2010 Annual Report to Congress

National Taxpayer Advocate

Annual Report to Congress

NATIONAL TAXPAYER ADVOCATE

2010 Annual Report to Congress

Executive Summary: Preface & Highlights

YOUR VOICE AT THE IRS

December 31, 2010

National Taxpayer Advocate

Annual Report to Congress

2010 Annual Report to Congress

NATIONAL TAXPAYER ADVOCATE

2010 ANNUAL REPORT TO CONGRESS

Executive Summary: Preface & Highlights

TAXPAYER ADVOCATE SERVICE

YOUR VOICE AT THE IRS

This page intentionally left blank.

Table of Contents

PREFACE . . . vii

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS . . . 1

1. The Time for Tax Reform Is Now . . . 2
2. The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs . . . 4
3. IRS Performance Measures Provide Incentives That May Undermine the IRS Mission . . . 5
4. The Wage & Investment Division Is Tasked With Supporting Multiple Agency-Wide Operations, Impeding its Ability To Serve its Core Base Of Individual Taxpayers Effectively . . . 6
5. IRS Policy Implementation through Systems Programming Lacks Transparency and Precludes Adequate Review . . . 7

Taxpayer Rights Issues

6. IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship . . . 8
7. The IRS Does Not Know the Impact of Ignoring a Non-IRS Debt When Analyzing a Taxpayer's Ability to Pay an IRS Debt . . . 9
8. The Failure of the Office of Appeals to Document Prohibited Ex Parte Communications May Violate Taxpayer Rights and Damage the Public's Perception of its Independence . . . 10
9. The IRS's Failure to Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered . . . 11
10. Third-Party Reporting of Cancellation-of-Debt Events Is Not Always Accurate, and the IRS's Reliance on Such Reporting May Burden Taxpayers . . . 12
11. The IRS's Failure to Track and Analyze the Outcomes of Audit Reconsiderations and Inconsistent Guidance Increase Taxpayer Burden and Inflate IRS Audit Results and Cost Effectiveness Measures . . . 13
12. Persistent Breakdowns in Power of Attorney Processes Undermine Fundamental Taxpayer Rights . . . 14
13. IRS Collection Policies Channel Taxpayers into Installment Agreements They Cannot Afford . . . 15
14. The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations . . . 16
15. State Domestic Partnership Laws Present Unanswered Federal Tax Questions . . . 17

Table of Contents

Tax Administration Issues

16. The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers 18
17. The IRS Does Not Process Vital Taxpayer Responses Timely 19
18. The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives 20
19. The IRS Has Been Reluctant to Implement Alternative Service Methods That Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance 21
20. The S Corporation Election Process Unduly Burdens Small Businesses 22
21. The Combined Annual Wage Reporting Program Continues to Impose a Substantial Burden on Employers 23

STATUS UPDATES

1. The IRS Has Been Slow to Address the Adverse Impact of its Lien Filing Policies on Taxpayers and Future Tax Compliance 24
2. Despite Program Improvements, the IRS Policy of Processing Most ITIN Applications with Paper Returns During Peak Filing Season Continues to Strain IRS Resources and Unduly Burden Taxpayers 26
3. The IRS's Handling of Collection Statute Expiration Dates Continues to Adversely Affect Taxpayers 27
4. The IRS Offer-in- Compromise Program Continues to be Underutilized 28

LEGISLATIVE RECOMMENDATIONS

1. Enact Tax Reform Now 29
2. Repeal Information Reporting on Purchases of Goods but Require Reporting on Corporate and Certain Other Payments 31
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 32
4. Remove the 36-Month "Testing Period" that May Trigger Cancellation of Debt Reporting 33
5. Amend Internal Revenue Code Section 3402(p) to Require Withholding on Payments Made for Lost Earnings or Profits from Disasters 34
6. Enact a Statute of Limitations to Limit the Retroactive Effect of Revocation of an Organization's Exempt Status 35
7. Refine Whistleblower Procedures to Better Protect Taxpayer Privacy While Providing Necessary Information to Whistleblowers 36

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 37
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 38
10. Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections 39
11. Enact a Uniform Federal Agency External Ombudsman Act 40

THE MOST LITIGATED ISSUES

1. Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609 41
2. Appeals from Collection Due Process (CDP) Hearings Under Internal Revenue Code Sections 6320 and 6330 41
3. Accuracy-Related Penalties Under Internal Revenue Code Sections 6662(b)(1) and (2) 42
4. Trade or Business Expenses Under Internal Revenue Code Section 162 and Related Sections 42
5. Gross Income Under Internal Revenue Code Section 61 and Related Sections 42
6. Failure to File Penalty Under Internal Revenue Code Section 6651(a)(1) and Estimated Tax Penalty Under Internal Revenue Code Section 6654 42
7. Frivolous Issues Penalty and Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673 43
8. Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under Internal Revenue Code Section 7403 43
9. Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151 43
10. Relief from Joint and Several Liability Under Internal Revenue Code Section 6015 44

VOLUME 2: TAS RESEARCH AND RELATED STUDIES

1. Unlimit Innocent Spouse Equitable Relief 45
2. Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform 46
3. An Analysis of IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission 48
4. Researching the Causes of Noncompliance: An Overview of Upcoming Studies 50
5. Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative 52
6. Evaluate the Administration of Tax Expenditures 54
7. TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge 55

This page intentionally left blank.

Honorable Members of Congress:

I respectfully submit for your consideration the National Taxpayer Advocate's 2010 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6 IRS Databook FY 2009, Table 9a.

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

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

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

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

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

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

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

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

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

11 IRC § 6330(c)(3)(C) (cross referenced by IRC § 6320(c)).

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

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

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

15 *Id.*

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

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

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

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

16 The dollar value of TDAs assigned to CFf was about $46.2 billion at the end of FY 2010. IRS, Collection Activity Reports NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010). The Collection Queue is an inventory of TDA accounts that are active, but unassigned to the ACS or CFf functions. *See* IRM 5.1.20.2 (May 27, 2008).

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

18 U.S. Department of the Treasury, *Budget in Brief, Internal Revenue Service, available at* www.treasury.gov/about/budget-performance/budget-in-brief/Documents/IRS. The IRS's appropriations for "Enforcement – Exam and Collections" for FY 2006 and FY 2010 were approximately $3.9 billion and $4.7 billion respectively.

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

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

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

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

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

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

The time for tax reform and tax simplification is now.

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

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

---

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

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

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

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

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

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

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2010

This page intentionally left blank.

The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to describe at least 20 of the most serious problems encountered by taxpayers. This year's report begins by identifying the five most serious problems and then divides the remaining problems into two categories – taxpayer rights issues and tax administration issues. This year's report also includes status updates on four issues addressed in previous Annual Reports, including the adverse impact of IRS lien filing policies, which was covered in depth in the 2009 report.

Each of the most serious problems includes the National Taxpayer Advocate's description of the problem, the IRS's response, and the National Taxpayer Advocate's final comments and recommendations. This format provides a clear picture of which steps have been taken to address the most serious problems and which additional steps the National Taxpayer Advocate believes are required.

The issues described in the report are as follows:

1. The Time for Tax Reform Is Now

Problem

The most serious problem facing taxpayers – and the IRS – is the complexity of the Internal Revenue Code.

Analysis

A TAS analysis of IRS data shows that taxpayers and businesses spend 6.1 billion hours a year complying with tax-filing requirements. To place this in context, it would require more than three million full-time employees to work 6.1 billion hours, making "tax compliance" one of the largest industries in the United States.

Tax law complexity imposes monetary costs on taxpayers as well. About 60 percent of individual taxpayers pay practitioners to prepare their returns, and another 29 percent use tax software to assist them. According to IRS researchers, the annual monetary compliance burden of the median individual taxpayer (as measured by income) came to $258 in 2007.

Perhaps most troubling, tax law complexity leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities. Taxpayers have developed a sense of cynicism about the tax system, and compliance takes a hit.

IRS data show that when taxpayers have a choice about reporting their income, voluntary tax compliance rates are disturbingly low. Among self-employed workers whose income is not subject to tax withholding, reporting compliance rates are 43 percent for the business income of non-farm sole proprietors and 28 percent for unincorporated farming businesses.

Although there are multiple causes of noncompliance, tax law complexity plays a significant role. No one wants to feel like a "tax chump" – paying more while suspecting that others are taking advantage of loopholes to pay less. Because of tax complexity, taxpayers often suspect that the "special interests" are receiving tax breaks while they themselves are paying full freight.

Tax simplification would go a long way toward addressing these concerns. The most promising approach would involve reducing tax preferences (often referred to as "broadening the tax base") in exchange for lower rates. However, it is essential that the taxpaying public have a realistic sense of the difficult trade-offs involved. Tax breaks created for narrow "special interests" receive considerable attention, which shapes a perception that these "special interests" receive a large share of tax benefits. While narrow tax breaks certainly do exist, the reality is that the biggest "special interests" are us – the vast majority of U.S. taxpayers.

Virtually all of us benefit from certain exclusions from income, deductions from income, or tax credits (collectively known as "tax expenditures"). Among the largest are the exclusion for employer-provided health care, the exclusion for retirement plan contributions and earnings, and the mortgage interest deduction. The Joint Committee on Taxation (JCT) estimates that tax expenditures total about $1.1 trillion a year. As compared with the 138 million individual tax returns filed in 2010, that translates to an average reduction in tax per return of about $8,000. 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 in tax of $8,000 when the tax rate is 25 percent).

If tax preferences are to be eliminated in order to reduce tax rates, we cannot pretend that broadening the tax base means eliminating someone else's tax break while preserving our own. Everything must be put on the table, and we must understand that, in exchange for lower rates, some tax breaks will be eliminated immediately and others will be phased out. If tax reform proceeds on a revenue-neutral basis, however, the average taxpayer's liability will not change, and we will end up with a tax system that is simpler, more transparent, and easier and cheaper for taxpayers to navigate.

The question of whether and to what extent to raise revenue is extremely contentious, and we are concerned if structural tax reform and revenue levels are considered together as a package, the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, we suggest that Congress consider addressing these issues separately. First, Congress could enact structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates accordingly.

Recommendations

The National Taxpayer Advocate recommends that Congress substantially reform and simplify the Internal Revenue Code (see accompanying legislative recommendation later in this report). The National Taxpayer Advocate further recommends that, to enhance taxpayer awareness of the connection between taxes paid and benefits received, Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent.

2. The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs

Problem

The IRS's current mission statement does not reflect the significant role the IRS is now playing in the administration of social benefits. From an organizational standpoint, there are substantial differences between benefits agencies and enforcement agencies in terms of culture, mindset, and the skills sets and training of their employees. As the IRS prepares to administer large portions of the health care legislation, it will have to shift from being an enforcement agency that primarily says, in effect, "you owe us" into an agency that places much greater emphasis on hiring and training caseworkers to help eligible taxpayers receive benefits and work one-on-one with taxpayers to resolve legitimate disagreements. Finally, from a budgetary standpoint, the IRS will require additional resources if it is expected to administer benefits programs without undermining its ability to perform its critical tax collection role.

Analysis

Running a social benefits program through the tax code has both advantages and drawbacks. The IRS experienced significant challenges in administering the recent First-Time Homebuyer Credit and Making Work Pay Credit, and now faces the monumental task of implementing several major provisions of the health care bill. The IRS's core function is to collect revenue for the federal government, and while the IRS does perform significant taxpayer service, its employees are trained in an enforcement mentality and culture and its overriding goal is to collect revenue. Absent additional resources, administration of social programs reduces the IRS's ability to perform its core enforcement and taxpayer service functions. To effectively administer social programs, it is essential that the IRS revise its mission statement to reflect its increasing responsibilities for administering benefits. This also entails realigning its organizational structure to accommodate this role.

Recommendations

The National Taxpayer Advocate recommends that the IRS revise its mission statement to reflect two distinct administrative roles of traditional tax collection and delivery of social benefits, an effort which should also include the following steps: (1) revising Revenue Procedure 64-22 to include the IRS's responsibility as social benefit administrator; (2) creating a program office and new deputy commissioner position to provide strategic direction for all social benefits programs; and (3) conducting a comprehensive evaluation of the administration of previous and existing social programs to aid in the planning and implementation of existing and future social programs.

Most Serious Problems

3. IRS Performance Measures Provide Incentives That May Undermine the IRS Mission

Problem

The IRS employs an extensive set of performance measures. However, a TAS analysis found that the IRS measures place disproportionate emphasis on cycle time. An overemphasis on cycle time creates incentives for IRS employees to take actions quickly, even where doing so produces inaccurate results or delays the final resolution of problems. As a consequence, taxpayers may face inaccurate audit determinations or unwarranted collection actions.

As a separate matter, the IRS measures the return on investment (ROI) of its enforcement activities, but not its taxpayer service activities. Under congressional budget scoring rules, funding for new IRS initiatives is exempt from otherwise applicable spending caps if an initiative is projected to produce an ROI of greater than 1:1. Therefore, because the IRS measures the ROI for enforcement activities but not services, the IRS receives disproportionate funding for enforcement activities. As Congress has given the IRS more benefits programs to administer in recent years (*e.g.,* Economic Stimulus Payments, First-Time Homebuyer credits, Making Work Pay credits, and health care reform), the effects of this incentive are reflected in a decline in critical taxpayer service functions, as discussed elsewhere in this report.

Analysis

Consistent with the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS uses three types of "balanced measures" – customer satisfaction, employee satisfaction, and business results. However, the IRS does not report its measures in a balanced way. For example, over two-thirds of the collection measures reported in the business performance review improve with cycle time, as do nearly half of the measures in the IRS-wide performance appraisal. IRS leaders thus face incentives to establish procedures that will minimize cycle time rather than promote voluntary compliance or obtain correct results.

With respect to funding, certain categories of taxpayer service produce an ROI of greater than 1:1. If the IRS did not publish tax forms, provide guidance, or answer taxpayer questions, for example, the compliance rate would be substantially lower. Yet because the IRS cannot quantify the ROI of such activities, an incentive arises to fund more enforcement activities rather than more outreach and education.

Recommendations

The National Taxpayer Advocate recommends the IRS develop (1) ROIs for its taxpayer service initiatives and (2) measures that create better incentives for IRS leaders to adopt procedures that prevent delinquencies and promote voluntary compliance.

4. The Wage & Investment Division Is Tasked With Supporting Multiple Agency-Wide Operations, Impeding its Ability To Serve its Core Base Of Individual Taxpayers Effectively

Problem

As the largest IRS operating division, Wage and Investment (W&I) supports servicewide operations such as submission processing, toll-free telephones, accounts management, and electronic services. These servicewide responsibilities interfere with W&I's ability to meet the needs of individual taxpayers, who are W&I's core customers. Particularly as the IRS gears up to administer health care reform, W&I's ability to focus on its core mission of serving individual taxpayers must be strengthened. Additionally, we are concerned that the structure of the IRS budget masks the relatively small amount of money spent on taxpayer service activities.

Analysis

While W&I serves the largest group of taxpayers within the IRS, it is also responsible for operations that benefit the IRS enterprise. Only one function within W&I – Examination – is dedicated exclusively to individual taxpayers. W&I is responsible for more than 50 Internal Revenue Manual sections, almost all of which contain technical guidance, forms and procedures relevant to other operating divisions. In this most serious problem discussion, we use the term "taxpayer service" to refer to those activities that actually assist the taxpayer with understanding their rights and obligations under the tax laws. Thus, IRS outreach and education activities clearly fall within this definition, regardless of whether these activities occur in a pre-filing or post-filing environment and regardless of whether they are performed by W&I Stakeholder Partnerships, Education and Communications (SPEC) personnel, IRS enforcement personnel or TAS personnel. In 2009, W&I served approximately 123 million taxpayers – more than two-thirds of taxpayers overall. However, almost 75 percent of the total W&I budget goes to support shared services for the entire IRS, leaving limited resources to serve individual taxpayers who have specific needs, especially low income taxpayers. The IRS should revamp the current W&I structure to improve its responsiveness to individual taxpayers.

Recommendations

The National Taxpayer Advocate recommends that the IRS create a new division under the Deputy Commissioner for Services and Enforcement to coordinate servicewide customer account services; remove funding for Submission Processing from the Taxpayer Services budget and place it in the Operations Support budget account instead; and divide the budget for Accounts Management, Field Assistance, and other similar organizations that perform both service and compliance activities on the basis of the percentage of their activities that constitute assistance, outreach, and education as opposed to enforcement or operations support.

5. IRS Policy Implementation through Systems Programming Lacks Transparency and Precludes Adequate Review

Problem

The IRS needs automation to administer tax laws and tax-based social programs efficiently. Automation can enhance speed, accuracy, and comprehension while promoting consistency and fairness. To be effective, tax policies and procedures administered through automated systems and software applications require transparency, and employee guidance embedded in systems must be reviewed and continually analyzed for proper application. However, not all IRS systems utilize a continuous feedback cycle to assess and update embedded policies. As a result, they may be programmed with incorrect, incomplete, or outdated guidance that harms taxpayers. Further, the IRS may not be fulfilling its duty to update or publish instructions or procedures affecting taxpayers under the Freedom of Information Act (FOIA) and Electronic FOIA (E-FOIA).

Analysis

The IRS established the Servicewide Policy, Directives and Electronic Research (SPDER) office to manage the process of administering and communicating internal management directives on which employees rely and to publish the directives under FOIA and E-FOIA. Each IRS operating division and function reviews proposed guidance from other functions to ensure conformance and identify any conflicts with current procedures and systems. But policies and procedures embedded within IRS systems, such as the computer program that helps employees decide whether to abate penalties assessed against taxpayers, are not subject to this kind of transparency and analysis. The IRS does not review these systems to determine whether the policies are working as designed or are disclosed to the public as required by law. Nor does TAS receive the opportunity to identify systemic problems that may burden or harm taxpayers if programming ignores statutory requirements or eliminates discretion. Finally, the IRS does not effectively use artificial intelligence, specifically "machine learning," to capture feedback and produce systems that will eliminate burden for taxpayers and employees alike.

Recommendations

The National Taxpayer Advocate recommends that the IRS expand the SPDER clearance process to systems that include embedded policy decision tools; require artificial intelligence and continuous feedback in new systems to continually assess and improve programming; plan and allocate funding for information technology hardware, software, and support of artificial intelligence and continuous feedback; and provide for public disclosure of embedded policy required for transparency.

Taxpayer Rights Issues

6. IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship

Problem

Last year, in *Vinatieri v. Commissioner*, the Tax Court held that the IRS abused its discretion by proposing to levy on a taxpayer with unfiled returns who had shown that she was in economic hardship. More than a year has passed since the *Vinatieri* decision, yet IRS guidance still does not adequately explain procedures for placing an account with unfiled returns into currently not collectible (CNC) status rather than proceeding with a levy. Thus, vulnerable taxpayers are still exposed to potentially devastating levies.

Analysis

Internal Revenue Code § 6343(a)(1)(D) requires the IRS to release a levy if the levy is creating an economic hardship. In *Vinatieri*, the IRS proposed to levy on a taxpayer even though she was within the IRS's definition of economic hardship. The IRS interpreted the Internal Revenue Manual (IRM) as preventing it from placing the taxpayer's account into CNC status because the taxpayer had not filed tax returns for certain years. In light of the statutory requirement that the IRS release levies that would create an economic hardship, the Tax Court held that the proposed levy was inappropriate and that proceeding with a levy that the IRS would have to immediately release constituted an abuse of discretion. Several IRM provisions still prevent eligible accounts with unfiled returns from being placed into CNC hardship status, which creates an ongoing risk of a *Vinatieri*-type violation of law.

Recommendations

The National Taxpayer Advocate recommends that the IRS work with TAS to revise the IRM and other procedural guidance to clarify that all collection employees can place an account into CNC status solely because of economic hardship even when the taxpayer has unfiled returns, independent of any other criteria; that the IRS work with TAS to train collection employees about how to manage taxpayer accounts when taxpayers are facing economic hardship and submit its 2011 collection CPE training materials on this issue to TAS for review; and that the IRS revise its quality review procedures to measure whether employees considered the possibility that a taxpayer was in economic hardship and managed the account appropriately.

7. The IRS Does Not Know the Impact of Ignoring a Non-IRS Debt When Analyzing a Taxpayer's Ability to Pay an IRS Debt

Problem

When a taxpayer is unable to pay a tax debt in full, the IRS computes how much it believes the taxpayer can reasonably pay. As part of this computation, the IRS compares the taxpayer's income with the taxpayer's "allowable" expenses and requires the taxpayer to pay the excess, if any. In computing the taxpayer's "allowable" expenses, however, the IRS does not make allowance for taxpayers to pay other debts for which they remain liable. As a result, taxpayers may be required to commit to making payments to the IRS in excess of what they can afford, thereby prolonging unresolved delinquencies, creating hardships, and leaving the taxpayers less able to pay taxes due in future periods.

Analysis

In determining a taxpayer's ability to pay a delinquent federal tax debt, the IRS does not make allowance for certain other debts the taxpayer faces, such as credit card bills, delinquent state or local taxes, court-ordered payments, excessive mortgage expenses, or any bill the taxpayer is not current in paying, including student loans, medical bills, and even secured debts. But other creditors will continue to press the taxpayer to repay these debts. For example, a state tax agency does not stop garnishing a paycheck and a credit card collection company does not stop calling just because the taxpayer has committed to an IRS payment plan. Thus, the IRS's unwillingness to allow for payments to other creditors is often unrealistic. Indeed, a 2009 TAS Research study found that more than half of a group of delinquent taxpayers who ultimately declared bankruptcy appeared able to pay based on the IRS's financial analysis.

By requiring taxpayers to commit to making larger payments than they can afford in light of their total financial picture, the IRS increases the likelihood that they will default on one or more of their payment arrangements. Moreover, the IRS's financial analysis may result in collection determinations that reduce future compliance. The 2009 TAS study found that about 74 percent of taxpayers with Taxpayer Delinquent Accounts (*i.e.*, delinquent accounts forwarded to Collection employees for resolution using the financial analysis described above) had one or more subsequent tax delinquencies or unfiled returns, even though they had no outstanding assessed tax liabilities before the period under study. Thus, the IRS's current approach fails to promote future compliance for an extraordinarily large percentage of these taxpayers.

Recommendations

The National Taxpayer Advocate recommends the IRS (1) test the effect of more realistic collection financial analysis on taxpayer hardship, installment agreement defaults, and future compliance, and (2) seek public comments on its collection financial analysis policies (such as the disallowed debt rule) and publish the reasons for them.

8. The Failure of the Office of Appeals to Document Prohibited *Ex Parte* Communications May Violate Taxpayer Rights and Damage the Public's Perception of its Independence

Problem

The IRS Office of Appeals (Appeals) was created to give taxpayers facing adverse IRS actions an opportunity to obtain an independent review of their cases. Taxpayers understandably may question whether an Appeals function within the IRS that consists largely of former audit and collection employees will treat them fairly. Largely because of that concern, Congress prohibited one-sided communications between Appeals and other IRS functions that appear to compromise Appeals' independence (*i.e.*, "*ex parte* communications"). However, less than two-thirds of taxpayers surveyed are satisfied with Appeals' independence, and one in four attorney practitioners surveyed reports an *ex parte* violation in Appeals. The perception that Appeals tolerates these violations erodes public trust in its independence. Yet Appeals has no method of tracking *ex parte* violations to determine to what extent they occur. Without this data, Appeals cannot take the steps necessary to reduce *ex parte* violations and increase public confidence in its independence. In addition, current *ex parte* guidance takes the form of a Revenue Procedure instead of a Treasury Regulation and does not provide a public notice-and-comment period, thereby denying taxpayers the opportunity to weigh in on rules that are supposed to protect their rights.

Analysis

Appeals' data suggest perceived independence is a strong driver of overall taxpayer satisfaction. Reports of *ex parte* violations and low satisfaction scores for independence should encourage Appeals to investigate the extent of its *ex parte* violation problem and correct it. However, Appeals has no formal system for employees to document when *ex parte* violations occur. Additionally, Appeals' quality control system is potentially misleading as to the degree to which *ex parte* violations occur. The IRS published official guidance on *ex parte* compliance, but did not seek comments on the guidance from taxpayers and practitioners. Appeals' rationale for this approach is that the *ex parte* rules are "essentially about the internal operations of the IRS, which do not need to be set forth in regulations." However, it is clear that Congress created the *ex parte* prohibition to ensure a taxpayer's right to procedural due process. While *ex parte* compliance is the responsibility of all IRS employees, no servicewide initiative exists to train employees on *ex parte* rules.

Recommendations

The National Taxpayer Advocate recommends that the IRS track *ex parte* violations to reduce any public misperception of Appeals' independence and, ultimately, the number of actual violations. Appeals should redesign its quality review procedures so that they separate any review of *ex parte* violations from other elements. The IRS should take the necessary procedural steps to publish *ex parte* guidance as a Treasury Regulation, ensuring that any new regulation upholds taxpayer rights. Appeals should take the initiative to assist other IRS functions with *ex parte* compliance through joint training.

9. The IRS's Failure to Provide Timely and Adequate Collection Due Process Hearings May Deprive Taxpayers of an Opportunity to Have Their Cases Fully Considered

Problem

Congress established Collection Due Process (CDP) hearings to provide taxpayers with an opportunity to have IRS lien filings or proposed levy actions reviewed by an independent Office of Appeals (Appeals), to ensure that "any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive then necessary." In practice, the IRS frequently issues CDP notices without verifying the taxpayer's liability or adequately analyzing his or her ability to pay. In addition, the IRS routinely asks taxpayers to withdraw their CDP hearing requests upon resolution of their cases, which imposes pressure on taxpayers and may cause them to forfeit their judicial review rights if their problems are not ultimately resolved. The IRS has no measures to determine whether delays or inadequate CDP hearings increase the IRS's downstream costs of collecting taxes, or impair future taxpayer compliance.

Analysis

In FY 2009, the IRS issued approximately 36 percent of its CDP notices before the Collection function could verify the liabilities or fully analyze the taxpayers' ability to pay them. This type of inadequate case development requires Appeals to take more time to resolve cases. The Automated Collection System (ACS) held unresolved hearing requests for an average of 93 days in FY 2010 before transferring them to Appeals, representing almost 49 percent of Appeals' CDP cycle time. If the ACS resolves an account, the IRS asks the taxpayer to withdraw the hearing request, but such withdrawals may prematurely deprive taxpayers of the important administrative review and balancing of interests required in CDP hearings, as well as judicial review if a dispute subsequently arises over the liability or resolution.

Recommendations

The National Taxpayer Advocate recommends that the IRS require its employees to make substantial efforts at telephone or in-person contact before proposing levies or filing liens to identify taxpayers who are able to pay; that Appeals should be the point of contact for all CDP hearing requests, should route cases to IRS Collection when necessary to attempt resolution, and should issue agreed decisions or determinations, rather than obtain withdrawals, to preserve the taxpayers' judicial review rights; that Appeals revise its notices and procedures to clearly inform taxpayers about the types and alternative locations of hearings; and that Appeals track CDP sustention and taxpayer default rates following CDP determinations.

10. Third-Party Reporting of Cancellation-of-Debt Events Is Not Always Accurate, and the IRS's Reliance On Such Reporting May Burden Taxpayers

Problem

When a lender cancels a debt, the lender must report the amount of the canceled debt to the IRS and the borrower is generally required to include the reported amount in gross income. As a general matter, the IRS assumes that when a creditor files a Form 1099-C, *Cancellation of Debt*, the creditor is reporting the actual cancellation of a debt and the amount shown on the form is correct. The IRS's document-matching system may generate notices, proposing additional tax due, to taxpayers who fail to report these amounts as income. However, the IRS's assumptions that a debt was canceled and the amount reported by lenders is accurate may be incorrect for any of these reasons:

- Creditors sometimes issue a Form 1099-C because Treasury regulations provide an incentive to do so or as a means of pressuring a debtor to pay – even where they are not canceling the debt;
- Creditors sometimes make errors on the form that debtors then may have to wage an uphill battle to correct; or
- IRS automated systems cannot distinguish taxpayers with canceled debts who have additional income and owe additional tax from taxpayers with canceled debts who are insolvent, have no additional income, and do not owe additional tax. As a consequence, the IRS may sometimes deny legitimate Earned Income Tax Credit (EITC) claims because it believes the taxpayer's income is too high.

Analysis

Creditors issued Forms1099-C to approximately two million taxpayers for 2008, almost half of whom were low income. The debt was more likely to be credit card debt than any other kind, and the amount was usually less than $10,000. A creditor that issues Form 1099-C is not necessarily canceling a debt, but the IRS is not able to determine that. As a result, the IRS may inform taxpayers they owe additional tax from the "canceled" debt, even as the creditor continues to collect the debt. Moreover, Form 1099-C does not signal additional taxable income for many taxpayers who default on their debts, because they are insolvent. Taxpayers who are issued a Form 1099-C may unnecessarily lose the EITC due to the IRS's reliance on the form. According to a TAS sample analysis, taxpayers who reportedly had cancellation of debt income lost on average $893 in EITC.

Recommendations

The National Taxpayer Advocate recommends that the IRS revise its regulations to better align the Form 1099-C reporting requirements with actual cancellation of debt; modify Form 1099-C to provide information about why the creditor is issuing it and whether a debt was actually canceled; send taxpayers an insolvency worksheet with the letter that proposes additional tax due; and adjust its computerized document-matching program to identify taxpayers that are likely insolvent and therefore not required to include in gross income amounts shown on a Form 1099-C.

11. The IRS's Failure to Track and Analyze the Outcomes of Audit Reconsiderations and Inconsistent Guidance Increase Taxpayer Burden and Inflate IRS Audit Results and Cost Effectiveness Measures

Problem

The IRS uses the audit reconsideration process to reevaluate the results of previous audits where additional tax was assessed and remains unpaid or a tax credit was reversed. Although the number of audit reconsiderations and tax abatements has significantly increased over the past three years, the IRS does not measure the impact of the growing number of audit reconsiderations and does not use the outcomes to improve procedures for original audits. Moreover, the IRS's failure to adjust its audit data to reflect the results of audit reconsiderations has served to inflate audit results and cost effectiveness measures. Audit reconsideration results differ from original audit results for a variety of reasons, including more automated processes with less human interaction, mail handling delays, and inconsistent, ambiguous, and often contradictory forms, publications, and IRM provisions.

Analysis

Audit reconsiderations have increased by about 190 percent, from nearly 164,000 cases in FY 2006 to over 474,000 cases in FY 2009, and now account for about ten percent of the IRS's total examination inventory. Tax abatements, which are one possible result of an audit reconsideration, have increased by 315 percent during the same period, from $1.2 billion in FY 2006 to $5.1 billion in FY 2009. The dramatic growth in tax abatements calls into question the effectiveness of the IRS policies, procedures, and processes that gave rise to the original audit assessments. Although the IRS has a form for almost everything imaginable, it does not have one designed specifically for taxpayers requesting audit reconsideration. Further, programming deficiencies led the IRS to omit audit reconsideration results from audit statistics presented to the IRS Oversight Board.

Recommendations

The National Taxpayer Advocate recommends that the IRS develop a method to control and track audit reconsideration results including the cycle time from all assessment sources; institute a program of reviewing representative samples of audit reconsiderations to analyze the reasons for and the outcomes of audit reconsiderations; clarify guidance in publications and instructions that taxpayers can use Form 12661, *Disputed Issue Verification Resolution*, to request audit reconsideration in writing; revise publications to provide clear, non-circular instructions for appealing an audit reconsideration denial and a mailing address to submit requests for audit reconsideration and appeal; and clarify guidance regarding collection holds during an audit reconsideration.

12. Persistent Breakdowns in Power of Attorney Processes Undermine Fundamental Taxpayer Rights

Problem

The Internal Revenue Code provides taxpayers with the right to designate a representative to represent the taxpayer in dealings with the IRS. Yet IRS processes and systems designed to recognize and record power of attorney (POA) form information continue to frustrate taxpayers and their representatives when attempting to comply with filing and payment responsibilities. Problems associated with POA processing can lead to a lack of representation, adverse IRS action (*i.e.,* unnecessary liens and levies), and lengthy delays in processing tax returns and refunds. Additionally, POA processing delays and systemic glitches curtail the ability of Low Income Taxpayer Clinics (LITCs) to represent taxpayers before the IRS.

Analysis

In early 2010, the IRS Centralized Authorization File (CAF) unit experienced significant delays in processing POA forms. In April 2010, the delays became so overwhelming that the IRS suspended its normal two- to three-day processing timeframe and extended the time to 15 days, even for Taxpayer Advocate Service priority cases. These processing delays are exacerbated by ineffective and outdated systems. CAF unit problems may also be linked to the significant increase in POA filings. Between 2004 and 2009, the number of POA forms filed by individual taxpayers who appointed a representative jumped from nearly one million to 1.8 million, an increase of 83 percent. Despite this increase, IRS staffing dedicated to POA form processing has remained stagnant.

Recommendations

The National Taxpayer Advocate recommends that the IRS establish a process for gathering and tracking taxpayer and POA complaints on direct contact violations; provide mandatory annual training for all contact employees; implement a "paperless fax" imaging system to prevent lengthy CAF delays and potential adverse actions; acknowledge receipt of a taxpayer POA in the CAF unit to prevent costly rework; create a POA form for use by school-based LITCs so an LITC director may substitute one student name for another when a new semester begins and a new group of students takes over cases; and implement dual address change letters in cases where a third-party payor has access to a client-employer's funds, alerting the employer that a third party has initiated a change of address.

Most Serious Problems

13. IRS Collection Policies Channel Taxpayers into Installment Agreements They Cannot Afford

Problem

If a taxpayer owes $25,000 or less and agrees to pay the liability in full within five years (and before the collection expiration date), the IRS may accept a "streamlined" installment agreement (IA) without regard to the taxpayer's ability to pay. Streamlined IAs are an appropriate tool for resolving many delinquencies. However, *an IRS study found that more than a quarter of taxpayers requesting streamlined IAs could not afford them.* Moreover, the IRS sometimes places taxpayers into streamlined IAs without their consent – a practice that may *violate the law*. As a result, some taxpayers may be unable to meet basic living expenses or fall behind on their tax payments in the future.

Analysis

Both taxpayers and the IRS face incentives to enter into streamlined IAs in lieu of collection alternatives. While most collection alternatives (*e.g.*, IAs with lower payments, offers in compromise, or currently not collectible (CNC) designations) require taxpayers to submit financial information, wait for collection personnel to analyze it, and trigger a lien filing, streamlined IAs do not. IRS employees with no training in collection or financial analysis process streamlined IAs in less than five minutes without contacting the taxpayer.

These procedures channel some taxpayers into IAs they cannot afford. The IRS exacerbates the problem for taxpayers who request to pay by installment but either do not indicate a payment amount or request an amount that will not repay the liability within five years. Rather than contacting these taxpayers to reach a common understanding, the IRS automatically places them into streamlined IAs with payments sufficient to satisfy the liability within five years without first obtaining their express written consent, notwithstanding legal concerns with this practice.

Recommendations

The National Taxpayer Advocate recommends the IRS discontinue the legally questionable practice of placing taxpayers into streamlined IAs with higher payments than they have agreed to make. She also recommends the IRS research why taxpayers default on streamlined IAs and the impact of streamlined IAs (and other collection alternatives) on future tax compliance.

14. The IRS's Over-Reliance on Its "Reasonable Cause Assistant" Leads to Inaccurate Penalty Abatement Determinations

Problem

The IRS requires employees to use the Reasonable Cause Assistant (RCA), an interactive decision support program, to evaluate taxpayers' requests for abatement of certain penalties. However, a study conducted by the IRS itself found that RCA determinations were accurate in only 45 percent of the cases examined, even though all employees thought their determinations were correct. In other words, a coin flip would have produced nearly the same level of accuracy as the RCA. The National Taxpayer Advocate believes RCA determinations are inaccurate for the following reasons: (1) RCA users are not properly trained in tax law, (2) IRS policies do not encourage employees to override incorrect recommendations by the computer, (3) the RCA has no feedback system to improve employee knowledge of reasonable cause and programming accuracy, and (4) taxpayers must initiate contact with the IRS to receive a First-Time Abatement (FTA), even though the IRS can grant the FTA automatically.

Analysis

While the RCA system may be technically correct in its programming, the IRS's systemic over-reliance on the software has allowed employee training in reasonable cause and tax law to deteriorate. Without such training, penalty determinations will be inconsistent, and employees may rely too heavily on the computer rather than their own judgment. This could be corrected in part if IRS policies encouraged employees to use the override feature when they believe an RCA recommendation is wrong. Further, employees receive no systematic feedback on how accurately they are using the RCA. The IRS should program the RCA to educate users on their mistakes and how to prevent them in the future. Employees would also have more time to spend on reasonable cause cases that require discretion if the IRS automatically issued FTA waivers instead of requiring taxpayers to contact the IRS after a tax assessment.

Recommendations

The National Taxpayer Advocate recommends the IRS improve RCA user and manager training in tax law (including case studies), encourage use of the override feature when the RCA recommendation is inappropriate, incorporate a corrective feedback system in the RCA to improve knowledge of reasonable cause and incorporate "lessons learned" from override cases, and program IRS computers to automatically grant FTA waivers for eligible taxpayers considering the compliance histories of individual spouses.

15. State Domestic Partnership Laws Present Unanswered Federal Tax Questions

Problem

Various states have recognized hundreds of thousands of domestic partnerships, civil unions, or marriages between individuals of the same gender. However, the specifics of these provisions vary considerably among the states, and to complicate matters, the federal Defense of Marriage Act prohibits recognition of same-gender marriages for federal purposes. The interaction of these provisions and their interpretation for federal tax purposes is ambiguous in several key areas, requiring taxpayers to file tax returns without clear guidance and potentially subjecting them to audit adjustments in the future.

Analysis

Federal taxation generally applies to rights and interests as created by state property and domestic relations laws. These state laws, in turn, often peg property or other rights to relationships, some of which may not be recognized by federal law. That anomaly creates confusion. Moreover, the Defense of Marriage Act, which effectively disregards same-gender marriages for federal purposes, was recently found to be unconstitutional, creating further confusion. That court decision is pending appeal. In 2006, the IRS issued legal advice that called into question reliance on state property law. Since that time, the advice has been revised for future – but not past – years. All of these competing rules have created ambiguities that leave same-gender spouses and other domestic partners uncertain about basic tax reporting rules. For example, is a same-gender spouse or domestic partner eligible for a dependency deduction? In a community property state, it may be unclear if he or she would qualify as a dependent or if the IRS would impute half of community income to him or her for this purpose.

Recommendation

To enable taxpayers to comply with the tax laws, the National Taxpayer Advocate recommends that the IRS create and publish guidance answering relevant questions.

Tax Administration Issues

16. The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers

Problem

The IRS mails over 200 million pieces of correspondence to taxpayers each year, including refunds, notices, and other official correspondence. A relatively large volume of this mail never reaches the intended taxpayer. Although the IRS does not itself track how much mail is returned as "undeliverable as addressed," a Treasury Inspector General for Tax Administration (TIGTA) audit estimated that during FY 2009, approximately 19.3 million pieces of mail, or 10 percent of the total, were returned to the IRS at an estimated cost of $57.9 million. Undeliverable mail can have a significant adverse impact on taxpayers.

Analysis

Undelivered mail can cause significant harm to taxpayers. If a refund check is not delivered, the taxpayer does not receive funds to which the taxpayer is entitled. If a notice of a proposed tax adjustment or collection action is not delivered, the taxpayer misses an opportunity to present substantiation that may persuade the IRS it made an error or misses an opportunity to enter into an installment agreement or other payment alternative. In such cases, the taxpayer may first learn of the issue when facing a levy, lien, or other enforcement action. Despite the adverse impact undelivered mail has on taxpayers, the IRS does not routinely notate a taxpayer's account when mail is returned as undeliverable. It also does not effectively use available tools to try to obtain a correct current address. Reorganizing mail and notice delivery as a central, IRS-wide service would improve service to taxpayers, increase efficiency, and save money on postage.

Recommendations

The National Taxpayer Advocate recommends that the IRS study its problems with undelivered mail and address perfection (including the establishment of baseline data and periodic data reporting); consider designating one enterprise-level organization to coordinate policy, procedures, and the protection and maintenance of taxpayer addresses, including one-stop processing of undelivered mail; use full-service intelligent bar coding on all outgoing mail to allow mail tracking and electronic file exchanges with the U.S. Postal Service; and use its existing address research (ADR) system for all undelivered mail.

17. The IRS Does Not Process Vital Taxpayer Responses Timely

Problem

The IRS receives more than 11 million pieces of taxpayer correspondence each year. It is critical that taxpayer correspondence be timely processed, because delays can lead to erroneous tax assessments, improper collection actions, and additional penalties and interest for taxpayers or additional refund interest costs to the government. Yet taxpayers and practitioners express frequent complaints about processing delays, and in one study, the IRS found that more than 75 percent of mail addressed to two campus collection sites took longer to process than the 14-day goal. In fact, nearly 40 percent of this correspondence took more than 30 days to process. Despite this strong evidence of significant processing delays, the IRS does not measure the accuracy or timeliness with which it handles taxpayer correspondence, and it lacks any comprehensive, reliable data to help it understand the sources or causes of misrouted mail. Moreover, because the IRS does not measure the time between first receipt of correspondence and its receipt by the correct technical operation or function, the IRS does not know whether the taxpayer response timeframes built into automated processes are sufficient.

Analysis

Notice operations cost the IRS nearly half a billion dollars annually, with 60 percent of this amount resulting from the downstream consequences of issued notices, including subsequent contacts between the IRS and taxpayers via phone calls, office visits, and correspondence.. Additionally, because the IRS cannot timely process taxpayer responses and associate documents with a taxpayer's case, taxpayers and their practitioners receive premature notices of deficiency. The IRS must change its automated systems and explore ways to improve mail routing in order to prevent severe downstream consequences for both taxpayers and the IRS.

Recommendations

To improve the timely and accurate processing of correspondence, the National Taxpayer Advocate recommends that the IRS track and assess the timeliness and accuracy of mail routing to each campus operation; revise timeframes for automated assessment processes so they provide sufficient time for the IRS to receive taxpayer responses and update its systems; and test the use of technology such as Intelligent Bar Coding on envelopes to improve routing of incoming mail.

18. The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives

Problem

IRS procedures generally require employees to code the source of subsequent, post-assessment tax payments it receives on balance due accounts. Knowing the source of tax payments serves important purposes. It enables the IRS to assess which activities are most effective at collecting revenue. It also enables the IRS to better comply with statutory requirements to properly record and account for the funding it receives in order to prepare reliable reports and measure tax enforcement results. However, a TAS study has found that the IRS cannot accurately identify the source of the significant majority of subsequent tax payments it receives on balance due accounts. Among the key factors that contribute to coding problems are a lack of meaningful transaction codes to identify received payments; deficient Internal Revenue Manual guidance for employees; and insufficient training and oversight of IRS employees and vendors involved in coding payments.

Analysis

The IRS has established two-digit Designated Payment Codes (DPCs) to identify the source of balance due, post-assessment payments. IRS employees are required to assign a DPC to all payments that result from specified IRS activities and carry certain transaction codes (TCs). A TAS analysis of IRS payment source data has found that the DPC is not present on payment vouchers in 81 percent of all post-assessment tax payments received in 2009. Even with transaction codes that require DPCs, about 75 percent of all entries either had no DPC or defaulted to DPCs of “00” (undesignated payment) or “99” (miscellaneous). At the same time, less than one percent of payments with TCs not requiring a DPC had identifiable sources. Thus, in most cases, the IRS does not know and cannot determine what event or action prompted the subsequent payment on a past due account. Accordingly, the IRS lacks critical data that would improve its ability to make meaningful policy decisions, assess existing programs, and effectively allocate its resources.

Recommendations

The National Taxpayer Advocate recommends that the IRS revise its guidance to require specific designated payment codes on all balance due payments; provide clear and specific guidance for the limited circumstances where employees can enter a miscellaneous DPC; implement a quality review of payment coding; and, in consultation with TAS and IRS research functions, review and revise DPCs and TCs to link each subsequent payment to specific enforcement and service activities.

19. The IRS Has Been Reluctant to Implement Alternative Service Methods That Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance

Problem

Taxpayer Assistance Centers (TACs) are the main form of face-to-face IRS customer service available to taxpayers. However, the IRS's 401 TACs are within a 30-minute drive of only 60 percent of the taxpaying population. TACs remain out of reach for many rural taxpayers as most are located in more populous areas and only 55 percent are open 36 to 40 hours per week.

Analysis

Brick and mortar TACs are not the only way the IRS can provide face-to-face services to taxpayers. In fiscal year 2010, the IRS has demonstrated a willingness to use alternate solutions for face-to-face services, such as placing IRS account resolution employees in volunteer tax preparation sites during filing season. However, the IRS should test other methods of serving taxpayers face-to-face outside of filing season. The IRS, with minimal investment, could create mobile TACs for areas where taxpayers otherwise would not have access to face-to-face service. The IRS could also partner with state and local tax agencies to share space for taxpayer service, and could pilot telepresence sites where taxpayers could interact remotely with IRS employees.

Recommendations

The National Taxpayer Advocate recommends the IRS test a program of using mobile vans to increase face-to-face service; pilot a program to collaborate with state and local agencies to increase face-to-face service; and test telepresence in remote areas.

20. The S Corporation Election Process Unduly Burdens Small Businesses

Problem

The IRS rarely denies applications for S corporation status based on a failure to meet the election criteria. However, many S corporation returns remain unprocessed for years because of missing or late elections, IRS errors in recognizing or processing valid elections, and an absence of effective relief procedures. The IRS does not provide examples of scenarios that meet the criteria for reasonable cause relief in its published guidance, nor does the IRS always fully inform taxpayers of their options for relief under five available Revenue Procedures. Challenges in the S election process for taxpayers include the complexity of relief procedures for a late S corporation election; the often prohibitive cost of retroactive relief via a private letter ruling (PLR); the IRS's inability to verify the receipt and acceptance of S corporation returns and election applications; and the downstream burdens on shareholders of the conversion of S corporation returns to regular, taxable corporate returns.

Analysis

In tax year 2009, S corporations accounted for about 64 percent of all corporate returns, with 45 percent of S corporation returns reporting gross receipts under $100,000 and 63 percent reporting gross receipts under $250,000. In processing year 2009, only 615 of approximately 419,000 elections were denied for failure to meet the election criteria. However, nearly 84,000 of these returns (approximately 20 percent) remain unpostable for multiple years. The IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under IRC § 1362 from FY 2007 to FY 2009, for which the IRS charges a user fee ranging from $625 to $14,000 per request.

Recommendations

The National Taxpayer Advocate recommends that the IRS expedite the issuance of a consolidated revenue procedure for late election relief; immediately identify and correct accounts where tax was assessed without following deficiency procedures; expand IRS outreach efforts to include a simple and complete guide to the late election relief process; develop an administrative appeal process for taxpayers whose elections are denied; and allow electronic filing of the S corporation election form.

21. The Combined Annual Wage Reporting Program Continues to Impose a Substantial Burden on Employers

Problem

The purpose of the Combined Annual Wage Reporting (CAWR) program is to ensure that employers pay and withhold the proper amount of tax. The program accomplishes this task by comparing the data on wage and information reporting forms submitted to the Social Security Administration (SSA) with the amounts reported to the IRS on employment tax forms. This process enables the IRS and SSA to identify potentially missing or incorrect tax and wage data. The IRS then contacts employers to resolve any discrepancies. However, IRS notices to employers are frequently misrouted, causing delays and potentially causing penalty assessments. Further, the IRS often does not respond to employers' correspondence within established timeframes and is reluctant to abate penalties.

Analysis

In May 2010, the CAWR program failed to work almost 87 percent of correspondence within the established period of 45 days from receipt. Even after taking additional steps to improve its ability to timely resolve CAWR cases, the IRS was still unable to timely work almost 45 percent of taxpayer correspondence as of September 2010. Because of revised and more restrictive IRS guidance to employees, the IRS is far less likely to abate Failure to Timely File Information Returns penalties and Intentional Disregard penalties. Without any discernable change in employer behavior, the percentage of Failure to Timely File Return Information penalty dollars abated declined from 82 percent in FY 2008 to 71 percent in FY 2010. The percentage of Intentional Disregard penalty dollars abated dropped even more significantly, from 85 percent in FY 2008 to 61 percent in FY 2010. This decline in abatement of penalties in CAWR cases may impose unnecessary financial burdens on businesses without achieving increased voluntary compliance. The IRS may be able to reduce unnecessary penalty assessments by modifying its systems to ensure that taxpayers timely receive notices about employment tax issues. Because the IRS's Business Master File (BMF) can record only one address per entity, IRS correspondence may be misrouted, particularly for large entities that have different divisions with separate addresses. If CAWR notices are misrouted, businesses may be unable to respond in time to prevent erroneous penalty assessments.

Recommendations

The National Taxpayer Advocate recommends that the IRS expand its First-Time Abatement policy to include late filing and intentional disregard penalties and upgrade its systems to allow correspondence to be sent to the appropriate corporate address.

Status Updates

1. The IRS Has Been Slow to Address the Adverse Impact of its Lien Filing Policies on Taxpayers and Future Tax Compliance

Problem

As described in detail in our 2009 Annual Report to Congress, a notice of federal tax lien (NFTL) filed against a taxpayer can severely damage the financial welfare of the taxpayer and his family and reduce federal revenue for years to come. Despite the National Taxpayer Advocate's specific concerns and actionable recommendations, the IRS has not altered its lien filing policies. To the contrary, the IRS filed liens against 1.1 million taxpayers last year, a 14 percent increase over the prior year, in the midst of the worst economy in a generation. The IRS also continues to file many liens automatically, without substantive human review. As a result, NFTL filing practices continue to harm millions of taxpayers, especially low income and minority families. These policies also risk undermining future tax compliance and may be wasting millions of taxpayer dollars on potentially unnecessary lien filing fees.

Analysis

As stated in last year's report, NFTL filings had increased by more than 475 percent from FY 1999 to FY 2009, from about 168,000 to nearly 966,000. In FY 2010, the IRS further increased lien filings to about 1.1 million. Despite the perception that more hard-core enforcement actions translate into more revenue, the data tell a very different story. Liens have now increased by about 550 percent since FY 1999, while inflation-adjusted revenue collected by the IRS Collection function has essentially remained flat (it has increased by just 4 percent). A lien generally remains on a taxpayer's credit report for seven years from the date the tax debt is satisfied or longer if it not satisfied. In all, the IRS has filed more than five million liens in recent years that continue to damage the credit of affected taxpayers. Despite the devastating impact of liens, the IRS still has not undertaken studies to evaluate whether its lien filing policies do much to increase revenue or boost future tax compliance. In 2010, the National Taxpayer Advocate issued two Taxpayer Advocate Directives (TADs) directing the IRS to implement specific changes to improve its lien filing policies and procedures and to grant relief to taxpayers harmed by the automatic lien filing process. We do not believe the IRS has adequately addressed the concerns we raised, and it has failed to alleviate – or even acknowledge – the enormous hardship its policies are now inflicting on millions of financially struggling taxpayers.

Recommendations

The National Taxpayer Advocate reiterates her previous recommendations that the IRS immediately rescind its policy of automatically filing liens, based on an unpaid balance threshold, against accounts designated as "currently not collectible" due to economic hardship; require managerial approval for NFTL filings in all cases where the taxpayer

has no significant equity in assets; base lien filing determinations on a thorough review of information including the taxpayer's assets, the taxpayer's income, and the value of the taxpayer's equity in the assets; and determine after weighing all the facts and circumstances whether (i) the lien will attach to property, (ii) the benefit to the government from the NFTL filing outweighs the harm to the taxpayer, and (iii) the filing will jeopardize the taxpayer's ability to comply with the tax laws in the future. To reverse the damage to a taxpayer's credit rating, the IRS also should develop and issue guidance allowing, upon the request of the taxpayer, the withdrawal of an NFTL where the statutory withdrawal criteria are satisfied.

2. Despite Program Improvements, the IRS Policy of Processing Most ITIN Applications with Paper Returns During Peak Filing Season Continues to Strain IRS Resources and Unduly Burden Taxpayers

Problem

In prior reports, the National Taxpayer Advocate expressed significant concerns about IRS processing of applications for Individual Taxpayer Identification Numbers (ITIN) and associated tax returns. The IRS has made improvements to its processes and procedures, but considerable problems continue to arise from the IRS's policy of declining to process most ITIN applications unless they are attached to paper tax returns. This policy results in recurring seasonal bottlenecks of ITIN applications that strain IRS resources and delay in processing hundreds of thousands of tax returns and refunds, thus creating an undue taxpayer burden.

Analysis

The IRS processes most ITIN applications only when they are associated with attached paper returns. This policy precludes ITIN applicants from filing electronic returns, creates a recurring bottleneck of ITIN applications and tax returns during peak tax season (totaling 1.6 million applications and more than 960,000 returns in 2010 alone), and causes backlogs of hundreds of thousands of unworked and suspended applications. Taxpayers' refunds may be delayed for as long as eight months if their ITIN applications are suspended. Of the 117,000 suspended applications as of April 10, 2010, 115,000 (98 percent) had associated and still unprocessed paper tax returns. A prior year analysis of ITIN returns showed that 83 percent of the taxpayers were due refunds totaling more than $500 million.

Recommendation

The National Taxpayer Advocate commends the IRS for working closely with TAS to improve many ITIN processes and procedures, but reiterates her recommendation to streamline the ITIN application process by assigning ITINs throughout the year upon proof of employment or self-employment. This change would allow new ITIN applicants to file returns electronically and reduce the backlogs that delay both ITIN applications and refunds for many taxpayers.

3. The IRS's Handling of Collection Statute Expiration Dates Continues to Adversely Affect Taxpayers

Problem

By statute, the IRS generally has ten years from the date it assesses a tax liability to collect the amount due. The collection statute expiration date (CSED) is sometimes difficult to track because the collection period may be extended by taxpayer agreement or suspended by certain provisions of the tax code. As a result, the IRS sometimes miscalculates CSEDs, subjecting taxpayers to unlawful collection. According to a TAS analysis of IRS data, more than 4,600 taxpayers have accounts with CSED extensions or waivers that would violate IRS policy if entered into today.

Analysis

In 2010, the National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) to the IRS directing resolution, adjustment, or correction of all accounts with CSEDs extended beyond 15 years after assessment (plus any statutory suspensions). In response, the IRS agreed it would participate in a workgroup with TAS to review, correct, and resolve these accounts. In connection with the TAD, the IRS Office of Chief Counsel issued an opinion prohibiting the termination of CSED waivers on accounts exceeding current IRS policy limits and authorizing write-off or abatement of taxes on these accounts only where administration and collection costs would not warrant collection of the amount due. In response to our 2009 Annual Report, the IRS agreed to review its CSED training to address any gaps, monitor the accuracy of CSED computations, and change programs as needed. However, the IRS has not attempted to centralize the functions that correct taxpayers' miscalculated CSEDs. The National Taxpayer Advocate recognizes that the IRS computes most CSEDs accurately, but until it develops a centralized unit to identify and correct errors, computation errors will continue to harm taxpayers.

Recommendation

The National Taxpayer Advocate renews her recommendation that the IRS designate a centralized function to identify and resolve CSED problems.

4. The IRS Offer-in-Compromise Program Continues to be Underutilized

Problem

An offer in compromise (OIC) is an agreement in which the government accepts less than the full amount of a tax debt in exchange for the taxpayer's promise to comply fully with his or her tax obligations for at least the next five years. An OIC can be good for a financially struggling taxpayer because it removes the threat of IRS collection action and allows the taxpayer to make a fresh start. An OIC can be good for the government because it enables the government to collect as much tax as it reasonably can and, importantly, provides a strong incentive for the taxpayer to remain in compliance; if a taxpayer fails to comply with his or her tax obligations anytime in the next five years, the original tax liability may be reinstated in full. Since 2001, the National Taxpayer Advocate has been expressing concern that the IRS has made the OIC program too inaccessible for most taxpayers to utilize.

Analysis

The current economic climate has prompted a nine percent increase in offer receipts. At the beginning of FY 2010, there were 4,031,093 taxpayers with delinquent accounts. During FY 2010, the IRS accepted only 13,886 offers, representing about one accepted offer for every 290 taxpayers with a delinquent account. To make the program more accessible, the IRS has proposed to make the offer amount flexible by allowing certain payments for unsecured debt, reducing or exempting automobile and home values, and using fewer months of future income to calculate reasonable collection potential.

Recommendations

The National Taxpayer Advocate supports the steps the IRS has proposed to take and further recommends that the IRS adopt the recommendations of a recent study concerning allowable living expenses, reasonable collection potential, and OIC outreach for low income taxpayers in currently not collectible status; incorporate elements of new streamlined offer processing procedures into employee guidance; revamp OIC quality reviews; and conduct periodic studies to review taxpayer compliance several years after their offers are accepted or rejected.

Legislative Recommendations

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(VIII) requires the National Taxpayer Advocate to propose legislative recommendations to resolve or mitigate problems encountered by taxpayers. This year's report offers the following 11 recommendations.

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 and described the sources and impact of complexity.

Recommendations

The National Taxpayer Advocate recommends that Congress make fundamental tax reform a high priority. In this connection, we offer general principles as well as specific simplification proposals for consideration.

A. General Principles

Tax reform should be approached in a manner similar to zero-based budgeting. To start the discussion, the assumption should be that all tax expenditures would be eliminated. An expenditure would be added back only if a compelling business case can be made that the benefits of providing the tax incentive through the tax 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. In some cases, the immediate elimination of a tax benefit could cause hardships for individuals or businesses. For example, the sudden elimination of the mortgage interest 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.

We further recommend that the protection of taxpayer rights and minimization of taxpayer burden be given appropriate emphasis as a new tax framework is developed. Toward this end, 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.

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.

B. Simplification Proposals

Among specific simplification proposals the National Taxpayer Advocate has made in past reports are the following:

1. Repeal the Alternative Minimum Tax for individuals.
2. Consolidate the "family status" provisions (including filing status, personal and dependency exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b).
3. Improve other provisions that govern taxation of the family unit, including "joint and several liability" and the "kiddie tax."
4. Consolidate the incentives to encourage savings for education (there are now at least 11 separate incentives).
5. Consolidate the incentives to encourage savings for retirement (there are now at least 16 separate incentives).
6. Simplify the worker classification rules to reduce disputes over employee-vs.-independent contractor status.
7. Reduce procedural incentives to use tax sunsets (more than 100 provisions in the tax code are temporary and thus require periodic renewal).
8. Reduce income phase-outs, which affect more than half of all returns each year and add considerable complexity to tax computations.
9. Streamline the penalty regime for tax violations (there are now more than 130 penalty provisions, up from 14 in 1954).

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

Problem

Under a new requirement, every business that purchases $600 or more of goods from a single vendor during a calendar year will be required to file an information report (Form 1099) with the IRS and the vendor showing the total amount of purchases. The intent of this requirement 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.

Analysis

The new requirement extended information reporting to purchases of goods as well as property of any sort and to payments to corporations. Because purchases of goods are so common, the requirement will create a widespread administrative burden disproportionate to the value of the information to the IRS. Small businesses and even non-profit organizations will shoulder the burden of filing paper information reports if they are not required to file electronically and are not set up to do so. The IRS will receive millions of such reports on paper, requiring it to devote significant resources to entering the data into its systems manually, increasing the risk of transcription errors, and rendering the data less reliable. Moreover, even if gross purchase 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. While third-party data are useful for tax administration, there are better ways to obtain the data.

Recommendations

The National Taxpayer Advocate recommends that Congress (1) amend Internal Revenue Code § 6041 to repeal the requirement for information reports on purchases of goods (as well as property of any sort); (2) retain the new requirement for information reports on payments to corporations for services, determinable gains, and other income; and (3) expand third-party data by requiring banks to file information reports with respect to all customer accounts whether or not an account bears interest and by pursuing certain state data, such as sales tax data.

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

Problem

Internal Revenue Code §§ 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." 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. Additional IRS guidance imposes the same deadline for claims for equitable relief from the operation of community property rules under IRC § 66(c). As a result of these limitations, an innocent spouse may be time-barred from requesting equitable relief and thus be held liable for the full amount of the tax due. As a separate matter, several district courts have not permitted taxpayers to raise innocent spouse claims as a defense in collection suits.

Analysis

As discussed in greater detail in Volume 2, *Unlimit Innocent Spouse Equitable Relief*, neither IRC § 6015(f) nor IRC § 66(c) limits the time within which a taxpayer must request equitable relief from joint and several liability or from the operation of community property rules. The Tax Court, in *Lantz v. Commissioner*, held the regulation imposing the two-year period invalid, and although the decision was reversed by the United States Court of Appeals for the Seventh Circuit, the Tax Court adheres to its position in cases appealable to other Courts of Appeals. The IRS maintains that the regulation imposing the two-year rule is valid and has appealed the issue to other Courts of Appeals. In addition, IRC § 6015 (e)(1)(A) permits an individual to seek relief from joint liability by petitioning the Tax Court "in addition to any other remedy provided by law." Other statutory provisions and judicial precedent make clear that taxpayers may raise IRC § 6015 in a variety of contexts.

Recommendations

The National Taxpayer Advocate recommends that Congress amend IRC §§ 6015 and 66 to specify that (1) taxpayers may request equitable relief for as long as the IRS could collect affected liabilities (*i.e.*, any time before expiration of the collection statute of limitations period) 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.

4. Remove the 36-Month "Testing Period" that May Trigger Cancellation of Debt Reporting

Problem

A taxpayer's gross income includes income from the discharge of indebtedness, and creditors report canceled debt to the IRS on Form 1099-C, *Cancellation of Debt*. As discussed in greater detail in 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*, creditors have issued Forms 1099-C to record numbers of taxpayers in recent years. However, Treasury regulations allow creditors to issue a Form 1099-C even when they are not discharging a debt. Thus, a creditor may issue a Form 1099-C reporting the cancellation of a debt – which, in turn, may prompt the IRS to assert an additional tax liability against the taxpayer – while the creditor itself continues to try to collect the debt.

Analysis

Regulations under IRC § 6050P require creditors to issue Form 1099-C if an "identifiable event" has occurred, whether or not an *actual* discharge of indebtedness has occurred. 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 has taken place. By issuing a Form 1099-C after 36 months of nonpayment, a creditor may avoid the penalty for failing to comply with its reporting obligations, yet it remains free to collect the debt. A taxpayer who does not report the amount shown on Form 1099-C on a return may receive an IRS notice that is the first step toward assessing additional tax.

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.

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

Problem

Payments received for lost earnings or profits as the result of a non-federally declared disaster, such as the 2010 Gulf oil spill, are includible in an individual's gross income. Unlike the wages these payments may replace, the Internal Revenue Code and accompanying regulations do not require federal income tax withholding on these payments. Although individuals can utilize the estimated tax payment process to satisfy quarterly tax liabilities, many disaster victims who have little or no experience making quarterly estimated tax payments will not make the required deposits, and thus will have a surprise year-end tax liability that could have been avoided if the payments had been subject to income tax withholding. This result will cause hardship to taxpayers not only because of the taxes owed, but also because of penalties, interest, and potential IRS collection actions. Without a withholding requirement, taxpayers may face an "IRS disaster" that could rival the personal economic damage caused by the disaster they just survived.

Analysis

Current law only allows voluntary income tax withholding for these types of payments if (1) the IRS publishes an enacting regulation and (2) both the taxpayer and the party making the payments agree to voluntary withholding. To date, the IRS has not published an enacting regulation. Even if it did so, the party making payments for lost earnings or profits could still legally refuse to withhold income taxes in spite of the taxpayer's desire to have taxes withheld. Without a withholding requirement, many taxpayers could find a "tax surprise" waiting for them on April 15. These unexpected tax burdens are easily avoidable if withholding is required unless taxpayers opt out at the time the payments are made. Even if less than the end of year tax liability is withheld, partial withholding will reduce taxpayers' burden.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 3402(p) to require withholding of income taxes at a ten percent rate for payments made pursuant to claims for lost earnings or profits that result from an event designated by the Secretary of the Treasury to be a disaster, regardless of whether that event is a federally-declared disaster, unless taxpayers expressly opt out of the required withholding when the payment is made.

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

Problem

No statute of limitation governs the revocation of tax-exempt status for charities and non-profit organizations. This situation creates a procedural loophole through which the IRS can revoke exempt status even for past years when assessment of tax is already time-barred. Potentially, an organization could face revocation and assessment in current years based on audited activities in closed years.

Analysis

Under initial and annual filing requirements, the IRS receives timely notice of a charity's claim to exempt status and honors deductions claimed by donors until announcement of a revocation, so it is unclear whose interests could be protected by an indefinite period for revocation. Meanwhile, exempt status generates numerous consequences, such as qualification for certain bond financing or participation in certain programs, which potentially could affect third parties. Given the far-reaching impact of revocation, procedural safeguards should apply.

Recommendation

The National Taxpayer Advocate recommends that Congress enact a statute of limitation on revocation of a charity's tax-exempt status, to run concurrently with the existing period of limitation on assessment in general. Thus, revocation may occur for up to three or, in case of substantial omission of items from a return, up to six years after the filing of the return. In case of fraud, tax evasion, or non-filing, no period of limitation on revocation would apply. The time-bar would apply not only to the effective date but also to past facts as a reason for revocation.

7. Refine Whistleblower Procedures to Better Protect Taxpayer Privacy While Providing Necessary Information to Whistleblowers

Problem

Although the IRS generally must keep tax return information confidential, a significant gap exists when a whistleblower supplies information about a taxpayer to the IRS and files a claim for an award. During adjudication of the claim, the taxpayer's tax return information may be revealed by the IRS to the whistleblower, and no provision in the tax code generally requires the whistleblower to keep such information confidential. The taxpayer may not know of the whistleblower's existence, and there is no requirement that the taxpayer be notified that his or her tax return information has been disclosed. Of greater concern, the whistleblower may appeal an adverse administrative decision to the Tax Court, and the Tax Court's opinion may include tax return information of the underlying taxpayer.

Analysis

If a whistleblower pursues a claim for an award from the IRS, administrative proceedings may contain relevant facts, including the taxpayer's name, gross income, and other tax return information. Ultimately, the Tax Court may publish an opinion that includes the taxpayer's return information even though he or she is not a party to the case and may not know about it. Meanwhile, it is unclear to what extent third-party disclosure is necessary to adjudicate a whistleblower claim. In another context, the IRS redacts identifying details in Private Letter Rulings but leaves in place facts sufficient to justify a holding.

Recommendation

To protect taxpayer privacy while affording due process to a whistleblower, the National Taxpayer Advocate recommends that Congress amend Internal Revenue Code § 7623 or other applicable provisions to require redaction of third-party return information in administrative and judicial proceedings. This change would provide the taxpayer with an opportunity to request further redaction before disclosure as well as 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 Statute to Encourage Business Owners to Continue Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act

Problem

Internal Revenue Code § 6672 provides for the assessment of a Trust Fund Recovery Penalty (TFRP) against any person who is responsible for withholding and paying over employment taxes to the IRS and who willfully fails to do so. The courts interpret the statute as requiring the responsible person to use all available funds to pay the delinquency. To avoid TFRP liability, the responsible person may not use any of the available funds to pay operating expenses of the business in situations where there was no change in ownership of the business. This judicial interpretation appears to cause unjust results when a responsible person of a struggling business tries to resolve a past tax delinquency that resulted from an intervening bad act, and it discourages the management of financially troubled companies.

Analysis

The taxpayer's willfulness under IRC § 6672 is generally established if he or she pays other creditors instead of paying the IRS after finding out about an employment tax liability, even if those payments are made in an effort to keep the business going. This outcome does not change even if the delinquency resulted from a third-party bad act, such as mismanagement or embezzlement by a trusted employee or third-party payer. Based on the United States Supreme Court's decision in *Slodov v. United States*, courts have limited the application of the penalty in cases where a financially troubled company changes ownership and an individual becomes a responsible person after the liability has accrued. The rationale for this limitation is to provide the company with at least minimal working capital to maintain operations and avoid liquidation of the business. However, this exception does not apply if there was no change in ownership.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 6672 to provide that where a responsible person obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act, his conduct 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. 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

Internal Revenue Code § 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. Fee-shifting provisions like IRC § 7430 provide an important protection of taxpayer rights. However, these provisions may be negatively affected by a recent Supreme Court ruling that calls into question some existing case law, and that may result in attorneys' fees awards being offset by the government to satisfy a litigant's preexisting government debt.

Analysis

IRC § 7430 is 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. However, the Supreme Court held that attorneys' fees awards paid under a fee-shifting statute containing language identical to IRC § 7430 were payable directly to the litigant, rather than to the litigant's representative. Thereby, the award was made subject to administrative offset to satisfy the litigant's existing government debt. If the likelihood of attorneys' fees being paid to the taxpayer's representative is reduced, it would have a chilling effect on the availability of low-cost or no-cost legal services for indigent civil litigants, and would undercut the purpose of the statute.

Recommendation

To safeguard the availability of low-cost or no-cost legal services for indigent civil litigants and protect against unreasonable government action, the National Taxpayer Advocate recommends that Congress amend Internal Revenue Code § 7430 to declare that attorneys' fees are ineligible for offset to satisfy a litigant's pre-existing federal government debt.

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 tax year, even though the corporation is not required to file its first tax return until the 15th day of the third month after the end of the tax year. Many taxpayers miss the deadline for filing an S corporation election because they do not focus on the issue until they prepare their first tax return, This is a significant, longstanding problem for small businesses, subjecting them to serious tax consequences that include taxation at the corporate level and the inability to deduct operating losses on their shareholders' individual tax returns. The IRS generally permits small businesses to make untimely elections if they follow certain procedures, but these procedures can be burdensome, confusing, and costly, and relief cannot be assured.

Analysis

Business entities that fail to timely file an election to be treated as an S corporation may be given retroactive relief upon a showing of reasonable cause. However, a small business entity that does not meet the requirements for relief, or is denied relief under a revenue procedure, is taxed as a C corporation for at least one year and may face the challenge of requesting relief by means of a Private Letter Ruling (PLR), which can cost up to $14,000. 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 valid elections, and an absence of effective relief procedures. These unprocessed returns accounted for nearly 17 percent and nearly 24 percent of all new S corporation filings, respectively, for those two years.

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. Enact a Uniform Federal Agency External Ombudsman Act

Problem

The federal agency external ombudsmen function expands yearly through legislation or individual agency initiative. While each ombudsman is charged with serving or advocating for a specific external public population, the similarities between offices often end at that point.

Analysis

A Federal Agency External Ombudsmen Act would cover the general mechanisms of any federal external ombudsman office. Such an act would ensure that each new federal external ombudsman has the basic structure and protections to succeed in the ombuds role. For a discussion of the variations between federal external ombudsmen offices, *see* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 105-127.

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.

The Most Litigated Issues

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts and to classify those issues by the category of taxpayer affected. The cases we reviewed were decided during the 12-month period that began on June 1, 2009, and ended on May 31, 2010. In addition, the report contains a discussion of certain judicial decisions that did not involve one of the ten most frequently litigated issues but were significant because of their holdings.

1. Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609

The IRS may examine any books, records, or other data relevant to an investigation of a civil or criminal tax liability. To obtain this information, the IRS may serve a summons directly on the individual who is the subject of the investigation or on any third party who may possess relevant information.

If the government serves a summons on a taxpayer who is the subject of an investigation and petitions a court to enforce it, the taxpayer has the right to contest the legality of the summons. If the IRS serves a summons on a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons. Generally, the burden on the taxpayer to establish the illegality of the summons is formidable. We identified 146 cases that included issues of IRS summons enforcement. The parties contesting the summonses prevailed in full in only four of these cases, with seven cases resulting in split decisions, and one resulting in no decision. The IRS prevailed in the remaining 134 cases.

2. Appeals from Collection Due Process (CDP) Hearings Under Internal Revenue Code Sections 6320 and 6330

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

Since 2003, CDP has been one of the federal tax issues most frequently litigated in the federal courts and analyzed for the Annual Report to Congress. The trend continues this year, with the courts issuing 131 opinions during the review period. The cases demonstrate that

CDP serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. Where taxpayers attempted to use the process inappropriately, courts imposed sanctions or warned taxpayers they might face sanctions in the future.

3. Accuracy-Related Penalties Under Internal Revenue Code Sections 6662(b)(1) and (2)

IRC § 6662(b)(1) and (2) authorize the IRS to impose a penalty if under § (b)(1) a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2) an underpayment of tax exceeded a computational threshold that renders it a "substantial understatement." We identified 125 federal court opinions involving such accuracy-related penalties. IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties. During our review period, however, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties; therefore, our analysis does not address the three other accuracy-related penalties.

4. Trade or Business Expenses Under Internal Revenue Code Section 162 and Related Sections

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 119 cases that included a trade or business expense issue during the review period. The courts affirmed the IRS position in the majority (approximately 64 percent) of cases, while taxpayers prevailed about seven percent of the time. The remaining cases resulted in split decisions.

5. Gross Income Under Internal Revenue Code Section 61 and Related Sections

When preparing a tax return, the taxpayer first must compute "gross income" for the taxable year. Gross income is among the most litigated tax issues every year. During the recent review period, we identified 103 cases in which gross income was an issue, including disputes over damage awards, foreign earned income, and discharge of indebtedness.

6. Failure to File Penalty Under Internal Revenue Code Section 6651(a)(1) and Estimated Tax Penalty Under Internal Revenue Code Section 6654

We identified 71 decisions regarding the addition to tax under IRC § 6651(a)(1) for failure to timely file an income tax return or the addition to tax under IRC § 6654 for failure to pay estimated tax. The phrase "addition to tax" is commonly referred to as a penalty, so we refer to these two additions to tax as the failure-to-file penalty and the estimated-tax penalty, respectively. Thirty-four cases involved imposition of the failure-to-file penalty in conjunction with the estimated-tax penalty, 35 cases involved only the failure-to-file penalty, and two cases involved only the estimated-tax penalty. The failure-to-file penalty is mandatory unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect. Similarly, the estimated-tax penalty is mandatory unless the taxpayer can meet one

of the statutory exceptions. In the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid these penalties.

7. Frivolous Issues Penalty and Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673

The federal courts issued decisions in at least 39 cases involving the IRC § 6673 "frivolous issues" penalty and in at least nine cases involving an analogous penalty at the appellate level. These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal. The United States Tax Court or a United States District Court raised IRC § 6673 *sua sponte* in a number of cases. In many of these cases, taxpayers escaped liability for the penalty but were warned that they could face sanctions for similar conduct in the future. Similarly, we identified two cases at the appellate level where the court did not impose a sanction under IRC § 7482(c)(4) or any other authority but warned the taxpayer that similar conduct will result in a sanction in the future.

8. Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under Internal Revenue Code Section 7403

IRC § 7403 authorizes the United States to file a civil action in a United States District Court against a taxpayer who has refused or neglected to pay any tax in order to enforce a federal tax lien or to subject any of the delinquent taxpayer's property to the payment of the tax. We identified 46 opinions that involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the significant majority of cases, as taxpayers prevailed in only five cases and one resulted in a split decision. This is the second year in which this issue has appeared among the ten most litigated tax issues.

9. Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151

Because family status issues center on interrelated exemptions, credits, and filing statuses claimed on federal tax returns, cases in this area often involve multiple issues with similar factual determinations. This report combines the following issues into a single "family status" category:

- Head of household filing status;
- Child tax credit;
- Earned Income Tax Credit (EITC); and
- Dependency exemption.

Many of the 45 federal court opinions we reviewed cover multiple family status issues, with the determination of one often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may impact eligibility for head of household filing status. Family status rules have broad impact; in tax year

2009, more than 20 million taxpayers filed as head of household, nearly 26 million received the EITC, and more than 55 million claimed some form of dependency exemption.

10. Relief from Joint and Several Liability Under Internal Revenue Code Section 6015

Married couples can file their federal income tax returns jointly or separately, but spouses filing joint returns are jointly and severally liable for any deficiency or tax due. Joint and several liability permits the IRS to collect the entire amount due from either taxpayer. IRC § 6015(b) provides "traditional" relief from joint and several liability for deficiencies, while IRC § 6015(c) provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together. IRC § 6015(f) provides "equitable" relief from both deficiencies and underpayments, but only if a taxpayer is not eligible for relief under IRC § 6015(b) or (c).

We reviewed 35 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2009, and May 31, 2010, as well as one significant decision, *Lantz v. Commissioner*, that was issued on June 8, 2010. The most significant issue the courts addressed this year is the period of time within which a taxpayer may request relief under IRC § 6015(f). The Tax Court also explored the doctrine of *res judicata* and its exception under IRC § 6015(g)(2) as well as the effect of a family court order that first required a taxpayer to file amended returns electing joint filing status and then allocated liability for the resulting tax. Finally, one district court decision demonstrates that whether IRC § 6015 can be raised as a defense in a collection suit remains an unresolved issue.

Volume 2: TAS Research and Related Studies

1. Unlimit Innocent Spouse Equitable Relief

Background

The validity of a Treasury Regulation effectively imposing a two-year statute of limitation on an innocent spouse's request for equitable relief from income tax liability has been denied by the U.S. Tax Court and is pending before multiple circuits of the U.S. Court of Appeals. The two-year regulatory period, which the IRS continues to enforce despite the National Taxpayer Advocate's recommendation for legislative removal and the Tax Court's invalidation, leaves innocent spouses in a quandary. Many requests for equitable relief filed after the two-year period cannot be resolved until the appellate courts rule, and thereafter, there may be divergent rules among circuits.

Analysis

In developing the applicable legislation, Congress heard testimony from innocent spouses who described circumstances that could delay a request for relief. Congress then affirmatively omitted from the equitable relief provision any statute of limitation (other than the pre-existing one on tax collection), while specifically prescribing a two-year period for traditional or separately allocated relief elsewhere within the same statute. Unlike traditional and separately allocated relief, which covered only understatements of tax, equitable relief covered underpayments as well, thereby affording relief even if there is no deficiency. Equitable relief thus extended the innocent spouse provision into the realm of collection, which already had a statute of limitations (generally ten years). Accordingly, the two-year limit on equitable relief under the regulation is not a reasonable interpretation of the statute. It forecloses a class of requests that equitable relief was designed to reach; namely, those in which an innocent spouse delayed a request for relief upon being misled or intimidated by a joint filer.

Recommendation

The National Taxpayer Advocate believes the law should be clarified, whether by administrative, judicial, or legislative means, to confirm the permissibility of equitable relief at any time within the applicable limitation period on collection. As a matter of tax administration, this rule should apply uniformly to taxpayers across the country. In short, a setting aside of the invalidated regulation would allow for effective and consistent implementation of the statutory scheme.

2. Patient Protection and Affordable Care Act: A Preliminary Analysis of the Challenges Facing the IRS in Implementing Health Care Reform

Background

Most Americans do not now interact with the IRS in connection with their health insurance. Under key provisions of the Patient Protection and Affordable Care Act, however, many Americans will begin to do so. The law is complex, and the challenges the IRS faces in implementing its provisions are significant in many respects. To cite one example, the IRS will be responsible for administering certain tax credits and penalties, but it often will not have the authority to make the underlying decisions about eligibility. The fact that other entities will make decisions that the IRS will be required to enforce may place the IRS in a difficult position when disputes arise.

Early discussion about these implementation challenges will help identify areas that could cause problems or confusion for taxpayers. Early identification of potential problems will allow the IRS, the National Taxpayer Advocate, and others to propose "fixes" for those problems – whether administrative or legislative. Early discussion will also focus the attention of the Administration and Congress on the funding needs of the IRS, thereby increasing the likelihood the agency will receive the resources it needs to do the job.

The National Taxpayer Advocate is confident the IRS can succeed in its implementation efforts. However, a comprehensive assessment of the issues and challenges that lie ahead is a prerequisite for success. This report identifies challenges relating to administration of the four main tax-related provisions in the new law: the Small Business Tax Credit, the Premium Tax Credit, the Individual Responsibility Requirement, and the Employer Requirement.

Analysis

The IRS has begun to implement the new health care law, but the major work lies ahead. The IRS faces a number of overarching challenges, including determining the types of new information it needs to gather, determining the new entities it needs to work with, resolving privacy issues, and implementing a new definition of income (*i.e.,* "household income").

Additionally, each of the main tax provisions raises its own questions and concerns. The advanceable and refundable nature of the premium tax credit will present questions regarding how the IRS communicates and works with a population of taxpayers that is not accustomed to having the IRS involved in its health insurance decisions. The individual mandate will challenge the IRS to balance the cost of compliance work for nonfilers with the underlying goal of the new law – near-universal health insurance coverage. Finally, the employer requirement will challenge the IRS to ensure employers are compliant without violating taxpayer privacy rules.

Recommendations

The new health care law will require a significant commitment by the IRS – one that will require the agency to think outside its traditional "revenue collection" box. The IRS faces a daunting task, not only in implementing the health care provisions within its own systems and organizations but in conducting the necessary outreach to educate taxpayers about the new law.

The IRS should consider hiring phone employees with experience in social work and case management who would be dedicated solely to health care. Additionally, the Commissioner should establish a cross-functional Executive Steering Committee to advise the program office the IRS has set up to lead the implementation efforts. This committee should include representatives from all four of the IRS operating divisions as well as from TAS and other IRS functions such as the Office of Appeals, Research, Criminal Investigation, Modernization and Information Technology Systems, Counsel, and Communications and Liaison.

While the National Taxpayer Advocate believes the IRS is capable of implementing this new law given sufficient funding and appropriate staffing, this discussion is designed to identify potential challenges and concerns with how the law may be administered – and to give Congress and the IRS enough time to address them.

3. An Analysis of IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission

Background

In the National Taxpayer Advocate's 2004 Annual Report to Congress, we raised concerns about the IRS's collection strategy and questioned the effectiveness of a one-size-fits-all approach to servicing accounts of taxpayers with collection-related tax problems. The IRS's assembly-line approach to processing collection accounts has remained essentially unchanged for over 25 years, even while the Collection operation has regularly received substantial criticism from key stakeholders. Notably, highly significant congressional and judicial actions have been taken during this time to provide better protection for taxpayers facing collection problems.

Analysis

Program results indicate the IRS collection strategy could be more effective in recovering delinquent revenue and reducing the IRS's inventory of unpaid assessments:

- The inventory of unpaid assessments rose from approximately $270 billion in FY 2006 to $359 billion in FY 2010 – an increase of 33 percent.
- Dollars reported as "currently not collectible" (CNC) rose from $16.2 billion in FY 2006 to $28.9 billion in FY 2010 – an increase of 78 percent.
- The number of taxpayer accounts reported as CNC rose from 751,012 in FY 2006 to approximately 1.3 million in FY 2010 – an increase of 73 percent.
- The dollar value of Taxpayer Delinquent Accounts (TDAs) assigned to the Collection Queue was approximately $46.2 billion in FY 2010 – a 70 percent increase from 2006.
- In FY 2010, the dollars reported as CNC by the Collection Field function (CFf) were approximately 320 percent of the combined total of dollars collected on open CFf TDAs and installment agreements generated by the CFf.

These problems were evident well before the recent downturn in the nation's economy, and they have worsened despite a 20 percent increase in the IRS's enforcement budget since 2006.

The IRS relies heavily on the bulk processing of correspondence and systemically generated enforcement actions to manage its considerable workload of collection accounts. While enforcement tools such as liens and levies are appropriate and necessary to address situations involving taxpayers who refuse to comply with the tax laws, these tools are often inappropriate and unproductive to apply to financially struggling taxpayers who simply cannot afford to pay, perhaps because of a job loss. Thus, these tools should not form the foundation of the IRS's collection strategy. More emphasis on prompt, personal contacts, coupled with a goal of providing "one-stop service" could result in a more effective use of the IRS's collection resources, protecting taxpayers from unnecessary harm *and* improving revenue collection.

In general, the IRS collection strategy appears to assume in far too many situations that delinquent taxpayers have made a conscious decision to not comply with their tax obligations, using the "full force of the law" to correct problems in a manner that is premature in many cases. The IRS should adjust this mindset and achieve a better balance between the use of enforcement actions and other collection tools, including payment alternatives such as reasonable installment agreements (IAs) and offers in compromise (OICs). Collection treatments should be tailored to the needs of each taxpayer, with the goal of not only addressing the delinquencies at hand but promoting future compliance as well.

The purpose of this study is to examine the performance of the IRS collection process (*i.e.*, the "collection strategy") over the past five years, identify trends that reflect results produced by the design of this process, and provide comments regarding the degree to which the IRS collection strategy is fulfilling its mission. This study indicates that a more effective IRS collection strategy must include greater emphasis on providing *timely attention* to collection problems as they arise, actually *talking to taxpayers* about their tax problems, and *assisting* taxpayers to regain a "fully compliant" status with *collection treatments that are flexible, considerate, and effective.*

Recommendations

At the conclusion of this analysis, the National Taxpayer Advocate offers the following recommendations for actions the IRS can take to improve its collection strategy:

1. Develop an improved working model of the "will pay," "can't pay," and "won't pay" distinctions in determining the most appropriate collection treatments to apply to taxpayers with collection problems.
2. Provide faster interventions for emerging collection problems.
3. Use more timely *personal contacts* to help taxpayers fully resolve their collection problems.
4. Deliver collection inventory to organizational segments trained and empowered to provide "one-stop service," based on the specialized needs of the taxpayer segment in question.
5. Make better use of all available collection tools, including the full range of collection payment alternatives (*e.g.*, offers in compromise and reasonable installment agreements).
6. Reevaluate the requirements for managerial review of IRS liens and levies.
7. Eliminate the Collection Queue.
8. Measure and evaluate the effectiveness of collection tools and treatments in meeting taxpayer needs and promoting future compliance.

4. Researching the Causes of Noncompliance: An Overview of Upcoming Studies

Background

The National Taxpayer Advocate has long advocated for research on how to increase voluntary tax compliance. She has proposed that the IRS undertake studies and has sponsored research. The National Taxpayer Advocate's 2007 Annual Report to Congress contained a study (the "2007 Study") that surveyed tax compliance literature to identify factors found to affect voluntary compliance. The National Taxpayer Advocate has also discussed with tax administrators and academics from around the world their efforts to study and influence voluntary taxpayer compliance.

Analysis

Broadly speaking, the factors identified by the 2007 Study and other research include not only the expected likelihood and cost of getting caught cheating (called "economic deterrence"), but other factors such as compliance norms, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of preparers. Perhaps surprisingly, this literature suggests that factors other than deterrence may have the greatest impact. Having surveyed the literature and identified potential factors, the Taxpayer Advocate Service is undertaking research to learn more about why taxpayers comply or fail to do so.

Because different taxpayers comply for different reasons, this research will focus on the segment responsible for the largest portion of the tax gap – participants in the cash economy (*i.e.*, taxpayers with income not subject to information reporting). Such participants are often sole proprietors who file Form 1040 Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.

The IRS is least likely to be able to detect or deter noncompliance by this segment without expending significant enforcement resources. Relatively inexpensive measures, such as document matching and correspondence examinations, cannot reliably detect income that is not subject to withholding or information reporting. Thus, it is particularly important for policymakers to gain a better understanding of how to improve compliance among this group of taxpayers using levers other than economic deterrence.

Recommendations

TAS is embarking on a multi-year study in this area. As the first stage of the research, this discussion summarizes TAS's initial plans for designing it. As a first step, TAS plans to survey a random nationwide sample of Schedule C filers by telephone. The survey will seek to identify which factors have the greatest impact on tax compliance.

This research could find, for example, that compliance by self-employed taxpayers in one industry is driven primarily by complexity and misconceptions about the rules, but is driven primarily by mistrust of the government in another. Such a finding might suggest

the IRS should focus its resources on simplifying the rules and educating those in the first industry and on fostering trust of the IRS by those in the second.

As a second step, TAS plans to over-sample taxpayers in specific geographic areas using the same survey. Because norms and attitudes are often formed locally, this may allow TAS to gain a clearer picture of the geographically-based factors that influence compliance.

5. Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative

Background

In an effort to better understand the effectiveness of IRS tax liens, the National Taxpayer Advocate asked the TAS Research & Analysis Division (Research) to investigate the impact of Notices of Federal Tax Lien (NFTL) on the compliance behavior of delinquent taxpayers. Although IRS research has indicated that NFTLs exhibit a positive impact on the collection of tax liabilities from delinquent taxpayers, questions remain as to what factors lead to the increase in collections.

Analysis

TAS Research will analyze delinquent individual tax return filers (IMF) taxpayers who had new unpaid tax liabilities that arose in tax year 2002 to determine the impact of imposing NFTLs. Further, we will study the payment activities and subsequent compliance behavior of these taxpayers, comparing payment activity and compliance behavior for taxpayers with and without an NFTL.

TAS Research will examine payment compliance and the overall compliance behavior on these taxpayers' 2002 to 2009 tax modules. The objectives of this lien research are:

- To determine any amounts of payments likely attributable to the NFTL;
- To determine the effect of the NFTL on future payment compliance;
- To determine the effect of the NFTL on future filing compliance; and
- To determine whether the NFTL is associated with a decline in future income.

TAS Research will employ a two-stage regression analysis. The first stage will determine the likelihood that the IRS will file a lien by examining various case factors and applying the lien filing criteria specified by the Internal Revenue Manual (IRM). This stage will result in the selection of "matched" pairs of cases with relatively equal chances of having an NFTL filed. Each pair will consist of one case where a lien was filed and another case where a lien was not filed. However, the matched cases will be very similar with respect to the characteristics the IRS uses to make a lien filing determination.

We will use the matched pairs in the second stage of the analysis to fairly compare the lien and non-lien groups. During the second stage, we will use regression analysis to determine what factors, including the NFTL itself, significantly affect the outcomes we are investigating (*e.g.,* dollars collected or future filing compliance) and the extent to which those factors influence the outcomes.

TAS Research also intends to conduct a sensitivity analysis to better understand when NFTLs are likely to be an effective collection tool. TAS does not envision that NFTLs are never effective, but rather that they may not be effective for certain taxpayers or in certain

situations, such as for taxpayers with low incomes and those whose liabilities have been reported as currently not collectible.

6. Evaluate the Administration of Tax Expenditures

Background

The National Taxpayer Advocate has identified legal complexity as a most serious problem of tax administration, particularly with respect to social benefits delivered through the tax law. Complexity arises in large part from tax expenditures, or government spending structured through the revenue system, which continue to proliferate, despite the fact that measures of their effectiveness are lacking. Whatever the nature of a particular tax expenditure, implementation falls to the IRS as a matter of tax administration.

Analysis

To the extent that any tax expenditure has a purpose other than modulating revenue collection, policy-makers should know if that purpose has been achieved. Like pure spending, tax expenditures should be subject to evaluation. This evaluation should account for the effectiveness of the IRS as the administrator of a particular tax expenditure.

With respect to social benefit programs, the National Taxpayer Advocate previously has observed that the fundamental design question is whether a program would be better suited to the tax system or to a pure spending program. Further, a social tax expenditure should incorporate effectiveness measures. If effectiveness measures would exceed IRS limitations, then the program may not be well suited to the tax system.

Assuming a tax expenditure is under consideration, evaluation could take place both before and after enactment of a tax expenditure. During consideration of legislation, evaluation would focus on design implications with projected costs and benefits. After enactment, actual administrative data would become available.

Recommendation

The National Taxpayer Advocate recommends adoption of a process to evaluate whether a tax expenditure presents an administrative challenge, and if so, the extent to which it achieves its intended purpose. Specifically, tax expenditures would be sorted into two categories. First, those that require minimal administration would not be assessed or evaluated for administrative purposes. Second, tax expenditures that involve expertise beyond the institutional competence of a revenue collector would be subject to further research. Tax expenditures should be subject to evaluation with respect to their programmatic intent. The efficacy of the IRS as the institutional host, or the resources required to transform the IRS into an effective administrator of a particular tax expenditure, also should be assessed. Although the National Taxpayer Advocate's recommendation is limited to administration of tax expenditures, research also could evaluate the policy performance of tax expenditures. While some tax expenditures may turn out to be efficiently administered by the IRS, others may add confounding complexity to the tax system.

7. TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge

Background

In the 1990s, the IRS developed a system known as TeleFile, enabling taxpayers who filed relatively simple tax returns and met specific requirements to file their returns using a touch-tone telephone. TeleFile was a type of electronic filing that helped the IRS move toward its goal of having 80 percent of tax returns filed via electronic means. However, the IRS discontinued TeleFile in 2005, citing increasing maintenance costs and decreasing use. Proponents of the system suggest the IRS abandoned TeleFile prematurely and left a segment of the taxpaying population with no convenient means of filing electronically. While some former TeleFilers adopted alternative methods of electronic filing, others did not. As part of the Taxpayer Assistance Blueprint (TAB) efforts, the IRS would like to know more about taxpayers who previously used TeleFile to help understand their needs and behaviors, and what would be needed to encourage those filing paper returns to use an electronic filing method.

Analysis

The data analyzed in this study suggest that a considerable number of taxpayers with relatively simple tax returns still file on paper. Nearly 30 percent of former TeleFile users filed a paper tax return in 2008, meaning the IRS was not successful in converting them to different electronic filing methods. Paper filers who previously used TeleFile tend to be older, have simpler tax returns, and prepare their own returns more than those who filed electronically in 2008. Those who used a paid preparer were more than six times as likely to file electronically as those who self prepared. One of the arguments for eliminating TeleFile was that taxpayers would use other electronic filing mechanisms, including the then newly developed Free File system. However, less than seven percent of former TeleFilers used Free File to complete and submit their tax return in 2008.

A telephone filing system offers the benefit of being available to taxpayers who do not have personal computers or Internet access or who are simply not computer savvy. By relaxing eligibility qualifications for a telephone system, the IRS could greatly expand the number of taxpayers who could use such a system - more than 27 million taxpayers could have used TeleFile in tax year 2008. For a TeleFile system to be successful, it must encourage new taxpayers to use the system to offset the taxpayers that can no longer use it because of changing life circumstances.

A recent Pew Internet Project survey shows that about one in four U.S. households does not have Internet access. However, more than half (53 percent) of Americans who do not use the Internet at all have cell phones. More significant, the U. S. Census Bureau's American Community Survey shows that nearly 98 percent of U.S. households have some type of telephone service – either a landline or cell phone. The ready availability of telephones makes telephone tax filing an attractive option.

Recommendations

The IRS's original assumptions that taxpayers who previously used TeleFile would automatically turn to another electronic method overstated some taxpayers' commitment to electronic filing. It would be worthwhile for the IRS to consider adding another e-filing method, thereby minimizing or eliminating problems associated with paper filing.

The National Taxpayer Advocate recommends that the IRS explore reinstating TeleFile with less restrictive eligibility criteria that allow taxpayers who move to use the system. Changes in the use of telephones and related technologies should be considered and included in the system evaluation so the IRS does not develop a system based on obsolete assumptions or technology. This would include evaluating current telephone technologies to determine the feasibility of allowing taxpayers with simple tax returns to interact with the IRS using cell phones and smart phones, as well as being able to file tax returns and interact with the IRS by voice or text.

Absent a telephone-based system, it is likely the IRS will need to develop more efficient alternatives for processing paper returns, because it appears some taxpayers will continue filing on paper unless they are forced to change. The IRS should evaluate how to capture information from paper returns by scanning a bar code rather than by transcription.

Publication 2104C (Rev. 12-2010) Catalog Number 23655L Department of the Treasury **Internal Revenue Service** www.irs.gov