sources (e.g., U.S. Census Bureau or the BLS) representing broad segments of the population. The National Taxpayer Advocate previously expressed concerns that the application of these standards to individual taxpayer cases may lead to erroneous conclusions regarding the appropriate use of reasonable collection payment alternatives.²⁰

In fact, the BLS, which is a primary source for the ALE data, advises caution in interpreting its consumer expenditure data when relating averages to individual circumstances. The warning reads:

Caution should be used in interpreting the expenditure data, especially when relating averages to individual circumstances. The data shown in the published tables are averages for demographic groups of consumer units. Expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the individual consumer unit. Income, family size, age of family members, geographic location, and individual tastes and preferences all influence expenditures.²¹

Some taxpayers forego expenses in order to make ends meet. By focusing on expenditures instead of what we think is the appropriate level for sustainable living expenses, we perpetuate taxpayers living in substandard living situations. It is imperative that all taxpayers, including those who cannot afford to meet their monthly costs of living, have a sufficient and equal amount of expense attributed to them for basic needs.

TAS is concerned that the IRS's proposal to reduce ALE standards is based on a premise that costs are decreasing.²² TAS is unaware of how this proposition can be tested using the current system of ALE standards, since the standards are based on averages spent by consumers.

When the IRS uses expense standards that focus on expenses paid, it can expect to resolve fewer collection cases through installment agreements or OICs, and force taxpayers to endure economic hardships. One case that demonstrates this is *Leago v. Commissioner*.²³ In *Leago*, the taxpayer did not contest that he owed a tax liability of approximately \$94,433. However, Mr. Leago suffered from a brain tumor which required surgery estimated to cost \$100,000. Mr. Leago had no health insurance. As part of

19 Based on concerns identified by the National Taxpayer Advocate, the IRS and TAS reached a joint agreement in 2007 whereby “the allowance amount for any ALE category cannot be decreased unless something economic changes significantly, such as a major sustained recession or depression.” IRS, SB/SE Finance, Research & Strategy, *2015 Allowable Living Expenses Project* iii (Sept. 2015). When costs associated with a specific allowance decrease below the prior year’s published allowance, the prior year’s allowance is used. IRS, SB/SE Finance, Research & Strategy, *2015 Allowable Living Expenses Project* iii (Sept. 2015). On March 28, 2016, the IRS announced that new ALE standards took effect and that “some ALE amounts reflect a decrease from last year’s standard amounts based on current data showing a decline in expenditures.” IRS, *Collection Financial Standards*, <https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Collection-Financial-Standards>. The IRS implemented a deviation from normal procedures for certain Automated Collection System and Compliance Services Collection Operations cases between December 17, 2015 and September 30, 2016 that involve financial analysis for particular types of installment agreements and CNC cases. Director, Collection Policy and Director, Campus Collection, *Memorandum for SBSE Directors, Collection Policy and Campus Collection* (Dec. 17, 2015). TAS will report on the results of this deviation in the National Taxpayer Advocate 2016 Annual Report to Congress.

20 National Taxpayer Advocate 2005 Annual Report to Congress 270-91; National Taxpayer Advocate 2006 Annual Report to Congress 83-109.

21 BLS, *CES Frequently Asked Questions*, <http://www.bls.gov/cex/csxfqa.htm#q13> (last visited March 17, 2016).

22 IRS, *2015 Allowable Living Expenses Project* (Sept. 2015).

23 T.C. Memo. 2012-39.

a collection due process (CDP) hearing in response to a proposed levy, Mr. Leago requested that his liability be classified as CNC due to financial hardship and health problems.²⁴ The proposed levy was sustained and Mr. Leago petitioned the Tax Court.

The Tax Court remanded the case back to Appeals for a supplemental CDP hearing. The settlement officer excluded any expenses for health care because Mr. Leago was not currently paying these expenses and instead offered him a PPIA in the amount of \$200 per month. Mr. Leago declined to accept this payment plan. Subsequently, Mr. Leago proposed an OIC based on doubt as to collectability with special circumstances. In his CIS, he reported \$3,100 per month for future expenses related to his brain surgery. The settlement officer who reviewed this offer again denied the future medical expense because it represented an amount Mr. Leago did not have. The court again remanded the case.

The court opinion does not shed light on the outcome for Mr. Leago after the second remand. From this case, it is clear that the current ALE standards do not always address what costs should be included in basic and necessary living expenses. In *Leago*, the IRS, by not allowing the cost of a life-saving surgery for Mr. Leago because he simply could not afford it at that time, condemned Mr. Leago to never having the surgery because he would have to pay the IRS any funds he might otherwise save toward his life-saving care. However, another taxpayer with the ability to pay for the surgery could have received a different outcome in his or her financial analysis.

Not all taxpayers will face such a drastic situation as the one faced by Mr. Leago. However, many taxpayers will experience an inability to cover their basic living costs at some point in their lives.²⁵ With this in mind, the IRS should reevaluate the current ALE standards and base expenses on the costs of a sustainable life and health instead of what taxpayers are actually paying. For instance, the IRS should ask: is it appropriate to cap housing expenses for a taxpayer who can afford only substandard housing, rather than allowing an expense amount that covers safe and adequate housing?

Additionally, the IRS should consider expanding what expenses are necessary for a basic lifestyle. For example, it is not realistic (and may very well be gender-based discrimination) to consider childcare expenses to be an “other” expense for working parents, thereby leaving its inclusion open to the judgment of individual IRS employees. Similar arguments can be made for health insurance premiums, an allocation for minimal technology in the home, such as a basic personal computer, and modest retirement savings, in light of the decline of defined benefit plans.

24 Prior to levying a taxpayer’s property, in most instances, the IRS must provide the taxpayer with an opportunity to have a hearing before Appeals. During this hearing, the taxpayer may be able to raise various issues, one of which is alternative collection options to the levy. IRC § 6330.

25 One estimate is that 59 percent of Americans will encounter a year or more of poverty by the age of 75. Mark. R. Rank, *Rethinking the Scope and Impact of Poverty in the United States*, 6 CONN. PUB. INT. L.J. 165, 171 (2007).

FOCUS FOR FISCAL YEAR 2017

In Fiscal Year 2017, TAS will continue to:

- Work with the IRS to address the IRS's decrease in ALE standards;
- Review how the ALE standards could be measured and implemented. This review will consider what expenses are not currently covered and will include a review of what other methods exist for determining basic needs. The results of this review will be shared with the IRS;
- Instruct Local Taxpayer Advocates to issue Taxpayer Assistance Orders in appropriate cases when IRS interpretation of the ALE standards harms a taxpayer or creates disparate treatment; and
- Encourage the IRS to develop a measurement to establish if existing guidance allowing for a deviation based on economic hardship is being followed, as provided for in IRM 5.15.1.1(7).