

MSP
#6**IRS Collection Policies and Procedures Fail to Adequately Protect
Taxpayers Suffering an Economic Hardship****RESPONSIBLE OFFICIALS**

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DEFINITION OF PROBLEM

In her 2008 Annual Report to Congress, the National Taxpayer Advocate urged the IRS to reconsider its longstanding collection enforcement policies and procedures, and recommended the IRS exercise more flexibility in dealing with taxpayers experiencing economic difficulties.¹ Last year, in *Vinatieri v. Commissioner*, the Tax Court held that the IRS abused its discretion by proposing to levy on a taxpayer who had shown that she was in economic hardship.² The error arose because the IRS interpreted the Internal Revenue Manual (IRM) as preventing it from placing the taxpayer's account into currently not collectible (CNC) status due to unfiled returns.³

More than a year has passed since *Vinatieri* was decided, yet IRS guidance still does not adequately explain procedures for placing an account with unfiled returns into CNC status rather than proceeding with a levy. To date, the IRS has not revised IRM sections that lead it to propose to levy on a taxpayer in economic hardship. Moreover, the IRS lacks sufficient procedures to monitor economic hardship among taxpayers. For example, the 136-page Appeals Quality Management System (AQMS) Reviewer's Guide, which provides guidance to Appeals employees on how to evaluate the quality of case dispositions, does not contain the word "hardship."⁴ TAS continues to see cases involving situations similar to *Vinatieri*, some of which required Taxpayer Assistance Orders to resolve.

ANALYSIS OF PROBLEM**Background**

IRC § 6343(a)(1)(D) states that a levy shall be released if "the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer."

¹ See National Taxpayer Advocate 2008 Annual Report to Congress 15-38 (Most Serious Problem: *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties*).

² 133 T.C. No. 16 (Dec. 21, 2009), discussed *infra*.

³ The National Taxpayer Advocate issued guidance to TAS employees explaining the Tax Court's decision and how to advocate for taxpayers who are facing IRS levies even though they are in economic hardship. TAS Interim Guidance Memorandum (IGM), *Interim Guidance on Handling Collection Cases Where Economic Hardship Is Present but the Taxpayer Has Not Filed All Required Returns* (Mar. 23, 2010), available at http://www.irs.gov/pub/foia/ig/tas/tas-13_1-0110-01.pdf.

⁴ The Appeals Quality Management System (AQMS) Reviewer's Guide in Collection Cases (Rev. Dec. 31, 2009), available at http://appeals.web.irs.gov/aqms/Documents/Collection_Reviewers_Guide.pdf.

Treasury Regulation § 301.6343-1(b)(4) provides that economic hardship is present “if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.”⁵ To determine if economic hardship is present, IRS compliance employees consider a number of factors such as the taxpayer’s general earning potential, basic living expenses, and the cost of living in the taxpayer’s geographic location.⁶

Existing Guidance May Lead to Inappropriate Levy Action.

In *Vinatieri*,⁷ where the taxpayer, who had unfiled returns, established that she was in economic hardship, the Tax Court held that the IRS’s proposed levy was not appropriate given that under IRC § 6343(a)(1)(D), the IRS must release a levy if economic hardship is present. Proceeding with a levy that would have to be immediately released constituted an abuse of discretion.

The IRM provision the IRS considered in *Vinatieri* states:

A compliance check will be made and the results documented in the case history for all hardship determinations per IRM 5.16.1.1(5). Any open filing requirements or Taxpayer Delinquency Investigation (TDI) modules [*i.e.*, years for which the taxpayer has not filed a return] must *be resolved* and *closed appropriately* when reporting an account currently not collectible under hardship provisions.⁸

The Appeals settlement officer interpreted this provision to mean that unfiled returns must be secured as a prerequisite for placing an account into CNC status because of the taxpayer’s economic hardship. Other provisions in the IRM describe conditions under which an account may be “resolved” or “closed appropriately” without securing unfiled returns,

⁵ The IRS makes economic hardship determinations in a variety of other contexts. IRM 5.1.12.20 (May 20, 2008) permits IRS employees to issue manual refunds if the taxpayer is in economic hardship; IRM 5.8.11.2.1 (Sept. 23, 2008) permits IRS employees to consider an effective tax administration offer in compromise where the taxpayer’s liability could be collected in full but collection would create an economic hardship, and IRM 5.16.1.1 (June 29, 2010) permits IRS employees to remove accounts from active inventory and report them as currently not collectible (CNC) where collection of the liability would create a hardship for the taxpayers by leaving them unable to meet necessary living expenses. In addition, a taxpayer may raise as a defense the inability to pay due to hardship in a hearing under IRC § 6330 as a “challenge to the appropriateness of collection action.” See IRC § 6330(c)(2)(ii); IRM 8.22.2.4.2 (Mar. 11, 2009).

⁶ IRM 5.19.4.4.10(4)(j) (Mar. 8, 2010), based on IRC § 6343 and Treasury Regulation § 301.6343-1(b)(4)(ii). Specific factors include the taxpayer’s age, employment status, employment history, future income earning ability, number of dependents, and status as someone else’s dependent; the amount reasonably necessary for food, clothing, housing, medical expenses, current tax payments, court ordered payments, and expenses necessary to the taxpayer’s production of income; the amount of property exempt from levy and available to pay the taxpayer’s ordinary and necessary expenses; extraordinary circumstances; and other factors the taxpayer brings to the attention of the IRS that show an economic hardship.

⁷ 133 T.C. No. 16 (Dec. 21, 2009).

⁸ IRM 5.16.1.2.9(8) (Dec. 1, 2006) (emphasis added), as in effect when the IRS proposed to levy on the taxpayer in *Vinatieri*. The provision was revised in May 2009 and in June 2010. The only relevant change was to insert “generally.” Such modules must now “generally” be resolved and closed appropriately when reporting an account CNC. As in the 2006 version, no guidance or cross reference explains how this “general” rule applies.

but none of them include economic hardship as an overriding condition that must be taken into account when the IRS is contemplating a levy.⁹

The IRM provision the IRS relied on in *Vinatieri* is not the only one that leads to the erroneous conclusion that an account with unfiled returns cannot be placed into CNC status. Similar provisions include:

- **IRM 5.1.7.7.3(5)** – “Caution: Do NOT report any cases as CNC (hardship) until all delinquent returns are filed and the cause of the delinquency addressed.”¹⁰
- **IRM 5.16.1.1(6)** – “All open filing requirements or Delinquent Return (Del RET) modules must generally be resolved and closed appropriately when reporting an account CNC.”¹¹
- **IRM 5.19.1.3.4.1(6)** – “Installment agreements and CNC hardships cannot be established if a return is required to be filed.”¹²
- **IRM 5.19.1.7.1(6)** – “Accounts with both a return delinquency and balance due that may qualify for a CNC hardship consideration, but have an open TDI module, a.k.a. Del Ret module, and the taxpayer refuses to file the delinquent returns, must be sent to QUEUE as unresolved. Before transferring to the QUEUE, *all levy sources MUST be exhausted* and a lien filed if appropriate (emphasis added)...Do not refer the TDI for Automated Substitute for Return (ASFR) processing or close the Taxpayer Delinquent Accounts (TDAs) as CNC hardship.”¹³
- **IRM 5.19.1.7.1(8)** – “Do not report any cases as CNC (hardship) until all delinquent returns are filed. Discuss options with the taxpayer to address and avoid future liabilities, such as increase withholding, etc. *Enforce collection action* if the taxpayer refuses to clearly correct the cause of the delinquency unless there would be no balance due on delinquent or future tax periods” (emphasis added).¹⁴

⁹ See e.g., IRM 1.2.14.1.18 (Aug. 4, 2006), Policy Statement P-5-133 (where reference to factors ensuring compliance and evenhanded administration of staffing and other Service resources would not require enforcement of delinquency procedures); IRM 5.1.11.7.3 (June 2, 2004) (where it can be substantiated that the taxpayer has no filing requirement for a given year); IRM 5.1.11.6.1(4) (Jan. 15, 2010) (where the delinquent module is six years or older); IRM 5.1.11.6.1(8) (Jan. 15, 2010) (where the delinquent module is less than six years old, but it is clear from information available that the non-filer does not have or will not have the ability to pay some if not all of the potential tax liability over the ten-year statutory collection period). Additionally, when a taxpayer fails to file a timely return, IRC § 6020(b) authorizes the IRS to make a return, referred to as a substitute for return (SFR), based on information reported to the IRS. An SFR is sufficient to close a delinquent tax module. IRM 5.18.1.3 (Oct. 1, 2005); IRM 5.18.1.3.4 (Jan. 25, 2008). Moreover, the *Vinatieri* case might not have reached Appeals if all IRS employees had the same authority to close accounts with unfiled returns. Automated Collection System (ACS) employees must refer to IRM 5.19 for all case actions; they are not authorized to proceed according to the Collection Field function (CF) portion of the IRM, i.e., IRM 5.1.11.

¹⁰ Where unfiled returns (referenced in various IRM provisions) not only prevent the account from being placed into CNC status, but also lead the IRS to levy or propose to levy, the IRS will have abused its discretion under *Vinatieri*.

¹¹ This provision is very similar to the one relied on by the Appeals settlement officer in *Vinatieri*, and leads to the same erroneous conclusion that returns must be secured as a prerequisite to placing an account in CNC status. As in *Vinatieri*, this conclusion may in turn lead the IRS to levy or propose to levy despite the taxpayer’s economic hardship, which would constitute an abuse of discretion.

¹² Reliance on this provision would exemplify the error the Appeals settlement officer made in *Vinatieri* because it leads to the conclusion that returns must be secured before CNC status is allowable, which in turn may lead the IRS to abuse its discretion by levying or proposing to levy despite the taxpayer’s economic hardship.

¹³ Imposing a levy in reliance on the penultimate sentence of this IRM would constitute an abuse of discretion, under *Vinatieri*.

¹⁴ Imposing a levy in reliance on the last sentence of this IRM would constitute an abuse of discretion, under *Vinatieri*.

- **IRM 5.19.18.5(4)** – “If the taxpayer is unable to pay, report the case Currently Not Collectible (CNC) using the unable to pay closing code. Caution: Do NOT report any cases as CNC (hardship) until all delinquent returns are filed and the cause of the delinquency addressed.”¹⁵

IRS employees would benefit from additional training on the principles outlined in the *Vinatieri* decision – independently of any other circumstance, the IRS should not levy or propose to levy if the levy will cause economic hardship. Any such levy will be *required* to be released immediately; thus, proposing or placing a levy that must be released immediately constitutes an abuse of discretion. Because of the potential for grievous harm, in addition to training on this issue, the IRM should provide that economic hardship *alone* is a sufficient basis for placing it in CNC status.

The National Taxpayer Advocate in March 2010 issued guidance to TAS employees discussing the *Vinatieri* decision and the IRM provisions that could lead to levies required to be immediately released.¹⁶ In addition, TAS submitted draft language to the IRS recommending changes to the misleading IRM provisions, and is actively engaging the IRS in discussion.¹⁷ As of October 1, 2010, the IRS has not implemented any of the suggested changes.¹⁸ Thus, taxpayers continue to encounter the same situation as Mrs. *Vinatieri* and some of them have come to TAS for help.¹⁹

On January 19, 2010, shortly after the Tax Court issued the *Vinatieri* opinion, IRS Appeals Tax Policy & Procedures, working with the Office of Chief Counsel, reviewed and revised its IRM guidance. The revised IRM 8.22.2.4.2 will provide, in part, “if a taxpayer is entitled to CNC status based on economic hardship, he or she should be granted CNC status based on economic hardship, even if he or she has not filed all required returns.”²⁰ Additionally, Appeals provided training to its settlement officers about the *Vinatieri* decision.²¹ The

¹⁵ Where unfiled returns (referenced in various IRM provisions) not only prevent the account from being placed into CNC status, but also lead the IRS to levy or propose to levy, the IRS will have abused its discretion under *Vinatieri*.

¹⁶ TAS IGM, *Interim Guidance on Handling Collection Cases Where Economic Hardship Is Present but the Taxpayer Has Not Filed All Required Returns* (Mar. 23, 2010), available at http://www.irs.gov/pub/foia/ig/tas/tas-13_1-0110-01.pdf.

¹⁷ E-mail from Special Counsel to the National Taxpayer Advocate, Office of Chief Counsel, to Director, Collection Policy (Mar. 24, 2010); E-mail from TAS Collection Technical Liaison to Supervisory Revenue Officer, Small Business/Self Employed (SB/SE) Collection Policy (Sept. 16, 2010).

¹⁸ According to Wage & Investment (W&I), “there is not a need to make additional changes to the IRM guidance or training material as it relates to addressing economic hardship situations.” W&I response to TAS research request (July 9, 2010) (response to question 3). However, on Aug. 20, 2010, W&I issued a Servicewide Electronic Research Program (SERP) Alert 100440, *Vinatieri Decision: Guidance When a Taxpayer Who Has Been Levied Indicates That the Levy Is Creating a Hardship* (Aug. 20, 2010) reminding its employees of two circumstances in which accounts can be closed without securing an unfiled return, and that accounts can be referred for SFR processing or the delinquent return module can be sent to the queue. According to SB/SE, “Since the *Vinatieri* decision...analysts have been working on an IRM revision [sic] CNC procedures for the IRM 5.19.1. Any changes will be incorporated in the IRM rewrite.” SB/SE response to TAS research request (July 13, 2010) (response to question 2).

¹⁹ As of Sept. 9, 2010, TAS issued 62 Operations Assistance Requests (OARs) to the IRS operating divisions (ODs), advocating for taxpayers suffering from economic hardship when the IRS has issued a notice of levy or a Final Notice of Intent to Levy but will not place the account in CNC status or release a levy because of unfiled returns. While often the required returns are ultimately secured, TAS successfully advocated for placing the taxpayer’s account in CNC status in five cases despite unfiled returns and successfully advocated for a levy release in 11 cases (one of these cases is included in the five CNC cases), despite unfiled returns.

²⁰ IRS Office of Appeals response to TAS research request (July 12, 2010) (response to question 3).

²¹ *Id.*

National Taxpayer Advocate applauds the Appeals division for its willingness to revise procedures and provide guidance to employees to avoid repeating the error in *Vinatieri*. However, taxpayers will continue to face inappropriate levies unless the IRS compliance functions take a similar approach to *Vinatieri* servicewide.

The IRS Has Insufficient Internal Oversight and Review Procedures to Monitor for Economic Hardship.

An examination of IRS quality reviews illustrates the need for change. The Wage & Investment and Small Business/Self Employed divisions carry out quality reviews of randomly selected cases using the National Quality Review System (NQRS).²² The reviewer evaluates, among other things, whether a collection employee considered a taxpayer's ability to pay and secured the taxpayer's financial information.²³ However, there is no specific rating for failing to properly manage the account of a taxpayer in economic hardship.²⁴ With respect to CNC determinations, the guidance references IRM 5.16.1, the same provision the settlement officer consulted in *Vinatieri*. Therefore, a quality reviewer today considering a case identical to *Vinatieri* would not be prompted to assign a negative rating based on the decision to proceed with a levy that would have to be immediately released. In addition to a revised IRM, taxpayers would benefit from an NQRS standard that prompts the reviewer to actively consider whether the employee dealt appropriately with any economic hardship.

The Office of Appeals, which reviews cases through the AQMS,²⁵ considers whether the case file reflects a "quality decision," but does not specifically measure whether the taxpayer's possible economic hardship has been addressed.²⁶ An additional quality review standard, measuring whether a taxpayer's economic hardship, if any, was properly considered, would implement the spirit as well as the specific holding of *Vinatieri*.

CONCLUSION

To bring the IRS into compliance with the letter and the spirit of the *Vinatieri* decision regarding economic hardship, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should work with TAS to revise its IRM and other procedural guidance to clarify that all collection employees have authority to put a taxpayer's account into

²² W&I response to TAS research request (July 9, 2010) (response to question 4); SB/SE response to TAS research request (July 13, 2010) (response to question 3). National Quality Review System (NQRS) reviewers use appropriate Embedded Quality Job Aids in carrying out their reviews. IRM 5.13.1.6(2) (Sept. 9, 2007).

²³ See IRS Doc. 12359, *The Collection Field function Attribute Job Aid*, available at <http://core.publish.no.irs.gov/docs/pdf/48360J09.pdf>.

²⁴ W&I, in its response to TAS research request dated July 13, 2010 (response to question 4), indicated that it is proposing a new code that would measure "case disposition incorrect" or "case disposition not substantiated." An example of the latter would be a case where a taxpayer wants to make monthly payments, but IRS records do not substantiate that the taxpayer can pay, or they indicate that the account qualifies for CNC status.

²⁵ See About the Appeals Quality Measurement System (AQMS), available at http://appeals.web.irs.gov/aqms/about_AQMS.htm.

²⁶ IRS Appeals response to TAS research request (July 12, 2010). The AQMS Reviewer's Guide in Collection Cases (Rev. Dec. 31, 2009), available at http://appeals.web.irs.gov/aqms/Documents/Collection_Reviewers_Guide.pdf, is 136 pages long and does not contain the word "hardship."

CNC status based on economic hardship even when the taxpayer has unfiled returns, independently of any other criteria.

2. The IRS should work with TAS to train collection employees how to manage taxpayer accounts when the taxpayer is facing economic hardship.
3. The IRS should establish quality review procedures that measure whether employees considered the possibility that a taxpayer was in economic hardship and managed accounts appropriately.

IRS COMMENTS

The IRS recognizes the importance of properly addressing economic hardship. Current guidance provides direction to collection employees on addressing situations and resolving cases when taxpayers experience economic hardship.²⁷ Written guidance also advises employees to use collection alternatives such as an installment agreement, an offer in compromise, and CNC to assist taxpayers who are experiencing financial hardship and are unable to pay their tax liability.

Since 2008, the IRS has expanded outreach efforts to ensure taxpayers understand the availability of payment alternatives and where to go for assistance in resolving their tax liability if they are experiencing hardship. A recent Treasury Inspector General for Tax Administration's (TIGTA) report stated, "New provisions, along with modifications to and re-emphasis of existing procedures, provide many viable alternatives to help resolve taxpayers' balance due accounts. The provisions were widely communicated to the public and tax preparers through various public media outlets and presentations. In addition, the provisions and procedures were communicated to IRS employees through various channels and in updates to the Internal Revenue Manual."²⁸ TIGTA also observed, "overall the IRS effectively implemented or re-emphasized options that will help economically distressed taxpayers who are now having difficulties paying their balance due accounts."

The IRS believes IRS collection policies and procedures maintain the proper balance between protecting the interest of the government and the rights of taxpayers. The fiscal year (FY) 2010 collection program letter outlined collection priorities to improve customer service and monitor taxpayer compliance.²⁹ The 2011 program letter includes a specific priority to continue identifying and implementing procedures to assist taxpayers who are experiencing economic challenges.³⁰ The expanded outreach and the priorities of the collection program demonstrate the IRS' commitment to assist taxpayers experiencing hardship.

²⁷ IRM 5.11.2.2.1.4 (Aug. 8, 2010); IRM 5.19.1.7.1 (Dec. 4, 2009); IRM 5.16.1.2.9 (June 29, 2010); IRM 5.19.4.4.10 (Mar. 8, 2010).

²⁸ TIGTA, Ref. No. 2010-30-032, *Collection Alternatives Were Available to Economically Distressed Taxpayers, but Some New Processes Need Improvement* (Mar. 15, 2010).

²⁹ SB/SE, Collection Program Letter for FY 2010.

³⁰ SB/SE, Collection Program Letter for FY 2011.

In the report, the National Taxpayer Advocate cites the court decision *Vinatieri v. Commissioner*³¹ in which the court held:

- IRC § 6343(a)(1)(D) and related regulations require release of a levy that creates an economic hardship regardless of the taxpayer's noncompliance with filing.
- A levy on the taxpayer's wages or car would cause the taxpayer to be unable to pay reasonable basic living expenses creating an economic hardship that would require release of the levy pursuant to IRC § 6343(a)(1)(D) and related regulations.
- The IRS determination to proceed with a levy was wrong as a matter of law and therefore an abuse of discretion.

The IRS agrees that the decision to proceed with a levy in the *Vinatieri* case was not consistent with IRS policy or related laws and regulations. We recognized the need to clarify this guidance and subsequently worked with the Taxpayer Advocate Service to improve the economic hardship guidance contained in IRM 5.11.2 for release of levies. Specifically, guidance was added to address levy releases involving economic hardship (IRC § 6343(a)(1)(D)) on accounts where there are unfiled returns.³² The revisions to the IRM were published August 8, 2010.

The IRS provided additional internal guidance changes to employees resulting from the *Vinatieri* decision.³³ These internal guidance changes will be published in the next revisions of the IRM. Additional IRM revisions, including sections for which the IRS has received and reviewed input from TAS based on the *Vinatieri* decision, are currently in process.³⁴ As part of the routine clearance process for the IRM, the Office of the Taxpayer Advocate serves as a reviewer.

While the court correctly held in *Vinatieri* that a levy must be released due to economic hardship even when there are unfiled returns, it did not hold that the IRS should not pursue those returns. The IRS believes that it is entirely appropriate—as well as sound tax administration and good customer service—to fully address and resolve delinquent returns even though a levy cannot proceed or must be released. The IRS will continue to address and resolve unfiled tax returns in such cases, as the decision in *Vinatieri* did not question or undermine this policy.

³¹ *Vinatieri v. Comm'r*, 133 T.C. No. 16 (Dec. 21, 2009), discussed *infra*.

³² IRM 5.11.2.2.1.4(5) (Aug. 8, 2010) ("Where the financial analysis shows that the taxpayer merits a full or partial levy release to relieve economic hardship, the taxpayer has a statutory right to enough relief to end the hardship. Document the financial analysis in the history and communicate the decision to the taxpayer. The levy release should be faxed or given to the taxpayer to provide to the levy source. Caution: When the Service determines that the levy is creating an economic hardship, do not refuse, delay or understate the release amount as a means to secure other compliance, e.g., missing tax returns.")

³³ IRM Procedural Updates (IPUs) are provided internally to collection employees via SERP. SERP is designed to provide employees from all IRS functions with intranet access to IRMs and other reference materials, and to retrieve frequently referenced documents required to perform their jobs. The IRS issued IPUs for IRM 5.19.1.7.1(6) on August 17, 2010, IRM 5.19.1.7.1(8) on August 17, 2010, IRM 5.19.18.5(4) on September 1, 2010, IRM 5.19.1.3.4.1(6) on November 3, 2010, and for multiple related sections of IRM 5.19.1 on October 27, 2010.

³⁴ E-mail from TAS to Collection Policy regarding IRM 5.16.1.1(5) and (6) (Aug. 19, 2010).

Further, we do not believe that *Vinatieri* requires the immediate closure of a case as CNC upon a determination that a levy is causing or would cause economic hardship. The issue presented and decided in *Vinatieri* was whether the proposed levy should proceed. Closing a case as CNC is not governed by *Vinatieri* and refers to an IRS administrative decision to remove an account from active inventory based on a determination that there is little or no current collection potential.³⁵ Although a CNC closure due to inability to pay is often referred to as a “hardship” case, such a determination may be made even when a levy is not a consideration.

As evidenced by the actions taken in response to *Vinatieri*, court decisions and changes in law are continually monitored by the IRS to determine potential impact. Based on the nature of the changes, the IRS updates policy and procedures to ensure employees are aware of any changes and take appropriate actions.

The IRS recognizes the importance of monitoring employee actions and maintaining adequate controls to ensure employees are taking appropriate actions when addressing economic hardship. Managerial safeguards and controls are incorporated into current IRS policies and procedures.

IRS management uses an employee performance review and a national review system to assess and monitor the quality of case actions in collection cases.³⁶ In addition to whether a collection employee correctly analyzed a taxpayer’s ability to pay and secured the taxpayer’s financial information, the IRS reviews for appropriate case disposition, use of appropriate enforcement tools—including levy, customer impact, and observation of the taxpayer’s rights.

There are opportunities available to ensure that taxpayers experiencing an economic hardship have recourse if they do not agree with a decision regarding an issuance of levy or a release of levy. Taxpayers have multiple appeal rights throughout the collection process; the most fundamental is an appeal to the manager.³⁷ The Collection Appeals Program (CAP), the Collection Due Process (CDP) hearing, and the opportunity for a taxpayer to request a judicial review of the Appeals determination by petitioning United States Tax Court all provide review and oversight opportunities to review collection actions.³⁸

An in-depth managerial review process, a national review process, and the taxpayer’s ability to request a review through the independent Office of Appeals collectively foster a robust and thorough internal oversight and review control to ensure that taxpayers who may be experiencing economic hardship are handled appropriately.

³⁵ IRM 5.16.1.2.9 (June 29, 2010). Cases closed as CNC due to inability to pay that subsequently meet certain income thresholds may be reactivated to the collection inventory to determine if the taxpayer had a change in financial condition that would allow the taxpayer an ability to pay toward the outstanding tax liability.

³⁶ See IRS Doc. 12359, *The Collection Field function Attribute Job Aid*, available at <http://core.publish.no.irs.gov/docs/pdf/48360J09.pdf>.

³⁷ IRS Pub. 1, *Your Rights as a Taxpayer* (May 2005).

³⁸ IRS Pub. 1660, *Collection Appeal Rights* (Mar. 2007).

Additionally, external oversight ensures employees follow IRS policies and procedures authorized by IRC and Treasury regulations.³⁹ For example, TIGTA found, for the sixth year in a row, in its FY 2010 annual audit regarding IRS compliance with legal guidelines when issuing levies, “The IRS is protecting taxpayers’ rights when issuing systemically generated and manually prepared levies.”⁴⁰

The National Taxpayer Advocate makes three preliminary recommendations to address IRS compliance with the *Vinatieri* decision regarding economic hardship. The IRS is taking or has taken the following actions with respect to these recommendations:

The IRS has proactively updated many of the internal procedures and is actively updating the remaining procedures based on the *Vinatieri* decision. IRM procedures currently advise employees that they must generally resolve unfiled returns prior to reporting an account CNC. IRM procedures also provide guidance for situations where an account may be reported CNC when an employee determines that the taxpayer is unable to pay the tax liability and has unfiled tax returns. In all situations, however, the unfiled returns must still be addressed. As part of the routine clearance process for the IRM, the Office of the Taxpayer Advocate serves as a reviewer.

The IRS agrees proper training and guidance for our employees is very important and, as such, continually looks for ways to improve. The IRS has drafted training materials to address economic hardship for collection field function employees for delivery in FY 2011 Continuing Professional Education. In FY 2010, the IRS delivered training on how to address economic hardship to Automated Collection System employees, Appeals settlement officers, and Appeals account resolution specialists.

Within the employee performance review, and the national review systems, there are many reviewed actions that are associated with ensuring taxpayer accounts are handled appropriately. These review systems look at many different facets of a case to ensure collection employees take the appropriate actions throughout the life of the case to arrive at a correct and complete case resolution with no material adverse impact on the taxpayer.⁴¹ The IRS utilizes contact recording and contact analytics to gather facts about specific complaints and conduct targeted reviews to identify areas needing improvement and training needs.

³⁹ The Government Accountability Office (GAO) and TIGTA conduct independent reviews of IRS enforcement programs, including levy.

⁴⁰ TIGTA, Ref. No. 2010-30-068, *Fiscal Year 2010 Statutory Review of Compliance with Legal Guidelines When Issuing Levies* (June 15, 2010).

⁴¹ See IRS Doc. 12359, *The Collection Field function Attribute Job Aid*, available at <http://core.publish.no.irs.gov/docs/pdf/48360j09.pdf>.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges that the SB/SE Collection Program Letter for FY 2011 states that the IRS will “continue to identify and implement procedures to assist taxpayers who are experiencing economic challenges.”⁴² However, because the IRS routinely issues final notices of intent to levy as part of an automated process, without contacting the taxpayer, the IRS is not necessarily aware that a taxpayer is in economic hardship when it proposes to levy.⁴³

In the *Vinatieri* case, the IRS proposed to levy even though it *knew* of the taxpayer’s hardship. While the IRS has revised a few offending sections of the IRM that would pertain to cases like *Vinatieri*, it has not corrected other sections. Thus, more than one year after the *Vinatieri* decision, taxpayers continue to be harmed because of the IRS’s failure to correct its instructions to its employees.⁴⁴

The errors in the *Vinatieri* case occurred because: (1) the IRM did not simply state that the IRS cannot levy or propose to levy on a taxpayer known to be in economic hardship (because if it does, it will be required by law to immediately release the levy); and (2) the IRM that permits CNC status for taxpayers in economic hardship was contradictory and incomplete in explaining the availability of CNC status where there were unfiled returns. The IRS has not corrected either of these conditions.⁴⁵

As the IRS observes, the Tax Court did not hold in *Vinatieri* that whenever the IRS becomes aware a taxpayer is in economic hardship, it must place his or her account into CNC status. As long as the IRS does not levy or propose to levy on a taxpayer it knows is in economic hardship, it operates consistently with the holding of *Vinatieri*.⁴⁶

However, we wonder why the IRS would *not* put the account of a taxpayer experiencing economic hardship into CNC status when this status is the mechanism that prevents issuance of levies. Failure to put an eligible account into CNC hardship status creates an

⁴² SB/SE Collection Program Letter for FY 2011, available at <http://mysbse.web.irs.gov/AboutSBSE/ProgramLetters/17840.aspx>.

⁴³ See Most Serious Problem: *IRS Policy Implementation Through Programming Systems Lacks Transparency and Precludes Adequate Review*, *supra*; Most Serious Problem: *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*, *supra*.

⁴⁴ The IRS does not always submit its interim guidance that announces changes to the relevant portions of the IRM for TAS for review. Examples are SERP Alert 100539 dated Oct. 27, 2010, and SERP Alert 10040 dated Aug. 20, 2010. As of Dec. 1, 2010, the only proposed revisions to the collection part of the IRM submitted to TAS for clearance using normal review procedures are IRM 5.9.16, received by TAS for review on Nov. 16, 2010; IRM 5.19.2, received on Nov. 26, 2010; and IRM 5.19.1, received on Nov. 30, 2010. TAS is working to clarify the IRM clearance process (for example, by participating on an Interim Guidance Task Force sponsored by the IRS’s Servicewide Policy Directives and Electronic Research office) to ensure that proposed changes to the IRM are submitted to TAS for review when appropriate.

⁴⁵ The IRS in its response does not provide a reference to the training materials it used in 2010 on how to address economic hardship, and we are unable to identify any training materials that take into account or refer to the *Vinatieri* decision. TAS welcomes the opportunity to assist the IRS in developing 2011 training materials for collection employees.

⁴⁶ As the IRS also notes, nothing in the *Vinatieri* decision suggests that the IRS should not pursue unfiled returns. The National Taxpayer Advocate’s position has never been that the IRS should not request unfiled returns.

ongoing risk of a *Vinatieri*-type violation of law. Thus, we are baffled by the IRS's position in this regard.

The IRS has revised some of the CNC provisions in the IRM to conform to the *Vinatieri* decision.⁴⁷ For example, IRM 5.19.1.7.1.5, *CNC Unable to Pay - Hardship*, was revised on November 3, 2010, to instruct employees how to respond when a taxpayer contacts the IRS and claims that he or she is unable to pay, or that a levy on salary or wages is creating a hardship. The provision makes clear that the IRS must release the levy, and explains how to manage the taxpayer's accounts thereafter, including accounts with unfiled returns. However, according to the revised provision, tax years with unfiled returns will be closed and removed from active collection only in certain circumstances.⁴⁸ If those conditions are not present, or the IRS cannot determine whether they are present, it will not close those tax years, but rather will place them in the Queue.⁴⁹ Unlike tax years in CNC status, where collection activity is reactivated by changes in the taxpayer's financial condition, the IRS routinely transfers cases into and out of the Queue to balance inventory levels. Therefore, tax years assigned to the Queue may return to the collection stream as IRS inventories fluctuate, with the attendant risk that the IRS may once again propose or issue a levy without considering the previously determined hardship.⁵⁰ It is unclear why the IRS adopted the practice of placing tax years in the Queue because of unfiled returns when the taxpayer has already shown economic hardship and the IRS has released any levies because of the hardship. Adopting a policy of simply closing these tax years and placing them in CNC status would be easier to administer and would more effectively ensure that the errors in *Vinatieri* are not repeated.⁵¹

As the IRS notes, it may learn that a taxpayer is in economic hardship when a levy is not a consideration. If it does not place the account into CNC status at that point, the IRS may repeat the error of *Vinatieri* by later proposing or issuing a levy that it would immediately have to release. For example, a taxpayer requesting an offer in compromise based on effective tax administration may demonstrate that he or she is in economic hardship. The IRM

⁴⁷ See, e.g., IRM 5.19.1.7.1(8); 5.19.18.5(4), discussed *supra*. As the IRS also notes, it has revised other provisions of the IRM pertaining to levy releases to clarify that a levy must be released if it is causing economic hardship, which is commendable, although we note that between Sept. 24, 2010, and Nov. 23, 2010, TAS successfully advocated for levy release due to economic hardship in five cases. In any event, however, the problems Mrs. *Vinatieri* encountered were not due to misapplication of IRM provisions that require the IRS to release a levy. Rather, the IRS, by *proposing* to levy when it knew the levy would cause hardship (and would therefore have to be immediately released), abused its discretion.

⁴⁸ One of the conditions is where the tax year for which there is an unfiled return "meets P-5-133 criteria," in which case the employee is to "close the [unfiled return year] little or no tax due, see IRM 5.19.2.6.4.5.3 [titled *IMF Little or No Tax Due*]." As explained *supra* note 9, Policy Statement P-5-133 enumerates factors that the IRS is to take into account in determining whether to enforce filing requirements. "Factors to be taken into account include, but are not limited to: prior history of noncompliance, existence of income from illegal sources, effect upon voluntary compliance, anticipated revenue, and collectibility, in relation to the time and effort required to determine tax due. Consideration will also be given any special circumstances existing in the case of a particular taxpayer, class of taxpayer, or industry, or which may be peculiar to the class of tax involved." IRM 5.19.1.7.1.5 as revised inappropriately reduces the application of Policy Statement P-5-133 to a single inquiry: the amount, if any, of tax due.

⁴⁹ The Queue is an electronic holding area for accounts that will not be worked immediately. See IRM 1.4.50.2.1.5 (July 1, 2007).

⁵⁰ See Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*, *supra*.

⁵¹ Moreover, closing tax years with unfiled returns and placing the accounts into CNC status would "simplify or eliminate processes that unnecessarily burden taxpayer or IRS resources" and accomplish the seamless approach to service the IRS adopted in its FY 2009-2013 Strategic Plan. See IRS Pub.3744, *IRS Strategic Plan 2009-2013* (Apr. 2009), available at <http://www.irs.gov/pub/irs-pdf/p3744.pdf>.

does not make clear that from the moment the hardship is established, those accounts can be closed and placed into CNC status despite unfiled returns.⁵² Instead, the IRM references the same unrevised IRM provision the settlement officer relied on in *Vinatieri*.⁵³ The IRS should revise other portions of the IRM (not only those pertaining to levies) to permit classification of taxpayers' accounts as CNC when the IRS learns they are in economic hardship, independently of the context in which it acquires this information, and independently of any other consideration such as unfiled returns.

Moreover, some IRM provisions are still contradictory or inconsistent with the *Vinatieri* decision. For example:

- IRM 5.19.1.3.4.1(6) was revised and released through SERP on November 3, 2010, but continues to state: "When speaking to the taxpayer, address compliance on current year return filing as follows...Installment agreements and CNC hardships cannot be established if a return is required to be filed... you can not allow the installment agreement or CNC hardship without securing all required returns."
- IRM 5.19.18.5.7 was revised and released through SERP on September 1, 2010, but now provides: "Cases are manually assigned to this inventory prior to initiating a currently-not-collectible (CNC) when...**All** levy sources have been exhausted."
- IRM 5.19.18.5.8(5) was revised and released through SERP on September 1, 2010, but now directs: "CAUTION: **Do not** report any cases as CNC (hardship) until all delinquent returns are filed and the cause of the delinquency addressed."
- Various IRM provisions, particularly those that collection field employees rely on, still instruct employees to "resolve" or "close" tax years with an unfiled return before placing an account into CNC status (IRM 5.16.1.1; IRM 5.16.1.1(6); IRM 5.16.1.2.9(8); IRM 5.19.1.7.1(6) (which cross-references 5.19.1.3.4.1, above)), without specifying that where there is economic hardship, "resolving" or "closing" does not necessarily mean securing unfiled returns. As long as these provisions are intact, and are relied upon by compliance employees and sustained by quality reviewers, the IRS may repeat the same errors it made in the *Vinatieri* case.

⁵² Part 5.8 of the IRM deals with offers in compromise. IRM 5.8.5.1, *Overview* (Sept. 23, 2008), references IRM 5.15, *Financial Analysis Handbook*, and directs that it be used in conjunction with the offer section. IRM 5.15.1.3, *Expectations* (Sept. 17, 2010), provides that the analysis of a taxpayer's financial condition is a basis on which to place an account into CNC status, but then cross-references IRM 5.16 rather than IRM 5.19. IRM 5.15.1.35, *Making the Collection Decision* (Oct. 2, 2009), contains the same provision.

⁵³ As another example, a taxpayer requesting innocent spouse relief may demonstrate economic hardship. IRM 25.15.2.1, *Employees with Taxpayer Contact* (July 17, 2009), found in the Relief from Joint and Several Liability portion of the IRM, simply directs the employee to refer the taxpayer to TAS ("If during a taxpayer contact it appears a hardship situation may exist, complete Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), and refer the taxpayer to the Taxpayer Advocate Service (TAS).")

Recommendations

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Continue to work with TAS to revise its IRM and other procedural guidance to clarify that all collection employees are authorized to close tax years with unfiled returns, and place a taxpayer's account into CNC status based on economic hardship, without securing unfiled returns, independently of any other criterion or condition.
2. Work with TAS to train collection employees how to manage accounts when the taxpayer is facing economic hardship and submit its 2011 collection CPE training materials on this issue to TAS for review.
3. Establish quality review procedures that measure whether employees considered the possibility that a taxpayer was in economic hardship and managed the account appropriately.

MSP
#7

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

RESPONSIBLE OFFICIALS

Chris Wagner, Commissioner, Small Business/Self-Employed Division
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DEFINITION OF PROBLEM

In determining how much a delinquent taxpayer can pay to satisfy a tax debt (*e.g.*, the minimum acceptable offer in compromise (OIC) amount or installment payment, or whether the account is currently uncollectible), the IRS does not take into account (*i.e.*, disallows or ignores) some of the taxpayer's other debts. Such disallowed debts may include credit card bills, delinquent state or local taxes, court-ordered payments, excessive mortgage expenses, and any bill the taxpayer is not current in paying, including student loans, medical bills, and even secured debts.¹

The IRS's approach is unrealistic because other creditors do not go away – the state tax agency does not stop garnishing a paycheck and a credit card collection company does not stop calling – just because the taxpayer is in an IRS payment plan that ignores these expenses. Moreover, the IRS policy of ignoring these actual debts may prolong unresolved delinquencies, create hardships, encourage taxpayers to enter into installment agreements they cannot afford, and make it more difficult for them to pay taxes due in future periods. By contrast, resolving a financially struggling taxpayer's debts holistically – as at least one other country's tax administrator does – may increase the amount the taxpayer is able to pay in the long run while improving his or her future tax compliance and avoiding economic hardship.

ANALYSIS OF PROBLEM

The IRS analyzes a taxpayer's ability to pay in deciding how to resolve a delinquency.

The IRS's decision about how to collect a tax debt often depends on its analysis of the taxpayer's ability to pay.² Based on this analysis, the IRS may:

- Request a full or partial payment;
- File a notice of federal tax lien (NFTL);

¹ See, *e.g.*, Internal Revenue Manual (IRM) 5.15.1.10 (Oct. 2, 2009) (chart).

² The IRS generally may accept an installment agreement (IA) without conducting a financial analysis if the taxpayer owes \$25,000 or less and proposes payments that are sufficient to pay the liability in full within five years. IRM 5.14.5 (Sept. 26, 2008). About 94 percent of all IAs accepted in FY 2010 did not involve an analysis of the taxpayer's ability to pay. Small Business/Self-Employed Division (SB/SE), CAR Report 5000-6 (Oct. 4, 2010). For a discussion of problems with these IAs, see Most Serious Problem, *IRS Collection Policies Channel Taxpayers into Installment Agreements They Cannot Afford*, *infra*.

- Levy or seize assets;
- Accept an installment agreement;
- Accept an offer in compromise; or
- Classify the taxpayer's account as currently not collectible (CNC) and put collection on hold.³

The IRS adds up a taxpayer's income and subtracts allowable expenses to determine how much he or she can pay on a monthly basis. IRS employees must use the allowable expense standards (ALE) – an estimate of what an average taxpayer spends on certain items – along with IRS policy guidance in deciding how much to allow for a given expense.⁴

When analyzing a taxpayer's ability to pay, the IRS ignores (i.e., disallows) payments on certain debts.

When conducting financial analysis, the IRS sometimes ignores debt payments it considers unnecessary.⁵ Such debts (called “disallowed debt”) may include:

- Unsecured debt that the taxpayer does not currently need for the production of income (*e.g.*, past-due medical bills and credit card debt);
- Student loans or secured debts that the taxpayer is not currently paying;
- Delinquent state and local taxes that do not have priority over the federal tax liability;
- Payments required by a state court order that would not otherwise be allowable (*e.g.*, a child's tuition); and
- Payments on a home mortgage that exceed the ALE – an estimate of average housing expenditures – unless documented as “necessary.”⁶

The IRS typically only allows these expenses (called “conditional” expenses) if the taxpayer enters into an IA to fully repay the tax debt within five years.⁷ For IAs that will not repay the debt within five years, the IRS will not allow conditional expenses after the first year.⁸ This so-called one-year rule is supposed to give the taxpayer an opportunity to eliminate conditional expenses.⁹

³ IRM 5.15.1.35 (Oct. 2, 2009); IRM 5.15.1.1 (Oct. 2, 2009).

⁴ For a discussion of difficulties with these standards, see National Taxpayer Advocate 2006 Annual Report to Congress 83-109 (Most Serious Problem: *Collection Payment Alternatives*); National Taxpayer Advocate 2005 Annual Report to Congress 270-291 (Most Serious Problem: *Allowable Expense Standards for Collection Decisions*).

⁵ Bankruptcy courts also use the ALE to determine if an individual is eligible for the Chapter 7 bankruptcy process. See, *e.g.*, 11 U.S.C. § 707(b)(2)(A)(ii)(I).

⁶ See, *e.g.*, IRM 5.15.1.10 (Oct. 2, 2009) (chart); IRM 5.15.1.9 (Oct. 2, 2009) (noting “[T]axpayers are allowed the standard amount for housing and utilities or the amount actually spent, whichever is less. If the amount claimed is more than the total allowed by housing and utilities standards, the taxpayer must provide documentation to substantiate those expenses are necessary.”); IRM Exhibit 5.15.1-1 (Q/A 5) (Oct. 2, 2009) (suggesting that if a taxpayer could rent for less, an unspecified portion of a taxpayer's actual mortgage payments may be ignored immediately, and he may be expected to sell his house within one year even if he has no home equity).

⁷ See, *e.g.*, IRM 5.15.1.10 (Oct. 2, 2009); IRM 5.8.5.6.4 (Sept. 23, 2008).

⁸ IRM 5.15.1.2(4) (Oct. 2, 2009).

⁹ *Id.*

However, many taxpayers are unlikely to be able to eliminate all disallowed debt expenses in one year, especially taxpayers with delinquent liabilities. One review of no-asset, non-business Chapter 7 bankruptcy cases closed between 2000 and 2002 found the debtors owed an average of \$17,738 in credit card debt (excluding store credit cards).¹⁰ At an interest rate of 18 percent, it would take a cardholder about 56 years to repay this debt if he or she made the minimum payment.¹¹

Moreover, if the terms of an IA will not fully pay the tax debt before the end of the period of limitations on collection, the IRS will not allow *any* conditional expenses.¹² Similarly, it does not allow conditional expenses when computing an acceptable offer amount or determining whether to classify an account as CNC based on hardship.¹³

Why does the IRS disallow some debt payments?

Notwithstanding the importance of the ALE and related policies such as the disallowed debt rules, the IRS generally updates them without giving the public prior notice, an opportunity to provide comments, or an explanation of the reasons for its policies.¹⁴ As a result, we can only speculate as to the reasons for the IRS's disallowed debt rules.¹⁵

Avoid abuse

The IRS may disallow debt payments because it does not want to provide an incentive for taxpayers to incur non-IRS debts in anticipation of compromising with the IRS. However, the IRS already addresses this concern through more narrowly tailored case-specific anti-abuse policies.¹⁶

¹⁰ Ed Flynn and Gordon Bermant, *Credit Card Debt in Chapter 7 Cases*, ABI J. (Dec./Jan. 2004), http://www.justice.gov/ust/eo/public_affairs/articles/index.htm. Pursuant to the Chapter 7 bankruptcy process, the debtor's non-exempt assets are liquidated and distributed to creditors and most debts are discharged, thereby giving the debtor a "fresh start." See generally IRM 5.17.9 (Aug. 1, 2010).

¹¹ See Board of Governors of the Federal Reserve System, *Credit Card Repayment Calculator*, <http://www.federalreserve.gov/creditcardcalculator/Default.aspx> (last visited Oct. 6, 2010). The minimum payment would start out at \$355 per month and decline each month. *Id.* A level payment of \$355 per month would repay the liability in about 8 years. *Id.*

¹² IRM 5.14.2.1.1(4) (Aug. 5, 2010) ("Conditional expenses are not allowed for PPIAs [partial payment installment agreements].").

¹³ IRM 5.15.1.10 (Oct. 2, 2009) (conditional expenses); IRM 5.16.1.2.9 (May 5, 2009) (CNC hardship determination); IRM 5.8.5.6.4 (Sept. 23, 2008) (offers).

¹⁴ See, e.g., SB/SE Research (Brooklyn/Hartford), Project BKN0086, *2007 Allowable Living Expenses Project* (Dec. 2007); SB/SE Research (Brooklyn/Hartford), Project BKN0152, *2010 Allowable Living Expenses* (Feb. 2010). However, the IRS did solicit comments when it redesigned the ALE in 2007. See IR-2007-163 (Oct. 1, 2007).

¹⁵ In response to TAS's inquiry about "[T]he reason(s) for the policy of disallowing payments on debts that are treated as conditional expenses," the IRS formally responded as follows:

As stated in IRM 5.15.1.7, the IRS allows necessary expenses which provide for the taxpayer and his or her family's health and welfare and/or the production of income. Under IRM 5.15.1.10, all other expenses, including conditional expenses, can be allowed if the taxpayer can pay the liability within a five year period.

IRS response to TAS information request (June 11, 2010).

¹⁶ The IRS may disallow the repayment of debt for an unnecessary purchase (e.g., a luxury car) incurred after becoming aware of the tax liability, even if the taxpayer enters into an agreement to fully repay the tax liability within five years. See IRM Exhibit 5.15.1-1 (Q/A 10) (Oct. 2, 2009). Similarly, for purposes of considering whether to accept an offer in compromise, the IRS discourages taxpayers from dissipating assets by adding the amount of any dissipated assets to the minimum acceptable offer amount. See IRM 5.8.5.5 (Sept. 23, 2008).

Collect before other creditors

Another possible reason for the IRS's policy of disallowing payments to junior creditors is to discourage taxpayers from making such payments because they will reduce the amount the IRS could collect in bankruptcy.¹⁷ The IRM explains: "Determine the priority of the [Notice of Federal Tax Lien] NFTL when considering whether to allow or disallow payments to other creditors," which is consistent with this reasoning.¹⁸ However, the IRS is applying the disallowed debt rules outside of bankruptcy – in situations where debtors are not under the protection of the bankruptcy court, and thus, generally need to pay all creditors, including those that would receive a lower priority in a bankruptcy. In fact, junior creditors are often much more persistent than the IRS, which does not even send monthly balance due notices. Thus, the IRS appears to base its disallowed debt policy on unrealistic assumptions, at least for some taxpayers.

Other approaches to pre-existing debts

Not all taxing jurisdictions follow the IRS in ignoring junior debts. Some recognize the importance of putting the taxpayer in a position to meet future tax obligations.

Sweden's debt relief program

The Swedish Enforcement Authority recognizes that being in debt is a self-perpetuating cycle and leads to ongoing tax noncompliance.¹⁹ When a taxpayer enters the debt relief program (a one-time administrative process – not bankruptcy), the agency looks at all debt owed by the taxpayer – federal, local, and private creditors – and works out a payment plan over a period of years that, if adhered to, will result in forgiveness of any outstanding debt at the end of the agreement. The payment plan does not ignore unsecured debt. Although the government may have priority over other creditors, it voluntarily accepts less than full payment because it has found that a taxpayer is more likely to pay future tax debts if all pre-existing debts are taken into account. If the taxpayer fails to complete the debt relief program, the debts stand and the government is in the same position as before the taxpayer

¹⁷ See 11 U.S.C. § 726; 11 U.S.C. § 507; IRM 5.17.8 (Oct. 16, 2007). The federal priority statute may also give the IRS priority over certain debts including state tax debts. See 31 U.S.C. § 3713; IRM 5.17.13 (Oct. 16, 2007). Similarly, a federal tax lien gives the IRS priority over most other creditors. See IRC § 6323. These priorities may determine which creditors are legally entitled to be paid when there is not enough money for all of them (e.g., in the context of a bankruptcy or other disposition or collection of a particular piece of property).

¹⁸ IRM 5.15.1.2(2)(g) (Oct. 2, 2009). See also IRM 5.8.5.6.4 (Sept. 23, 2008) (explaining that "[M]onthly payments to state or local taxing agencies should not be allowed as a necessary expense, even if the state or local taxing agency has a lien that is senior to the IRS's lien or is collecting funds through a wage attachment or approved installment agreement....Since future earnings of the taxpayer are after-acquired property, the Service has first right to the earnings. Explain to the taxpayer that although the payment may be allowed in an installment agreement, where the tax will be paid in full, it will not be allowed for computation of an acceptable offer amount because the Federal government has priority rights to the funds.").

¹⁹ For general information about Swedish debt relief, see, e.g., Jason Kilborn, *Out with the New, in with the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen off the Learning Curve?* 80 Am. Bankr. L.J. 435 (2006); More on Kronofogden (the Enforcement Authority), <http://www.kronofogden.se/omkronofogden/allmantomkronofogden/paandrasprakinothelanguages/engelska.4.7856a2b411550b99fb7800086559.html> (last visited Sept. 10, 2010). Our discussion is based in large part on information provided to the National Taxpayer Advocate by the Swedish Enforcement Authority in May 2009.

entered the program.²⁰ However, if the taxpayer completes the program, he or she is better able to pay future tax liabilities.²¹

Joint federal-state installment agreements

Even the IRS has acknowledged the benefit of allowing taxpayers to pay junior creditors outside of bankruptcy. Before April 2008, the IRS and the state of New York allowed taxpayers with both federal and state tax delinquencies to enter into a joint federal and state installment agreement based on their ability to pay.²² Thus, the IRS allowed taxpayers to make payments to satisfy a state tax delinquency.²³ The IRS described one benefit of the program as allowing taxpayers to avoid pressure from each agency for more money.²⁴

Disallowing actual debt may produce unrealistic payment expectations.

Junior creditors do not go away – the state tax agency does not stop garnishing a paycheck and a credit card collection company does not stop calling – just because the taxpayer is in an IRS payment plan that ignores these expenses. Research supports this analysis. A 2009 TAS Research study examined a group of individual taxpayers who had no prior unpaid tax delinquencies, but failed to pay taxes assessed in 2002 (*i.e.*, following a previous recession).²⁵ The study found that more than half of the taxpayers who declared bankruptcy appeared able to pay based on the IRS's standard collection financial analysis.²⁶ The study concludes the IRS overestimates these taxpayers' ability to pay because it fails to consider their disallowed debts.

Unrealistic payment expectations may contribute to subsequent noncompliance.

The 2009 TAS study also found that about 74 percent of those 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 balance due prior

²⁰ Because this program is generally available only once, it is less likely to be subject to abuse.

²¹ *The Swedish Enforcement Authority*, May 2009 (presentation to the National Taxpayer Advocate) (stating that “a person in very deep indebtedness may be forced to live at the level of subsistence for the rest of his/her life if he/she does not get a debt relief.”).

²² See, e.g., IRM 5.19.1.5.4.2 (Dec. 15, 2002); Memorandum of Understanding Between the IRS and New York State Department of Taxation and Finance, *Joint Installment Agreements* (Sept. 2000); IRM 5.19.1.5.5.24 (Apr. 28, 2008) (noting that the fed-state IA program was discontinued in April 2008).

²³ See IRM 5.19.1.5.4.2(4) (Dec. 15, 2002). See also Memorandum of Understanding between the IRS and New York State Department of Taxation and Finance, *Joint Installment Agreements* § 3(c) (Sept. 2000). However, a taxpayer's liability to the IRS could not exceed \$25,000 because he or she had to meet streamlined IA criteria to be eligible for the program. SB/SE Research, Detroit/Milwaukee, 09.08.002.04, *New York State and IRS Joint Installment Agreement Project* (Nov. 2004). Between October 1, 2004, and May 31, 2005, the IRS and NY received 51 and 168 inquiries, respectively, but initiated only five joint IAs, in large part because taxpayers who made inquiries were ineligible for the program. Memorandum for Department Manager 1 from Manager, Team G, *Eligibility Versus Non-eligibility for the Federal/State Joint Installment Agreement Program* (2005).

²⁴ IRM 5.19.1.5.4.2(4) (Dec. 15, 2002).

²⁵ See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 21-33 (*Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge for the IRS*).

²⁶ National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 21, 30. Similarly, more than half of the taxpayers who reported cancellation of indebtedness income – meaning another creditor cancelled the taxpayer's debt – also appeared able to pay. National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 21, 30.

to 2002.²⁷ Thus, although the study did not definitively identify the causes of subsequent noncompliance, it confirms that the IRS's current approach fails to promote future compliance for an extraordinarily large percentage of these taxpayers.

CONCLUSION

Outside of bankruptcy, junior creditors will continue collection efforts, even if the debtor also owes the IRS. Thus, IRS policies that ignore these debts could prolong unresolved delinquencies, create hardships, encourage taxpayers to enter into IAs that they cannot pay, and promote future delinquencies.

The National Taxpayer Advocate offers these preliminary recommendations:

1. Study the effect of more realistic financial analysis policies on taxpayer hardship, IA defaults, and future compliance.²⁸ For one group of taxpayers, the IRS should use its current financial analysis. For another, it should allow payments on debts to government entities (*e.g.*, student loans and state and local tax debts). For a third group, it should allow all currently disallowed debts. As part of this study, the IRS should survey the taxpayers who default to find out why;
2. Solicit public comments on the methodology the IRS uses to compute the ALE, how the IRS should apply the ALE, and related policies for conducting financial analysis (including the disallowed debt policy); and
3. Incorporate the public comments into published guidance that addresses the public's concerns and fully explains the reasons for the policies adopted by the IRS.

IRS COMMENTS

In collecting revenues owed to the United States, the IRS must balance the needs of the government and taxpayers while at the same time administering the tax laws consistently and fairly to all.

The IRS offers a number of options for taxpayers to satisfy their tax liabilities. In the majority of cases, balance due accounts that are resolved are done so without the need for extensive analysis of the taxpayer's income and expenses. In these cases, the IRS is willing to accept payment over time without asking the taxpayer to reveal and substantiate other debts, let alone forgo payment of the other debts. Less often, situations require a detailed financial analysis. When a taxpayer requests terms of payment that present a heightened risk that the taxes owed will go uncollected if the agreement terms are not met, sound financial analysis and an accurate determination of ability to pay are essential to making the correct collection determination. IRS financial analysis guidelines provide a

²⁷ National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 29. However, TAS could not determine how many of these taxpayers actually had a filing requirement.

²⁸ The IRS should stratify the results of this study by taxpayer debt and income levels.

comprehensive structure for making this determination. The treatment of other debts and expenses in these guidelines is intended to balance the needs of the government and the taxpayer while at the same time fostering confidence across the taxpaying public that all taxpayers are being held to the same standard of compliance.²⁹

The IRS routinely conducts financial analysis training for collection employees and performs periodic reviews of casework to ensure compliance with financial analysis and Allowable Living Expense guidelines. In addition, the IRS strives to make the ALE data driven and fair to taxpayers, and continues to consider new data sources to produce the ALE, as demonstrated by the 2007 redesign of the ALE.³⁰

In determining ability to pay, the IRS allows for all “necessary expenses,” defined as expenses that are necessary to provide for a taxpayer’s and his or her family’s health and welfare and/or production of income. The expenses must be reasonable. The total necessary expenses establish the minimum a taxpayer and family needs to live.³¹ IRS guidance explicitly lists all of the necessary living expenses identified in the Treasury Regulations as relevant when determining whether collection action would cause economic hardship,³² but goes on to state that other expenses should be allowed if they meet the necessary expense definition. Where standards for a specific expense are provided, those amounts are based on what an average citizen spends for basic living expenses. Nevertheless, the IRS recognizes the fact that no set of standards can be expected to fit every circumstance; therefore, IRS employees are directed to consider a taxpayer’s extraordinary circumstances and to make exceptions to the application of the ALE when warranted to allow taxpayers the means to adequately meet living expenses.³³ For expenses such as food, clothing, and out-of-pocket medical expenses, taxpayers are allowed the standard amount even if they report that they spend less, and are not required to provide documentation unless the amount they claim exceeds the standard amount.³⁴

In FY 2010, the IRS granted over three million installment agreements for individuals and businesses.³⁵ Fewer than six percent of these agreements required financial analysis where ALE standards were considered. The vast majority of agreements secured are guaranteed and streamlined agreements, which essentially allow individuals owing less than \$25,000 to choose their own payment plans as long as the debt will be paid in five years of when the

²⁹ IRS Policy Statement P-5-2, Collecting Principles. IRM 1.2.14.1.2 (Feb. 17, 2000).

³⁰ See, e.g., SB/SE Research (Brooklyn/Hartford), Project BKN0086, *2007 Allowable Living Expenses Project* (Dec. 2007).

³¹ See IRM 5.15.1.7 (Oct. 2, 2010).

³² The amount reasonably necessary for food, clothing, housing (including utilities, homeowner insurance, homeowner dues, and the like), medical expenses (including health insurance), transportation, current tax payments (including federal, state, and local), alimony, child support, or other court-ordered payments, and expenses necessary to the taxpayer’s production of income (such as dues for a trade union or professional organization, or child care payments which allow the taxpayer to be gainfully employed). See Treas. Reg. § 301.6343-1.

³³ See IRM 5.15.1.7(5). National and local expense standards are guidelines. If it is determined a standard amount is inadequate to provide for a specific taxpayer’s basic living expenses, allow a deviation. Require the taxpayer to provide reasonable substantiation and document the case file.

³⁴ See IRM 5.15.1.7(3).

³⁵ CAR 5000-6, *Installment Agreement Cumulative Report*, Oct-Sep FY 2010.

agreement starts. Cases in which taxpayers owe more than \$25,000 are subject to financial analysis, but those cases qualify for their own “five-year rule” which accounts for the payment of all or some junior debts or other “conditional expenses” if the tax liability can be full paid in five years. These conditional expenses include unsecured debts, and other debts, that do not have priority over the federal tax liability. In those situations where the taxpayer does not qualify for the five-year rule, the IRS still allows one year for the taxpayer to pay off other debts or adjust their expenses to be able to pay the tax liability. Thus, it is only in the cases posing the greatest risk of nonpayment (*i.e.*, those in which the agreement covers large balances due or for which final payment would come very late in the ten-year statutory period for collection) that the IRS asserts the full measure of its priority over junior creditors.

If a taxpayer has a secured debt that he or she is not paying, the IRS would normally not allow it when determining ability to pay; however, if the taxpayer does start paying the debt or the creditor garnishes the taxpayer's wages, the IA would be amended to reduce the payment amount to the IRS. IAs can also be amended if a taxpayer incurs additional necessary living expenses, such as car payment if an old vehicle needed to be replaced.³⁶

The National Taxpayer Advocate cites the Swedish Debt Relief Program as one that recognizes junior debts. This program is an administrative approach to the consumer debt relief process, but is the functional equivalent of a bankruptcy. The state Enforcement Agency, Kronofogdemyndigheten (KFM), posts a notice of case opening and holds a meeting of creditors, creating an open record of the proceeding. Unlike the IRS, KFM has the power to impose final, binding payment plans on dissenting creditors.³⁷ The Swedish law also requires the debtor to attempt to pay off debts by liquidating all nonessential property as a precursor to seeking formal relief, whereas the IRS rarely requires taxpayers to liquidate assets when they are able to full pay the liability through installment payments. Although an administrative, rather than judicial process, it appears that implementation of a system such as the Swedish system could only be effectuated by legislative changes by Congress. One could reasonably question whether such system would have benefits not already provided by the Bankruptcy Code.

Although taxpayers on installment agreements may incur additional liabilities, it does not appear as though disallowance of other debts for our financial analysis is the primary cause for subsequent tax delinquencies or unfiled returns. In 2009, TAS found similar and even

³⁶ See IRM 5.14.1.4.4.

³⁷ Jason Kilborn, *Out with the New, In with the Old: As Sweden Aggressively Streamlines Its Consumer Bankruptcy System, Have U.S. Reformers Fallen off the Learning Curve?* 80 Am. Bankr. L.J. 435 (2006).

higher rates of noncompliance for taxpayers assigned to the queue or reported currently not collectible, with no payments being made toward the delinquent tax liabilities.³⁸

Regarding the preliminary recommendations for the IRS to consider when analyzing a taxpayer's ability to pay, we are taking or have taken the following actions with respect to these recommendations.

The National Taxpayer Advocate recommended studying the effects of different financial analysis policies by deducting debt payment to other creditors from the ability to pay determination, allowing the taxpayers to make lesser payments based on this change in policy, and then tracking the results in terms of future taxpayer behavior. We do not agree that giving priority to other debts in this manner is sound tax administration. Given the flexibility already in existence, we will consult with research as to whether existing data — *i.e.*, closed cases in which conditional expenses were allowed — can be used to measure this effect.

The National Taxpayer Advocate recommends that we solicit public comments on the methodology used to compute the allowable living expenses and incorporate those comments into published guidance. Normally, annual changes to the ALE standards only involve updating the standard amounts to reflect changes in the cost of living. The methodology for calculating the ALE standards was recently revised in 2007. Significant changes had not occurred for several years prior to this revision. Prior to redesigning the ALE standards in 2007, the IRS solicited input from practitioners, as well as TAS, as noted in the 2007 Annual Report to Congress.³⁹ Since 2007, the IRS has continued to solicit input on the ALE standards at various presentations, including the Taxpayer Advocacy Panel and the American Bar Association. In 2010, the IRS conducted surveys with the IRS Advisory Council and practitioners at the Nationwide Tax Forums to evaluate the effectiveness of the 2007 changes and to seek recommendations for future updates.

While the IRS cannot implement every suggestion, we give consideration to all comments received and will continue to work with SB/SE Research to make improvements to the ALE standards whenever possible. The IRS agrees that the methodology should be transparent. We will consult with our communication function as to appropriate outreach channels, but do not believe that a lengthy formal notice and comment is necessary at this time.

³⁸ National Taxpayer Advocate 2009 Annual Report to Congress vol. 2 21-33 (Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge for the IRS). Taxpayers whose accounts were placed in the queue or in CNC status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached TDA status and were worked in the Automated Collection System or by the Collection Field function had especially high levels of subsequent noncompliance, regardless of the disposition.

³⁹ "The IRS has recently made changes, some positive, to the ALE standards. The IRS initiated an in-depth study in response to the 2005 Annual Report to Congress and provided TAS with a set of proposals in March of 2007. This led to interaction with SB/SE Collection Policy and Research to seek the most efficient means of determining an accurate picture of a taxpayer's ability to pay. As a result of these discussions, the IRS published a set of revised standards on October 1, 2007, that took into consideration some of TAS concerns. More importantly, the IRS committed to continue to collaborate on developing standards that might better reflect taxpayers' actual living expenses and needs for self-sufficiency. This collaboration will ensure that the application of these standards does not force lower income taxpayers to remain at or below the poverty level." National Taxpayer Advocate 2007 Annual Report to Congress 430, 435.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS agrees the ALE methodology should be transparent. She is also pleased the IRS has continued to solicit comments from the public. However, the public does not know what comments the IRS has received or have any evidence that the IRS has actually considered them.⁴⁰

While it may not be necessary for the IRS to publish regulations, which would be subject to the public notice and comment process, additional public dialog could (1) help the IRS develop policies that are more coherent and (2) help the public understand the rationale behind policies that may otherwise seem arbitrary. In this spirit, we address several of the IRS's substantive comments below.

As described above, in determining the minimum acceptable IA payment, offer amount, or whether to classify a taxpayer's account as CNC, the IRS sometimes ignores the taxpayer's other debts, even if another creditor (*e.g.*, a state tax authority) is actually garnishing the taxpayer's wages.⁴¹ As justification for doing so, the IRS states:

[i]t is only in the cases posing the greatest risk of nonpayment (*i.e.*, those in which the agreement covers large balances due or for which final payment would come very late in the ten-year statutory period for collection) that the IRS asserts the full measure of its priority over junior creditors.

This explanation is confusing. Taxpayers seeking offers, CNC designations, and IAs (including PPIAs) are not in bankruptcy or any other proceeding where the priority of a debt is necessarily relevant. The debts that the IRS is ignoring will not be discharged, and the IRS is not actually asserting "priority" over anyone. If the IRS is considering a collection alternative, it is not attempting to collect the debt by levy or other enforcement mechanism. Rather, it is simply ignoring the fact that a taxpayer is obligated to make payments to a third party. Thus, the IRS had not explained how the priority that these other debts would receive in a bankruptcy is relevant to its analysis.

Other statements in the IRS response suggest that the reason for the policy may have something to do with the IRS's conclusion that taxpayers who cannot fully pay the liability in full within five years "present a heightened risk that the taxes owed will go uncollected if the agreement terms are not met." This is similarly confusing. In the case of offers, CNC designations, and PPIAs, the IRS is conducting a financial analysis to determine if it should allow some amounts to go uncollected even if the terms of the agreement *are* met.

⁴⁰ For a discussion of the benefits of transparency, see National Taxpayer Advocate 2006 Annual Report to Congress 10-30 (Most Serious Problem: *Transparency of the IRS*).

⁴¹ See, *e.g.*, IRM 5.15.1.10(3) (Oct. 2, 2009) (stating: "Delinquent state and local taxes are allowable depending on the priority of the FTL and/or Service agreement with the state and local taxing agencies."). In the case of IAs, however, the IRS does not ignore these expenses if the taxpayer can repay the federal tax liability in full within five years. See, *e.g.*, IRM 5.15.1.2(4) (Oct. 2, 2009).

Policymakers have concluded that doing so may foster future compliance, avoid economic hardship, and allow the IRS to collect what is reasonably feasible at the earliest possible time and at least cost.⁴² Ignoring actual debts may frustrate these goals.

In addition, the IRS comments attempt to distinguish the Swedish debt relief program from the U.S. system. The IRS notes that under the Swedish program, the government can impose a payment plan upon other creditors (which they can appeal), and observes that legislation would be necessary to establish such a program in the U.S.⁴³ The National Taxpayer Advocate is not suggesting the IRS recreate the Swedish debt relief program. She is merely observing that at least one other country takes a more holistic approach when analyzing a taxpayer's financial condition, rather than ignoring a taxpayer's other debts.

The IRS comments also conclude that its policy of ignoring actual debt when computing taxpayer's minimum IA payments is not the primary cause of subsequent tax delinquencies or unfiled returns. The IRS bases this conclusion on a 2009 TAS study, asserting that it found similar rates of future noncompliance for taxpayers who entered IAs, were assigned to the queue, or whose accounts were reported as CNC. As the IRS comments point out, fewer than six percent of individual IAs involve any financial analysis (*i.e.*, most IAs are streamlined IAs). Thus, we cannot draw broad conclusions about the impact of the IRS's financial analysis on future compliance by looking at the future compliance of taxpayers entering into IAs that did not involve financial analysis.⁴⁴

Finally, the IRS discounts the benefit of studying the impact of allowing certain normally disallowed debt using random selection techniques. It suggests that even studying the matter is inconsistent with "sound tax administration." However, it has done so before.⁴⁵ Moreover, the IRS's own multifunctional Collection Process Study team recommended revising the IRS's financial analysis to "allow for minimum payments on certain debts junior to a Notice of Federal Tax Lien (NFTL): [including] (1) Payments on state tax installment agreements, [and] (2) Payments on unsecured debts (*e.g.*, student loans, credit cards)."⁴⁶

⁴² See, e.g., Policy Statement 5-71, IRM 1.2.14.1.14 (Nov. 19, 1980) (CNC to avoid hardship); Policy Statement P-5-100, IRM 1.2.1.5.18 (Jan. 30, 1992) (offers). Indeed, one justification for the offer program is for offers to replace "protracted" IAs. *Id.* (stating "[A]n OIC is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government...an adequate offer will also result in creating for the taxpayer an expectation of a fresh start toward compliance with all future filing and payment requirements.").

⁴³ The IRS also attempts to distinguish the Swedish approach to debt relief on the basis that debtors generally must liquidate all nonessential property as a precursor to seeking relief. However, the IRS similarly expects taxpayers utilize any equity in assets before pursuing collection alternatives, including installment agreements. See, e.g., IRM 5.14.1.4 (June 1, 2010) (directing IRS employees to "inform taxpayers installment agreements will be recommended for rejection ... if there is sufficient equity or cash available to [fully or] partially pay the taxes..."). Moreover, any such equity will be considered in determining an acceptable offer amount, whether to CNC the account, and whether to accept a PPIA. See, e.g., IRM 5.16.1.2.9 (June 29, 2010) (CNC); IRM 5.14.2.1.2 (Sept. 26, 2008) (PPIA); IRM 5.8.5.5 (Oct. 22, 2010) (offers).

⁴⁴ Moreover, the IRS may accept streamlined IAs even when taxpayers cannot afford the payments, see *IRS Collection Policies Channel Taxpayers Into Installment Agreements They Cannot Afford, supra/infra*. Thus, streamlined IA default rates may not provide an appropriate benchmark for comparison.

⁴⁵ See, e.g., SB/SE Research, Ft. Lauderdale/Greensboro, Project 04.08.002.03, *The Impact on the Installment Agreement Default Rate When Using a "Financial Calculator"* (June 2005); Memorandum of Understanding between the IRS and New York State Department of Taxation and Finance, *Joint Installment Agreements* (Sept. 2000).

⁴⁶ IRS Collection Process Study, Final Report § 6.3.3.4 (Sept. 30, 2010).

When you add the team's recommendation to the National Taxpayer Advocate's analysis (above), it seems inconsistent with sound tax administration for the IRS *not* to study this recommendation properly.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Study the effect of more realistic financial analysis policies on taxpayer hardship, IA defaults, and future compliance, as described above. As part of this study, the IRS should survey taxpayers who default to find out why;
2. Solicit public comments on the methodology the IRS uses to compute the ALE, how the IRS should apply the ALE, and related policies for conducting financial analysis (including the disallowed debt policy); and
3. Incorporate the public comments into published guidance that addresses the public's concerns and fully explains the reasons for the policies adopted by the IRS.

MSP
#8

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

RESPONSIBLE OFFICIAL

Diane Ryan, Chief, Appeals

DEFINITION OF PROBLEM

Since 1927, the IRS Office of Appeals (Appeals) has played a vital role in effective tax administration by resolving taxpayer disputes without litigation.¹ A critical component of the organization's success has been its independence. In 1998, Congress codified this independence by prohibiting certain *ex parte* communications between Appeals and the rest of the IRS.² The IRS defines prohibited *ex parte* communications as those that take place between Appeals and another IRS function without the participation or consent of the taxpayer or the taxpayer's representative.³

Appeals recognizes that Congress designed the *ex parte* prohibition to ensure its independence.⁴ However, Appeals does not maintain a separate database of *ex parte* violations. Without such a database, Appeals does not know to what extent the violations occur and what remedies it should prescribe.

Surveys indicate that approximately one out of every three taxpayers who have dealt with Appeals is other than satisfied with its independence.⁵ This is an unacceptably low customer satisfaction score for an attribute so critical to Appeals' mission. The National Taxpayer Advocate is concerned that taxpayers may perceive Appeals as allowing *ex parte* violations to occur, thereby diminishing the public's confidence that Appeals provides an independent review of a taxpayer's case. In addition, 25 percent of American Bar Association (ABA) member practitioners responding to a 2007 survey reported an *ex parte* violation while in Appeals.⁶ Although Appeals' internal quality scores indicate a very high rate of *ex parte* compliance, Appeals must make a stronger effort to reconcile this with its customer satisfaction scores and the 2007 ABA survey.

Congress granted the Commissioner explicit authority to establish administrative rules to enforce the *ex parte* prohibition. The IRS chose to implement these rules first by IRS Notice

¹ Internal Revenue Manual (IRM) 8.1.1.1(1) (Oct. 23, 2007).

² See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. 685 (1998) (RRA 98).

³ See Rev. Proc. 2000-43, 2000-2 C.B. 404.

⁴ See IRM 8.1.6.3 (Oct. 23, 2007).

⁵ *Appeals Customer Satisfaction Survey FY 2009 Results* 29 (reporting a 65 percent satisfaction rate).

⁶ American Bar Association Section on Taxation, *Survey Report on Independence of IRS Appeals* 16 (Aug. 11, 2007) (ABA Survey) (reporting 25.1 percent of respondents). This survey was sent to members of the ABA's Section on Taxation.

and then by Revenue Procedure.⁷ Although the public had the opportunity to comment on the original IRS Notice, Appeals plans to issue a new Revenue Procedure on *ex parte* rules.⁸ Without a new opportunity for notice and comment, Appeals would create a new rule to protect taxpayer rights without allowing the taxpayer to weigh in on its content.

ANALYSIS OF PROBLEM

Background

The IRS generally supports administrative settlement over litigation when resolving tax disputes.⁹ Accordingly, it is essential for the IRS to have an administrative appeals function that commands the confidence of taxpayers and provides them with an independent review of disputes.¹⁰ The effectiveness of Appeals depends greatly on the trust the public has in its independence from the rest of the IRS.

The Historical Basis for the Ex Parte Prohibition

The rationale for having an independent administrative appeals function finds its roots in the Fifth Amendment of the United States Constitution. The “due process of law” clause to the Bill of Rights provides that “No person shall be ... deprived of life, liberty, or property without due process of law.”¹¹ This due process right extends to substantive laws as well as government procedures, such as reasonable notice and the right to be heard by an impartial arbiter.¹²

For this reason, the United States Government has maintained procedures for taxpayers to appeal proposed tax assessments since 1789.¹³ This continued into the present income tax system when the Revenue Act of 1918 created the Advisory Tax Board within the IRS (still

⁷ Notice 99-50, 1999-2 C.B. 444 (Oct. 4, 1999); Rev. Proc. 2000-43, 2000-2 C.B. 404 (Oct. 23, 2000).

⁸ *Filing Season Return Preparer Visits Will Resume Despite Criticism, Fink Says*, 2010 TNT 201-4 (Oct. 19, 2010) (“IRS Office of Appeals Chief Diane Ryan announced that the agency is working to revise the existing *ex parte* rules as outlined in Rev. Proc. 2000-43, which generally prohibit IRS personnel from discussing the substance of a case with Appeals.”).

⁹ See, e.g., IRM 8.1.1.1(2) (Oct. 23, 2007); see also Donald C. Alexander & Brian S. Gleicher, 623-2nd T.M., *IRS Procedures: Examinations and Appeals A-79* (Sept. 4, 2004) (“[Appeals’] purpose is to resolve as many issues as possible without trial”).

¹⁰ Appeals Officers and Settlement Officers are Appeals employees who hear cases and recommend settlements. They serve in quasi-judicial capacities, although final settlement authority rests with their managers or team case leaders. They do not serve as administrative judges subject to the Administrative Procedures Act. See *Tucker v. Comm’r*, 135 T.C. 6 (2010), for a lengthy explanation of how Appeals Officers fit within our constitutional system of appointed officers and administrative law judges.

¹¹ U.S. CONST., amend V. The idea of “due process of law” pre-dates the U.S. Constitution and is originally expressed in the MAGNA CARTA, cl. 39 (1215).

¹² See *Goldberg v. Kelly*, 397 U.S. 254 (1970) holding that procedural due process includes a person’s right to be adequately notified of proceedings, the opportunity to be heard at these proceedings, and that the person or panel making the final decision over the proceedings be impartial in regards to the matter before them. *Id.* at 267.

¹³ The Act of 1789 establishing the Treasury Department provided that any person dissatisfied with an audit could “within six months appeal to the Comptroller.” The IRS memorialized this due process rationale in IRS Policy Statement 4-7: “An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution.” IRS Policy Statement 4-7, reprinted in IRM 1.2.13.1.5 (Dec. 23, 1960).

referred to as the Bureau of Internal Revenue) to hear appeals of proposed deficiencies.¹⁴ Later, Congress concluded that this appellate body should be outside of the IRS and created the U.S. Board of Tax Appeals (predecessor to the U.S. Tax Court) in 1924.¹⁵ However, the workload for this new tribunal soon became unbearable, and the IRS realized the value of an internal administrative appeals function that could settle taxpayer disputes without formal litigation.¹⁶

As a result, the IRS established the current Office of Appeals in 1927. This new administrative appeals division was part of the Commissioner's office, independent of the organizational functions making the determinations that taxpayers appealed. The independent nature of Appeals was not only organizational in its separation from the other operating divisions. Appeals was also to have decisional independence, which means the individuals hearing the appeals were to be insulated from attempts by others to influence the outcomes of their individual cases.¹⁷

Congress codified Appeals' independence in 1998 by prohibiting *ex parte* communications that appear to compromise an Appeals employee's decisional independence.¹⁸ Thus, the purpose of the *ex parte* prohibition is to maintain an independent appeals function, both real and perceived.

Ex parte compliance remains a major concern for Appeals executives.¹⁹ Violations are also a concern for taxpayers and their representatives. A member survey conducted by the ABA concerning the independence of Appeals indicates that one out of every four attorney-practitioners who responded to the survey reported *ex parte* violations.²⁰ What is perhaps more telling is that almost half of the respondents were unable to answer whether *ex parte* violations had occurred.²¹ One of the respondents to the ABA survey commented, "It would be helpful to get a sense of the magnitude of *ex parte* violations, which [seem] fairly common."²² Appeals may have the same problem answering this question since it has no separate database for tracking *ex parte* violations, relying instead on its managers and internal quality measurement system to monitor and measure compliance.

¹⁴ Revenue Act of 1918, § 1301(d), Ch. 18, 40 Stat. 1057, 1141 (Feb. 24, 1919). The Revenue Act of 1921, § 250(d), Ch. 136, 42 Stat. 227, 265, 266 (Nov. 23, 1921) provided that if a tax or deficiency in tax should be discovered, the taxpayer should be notified and given a period of not less than 30 days in which to file an appeal.

¹⁵ Revenue Act of 1924, § 900, Ch. 234, 43 Stat. 253, 336 *et seq.* (June 2, 1924).

¹⁶ By 1929, the Board of Tax Appeals was 20,000 cases in arrears. *The Cabinet: Since Hamilton*, TIME (Feb. 4, 1929), available at <http://www.time.com/time/magazine/article/0,9171,737244,00.html>.

¹⁷ See, e.g., Stephen H. Legomsky, *Deportation and the War on Independence*, 91 CORNELL L. REV. 369, 386 (2006) (discussing the need for decisional as well as organizational independence in administrative appellate tribunals).

¹⁸ See RRA 98 § 1001(a)(4); *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93 ("Actual influence isn't required, only a reasonable possibility that the prohibited [*ex parte*] communication may have compromised the Appeals officer's impartiality.")

¹⁹ See, e.g., *IRS Appeals Office Strives for Independence, Says Official*, 2009 TNT 185-13 (Sept. 28, 2009). The then-Deputy Chief of Appeals stated, "[r]ules against *ex parte* communications and maintaining independence continue to be the top challenges for the IRS's Appeals function."

²⁰ ABA Survey at 16 (reporting 25.1 percent of respondents).

²¹ *Id.* (reporting 47.4 percent of respondents).

²² ABA Survey at 40.

The National Taxpayer Advocate has repeatedly expressed her concern that taxpayers who perceive Appeals as not being independent will bypass the Appeals process altogether, thereby clogging up courts with unnecessary litigation.²³ Similar to that of the Taxpayer Advocate Service, part of Appeals' congressional mandate is to strike the "necessary balance between being independent and remaining part of the agency."²⁴

Appeals must have a solid understanding of the problem's magnitude so it can act appropriately to address perception issues regarding this important taxpayer protection. Further, taxpayers need to see that Appeals is addressing the issue of *ex parte* compliance. As former Appeals Chief Sarah Hall Ingram once said of the *ex parte* issue, "To the extent that rumors continue floating around, it undermines credibility and damages Appeals."²⁵

Taxpayer Satisfaction for Appeals' Independence Is Unacceptably Low

Only 65 percent of taxpayers surveyed for Appeals fiscal year (FY) 2009 customer satisfaction survey were satisfied with Appeals' independence.²⁶ Appeals notes that this is a two-point increase from FY 2008.²⁷ However, analysis of the customer satisfaction survey data shows that there has been no statistically significant change in satisfaction for independence since FY 2004. In other words, taxpayer satisfaction may not have improved at all over the past six years.

Recent data suggest that Appeals' perceived independence appears to have a parallel relationship with overall taxpayer satisfaction. This means taxpayers' perception of Appeals' independence could be a driver of their overall satisfaction.

²³ National Taxpayer Advocate 2009 Annual Report to Congress 70-84, 346-350, 418-429; National Taxpayer Advocate 2008 Annual Report to Congress 476-487; National Taxpayer Advocate 2007 Annual Report to Congress 569-581; National Taxpayer Advocate 2006 Annual Report to Congress 266-288; National Taxpayer Advocate 2005 Annual Report to Congress 136-161; National Taxpayer Advocate 2004 Annual Report to Congress 264-289, National Taxpayer Advocate 2006 Objectives Report to Congress App. VIII 20; National Taxpayer Advocate 2004 Objectives Report to Congress 13.

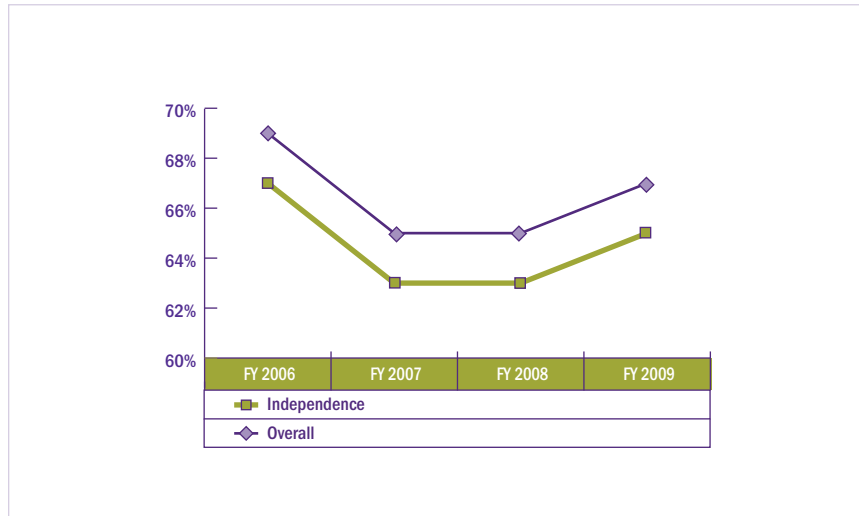
²⁴ Nina E. Olson, *The Taxpayer Advocate Service: Independence Within the IRS*, 126 TAX NOTES 1257 (Mar. 8, 2010); see also Bryan T. Camp, *What Good Is the National Taxpayer Advocate?*, 126 TAX NOTES 1243 (Mar. 8, 2010).

²⁵ *Appeals Chief, Practitioners Spar Over Ex Parte Rules*, 2008 TNT 221-3 (Nov. 13, 2008).

²⁶ *Appeals Customer Satisfaction Survey FY 2009 Results* 29.

²⁷ Appeals, *Business Performance Review – Q1 4* (Feb. 23, 2010) ("[T]he majority of taxpayers continue to be satisfied with the degree of independence shown by Appeals, which grew two percent (to 65 percent).").

FIGURE 1.8.1, Taxpayer Satisfaction Scores for Appeals' Independence and Overall Satisfaction FY 2006 – FY 2009²⁸



A 65 percent satisfaction rate means that only about two-thirds of taxpayers are satisfied with an attribute that is essential to the success of Appeals' mission and appears to be a strong driver of overall taxpayer satisfaction. Appeals has many opportunities to improve taxpayers' perception of its independence, which in turn should also increase taxpayers' overall satisfaction with the organization.

Court Cases and Practitioners Report Ex Parte Violations

Recent U.S. Tax Court cases reveal that *ex parte* violations occur between the IRS and Appeals.²⁹ One case in particular, *Industrial Investors v. Commissioner*,³⁰ prompted a particularly strong rebuke from the court:

This needs to stop. Congress wanted to give taxpayers an opportunity to appeal their case to an IRS employee who would take a fresh look at the facts. *Ex parte* contacts not only undermine the impartiality of the officer hearing the appeal, but are especially pernicious because they are so hard to detect.³¹

²⁸ Appeals Customer Satisfaction Survey FY 2009 29; Appeals Customer Satisfaction Trends FY 2003 – FY 2009.

²⁹ See, e.g., *Robert v. United States*, 364 F.3d 988 (8th Cir. 2004); *Drake v. Comm'r*, 125 T.C. 201 (2005); *Medical Practice Solutions, LLC v. Comm'r*, T.C. Memo. 2010-98; *Hotchkiss v. Comm'r*, T.C. Memo. 2010-32; *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93; *Moore v. Comm'r*, T.C. Memo. 2006-171.

³⁰ *Industrial Investors v. Comm'r*, T.C. Memo. 2007-93.

³¹ *Id.*

Taxpayers and practitioners have also reported *ex parte* violations that compromise Appeals' independence. The following is a partial list of narrative comments from recent surveys:³²

- *"They should be independent. Their opinion should not be changed by the auditor."*³³
- *"The prohibition against Appeals Officers having ex parte discussions with the examiner or collection officer is frequently ignored."*³⁴
- *"There is often ex parte contact between examinations and Appeals that is not supposed to occur."*³⁵

The customer satisfaction rating of 65 percent and these first-hand experiences indicate that a problem exists, at a minimum, with the public's perception of *ex parte* violations affecting Appeals' overall independence. The current lack of an *ex parte* database makes it difficult for Appeals to know what systemic problems exist and how to fix them.

Improved Measurements Would Help Appeals Determine to What Degree Ex Parte Violations Are Real or Perceived

Without accurate data on the number of *ex parte* violations, taxpayers are left to speculate as to what degree this is a problem and how seriously Appeals' overall independence is compromised. Rumors and negative anecdotes harm Appeals' perceived independence, while accurate data can determine if a problem truly exists and – most importantly – can suggest remedies. It would also be a clear indication that Appeals takes *ex parte* violations seriously. Even if taxpayers' perceptions of an independence problem differs from Appeals' perception, Appeals still needs to figure out why that difference exists, since it contributes to an unsatisfactory Appeals customer satisfaction rating.

Appeals Should Redesign Its Quality Measurement System to Separately Report Ex Parte Violations.

The only method of data collection Appeals has that touches upon *ex parte* compliance is Standard 1F of the Appeals Quality Measurement System (AQMS). A subset of one of the standards is a review for inappropriate *ex parte* communication. For FY 2009, Appeals' AQMS score for Standard 1F (the aggregate elements of "Privacy and Disclosure Provisions & Ex Parte") was 99.1 percent.³⁶ To arrive at this score, AQMS reviewers randomly select closed Appeals cases and evaluate them on multiple standards of quality. The reviewer can access only the information in the administrative case file. This means the reviewer cannot see any evidence of an *ex parte* communication unless the Appeals employee documents

³² For a complete list from the Appeals FY 2009 Survey and the ABA Survey, see *Appeals Customer Satisfaction Survey FY 2009 Results* 10, and ABA Survey at 40, 70, 82, 91, 93.

³³ *Appeals Customer Satisfaction Survey FY 2009 Results* 10.

³⁴ ABA Survey at 40.

³⁵ *Id.*

³⁶ Standard 1F covers whether Appeals properly processed power of attorney forms, if the Appeals employee allowed someone to represent the taxpayer who was not authorized to do so, and if third-party contact rules were followed. See, e.g., Appeals, *AQMS Reviewer Non-Collection Checklist* 3 (Rev. Oct. 1, 2009). These are unrelated to the *ex parte* prohibition in RRA 98.

it. Consequently, relying on the AQMS score to ascertain a systemic problem with *ex parte* violations would be misleading.

Given the disparity between the 99.1 percent internal quality score and the 65 percent satisfaction score for Appeals' independence in FY 2009, Appeals should not assume from its AQMS score that it excels in *ex parte* compliance and that taxpayer perception of its independence is simply mistaken. However, it appears as though Appeals does just that. Appeals' FY 2009 AQMS report states, "Appeals has consistently excelled over the past three years in ... following Privacy, Disclosure and *Ex Parte* guidelines."³⁷ If Appeals is relying on the 99.1 percent quality score to conclude that *ex parte* violations are not occurring, it may be missing major opportunities to improve its *ex parte* compliance.

The National Taxpayer Advocate recommends that Appeals institute a formal system to document and track *ex parte* communications. Similar to its existing means of tracking expired statutes of limitation³⁸ and unauthorized access of taxpayer data,³⁹ the system would require Appeals employees to report all *ex parte* communications. Employees would submit these reports to their managers to determine if the incident rises to the level of an *ex parte* violation. The manager could then take the appropriate action to remedy the situation, including assigning a new Appeals employee to hear a specific case if the taxpayer so requests. The manager could also input the incident and his or her determination into a central database for systemic analysis by Appeals executives.

Appeals should also redesign its AQMS review standards to report *ex parte* violations separately from the general privacy and disclosure element. This way, Appeals and taxpayers will have a clearer understanding of how often *ex parte* violations occur.

The *Ex Parte* Prohibition Should Be Elevated to a Regulation.

Congress gave the Commissioner express authority to propose regulations on the independent organization of Appeals and *ex parte* prohibitions.⁴⁰ In response to the congressional directive in RRA 98 prohibiting *ex parte* communications, the Commissioner opted to publish Revenue Procedure 2000-43 rather than attempting to implement this mandate by Treasury Regulation.

There is an important distinction between Revenue Procedures and Treasury Regulations. Treasury Regulations must first be proposed and the public given the opportunity

³⁷ Appeals, *FY 2009 AQMS Results Report 4* (Nov. 13, 2009).

³⁸ See IRM 8.21.7, *et seq.* (Aug. 1, 2007).

³⁹ See Taxpayer Browsing Protection Act, 105 Pub. L. No. 35, 111 Stat. 1104 (1997); see also Form 11377 (Rev. July 2008).

⁴⁰ Congress explicitly left a gap for the IRS to fill by directing the Commissioner to "ensure an independent appeals function within the [IRS], including the prohibition ... of *ex parte* communications between appeals officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the appeals officers." RRA 98 § 1001(a)(4); see also *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843-44 (1984) ("If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation.").

to comment on them.⁴¹ Revenue Procedures, on the other hand, are internal IRS pronouncements of procedure that generally are not subject to public notice and comment.⁴² Although Appeals sought public comments in 1999 for the current Revenue Procedure, it is now looking to revise the *ex parte* Revenue Procedure.⁴³

The National Taxpayer Advocate believes official rules regarding *ex parte* prohibitions should be elevated to a Treasury Regulation instead of relegated to a Revenue Procedure. This step will give taxpayers a fresh opportunity to comment on the proposed regulation.⁴⁴ It will also raise the importance of *ex parte* compliance for all IRS employees and afford the regulations greater judicial deference.⁴⁵ Since Appeals seeks to publish new *ex parte* guidance, this is the best opportunity to initiate the regulatory drafting process.

Appeals Should Lead the Initiative for Servicewide Training.

By definition, every potential *ex parte* violation involves Appeals. However, Appeals is not solely responsible for *ex parte* compliance, as everyone in the IRS shares this responsibility.⁴⁶

Since Appeals is best suited to help the operating divisions train their employees on *ex parte* compliance, it should be the first to reach out to other functions and develop joint training and tracking programs so that all IRS employees can be mindful of prohibited communications that appear to compromise Appeals' independence.

CONCLUSION

The National Taxpayer Advocate recognizes that any disparity between alleged and actual *ex parte* violations might be a matter of perception. However, multiple court cases show that taxpayers and the IRS differ on what constitutes an *ex parte* violation.⁴⁷ Without a formal method of tracking such violations, Appeals will never know to what extent this problem is real or perceived, or how best to remedy the problem. In addition, formal regulations will increase public involvement in *ex parte* definition and enforcement, while

⁴¹ 5 U.S.C. § 553; IRC § 7805.

⁴² See Treas. Reg. § 601.601(d)(2)(vi). The IRS has the authority to follow the notice-and-comment rules for Revenue Procedures if it chooses and has done so in the past. Treas. Reg. § 601.601(d)(2)(v)(f); see e.g., Rev. Proc. 2005-31, 2005-1 C.B. 1374, finalizing rules proposed in Notice 2003-15, 2003-1 C.B. 540, pursuant to comments discussed in Announcement 2005-45, 2005-1 C.B. 1377.

⁴³ See Notice 99-50, 1999-2 C.B. 444 (Oct. 4, 1999); *Filing Season Return Preparer Visits Will Resume Despite Criticism, Fink Says*, 2010 TNT 201-4 (Oct. 19, 2010).

⁴⁴ See *Hector v. USDA*, 82 F.3d 165, 171 (7th Cir. 1986) (stating that the notice-and-comment rules are “the procedure by which the persons affected by legislative rules are enabled to communicate their concerns in a comprehensive and systematic fashion to the legislating agency.”); Ronald A. Cass, *Models of Administrative Action*, 72 Va. L. Rev. 363, 364 (1986) (stating that the notice-and-comment requirement “loosely resembles the legislative process”). The IRS should take the necessary steps to ensure that the final regulations better serve and protect the right of taxpayers to a timely and independent review of their disputes.

⁴⁵ In general, the courts afford greater deference to legislative regulations subject to the notice-and-comment procedure found in 5 U.S.C. § 553. See Steve R. Johnson, *Intermountain and the Importance of Administrative Law in Tax Law*, 128 TAX NOTES, 837, 843 (Aug. 23, 2010).

⁴⁶ Rev. Proc. 2000-43, 2000-2 C.B. 404, Q&A 29.

⁴⁷ See, e.g., *Robert v. United States*, 364 F.3d 988 (8th Cir. 2004); *Drake v. Comm’r*, 125 T.C. 201 (2005); *Medical Practice Solutions, LLC v. Comm’r*, T.C. Memo. 2010-98; *Hotchkiss v. Comm’r*, T.C. Memo. 2010-32; *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93; *Moore v. Comm’r*, T.C. Memo. 2006-171.

cross-functional training will better represent the fact that *ex parte* compliance is a service-wide responsibility.

In conclusion, the National Taxpayer Advocate makes the following preliminary recommendations to help minimize actual *ex parte* violations and improve taxpayers' perception of Appeals' independence:

1. Create a system to document *ex parte* communications in an effort to understand any difference between Appeals' actual compliance and public perception. The documentation system should be non-evaluative to encourage Appeals employees to report even suspected violations.
2. Track reported *ex parte* violations and the surrounding facts and circumstances to serve as the basis for improved policies and procedures to reduce actual *ex parte* violations.
3. Conduct focus group and survey research to determine how the public defines prohibited *ex parte* communications, and how it influences perceptions of independence and the public's willingness to utilize the Appeals process.
4. Develop a public information campaign based on the findings of the above research.
5. Re-design the AQMS review standards to separate *ex parte* violations from the privacy and disclosure elements.
6. Elevate the current *ex parte* guidance to a Treasury Regulation, ensuring that any new regulation uphold and protect taxpayers' rights.
7. Assist other IRS business units with *ex parte* compliance through joint training initiatives.

IRS COMMENTS

The National Taxpayer Advocate continues to express a concern about Appeals' independence under the congressional mandate established by RRA 98. The National Taxpayer Advocate's concerns focus on three areas:

1. Appeals' system of documenting and tracking *ex parte* violations;
2. The impact of perceived *ex parte* violations on Appeals' independence and a presumed correlation to overall customer satisfaction ratings; and
3. The lack of opportunity for public comment on *ex parte* procedures and the National Taxpayer Advocate's exception to the Commissioner's method of published guidance on prohibited *ex parte* communications.

Appeals is extremely proud of the service our employees provide to taxpayers and appreciates the National Taxpayer Advocate's recognition of the vital role we play in effective tax administration. Appeals values the National Taxpayer Advocate's support and feedback as we continually strive to improve our processes to meet the goals of our strategic plan

and carry out our mission. In effecting that mission, independence continues to be one of Appeals' most important core values, and the RRA 98 statutory prohibition on *ex parte* communications is a significant component of Appeals' independence. Each Appeals employee is trained to understand and appreciate the seriousness of our commitment to these principles.

In the report, the National Taxpayer Advocate opines that a 2007 ABA Tax Section survey and Appeals customer satisfaction surveys reflecting "no statistically significant change in satisfaction for independence since FY 2004" support the concerns about Appeals. We respectfully disagree. Without diminishing its value as a tool to evaluate our operations, the 2007 ABA survey report [560 responses] is both limited in scope/currency and restricted in the number of participants.

However, in response to the National Taxpayer Advocate's 2004 Annual Report to Congress and the Most Serious Problem: *Independence of Appeals*,⁴⁸ a Treasury Inspector General for Tax Administration (TIGTA) audit was requested by Appeals. TIGTA's review, completed in 2005, was extensive. As part of its audit, TIGTA interviewed representatives from the ABA, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Society of Accountants. The report stated that those professional associations "believe the independence of Appeals is generally very high."⁴⁹ Interestingly, despite the fact that the National Taxpayer Advocate commended Appeals for requesting the TIGTA audit, this Most Serious Problem (MSP) 2010 neglects to cite either the audit or its strong conclusion that "The overall independence provided by Appeals' structure and processes appears to comply with the intent of the RRA 98."⁵⁰

Procedural Updates

The National Taxpayer Advocate indicates that Appeals should seek input from external stakeholders. This implies that Appeals does not already do so, which is incorrect. The ABA survey and the National Taxpayer Advocate provide valuable information to incorporate into our planning and operations to improve overall tax administration, but cannot be evaluated in isolation from other feedback.

Appeals has made a number of procedural changes since the 2005 TIGTA audit, 2007 ABA survey, and ongoing National Taxpayer Advocate feedback. This included updates/clarifications to numerous IRM provisions, letters, publications, forms, and communications to ensure that we address internal and external stakeholder concerns on a continuing basis.

In FY 2010, Appeals participated in 250 outreach events reaching over 20,000 participants. Our participation at the IRS Nationwide Tax Forums was a particular success.

⁴⁸ See National Taxpayer Advocate 2004 Annual Report to Congress 279.

⁴⁹ TIGTA, Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to Be Sufficient 1* (Sept. 9, 2005).

⁵⁰ *Id.*

Appeals has delivered over 100 presentations to external stakeholders and IRS personnel outside of Appeals on the subjects of both Appeals independence and prohibited *ex parte* communications. As updates to the *Ex Parte* Revenue Procedure are effected, Appeals will be instrumental in developing and delivering servicewide training. We are pleased that the National Taxpayer Advocate is supportive of this cross-divisional endeavor.

Appeals devotes significant resources to ongoing *ex parte* training to its employees and the success of that effort is demonstrated in the decrease in post-FY 2006 prohibited *ex parte* violations as determined by the stringent review of AQMS reviews.

Documenting *Ex Parte* Communications

According to the National Taxpayer Advocate, reliance on AQMS reviewer scores to ascertain whether a systemic problem exists with prohibited *ex parte* communications is misleading in ascertaining whether a systemic problem exists because the reviewer only “touches upon” *ex parte* and is limited by the administrative file and Appeals Centralized Database System (ACDS).

The National Taxpayer Advocate states, “Recent U.S. Tax Court cases reveal that *ex parte* violations occur between the IRS and Appeals,” and then cites six cases decided between 2004 and 2010. In two of the six cases cited, the courts, in fact, determined that **no** *ex parte* violations occurred.⁵¹ In **each** case, the Appeals administrative case file fully documented contacts with and receipt of information from IRS Compliance employees. This clearly demonstrates the strength/reliability of the current system.

Appeals technical employees are required to use the Case Activity Reporting and Automated Timekeeping System (CARATS), a subsystem of ACDS, to “control their inventory, record case activities, record time spent, and establish follow-up actions, etc.”⁵² Employees are required to document their activities, inclusive of communications whether oral or written, with internal and external parties on a contemporaneous basis. Appeals managers are actively engaged conducting case, workload, and progress reviews all of which include reviewing communications.

IRM Part 8, *Appeals*, contains dozens of specific instructions for technical employees to “document” contacts, meetings, actions, events, verifications, receipts, plans, etc. While several of the IRM provisions address *ex parte* communications, Appeals does see an opportunity to improve upon our guidance to our technical employees and will include additional IRM guidance with respect to documenting *ex parte* communications in CARATS, as well as the importance of notifying their manager of potential or actual prohibited communications.

⁵¹ *Medical Practice Solutions, LLC v. Comm’r*, T.C. Memo. 2010-98; *Hotchkiss v. Comm’r*, T.C. Memo. 2010-32.

⁵² IRM 8.1.3.2.7.

Tracking *Ex Parte* Violations

The National Taxpayer Advocate states in the report that Appeals has no accurate data on the number of *ex parte* violations because it has no way of tracking such violations. This is simply not the case. *Ex parte* contacts, in conjunction with other quality data, are reviewed under the AQMS. The AQMS review team reviews over 1,000 cases annually. Each selected case goes through a lengthy and comprehensive quality review of every document in the case file (inclusive of emails, correspondence, notes, calculations, etc.), including the case activity record, culminating in a separate report for each case. Exclusive data on Appeals employees' compliance with *ex parte* communication are captured and tracked under Review Standard 1, Attribute F.

The following table reflects AQMS data over the past eight years for Review Standard 1, Attribute F, Reason Code 5 (where rating is "not met"):

TABLE 1.8.2, AQMS Reviews, Review Standard 1, Attribute F

Fiscal Year	Total 1.F.5 'Not Met' Ratings	Fiscal Year	Total 1.F.5 'Not Met' Ratings
2003	7	2007	1
2004	2	2008	0
2005	3	2009	0
2006	4	2010	0

Through Appeals' efforts at improving our compliance with the prohibited *ex parte* communication guidelines, the AQMS results clearly show significant improvement and have identified no violations since 2007.

As part of its overall responsibility, AQMS issues "quality alerts" to Appeals when they identify trends or issues of concern. The 2005 TIGTA report referenced such an alert issued by AQMS in 2003 relating to *ex parte* communication issues.⁵³ Based on the nature and extent of the AQMS review system, we believe we are adequately capturing prohibited *ex parte* communication data, and as the National Taxpayer Advocate recommended, in a non-evaluative manner.

***Ex Parte* Impact on Appeals' Independence and Overall Customer Satisfaction**

Appeals conducts an annual Customer Satisfaction Survey, which includes an analysis of 17 individual attributes. However, the National Taxpayer Advocate attributes changes in Appeals' overall customer satisfaction score solely to a parallel relationship with a single survey item – satisfaction with Appeals' independence. Appeals' FY 2009 Overall

⁵³ TIGTA, Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to Be Sufficient* (Sept. 9, 2005).

Satisfaction rate reflected its second highest result since the inception of the study, increasing two percentage points above FY 2008 satisfaction results and coming within two percent of the all-time Overall Satisfaction score. Appeals’ overall dissatisfaction rate has improved significantly and is down to 17 percent. In merely four years since TIGTA performed its audit, Appeals has seen considerable improvement in both overall satisfaction as well as a sharp decline in the level of those dissatisfied.

TABLE 1.8.3, Appeals Satisfaction Rates, FY 2005-2009

Fiscal Year	Satisfied %	Neutral %	Dissatisfied %
2005 ⁵⁴	56	18	26
2009 ⁵⁵	67	17	17

Appeals takes very seriously the individual satisfaction scores on all 17 survey attributes, including Appeals’ independence; however, there are no fewer than five other attributes that display a similar or nearly identical “parallel relationship” during that same time period.⁵⁶ Clearly, one cannot assume causation by observed correlation and the tracking of multiple factors with correlative attributes emphasizes the unreliability of such an approach.

The third-party vendor, however, identified seven attributes that were strong drivers of overall satisfaction during the FY 2009 survey, meaning they have the strongest impact on customers’ perceptions of their experience. “Independence of Appeals” was listed as the lowest of the seven “high” attributes in 2009.

With respect to the ABA survey which specifically asks about *ex parte*, it is not clear from the reported results whether practitioners were applying a judicial *ex parte* rule as opposed to Rev. Proc. 2000-43, especially given the concerns espoused with respect to Fast Track Settlement/Fast Track Mediation communications, sharing of protests with Compliance for rebuttal and Appeals engagement on Issue Management Teams and Tax Shelter Settlement initiatives.

First and foremost, it should be clarified that while taxpayers’ perceptions on whether Appeals engaged in an *ex parte* communication (whether through the lens of Revenue Procedure 2000-43, judicial rules or other vantages) can impact the rating attributable to Appeals independence, it is not necessarily considered by the respondent when assigning a rating to independence. There are likely other experiences (outcome, knowledge, views on law, understanding of settlement, etc.) that drive the taxpayers’ rating of Appeals independence. Moreover, this cannot be equated with either *ex parte* concerns or satisfaction.

⁵⁴ Appeals Customer Satisfaction Survey for Fiscal Year 2005 31.

⁵⁵ Appeals Customer Satisfaction Survey for Fiscal Year 2009 30.

⁵⁶ Explanation of Appeals Process; Listening to Your Concerns; Professionalism of Appeals Person; Degree of Respect Shown; Explanation of Payment Options; Appeals Customer Satisfaction Surveys for Fiscal Years 2006 Through 2009.

Consequently, Customer Satisfaction data cannot be used to support a view that an *ex parte* problem exists.

The National Taxpayer Advocate also continues to express the concern that taxpayers who perceive Appeals as not being independent will bypass the Appeals process altogether, thereby clogging the courts with unnecessary litigation. However, over the past several years Appeals receipts have grown by an average of nearly ten percent per annum. Clearly, taxpayers are not bypassing the Appeals process.

Elevating the *Ex Parte* Communication Rules to a Regulation and Opportunity for Public Comment

The National Taxpayer Advocate recommends that the *ex parte* communication rules be elevated to a regulation and states that Congress expressly gave the Commissioner the authority to issue regulations on the subject. There is no question that Treasury and the IRS have the authority to issue regulations addressing *ex parte* communications under their general rulemaking authority contained in IRC § 7805(a). However, RRA § 1001(a) does not mention regulations so there is clearly no requirement to implement the provision by issuing regulations. RRA § 1001(a) only required the Commissioner to develop and implement a “plan” to reorganize the IRS, which would include, among other things, an independent appeals function and “the prohibition in the plan of *ex parte* communications”... to the extent that such communications appear to compromise the independence of the appeals officers.” Although Congress specified certain things that needed to be included in the plan, such as restrictions on *ex parte* communications, there is nothing that suggests that the plan had to take a particular form. At its core, RRA § 1001(a) is about the structure of the IRS and how its various functions interact with Appeals. Hence, the provision is essentially about the internal operations of the IRS, which do not need to be set forth in regulations. A revenue procedure is a more appropriate vehicle to set forth the *ex parte* communication rules.

Conclusion

At the heart of the National Taxpayer Advocate’s Annual Report to Congress is the continuing strong support for the Appeals organization. The IRS agrees that the Appeals function is vital to sound tax administration. However, we believe that our system of documenting *ex parte* contacts is not only reliable but has provided us with the trend and training information crucial to insuring a strong and sustained commitment to our core value of Appeals independence. The depth of the 2005 TIGTA examination supports our confidence in the established safeguards for maintaining an independent administrative forum to resolve tax controversies.

Appeals values the input and insight of all stakeholders, whether through formal or informal means, and continually seeks to improve upon our policies, procedures, and processes to ensure that we provide the finest Appeals process. We appreciate and are grateful for National Taxpayer Advocate and Congress’ support as we continue to be a world-class resolution forum for all taxpayers.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate reiterates her support for Appeals' vital role in effective tax administration. A key component of that role is Appeals' independence within the IRS and the public's perception that it complies with rules to safeguard that independence, such as the *ex parte* prohibitions of RRA 98. In its response, Appeals categorizes *ex parte* protections as being "essentially about the internal operations of the IRS." This statement demonstrates a profound misunderstanding of the importance of *ex parte* and the fundamental role it plays in assuring taxpayers that Appeals is, in fact, providing an impartial and independent review of the taxpayers' concerns.

In this Most Serious Problem, we identify a variety of facts that indicate there may be a problem with the public's perception of Appeals' *ex parte* compliance, and its independence as a whole. We recommend process improvements that would enable Appeals to know with greater certainty the extent to which these problems are real or perceived. If Appeals were to improve existing processes in making this distinction, it could take steps to improve *ex parte* compliance. It could also look for ways to improve the public's perception, even if no actual compliance problem exists. This is an important distinction, as any effective strategy to deal with an actual problem involving prohibited *ex parte* communications will differ significantly from one dealing only with the public's perception.

The 2007 ABA survey reported that 25 percent of tax practitioners experienced *ex parte* violations first hand.⁵⁷ In its response, Appeals eschews the ABA survey as "limited in scope/currency and restricted in the number of participants." Instead, Appeals presents TIGTA's 2005 audit of Appeals' independence as dispositive evidence of its compliance with the *ex parte* prohibition. The ABA survey reviewed responses from 560 tax practitioners, while the TIGTA audit reviewed 39 survey responses from taxpayers and their representatives.⁵⁸ Moreover, the 39 responses in the TIGTA audit were from taxpayers and representatives who participated in Appeals' Fast Track Settlement Program, a condition of which required taxpayers to *wave* the prohibition on *ex parte* communications. This means the population in the report that Appeals relies on to prove its *ex parte* compliance voluntarily gave up the protections the *ex parte* prohibition affords. If either report is "limited in scope/currency and restricted in the number of participants," based on these facts, it is the 2005 TIGTA audit and not the 2007 ABA survey.

The National Taxpayer Advocate finds Appeals' outreach efforts a good beginning and encourages Appeals to further pursue its outreach programs, which should include a *dialogue* with taxpayers and their representatives in addition to presentations. Presenting

⁵⁷ Respondents were ABA tax section members.

⁵⁸ TIGTA, Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to Be Sufficient* 10 (Sept. 9, 2005). Some representatives within large accounting and law firms are prohibited by their employers from participating in surveys on specific cases. *Id.* at 11 n.11. This could have made even those who elected to participate in the TIGTA surveys reluctant to be completely forthcoming about details of a specific case. On the other hand, the 560 respondents in the ABA survey were anonymous so there is a greater chance of candor in their responses.

information to taxpayers is one thing; directly soliciting their comments and opinions is another. It is in this spirit of outreach that we recommend Appeals seek more information from internal and external stakeholders in working to improve its *ex parte* compliance procedures.

The National Taxpayer Advocate acknowledges that Appeals trains its employees on *ex parte* compliance. However, she would constructively challenge Appeals to complement its training initiatives with procedures that will better guarantee the detection, documentation, reporting, and tracking of *ex parte* violations that occur.

Appeals points out that in two of the six cases cited, the court found no *ex parte* violations. This is true and in the interest of full disclosure we acknowledge that not every case taken before the U.S. Tax Court on an *ex parte* issue contains a violation. However, as Appeals points out, the court found *ex parte* violations in four of the six cases. The U.S. Tax Court in *Industrial Investors v. Commissioner* observed, “[*ex parte*] contacts not only undermine the impartiality of the officer hearing the appeal, *but are especially pernicious because they are so hard to detect.*”⁵⁹ It is because *ex parte* violations are so hard to detect that the National Taxpayer Advocate recommends Appeals institute a formal documentation system that will allow Appeals employees to record suspected *ex parte* communications as they occur to determine whether Appeals has a systemic problem or one of perception only. This will also elevate *ex parte* above being considered merely an “internal operation of the IRS.” Instead, it will be treated as an aspect of constitutional procedural due process in tax administration.

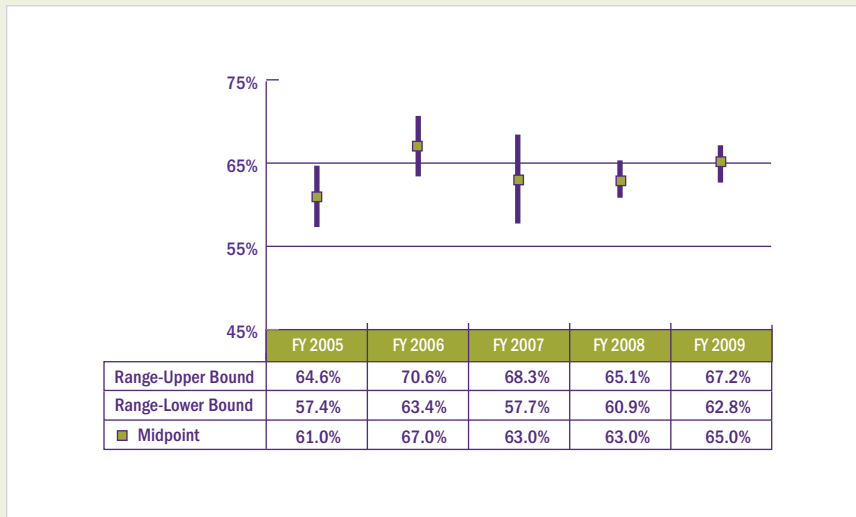
Appeals suggests that its current quality review system (AQMS) is sufficient for this purpose. However, AQMS reviewers look only at a sample of case files after the fact to find out if there is evidence of an *ex parte* violation. There is a significant difference between a system that diligently attempts to track each suspected violation and one that reviews a sample of files to see if a violation was recorded after it has already occurred. TIGTA recognized the same problem in its 2005 audit of Appeals independence when it wrote, “[i]t is also possible that inappropriate *ex parte* communications occurred that affected the outcome of cases for which there were no comments at all made in the case files, which would not have been identifiable by the AQMS process.”⁶⁰

Appeals’ AQMS process yielded a 99.1 percent quality score for the attribute “Privacy and Disclosure Provisions & *Ex Parte*” for FY 2009. Yet its customer satisfaction score for independence for the same period was only 65 percent. While Appeals continues to present its independence score as a significant increase over previous years, an analysis of the survey data shows that there has been no statistically significant change in Appeals’ customer satisfaction rates for independence since FY 2005, as shown in Figure 1.8.4.

⁵⁹ *Industrial Investors v. Comm’r*, T.C. Memo. 2007-93 (emphasis added).

⁶⁰ See TIGTA, Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to Be Sufficient* 4 (Sept. 9, 2005).

FIGURE 1.8.4, Appeals Independence Customer Satisfaction Scores, Percent of Customers Satisfied FY 2005 – FY 2009⁶¹



Once again, given the disparity between the 99.1 percent internal quality score and the 65 percent satisfaction score for Appeals’ independence in FY 2009, Appeals should make every effort – including modifying its tracking and quality review systems – to try to bridge the gap between its high internal quality score and its relatively low external rating.

The National Taxpayer Advocate does not predict which result reflects reality. She merely points out that a disparity exists, which could affect taxpayers’ perceptions of an independence problem, and that Appeals should address. If taxpayers’ perceptions differ from Appeals’ perception, Appeals still needs to discover why that difference exists, since it contributes to an unsatisfactory Appeals customer satisfaction rating. The National Taxpayer Advocate believes better systems to track *ex parte* compliance are the first step in making that discovery.

Appeals responds to the National Taxpayer Advocate’s recommendation to elevate *ex parte* rules to a regulation by stating, “RRA § 1001(a) does not mention regulations so there is clearly no requirement to implement the provision by issuing regulations.” It goes further and summarily declares that a “revenue procedure is a more appropriate vehicle to set forth the *ex parte* communication rules.” However, merely declaring that a revenue procedure is the appropriate form of guidance does not make it so. The National Taxpayer Advocate stands by her strong recommendation that *ex parte* rules be elevated to a regulation.

⁶¹ TAS analysis of Appeals Customer Satisfaction Survey data from FY 2005 to FY 2009. When considering confidence intervals and comparing one year to the next, there have been no statistically significant improvements from year to year (if there is any overlap in the range in the years being compared, there is no statistically significant difference). Using FY 2005 as a baseline, as Appeals does in its response, there were no statistically significant improvements through FY 2009.

When implementing RRA 98, Appeals should ask, “Who is the beneficiary of §1001(a)?” It is not the IRS, nor is it Appeals. Congress passed the law for the direct benefit of the taxpayer. To claim, “the provision is essentially about the internal operations of the IRS, which do not need to be set forth in regulations” misses the point. Congress did not seek to restructure the IRS in a vacuum. It sought to do so in an effort to provide increased taxpayer protections. The *ex parte* prohibition and its rules should not be divorced from the effects such rules would have on the beneficiaries of RRA 98 § 1001(a). Therefore, the National Taxpayer Advocate maintains her position that a regulation subject to notice and comment from the very taxpayers Appeals must protect is appropriate.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Create a system to document *ex parte* communications in an effort to understand any difference between Appeals' actual compliance and public perception. The documentation system should be non-evaluative to encourage Appeals employees to report even suspected violations.
2. Track reported *ex parte* violations and the surrounding facts and circumstances to serve as the basis for improved policies and procedures to reduce actual *ex parte* violations.
3. Conduct focus group and survey research to determine how the public defines prohibited *ex parte* communications, and how it influences perceptions of independence and the public's willingness to utilize the Appeals process.
4. Develop a public information campaign based on the findings of the above research.
5. Re-design the AQMS review standards to separate *ex parte* violations from the privacy and disclosure elements.
6. Elevate the current *ex parte* guidance to a Treasury Regulation, ensuring that any new regulation uphold and protect taxpayers' rights.
7. Assist other IRS business units with *ex parte* compliance through joint training initiatives.

MSP
#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****RESPONSIBLE OFFICIALS**

Diane Ryan, Chief, Appeals
Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The IRS Restructuring and Reform Act of 1998 (RRA 98) requires the IRS to give taxpayers notice and the opportunity to be heard by an independent Office of Appeals (Appeals) in a Collection Due Process (CDP) hearing to review IRS collection activity.¹ In CDP hearings, impartial Appeals officers must determine “whether 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 than necessary.”² The National Taxpayer Advocate is concerned that IRS actions and Appeals’ handling of CDP hearings may deprive taxpayers of meaningful hearings. These problems include:

- In fiscal year (FY) 2009, the IRS issued approximately 36 percent of CDP notices before the Collection function could verify the tax liabilities or adequately analyze the taxpayers’ ability to pay.³
- Appeals’ CDP quality score in FY 2009 was 57 percent for documenting whether applicable law and administrative procedures were met, indicating that Appeals may not be receiving proper verification from the IRS.⁴
- IRS Automated Collection System (ACS) employees routinely ask taxpayers to withdraw their CDP hearing requests upon reaching a resolution of their cases. These

¹ Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, §§ 1001(a) & 3401, 112 Stat. 685 (1998).

² Internal Revenue Code (IRC) §§ 6330(b)(3) & (c)(3). IRC §§ 6330(c), (d) (other than paragraph (2)(B)), & (e) apply to Collection Due Process (CDP) actions brought after the filing of a Notice of Federal Tax Lien (NFTL). IRC § 6320(c).

³ The IRS generally issues Letter 1058, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing* (rev. Oct. 2008), for proposed levy actions or a Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320* (rev. Mar. 2009), after it files a Notice of Federal Tax Lien (NFTL) to provide taxpayers an opportunity for a CDP hearing. Internal Revenue Manual (IRM) 5.19.8.3 (Aug. 27, 2010). IRS, CDW, Integrated Data Retrieval System (IDRS), analysis of IDRS transaction code (TC) 971, action codes (ACS) 69 (for levy CDP notices) and 252 (for lien CDP notices) for status 22, Automated Collection System (ACS), and status 26, Collection Field function (Cff), cases for fiscal year (FY) 2009. The IRS issued 36 percent of CDP notices at the same time as or just before the tax module was assigned to the ACS or Cff.

⁴ At the hearing, Appeals must obtain verification from the IRS that the requirements of any applicable law or administrative procedure have been met. IRC § 6330(c)(1). Appeals, Appeals Quality Measurement System (AQMS), *All Areas Results Report for FY 2009* 11 (Nov. 13, 2009). IRC § 6330(c)(1). The AQMS provides overall case quality data from the review of a statistically valid sample of closed cases. National Taxpayer Advocate 2009 Annual Report to Congress 75.

requests create pressure on taxpayers and may cause them to lose judicial review rights if their cases are not completely resolved.⁵

- In FY 2010, ACS held unresolved hearing requests for an average of 93 days before transferring them to Appeals. This period represents almost 33 percent of total CDP cycle time, *i.e.*, the number of days from the date of the hearing request to the issuance of a determination.⁶

Untimely and inadequate hearings harm taxpayers who qualify for a collection alternative or can receive a partial abatement of their tax liability, because additional interest and penalties accrue on the correct amount owed, and the statutory period for collection is suspended.⁷ Yet the IRS has no measures to determine whether delays or inadequate CDP hearings increase downstream costs of collecting taxes or impair future compliance.

ANALYSIS OF PROBLEM

Background

Congress established the CDP process to provide taxpayers an opportunity for an independent review of a tax lien filing or a proposed levy action.⁸ CDP hearings are held by an impartial officer from Appeals,⁹ are informal, and can be conducted face-to-face, by teleconference, or by correspondence.¹⁰ The process generally begins when the IRS sends the taxpayer a certified letter giving notice of the filed lien or proposed levy action.¹¹ To schedule a hearing and to preserve their right to a judicial appeal of the determination, taxpayers must return a signed written request for a hearing within 30 days of the date of the CDP notice.¹²

At the CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, lien, or proposed levy, including the appropriateness of collection action,

⁵ IRS procedures require a taxpayer to file a request for a CDP hearing with the office initiating the action, not Appeals. IRM 5.19.8.4.2(6) (Aug. 27, 2010). Through the first half of FY 2010, ACS generated 73 percent of Appeals CDP receipts. Appeals, *Business Performance Review* 5 (May 20, 2010). Only the first CDP notice properly sent to the taxpayer confers a right to request a CDP hearing for the tax period listed on the notice. Treas. Reg. §§ 301.6320-1(a)(3) A-A9, A-A10, -1(b)(2) A-B4 & 301.6330-1(a)(3) A-A9, A-A10, -1(b)(2) A-B4. Upon withdrawal of the CDP hearing request, a taxpayer is not entitled to a Notice of Determination. Treas. Reg. § 301.6320-1(e)(3) A-E8(ii); Treas. Reg. § 301.6330-1(e)(3) A-E8(ii). The Notice of Determination is the taxpayer's "ticket" to the Tax Court. *Weber v. Comm'r*, 122 T.C. 258, 263 (2004). Thus, a taxpayer may not seek another CDP hearing or Tax Court review upon withdrawal of his or her CDP hearing request for a tax period.

⁶ Appeals, CDP P1 *Measures* (Sept. 2010); Appeals, *Commissioner's Monthly Report* (Sept. 2010) (Appeals CDP cycle time for FY 2010 averaged 191 days). ACS held unresolved CDP hearing requests 48 days longer than is permitted under its procedures. IRM 5.19.8.4.7.5(14) (Aug. 27, 2010).

⁷ See IRC § 6601(a) (interest on underpayments continues until the liability is paid); IRC § 6651(a)(2) (penalty for failure to pay continues for up to 50 months); and IRC § 6330(e) (suspension of statutory period of limitations during the CDP hearing and any appeals of CDP determinations to Tax Court).

⁸ RRA 98, Pub. L. No. 105-206, Section 3401. IRC § 6323(h)(5).

⁹ IRC §§ 6330(b)(1) and 6330(b)(3).

¹⁰ Treas. Reg. § 301.6330-1(d)(2) Q & A-D7.

¹¹ IRC §§ 6320(a)(2) and 6330(a)(2). The notice is given in person, left at the dwelling or usual place of business of the taxpayer, or sent by certified or registered mail, returned receipt requested, to the taxpayer's last known address. After the NFTL is filed, the notice regarding the lien must be sent not more than five business days after the day of the filing. The notice regarding a levy is generally sent prior to the levy action and must be sent not less than 30 days before the day of the first levy.

¹² Treas. Reg. § 301.6330-1(c)(2), Q&A-C1,C3.

collection alternatives, spousal defenses, and in certain circumstances the underlying tax liability.¹³ Taxpayers have the right to judicial review of Appeals' determinations provided they timely request the CDP hearing and petition the court.¹⁴ Taxpayers who file an untimely request for a CDP hearing may be eligible for an equivalent hearing, which is similar to the CDP hearing but without court review, if requested within one year of the CDP notice.¹⁵ Generally, the IRS suspends collection action during the hearing and any judicial review that may follow.¹⁶

The IRS significantly increased enforcement actions in FY 2009 by issuing 965,618 NFTLs and 3,478,181 levies, a 26 percent and 32 percent increase over FY 2008, respectively.¹⁷

The following table shows the number of levies and liens filed, CDP hearing requests received each year (by Collection and Appeals), and Tax Court CDP petitions filed since FY 2007.¹⁸

TABLE 1.9.1, Levies, Liens, and CDP Hearing Requests

Fiscal Year	2007	2008	2009
Levies ¹⁹	3,757,190	2,631,038	3,478,181
Liens ²⁰	683,659	768,168	965,618
CDP Hearing Requests (received by ACS & Cff) ²¹	41,862	47,866	60,556
CDP Hearing Requests (received by Appeals) ²²	30,938	35,760	42,447
Tax Court Petitions Filed ²³	1,527	1,463	1,629

The IRS generates a vast majority of these levies and liens through the ACS due to its high-volume operation, which handles over 90 percent of IRS collection inventory.²⁴ One of

¹³ IRC § 6330(c)(2). The taxpayer may raise the underlying liability in a CDP hearing for any tax period if he or she did not receive a statutory notice of deficiency for such liability or did not otherwise have an opportunity to dispute the liability. IRC § 6330(c)(2)(B).

¹⁴ IRC § 6330(d).

¹⁵ Treas. Reg. §§ 301.6320-1(i)(1) & 301.6330-1(i)(1).

¹⁶ IRC § 6330(e).

¹⁷ IRS Data Book SOI Tax Stats 2009; Delinquent Collection Activities Table 16. The trend in increased collection actions has continued in FY 2010, in which the IRS issued 1,096,376 liens and 3,606,818 levies, an increase of 13 percent and 3 percent, respectively, over FY 2009. IRS, *FY 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf (last visited Dec. 16, 2010).

¹⁸ The table starts with FY 2007 because effective for determinations after August 17, 2006, Congress mandated the Tax Court have sole jurisdiction with respect to judicial review of CDP determinations. Pub. L. No. 109-280, Title VIII, Section 855(a), 120 Stat. 1019.

¹⁹ IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators Reports* (FY 2007, FY 2008 and FY 2009).

²⁰ *Id.*

²¹ SB/SE response to TAS research request (July 7, 2010).

²² Appeals, Commissioner's Monthly Report September (FY 2009). Appeals reviews all late-filed CDP hearing requests in a CDP timeliness determination (CDPTD). IRM 8.22.1.1.1.2.2.1 (Apr. 7, 2009). Appeals receipt data does not include CDPTD receipts. Appeals received 4,534 and 5,124 CDPTD cases in FY 2008 and FY 2009, respectively. Appeals, *Business Performance Review 10* (Nov. 17, 2009).

²³ IRS Chief Counsel, Counsel Automated Tracking System, PPL3254 (Jan. 22, 2010).

²⁴ At the end of FY 2010, there were 3,057,827 taxpayer cases in the ACS ending inventory and 207,810 in the Cff. During FY 2010, ACS received 3,748,410 taxpayer cases and Cff received 364,723. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report for FY 2010* (Oct. 4, 2010); IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Cumulative Report for FY 2009* (Aug. 11, 2010).

the downstream consequences of the increased IRS enforcement activity is an increase in Appeals' CDP cases. In FY 2009, Appeals CDP receipts increased 19 percent over FY 2008.

IRS Early Issuance of CDP Notices May Deprive Taxpayers of Due Process Review of Collection Actions.

Congress intended § 3401 of RRA 98 to provide formal procedures to ensure due process where the IRS seeks to collect taxes by levy or after filing the NFTL.²⁵ Although not required to itemize property subject to collection, the IRS is required to verify that all statutory, regulatory, and administrative requirements for the proposed collection action have been met, including verification of the taxpayer's liability and thorough consideration of the facts of the case.²⁶ Further, § 3421 of RRA 98 requires the IRS to implement an approval process under which any lien, levy, or seizure would, where appropriate, be approved by a supervisor who, in addition to other analysis, may certify that the employee has reviewed the taxpayer's information, verified the balance due, and affirmed that the action proposed is appropriate, considering the amount due and the value of the property.²⁷ Review, verification, and consideration of the facts of the case are necessary to develop an adequate record before sending a CDP notice.

The IRS routinely files an NFTL or issues a notice of intent to levy before it determines a taxpayer's ability to pay or economic hardship through an initial telephone or in-person contact. In FY 2009, the IRS issued CDP notices on the same day or before a case was assigned to ACS in 45 percent of ACS cases and to CFf in almost two percent of CFf cases. Further, the IRS issued CDP notices and did not assign the case to ACS or CFf in 24 percent of lien cases and almost ten percent of levy cases.²⁸

Inadequate case development by IRS Collection can cause Appeals to take more time to resolve cases or deprive taxpayers of the opportunity to discuss and develop their issues with the IRS.²⁹ By foregoing case review and managerial approval before issuing CDP notices, Collection is leaving Appeals with the difficult task of holding a hearing on a case where the proposed collection action may not be in the government's or the taxpayer's best interest. Taxpayer satisfaction scores reflect the challenges Appeals faces when conducting CDP hearings. In FY 2009, taxpayer satisfaction scores for CDP hearings were 56 percent

²⁵ RRA 98, § 3401, Pub. L. No. 105-206, 112 Stat. 758 (1998). H.R. Rep. No. 105-599, at 263, 265 (1998) (Conf. Rep.).

²⁶ H.R. Rep. No. 105-599, at 264-265 (1998) (Conf. Rep.).

²⁷ RRA 98, Title III, § 3421(b), Pub. L. No. 105-206, 112 Stat. 758 (1998). See S. Rep. No. 105-174, at 78 (1998). The provision will preclude the IRS from "abusively us[ing] its liens-and-seizure authority." Unanimous Consent Request - H.R. 2676, 143 Cong. Rec. S12230-02, at S12231 (Statement of Sen. Roth). See National Taxpayer Advocate 2009 Annual Report to Congress 33, 38 (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*).

²⁸ IRS CDW, analysis of IDRS TC 971, ACs 69 (for levy CDP notices) and 252 (for lien CDP notices) for status 22 (ACS) and status 26 (CFf) cases for FY 2009.

²⁹ For example, the IRS has not verified delivery of a deficiency notice to a taxpayer, or receipt of a waiver of a notice of deficiency from taxpayers. See *Hoyle v. Comm'r*, 131 T.C. 197 (2008); *Marlow v. Comm'r*, T.C. Memo. 2010-113.

and 54 percent for the adequacy of resources applied by Appeals, and the length of the appeals process, respectively.³⁰

The IRS Is Harming Taxpayers by Asking Taxpayers to Withdraw Their CDP Cases.

The ACS Support (ACSS) function is responsible for supporting ACS call sites.³¹ Among other things, its duties include perfecting lien requests and levies; processing paper levy responses, ACS undelivered mail, and delinquent returns; performing account actions from correspondence; processing TAS cases; and resolving CDP cases.³² Once a case is assigned to ACSS, an employee will attempt to make one phone contact within five days and, if no response is received, send a letter asking the taxpayer to respond within 15 days to resolve the case with ACSS. If the taxpayer makes contact and is satisfied with the resolution reached with ACSS, the ACSS employee will ask the taxpayer to withdraw his or her request.³³ In FY 2009, ACSS received 46,082 CDP cases and processed 2,127 withdrawals.³⁴ Premature withdrawals deprive taxpayers of meaningful CDP hearings and judicial review of IRS actions. For example, ACSS employees are not responsible for discussing liability issues with the taxpayer.³⁵ The National Taxpayer Advocate believes the IRS should cease this practice immediately. Taxpayers may feel pressured by withdrawal requests from Collection personnel to give up their due process rights in exchange for achieving a resolution – a resolution that in no way guarantees a taxpayer will not need those due process rights again.

In cases where the IRS issues a CDP notice before contacting the taxpayer or the taxpayer indicates a willingness to resolve the case at the Collection level, the IRS could suspend the hearing for a short interval.³⁶ This approach would provide for future consideration by Appeals if a dispute should arise over the resolution (*e.g.*, the termination or default of an installment agreement).³⁷ However, the IRS does not record the nature of the resolutions reached or their success rate after taxpayers withdraw their CDP hearing requests.³⁸

³⁰ IRS, *Appeals Customer Satisfaction Survey, National Report FY 2009 79* (Apr. 2010). Only the satisfaction score for time to hear from appeals was lower (52 percent) than these two attributes for FY 2009.

³¹ Four ACS Support sites receive and prepare ACS CDP cases. The SB/SE sites are in Philadelphia and Cincinnati. The Wage and Investment division (W&I) sites are in Kansas City and Fresno. IRM 5.19.8.4.2 (Aug. 27, 2010).

³² IRM 5.19.6.1(5) (July 8, 2008).

³³ IRM 5.19.8.4.7.5(7) (Aug. 27, 2010) (cross-referencing IRM 5.19.8.4.8 (Oct. 23, 2008)).

³⁴ SB/SE response to TAS research request (July 7, 2010). The CFB reported 933 withdrawals for FY 2009.

³⁵ IRM 5.19.8.4.7.5(5) (Aug. 27, 2010).

³⁶ Alternatively, the IRS might rescind the notice to preserve the taxpayer's CDP rights. Collection forwards cases to Appeals when the taxpayer indicates he or she only wants to work with Appeals, when a resolution is reached and the taxpayer will not withdraw his or her hearing request, or whenever discussions with the taxpayer reach an impasse. IRM 5.19.8.4.7.5 (Aug. 27, 2010).

³⁷ This would be consistent with Appeals' retained jurisdiction of CDP hearings after a determination has been made under IRC § 6330(d)(2).

³⁸ SB/SE response to TAS research request (July 7, 2010).

Appeals and ACSS Inaction May Cause Delays and Errors that Impact Taxpayer Rights.

Upon receipt of a processable request for a CDP hearing, ACSS employees update the CDP Tracking System (CDPTS), review the request, contact the taxpayer for clarification or missing information, and gather documents.³⁹ An ACSS employee must document the file if the taxpayer is willing to work on a case resolution beyond 45 days, and if not, the case must be transferred to Appeals.⁴⁰ In FY 2010, ACSS held Appeals' unresolved CDP hearing requests for an average of 93 days before transferring them to Appeals, which is almost 33 percent of the average length of CDP hearings.⁴¹ In the ACSS customer satisfaction survey for the period ending in December 2009, one in four respondents was dissatisfied with the length of resolution, and 38 percent of those who provided comments stated "it took too long" or "I haven't still been notified."⁴² However, ACSS does not keep customer satisfaction data specifically for CDP cases. ACSS should redouble its efforts to meet the 45-day deadline for processing cases, and gather its customer satisfaction data by function to better serve taxpayers and improve timeliness.

Appeals' gaps in activity and its untimely case actions may be causing further taxpayer dissatisfaction. For FY 2009, taxpayers had some of the highest rates of dissatisfaction, 22 and 21 percent respectively, concerning the time it takes to hear from Appeals and the length of Appeals procedures.⁴³ Appeals Quality Measurement System (AQMS) reports do not track timely actions for CDP alone, but for collection cases the reports indicate that timely case actions were rated 75 percent in FY 2009, which is an eight percent decrease from FY 2008.⁴⁴ Half of the negative ratings were attributed to delays in initial conference activity, which may have caused gaps in activity from six weeks to just over a year.⁴⁵

ACSS and Appeals may be harming taxpayers by failing to update or incorrectly updating the CDPTS. An ACSS employee posts a collection statute suspension code to a taxpayer's master file transcript when the taxpayer makes a timely CDP hearing request.⁴⁶ The Treasury Inspector General for Tax Administration (TIGTA) estimates that almost 13 percent of CDP cases closed in FY 2009 have an incorrect collection statute expiration date

³⁹ IRM 5.19.8.4.7.5 (Aug. 27, 2010).

⁴⁰ IRM 5.19.8.4.7.5(14) (Aug. 27, 2010).

⁴¹ Appeals, CDP P1 Measures (Sept. 2010); Appeals, Commissioner's Monthly Report (Sept. 2010) (Appeals CDP cycle time for FY 2010 averaged 191 days). The 93 days in which the unresolved hearing request was held by ACS is not part of the average days a CDP case was pending in Appeals.

⁴² IRS, ACS Correspondence Support Customer Satisfaction Survey National Report, October – December 2009 13, 23 (Mar. 2010).

⁴³ IRS, Appeals Customer Satisfaction Survey, National Report FY 2009 79 (Apr. 2010).

⁴⁴ Appeals, AQMS, All Areas Results Report for FY 2009 10 (Nov. 13, 2009). AQMS compiles some data attributes specifically for CDP, such as attribute 1G for CDP substantive contacts, some attributes under standard 6 for CDP procedural requirements, and some attributes under standard 8 for CDP processing. However, standard 5 for time span and time applied is only reviewed from a sample of collection and non-collection cases closed. In FY 2009, 72 percent of the 56,365 Appeals' collection cases closed were attributable to CDP cases (35,509) and CDP timeliness determinations (5,016). Appeals, Commissioner's Monthly Report September (FY 2009). Appeals, Business Performance Review 10 (Nov. 17, 2009).

⁴⁵ Appeals, AQMS, All Areas Results Report for FY 2009 10 (Nov. 13, 2009).

⁴⁶ ACSS employees will post a TC 520 on the IDRS for any module with a timely CDP hearing request to suspend collection action and the statutory period for collection, but not for an equivalent hearing, which will not suspend collection action or the statutory period. IRM 5.19.3.6.1 (Nov. 28, 2008); IRM 5.19.8.4.10 (Nov. 1, 2007); IRM 5.19.8.4.3 (Nov. 1, 2007).

(CSED), and that ACSS inappropriately suspended the CSED in one percent of equivalent hearing cases.⁴⁷ Moreover, Appeals' AQMS quality score is 75 percent for timely verifying collection statutes for FY 2009 cases.⁴⁸ Incorrect CSEDs harm taxpayers when the CSED is extended, but the government's interest is harmed when the CSED is shortened. The National Taxpayer Advocate is concerned that the IRS is not addressing the CSED problem.⁴⁹

Appeals Processes, Forms, and Letters Provide Limited Opportunities for Taxpayers to Choose a Preferred Hearing Location.

Congress intended CDP to provide taxpayers with an opportunity for a "meaningful hearing" and "that following procedures designed to afford taxpayers due process in collections would increase fairness to taxpayers."⁵⁰ The IRS provides face-to-face CDP hearings at the Appeals office closest to the taxpayer's business or residence for taxpayers who raise relevant, non-frivolous issues.⁵¹ When the IRS intends to levy or has filed an NFTL, the IRS sends the taxpayer a CDP notice including a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. However, this form does not prompt the taxpayer to choose the type of hearing or explain the circumstances under which he or she may want or need a local hearing or a face-to-face hearing with Appeals.⁵²

Appeals maintains that telephone or correspondence hearings are the preferred choice of taxpayers.⁵³ Yet Appeals' most recent customer satisfaction survey indicates that 73 percent of taxpayers who receive field CDP hearings prefer them, compared to 62 percent of taxpayers who receive IRS campus hearings.⁵⁴ Appeals should ask taxpayers which type of hearing they want and where it should take place. Further, Appeals should track the effectiveness of field and campus hearings by tracking sustention and default rates, and other indicators of long-term compliance, after determinations are made.⁵⁵

The National Taxpayer Advocate supports teleconferencing and correspondence hearings with taxpayers who prefer them. However, the National Taxpayer Advocate also believes that taxpayers, especially unrepresented ones, should be able to meet face-to-face or have telephonic or correspondence hearings with local appeals or settlement officers,

⁴⁷ TIGTA, Ref. No. 2010-10-075, *The Office of Appeals Has Improved Compliance Within Its Collection Due Process Program; However, Some Improvement Is Still Needed* 6-7 (July 15, 2010).

⁴⁸ Appeals, AQMS, *All Areas Results Report for FY 2009* 11-12 (Nov. 13, 2009).

⁴⁹ For a further discussion of CSED issues, see Status Update: *The IRS's Handling of Collection Statute Expiration Dates Continues to Adversely Affect Taxpayers*, *infra*.

⁵⁰ Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* 81-2 (Nov. 24, 1998).

⁵¹ Treas. Reg. §§ 301.6320-1(d)(2) A-D7 & 301.6330-1(d)(2) A-D7.

⁵² Form 12153, *Request for a Collection Due Process or Equivalent Hearing* (Nov. 2006).

⁵³ Appeals, *Strategic Plan FY 2009-2013* 4.

⁵⁴ IRS, *Appeals Customer Satisfaction Survey, National Report FY 2009* 67 (Apr. 2010).

⁵⁵ See Appeals response to TAS research request (July 21, 2010). "Appeals does not track or report sustention data; information on docketed resolutions, or 'informal remands' is likewise not available."

because knowledge of local economic conditions or issues may be key to a successful case resolution. Otherwise, these taxpayers may not be able to receive a meaningful hearing.

Appeals Fails to Effectively Communicate and Document Case Information or Explain Resolutions to Taxpayers.

Appeals FY 2009 AQMS reports show that the organization is having difficulty communicating with taxpayers, contacting taxpayers, and documenting case actions. Appeals received a quality score of 57 percent for its documentation that applicable law and administrative procedures were met in CDP cases, which has been reflected in recent Tax Court cases.⁵⁶ In FY 2009, Appeals received scores of 63 and 71 percent, respectively, for its communication of case status and substantive contacts in CDP cases, and a rating of 71 percent on whether the case narrative included in its determination was adequate for collection cases.⁵⁷ Failure to effectively contact taxpayers and communicate case status and determinations leads to dissatisfaction and misunderstanding, as well as missed educational opportunities, and may lead taxpayers to seek Tax Court review.

CONCLUSION

The National Taxpayer Advocate is concerned that certain IRS procedures undermine the adequacy and effectiveness of CDP hearings, and that the IRS pressures taxpayers to withdraw CDP hearing requests and unnecessarily delays processing these requests. The National Taxpayer Advocate offers the following preliminary recommendations to improve the adequacy and timing of CDP hearings:

1. The IRS should require substantial efforts at telephone or in-person contacts before proposing levies or filing liens, to identify taxpayers who are able to pay;
2. ACSS should suspend and not withdraw CDP hearing requests when taxpayers are willing to work with ACSS to attempt resolution, in order to preserve the taxpayer's CDP judicial review rights;
3. ACSS should revise its customer satisfaction survey to gather data by function;
4. Appeals should revise its notices and procedures to clearly inform taxpayers about the types and alternative location of hearings, including Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, to allow taxpayers to select their preferred type of hearing; and
5. Appeals should track field and campus CDP sustention and taxpayer default rates following CDP determinations.

⁵⁶ Appeals, AQMS, *All Areas Results Report for FY 2009 11* (Nov. 13, 2009). IRC § 6330(c)(1); see also *Marlow v. Commissioner*, T.C. Memo. 2110-113, at 23-33; *Hoyle v. Commissioner*, 131 T.C. 197, 203-06 (2008).

⁵⁷ Appeals, AQMS, *All Areas Results Report for FY 2009 4, 9* (Nov. 13, 2009).

IRS COMMENTS

The National Taxpayer Advocate expresses concern over whether taxpayers are receiving timely and adequate service when requesting a CDP hearing. The stated concerns focus on four key issues:

1. Early issuance of CDP notices by the IRS may deprive taxpayers of due process review of collection actions;
2. Taxpayers are harmed when asked to withdraw their CDP hearing requests;
3. Appeals' communication problems and activity gaps are harming taxpayers; and
4. Taxpayers have limited opportunities to choose their preferred hearing.

Early Issuance of CDP Notices

The IRS recognizes the need to ensure collection actions are taken based on the most accurate information known at the time of the action. The amount owed, and all other pertinent information available at the time, are considered part of the determination to either issue a notice of levy or file an NFTL. Additionally, in those situations when it is appropriate, managerial approval is required prior to issuing a levy or filing a lien. In RRA 98, Congress directed IRS to develop and implement procedures for supervisory review and approval, where appropriate, of liens, levies, and seizures. The conference agreement from RRA 98 § 3421 states as follows:

The conference agreement follows the Senate amendment. The conferees *intend that the Commissioner have discretion* in promulgating the procedures required by this provision to determine the circumstances under which supervisory review of liens or levies issued by the automated collection system is or is not appropriate.⁵⁸

In accordance with § 3421, the IRS has used discretion to ensure that authorities are based on the training and experience of the employee and the type of case at issue, not the pay grade of the employee.

The IRS attempts to contact each taxpayer through various methods to resolve balance due accounts so that individual circumstances can be considered. Several recent reviews by TIGTA have found that the IRS consistently protects taxpayer rights in both lien and levy contexts.

The IRM addresses lien determinations and requires prior written notice of possible lien filing.⁵⁹ When accounts are issued to Collection Field function (CFf), typically after process-

⁵⁸ RRA 98, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (1998); H.R. Rep. No. 105-599, at 278 (1998) (Conf. Rep.) (emphasis added).

⁵⁹ IRM 5.19.4.5.1. "Be sure a written warning of lien filing is evident on each module to be included on the NFTL."

ing in the Automated Collection System (ACS), the IRM states that the lien determination will generally be made in conjunction with the initial contact.⁶⁰

Both ACS and Cff have received guidance on situations in which lien filing may be deferred or delayed based on taxpayer circumstances. Most taxpayers in the collection process have received at least two notices of the balance due and have failed or refused to make arrangements to resolve the liability. The IRS stands ready to assist any taxpayer responding to notices of liability (whether in writing or otherwise).

TIGTA found, for the sixth year in a row, in its FY 2010 annual audit regarding IRS compliance with legal guidelines when issuing levies, "The IRS is protecting taxpayers' rights when issuing systemically generated and manually prepared levies."⁶¹ TIGTA noted that the IRS has strong controls on systemic levy that "prevent a levy from being generated if there are fewer than 30 calendar days between the date the taxpayer was notified of the pending levy and the date requested for actual issuance of the levy."

IRS policies and procedures provide further guidance regarding the use of enforcement action. Cff employees are instructed to make prompt contact on all taxpayer cases. During these contacts, the employees attempt to secure all the necessary information and address the unique facts and circumstances of each case to resolve the balance due. IRS guidance requires that enforcement action take place only after the taxpayer is given an opportunity to resolve their tax liability but fails to do so.

In addition, the IRM allows for discretion during the initial contact with taxpayers in issuing CDP notices to consider the circumstances of the case and the compliance history of the taxpayer.⁶²

Taxpayers Harmed When Asked to Withdraw Request for CDP Hearing

We respectfully disagree with the National Taxpayer Advocate in her assertion that taxpayers are being harmed when they reach a mutually agreed upon resolution to their tax matters and withdraw their CDP hearing requests.

When a taxpayer requests a CDP hearing, the taxpayer may present new information or may request a collection alternative not previously considered by the IRS. In appropriate cases, and if the taxpayer is willing, the Collection employee works with the taxpayer to see

⁶⁰ IRM 5.12.2.3(2). "While the notices sent in the notice stream are sufficient for filing a NFTL, generally when a NFTL has not been previously filed the revenue officer's determination with respect to the filing of the NFTL will be done in conjunction with the initial actual contact or initial attempted contact. Contact (request for full payment) may be made by: a. field contact (preferably). b. telephone. c. mailing a notice or letter to the last known address (when appropriate). See IRM 5.11.1.2.1.1 for 'last known address' description."

⁶¹ TIGTA, Ref. No. 2010-30-068, *Fiscal Year 2010 Statutory Review of Compliance with Legal Guidelines When Issuing Levies* (June 15, 2010).

⁶² IRM 5.11.1.2.2 (4). "Use discretion when issuing the L1058 on initial contact with an IMF only balance due taxpayer. Consider the circumstances of the case and the compliance history of the taxpayer in determining whether to issue the L1058."

if the issue can be resolved. If the issue can be resolved prior to Appeals consideration, it expedites the process for the taxpayer.⁶³

Many taxpayers clearly state on their CDP hearing request the resolution they are seeking, *e.g.*, an installment agreement. When issues raised are unambiguous and routine, Collection employees can explain the requirements to the taxpayer and address such issues more quickly than if the taxpayers are required to go through the formal appeals process only to end up with the same result.

By retaining the case in Collection after a CDP hearing request is received and continuing to work with the taxpayer in reaching a mutually agreeable resolution, we are also following the CDP regulations:⁶⁴

Q-C9. Can taxpayers attempt to resolve the matter of the proposed levy with an officer or employee of the IRS office collecting the tax liability stated on the CDP Notice either before or after requesting a CDP hearing?

A-C9. Yes. Taxpayers are encouraged to discuss their concerns with the IRS office collecting the tax, either before or after they request a CDP hearing. If such a discussion occurs before a request is made for a CDP hearing, the matter may be resolved without the need for Appeals consideration. However, these discussions do not suspend the running of the 30-day period within which the taxpayer is required to request a CDP hearing, nor do they extend that 30-day period. *If discussions occur after the request for a CDP hearing is filed and the taxpayer resolves the matter with the IRS office collecting the tax, the taxpayer may withdraw in writing the request that a CDP hearing be conducted by Appeals.*

When a mutually agreed upon resolution of the issue is reached, we advise the taxpayer of the option to voluntarily withdraw the CDP hearing request and explain the effect of the withdrawal.⁶⁵ If the issue is satisfactorily resolved, the taxpayer often no longer wants a hearing with Appeals. The taxpayer's right to withdraw the hearing allows the taxpayer to waive the hearing with Appeals. If the taxpayer does not withdraw the hearing request, the request is sent to Appeals for the hearing.⁶⁶

The withdrawal of the CDP hearing request must be in writing. Form 12256, *Withdrawal of Request for Collection Due Process or Equivalent Hearing*, is provided to the taxpayer to

⁶³ IRM 5.1.9.3.3(3). "If the taxpayer presents new information or requests collection alternatives not previously considered and if the taxpayer is willing, the RO should work with the taxpayer to see if the issue can be resolved. If the case can be resolved prior to Appeals consideration, it expedites the process for the taxpayer."

⁶⁴ Treas. Reg. § 301.6330-1(c)(2) Q & A-C9.

⁶⁵ IRM 5.1.9.3.3.1(1). "A taxpayer that reaches a satisfactory resolution with Collection after filing a request for a CDP hearing can withdraw the request for a CDP hearing. When resolution is reached, explain to the taxpayer the option to withdraw the request for a CDP hearing and the effect of doing so, *i.e.*, the taxpayer will lose CDP rights with respect to the CDP tax periods and proposed collection action, including the right to judicial review. The decision to withdraw belongs to the taxpayer. A taxpayer can also withdraw the request for hearing with Appeals."

⁶⁶ IRM 5.1.9.3.3.1(2). "If a withdrawal is not secured, the timely CDP hearing request must be sent to Appeals even if the account is otherwise resolved."

use to withdraw the hearing request.⁶⁷ This form clearly explains to the taxpayer the effect of the withdrawal. It states that by withdrawing the hearing request, the taxpayer gives up the right to a hearing with Appeals and gives up the right to judicial review of the Appeals determination. It also specifies that the taxpayer does not give up other appeal rights such as the right to appeal the proposed termination or default of an installment agreement under the Collection Appeal Program or the right to an equivalent hearing.

This process was created cross-functionally by Appeals, Chief Counsel, SB/SE (Collection) and Wage and Investment, in an effort to allow taxpayers to resolve collection disputes at the earliest possible level and at the lowest cost to both the taxpayer and the government. If at any time the taxpayer expresses a desire to end its negotiations with Collection and go straight to Appeals, Collection expeditiously transfers the case to Appeals.⁶⁸

Resolving the case at the earliest possible level directly benefits the taxpayer whose tax matter is resolved more expeditiously. Taxpayer withdrawals of CDP hearing requests in appropriate, mutually agreeable situations also benefit other taxpayers by freeing Appeals employees to work on truly unresolved cases.

Appeals' Communication and Activity Gap Issues

Appeals continues to experience record receipts with over 49,000 CDP cases received in FY 2010.⁶⁹ This is a 16 percent increase over FY 2009 receipts and a 37 percent increase over FY 2008 totals.⁷⁰

To meet the challenges associated with dramatic increases in receipts, Appeals did undertake additional hiring, bringing on approximately 200 new settlement officers over the last two years. This represents roughly 35 percent of all settlement officers. Appeals has been ensuring the new workforce receives the required training and transition to the organization, which also requires a significant resource investment from the experienced settlement officers.

The overall workforce investment will position Appeals to handle the increases in case receipts and provide improved customer service. In fact, we believe we're already seeing some positive trends. While our CDP receipts and inventory increased in FY 2010, average hours per resolution decreased, and closed non-docketed cycle time improved.

The FY 2009 AQMS and customer satisfaction scores reflect the:

- Dramatic increase in Collection-sourced receipts;

⁶⁷ IRM 5.1.9.3.3.1(2). "Form 12256, *Withdrawal of Request for Collection Due Process or Equivalent Hearing, Under Section 6320 and/or 6330* is available to taxpayers to use for withdrawing the CDP hearing request."

⁶⁸ IRM 5.1.9.3.3.

⁶⁹ IRS Data Book FY 2010.

⁷⁰ IRS Data Book - 2009 49; IRS Data Book - 2008 49.

- Significant number of new settlement officers hired to address the receipts; and
- Training and orientation investment by many experienced Appeals employees.

Appeals agrees there are improvement opportunities in key AQMS and customer satisfaction survey elements. For example, the IRM requirement to document in the case activity record that applicable laws and administrative procedures were met in CDP cases is relatively new⁷¹ and reinforces the longstanding requirement to document the same in the Appeals Case Memorandum,⁷² for which AQMS score were 99 percent in FY 2009 and 95.4 percent in FY 2010.⁷³

Appeals continues to monitor workload levels to ensure taxpayers are provided the opportunity to have a fair and timely hearing in Appeals.

Opportunities to Choose Preferred Hearing

The National Taxpayer Advocate states that Appeals provides taxpayers with “limited opportunities” to choose the type of hearing they prefer and cites FY 2009 customer satisfaction survey scores to conclude “taxpayers who receive field CDP hearings prefer them” over CDP hearings heard by campus Appeals employees. This statement is misleading because the percentages cited were for overall customer satisfaction and not about whether the taxpayers responding to the survey preferred a field settlement officer over a campus settlement officer.

Meeting the needs of taxpayers is something Appeals takes very seriously and we respectfully disagree with the National Taxpayer Advocate about funneling taxpayers into any type of hearing they do not want. Appeals transfers several thousand CDP cases annually for a variety of reasons rooted in providing the best service possible and this most definitely includes honoring requests or needs for face-to-face hearings. TIGTA included the following statement in its latest report: “Due to our prior recommendation and Appeals management’s corrective actions, these taxpayers’ right of requesting a face-to-face hearing was protected.”⁷⁴

⁷¹ The requirement to document in the case activity record verification that all applicable laws and administrative procedures were followed first appeared in the October 2007 revision of IRM 8.22.2.2.4.7. The AQMS score for FY 2008 (first year) was 35.3 percent, so although 57.1 percent is low, it nonetheless represents a significant increase that is expected to improve again in FY 2010.

⁷² Original guidance was placed in IRM 8.7.2 in November of 2001 and later moved in October of 2007 to IRM 8.22.2. The Nov. 2001 revision of IRM 8.7.2.3 (15) and all subsequent revisions read: The Appeals employee must consider in the hearing and address in the determination letter/Appeals Case Memorandum (ACM) the following “Big Three” areas:

1. Verification from the Service that the requirements of any applicable law or administrative procedure have been met.

⁷³ *AQMS Reviewer Collection Check Sheet*, Reason Code 4.C.4 requires the Appeals Case Memorandum to address “the three required elements of IRC 6330(c)(3).”

IRC § 6330(c)(1) REQUIREMENT OF INVESTIGATION—The appeals officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedures have been met.

IRC § 6330(c)(3) BASIS FOR DETERMINATION—The determination by an appeals officer under this subsection shall take into consideration—

(A) the verification presented under paragraph (1).

⁷⁴ TIGTA, Ref. No. 2010-10-021, *Appeals Has Made Considerable Progress in Its Campus Centralization Efforts, but Some Opportunities Exist for Improvement* (Feb. 19, 2010).

The Appeals Team Manager issues a letter to the taxpayer acknowledging receipt of their request for a CDP hearing.⁷⁵ The letter includes the following statement regarding the hearing:

If...you would prefer your conference to be held by face-to face conference at the Appeals office closest to your current residence, the school you attend or your place of employment or if you are a business, your business address, or by correspondence, please let me know within fourteen (14) days from the date of this letter. I will discuss with you if there are any offices that may be more convenient for you (e.g., Appeals office nearest place of employment or school) when you contact me.

In most cases, the settlement officer assigned to the case then issues a second “substantive contact” letter⁷⁶ to the taxpayer that includes the same language identified above.

Appeals also recently revised its guidance on circuit riding to make access to face-to-face hearings more convenient for more taxpayers.⁷⁷ This includes circuit riding “at least quarterly to meet the needs of each and every taxpayer.”

In the report of the National Taxpayer Advocate there are five recommendations. We are taking or have taken the following actions with respect to these issues:

Personal contact is an important tool for helping taxpayers return to compliance. In striving to contact the greatest number of taxpayers as early as possible in the collection process, we consider the entire collection system, including our notice process and our campus operations. We have designed our treatments to direct as many taxpayers as possible to the least invasive and least burdensome option possible. We believe that a balance between prompt attention and appropriate treatment streams will ultimately secure payment of as much of the delinquent tax as possible.

The IRS uses several resources to ensure our records reflect a taxpayer’s most current address.⁷⁸ In any instance, the IRS issues a final notice of intent to levy and notice of a right to a CDP hearing before taking enforcement action. The notice must be given to the taxpayer, left at the residence or place of business, or sent by certified mail. Further, annual TIGTA reviews have consistently verified IRS compliance with lien notice requirements. Therefore, we believe existing IRS policy and guidance properly address the need to ensure contact with a taxpayer has been attempted prior to filing an NFTL or issuing a levy.

When a taxpayer is willing to work with ACS Support (ACSS), and ultimately agrees to a resolution that is satisfactory to him or her, only then will ACSS ask if they wish to

⁷⁵ IRM 1.4.28.3.1.

⁷⁶ IRM 8.22.2.2.6.

⁷⁷ IRM 8.6.1.3.1.1 (June 8, 2010).

⁷⁸ We utilize National Change of Address files from the United States Postal Service; the Address Research system; additional locator services or phone calls when notices are returned as undeliverable.

withdraw their CDP hearing request. ACSS does not withdraw CDP hearing requests on its own without the formal written request of the taxpayer. The taxpayer submits a Form 12256 to accomplish this. By submitting this form, the taxpayer is explicitly stating that a satisfactory resolution has been reached and understands the implications of the withdrawal. The taxpayer does not have to submit the withdrawal and they often do not. In these instances, the resolved case is forwarded by ACSS to Appeals. This process encourages the quickest resolution of taxpayers' problems at the lowest level. However, we will revise the ACSS CDP IRM 5.19.8.4.7.5(12), and any related correspondence, to clarify that the withdrawal is not required for the offer in compromise request or Innocent Spouse (IS) claim to go forward.

The ACS customer satisfaction survey is designed to be conducted for ACS call sites during phone calls. Before a phone conversation ends, randomly selected taxpayers are asked if they would like to take the survey. If they agree, they are transferred to an IRS Quality Unit that collects data then to a vendor system that administers the survey questions. This is all handled electronically through the call site telephone system.

ACS Support is an operation that supports the ACS call sites by processing paper documents generated as a consequence of an action by the call site, or responding to correspondence from taxpayers prompted as a result of contact with an ACS call site. The two operations are linked closely and most taxpayers may not know that they are dealing with ACS Support as opposed to an ACS call site. The distinction between the two functions is not to such an extent that a taxpayer would be able to complete a survey regarding ACS Support as a distinct function; therefore, there is no separate survey for ACS Support.

We will look for other ways to gather information that may reflect or impact satisfaction of the taxpayers that directly interact with ACS Support such as determining if additional data can be extracted from our quality systems and monitoring the results of local site CDP quality reviews.

Appeals offers taxpayers multiple opportunities to select their preferred type of hearing. Acknowledgement and substantive contact letters both specifically offer taxpayers the opportunity for a face-to-face hearing and administrative procedures applicable to both campus and field personnel are already in place to ensure taxpayers receive meaningful hearings in whatever manner the taxpayer chooses.

Appeals ensures the IRS has complied with all legal and administrative procedures and has documented such in its formal case memorandums at a rate of 99 percent in two of the past three fiscal years. Appeals employees are now also documenting this in their case activity records to comply with more recent IRM requirements.

Conclusion

We appreciate the feedback from the National Taxpayer Advocate on this important collection process just as we do from all stakeholders. The IRS remains committed to providing America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all. This includes enforcing the law to ensure everyone meets their obligation to pay their taxes. For taxpayers who have balance due accounts, IRS works directly with the taxpayer towards a mutually agreeable resolution which takes into consideration the taxpayers' facts and circumstances. We work hard to incorporate taxpayer perspective, expedite resolution of taxpayer issues and provide timely guidance to help all taxpayers pay their fair share of taxes. We are equally dedicated to ensuring that our employees receive the best training and technology to meet those needs. We continually strive to maintain the fairest and most effective system of voluntary compliance in the world.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees that the IRS should use its discretion and take collection actions based on the most accurate information available. However, the National Taxpayer Advocate finds it deeply ironic that the IRS justifies its decision to allow taxpayers to bargain away their CDP hearing rights on the grounds that it leads to early case resolution, even as Appeals complains of its dramatically increasing CDP caseload – which arises from the IRS's failure to make early meaningful contact (and resolution) with the taxpayer before issuing the CDP notice. The IRS's inability to see the connection between these two conditions – and Appeals' acquiescence – is at the heart of all that is wrong with the IRS's administration of CDP hearings.

The IRS's Reliance on Its Systems to Issue CDP Notices Without Discretion or Adequate Information Harms and Frustrates Taxpayers Willing to Work with the IRS.

The National Taxpayer Advocate acknowledges that Collection employees receive training and the IRS has procedures to determine whether to take specific collection actions. However, she questions whether these procedures can be followed when the IRS generates CDP notices and NFTLs by computer before the case reaches a Collection employee (*i.e.*, has anyone made an outbound call to the taxpayer? Who makes the lien determination? Who determines the levy source? Who determines if the taxpayer can pay?). TAS reviewed FY 2009 cases and found the IRS issued proposed levy or lien filing notices on 11 percent of taxpayers' tax year modules before their cases were ever assigned to Collection.⁷⁹

The IRS cites a TIGTA report to support its efforts to protect taxpayer rights. However, the report measures only whether the IRS complied with the minimum required actions – *i.e.*, providing CDP rights to taxpayers at least 30 days before the IRS levied.⁸⁰ TIGTA did not evaluate whether the IRS used its discretion properly or whether issuing a CDP notice to an economically-disadvantaged taxpayer increased compliance. Further, in a later report, TIGTA found the IRS did not update its records when CDP lien notices were returned undeliverable, and that in 84 percent of these cases the IRS did not follow procedures to research where to send a returned notice.⁸¹ The National Taxpayer Advocate urges the IRS to change its practices by requiring telephone or in-person contact and having employees review taxpayers' accounts before filing NFTLs or proposing levies in every case.⁸²

⁷⁹ See Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*, *supra*. IRS, CDW, Integrated Data Retrieval System (IDRS), analysis of IDRS transaction code (TC) 971, action codes (ACs) 69 (for levy Collection Due Process (CDP) notices) and 252 (for lien CDP notices) for status 22, ACS, and status 26, CF, cases for FY 2009. Further, 24 percent of the modules were not in Collection before issuance of CDP lien notices, and almost ten percent of the modules were not in Collection before the issuance of a CDP levy notice. Of those modules not in Collection, 28 percent of modules were in the queue on or before a CDP levy notice was issued and 47 percent of modules were in the queue on or before a CDP lien notice was issued.

⁸⁰ TIGTA, Ref. No. 2010-30-068, *Fiscal Year 2010 Statutory Review of Compliance with Legal Guidelines When Issuing Levies* (June 15, 2010).

⁸¹ TIGTA, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* 7, 9 (July 9, 2010). Additionally, TIGTA found the IRS did not notify taxpayers' representatives of taxpayers' CDP lien appeal rights in 26 percent of the cases it reviewed. *Id.* at 6. See Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*, *infra*.

⁸² See *The IRS Collection Strategy Is Failing to Meet Key Objectives of the IRS Mission*, vol. 2, *infra*.

The IRS Requires Taxpayers to Waive Their CDP Rights to Quickly Resolve Their Accounts.

The National Taxpayer Advocate is pleased that ACS will revise its procedures to clarify that withdrawal of a CDP request will not be required when taxpayers are seeking relief in the form of an offer in compromise or innocent spouse relief. However, she disagrees with ACS's overall policy of soliciting withdrawals of CDP requests despite reaching resolutions with taxpayers.⁸³ Taxpayers may not understand the significance of waiving their hearing rights and may feel pressure from ACS employees to withdraw.

The CDP hearing process not only provides due process protections to individual taxpayers but also ensures that Collection as a whole functions appropriately. CDP accomplishes this goal by, among other things, requiring settlement officers to verify that the requirements of any applicable law or administrative procedures have been met, to consider the issues raised by taxpayers, and most importantly, to balance the need for the efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.⁸⁴ In conducting this review, Appeals serves as a check on potential excesses by the Collection function. Therefore, Appeals should fulfill these statutory requirements in every CDP hearing, regardless of the administrative level at which an agreement regarding collection was reached.

The National Taxpayer Advocate acknowledges that reliance on IRS Collection to receive and work CDP requests was necessary when RRA 98 created CDP, because Appeals' workload at that time primarily concerned audit issues. However, now that Appeals has had an opportunity to handle thousands of collection cases, the IRS should redesign the process to deliver CDP requests directly to Appeals and provide one-stop service for taxpayers. Where IRS Collection does not have the opportunity to speak with a taxpayer, Appeals can "send" the case back to Collection. Once it reaches a resolution with the taxpayer, the IRS would send the case back to Appeals, which would review the proposed resolution in light of the statutory balancing test and determine whether the IRS had followed all applicable laws and procedures. Appeals would then issue a determination.⁸⁵ However, if a taxpayer raises liability issues, before addressing collection alternatives Appeals should decide whether to suspend the case and send the issue to audit reconsideration (or for amended return processing), or retain the case because liability may be considered during the CDP process, or possibly for Tax Court review.⁸⁶ The National Taxpayer Advocate recommends that the IRS revise the CDP process to eliminate the need for withdrawals and provide one-stop service to taxpayers.

⁸³ In its response, the IRS acknowledges that TAS – the statutory voice of the taxpayer inside the IRS – was absent from the discussion leading to the policy of CDP withdrawals.

⁸⁴ IRC §§ 6330(c)(1), (c)(2), and (c)(3).

⁸⁵ Appeals issues Form 12257, *Summary Notice of Determination, Waiver of Right to Judicial Review of a Collection Due Process Determination, and Waiver of Suspension of Levy Action*, to close agreed cases.

⁸⁶ IRC § 6330(c)(2)(B); Treas. Reg. §§ 301.6320-1(e)(3) Q&A-E11 & 301.6330-1(e)(3) Q&A-E11.

Appeals Favors Form Over Substance When Documenting Whether Applicable Law and Procedures Are Followed in CDP Cases.

Appeals claims its quality rating for verification that applicable law and procedures are being followed was 99 percent in FY 2009 and 95.4 percent in FY 2010. However, TAS has reviewed the AQMS reviewer's guide and determined that Appeals is referring to an attribute concerning whether the Appeals Case Memorandum (ACM) "discusses" whether the requirements of any applicable law or administrative procedure were met.⁸⁷ The rating for whether hearing officers appropriately documented their review of whether these requirements were met was 57.1 percent in FY 2009 and 66.9 percent in FY 2010.⁸⁸ The National Taxpayer Advocate agrees that there are improvement opportunities in the AQMS, but believes Appeals should start by acknowledging that the documentation of its reviews in CDP cases may be insufficient.

Appeals Is Reluctant to Study Taxpayer Satisfaction to Determine if Taxpayers Prefer Local or Face-to-Face Hearings.

The National Taxpayer Advocate disagrees that the statement regarding the customer satisfaction survey results of campus and field Appeals is misleading. Of the taxpayers taking the survey, 73 percent of those who received a field appeal were satisfied; 62 percent of those who received a campus appeal were satisfied. A reasonable inference from this significant difference is that the location of the hearing has a major impact on taxpayers' satisfaction. The National Taxpayer Advocate recommends that Appeals just ask taxpayers what type of hearings they want, and whether they prefer campus or field appeals, in the

⁸⁷ Appeals, AQMS, *Reviewer's Guide for Collection Cases 71* (Dec. 31, 2008). Reason Code 4.C.4 applies to CDP cases in which one or more of the required elements of IRC § 6330(c)(3) were not "discussed" in the ACM. Discussion typically involves a statement that the requirements of applicable law and procedure were met in the case. The overall scores for Reason Code 4.C. (ACM narrative adequate) were 70.9 percent for FY 2009 and 68.2 percent for FY 2010. Appeals, AQMS, *All Areas Results Report for FY 2010 8* (Nov. 17, 2010).

⁸⁸ Appeals, AQMS, *All Areas Results Report for FY 2010 10* (Nov. 17, 2010). "Even if the Collection Specialist previously reviewed and documented verification of legal and administrative requirements; the hearing officer must document their review independent of the Collection Specialist." Appeals, AQMS, *Reviewer's Guide for Collection Cases 125-26* (Dec. 31, 2008).

hearing request.⁸⁹ Further, Appeals should track CDP sustention rates and default rates for campus and field CDP hearings. The National Taxpayer Advocate believes this information will help Appeals make an informed decision about staffing and handling of CDP cases.

ACS Support Can Track Taxpayer Satisfaction for CDP Cases it Handles.

The National Taxpayer Advocate is disappointed that ACS is unable to separate its customer satisfaction survey results for the CDP cases it handles.⁹⁰ She recommends that the IRS and Appeals address ACSS handling of CDP cases in the Appeals customer satisfaction survey.

⁸⁹ Evidence of the negative impact Appeals' dogged refusal to offer face-to-face hearings can have on taxpayer satisfaction recently surfaced on the American Bar Association's (ABA's) Low Income Taxpayer Clinic (LITC) listserv:

I just finished a very frustrating phone call with appeals. In the past, when we have requested a face-to-face CDP hearing, we have had to insist very strongly on a face-to-face hearing. The IRS does not like to grant these requests, even though CFR 301.6330 provides for face-to-face hearings. They have given me all kinds of reasons to try to schedule telephone hearings. However, I have never had them outright refuse to give me a face-to-face hearing or to require prerequisites.

Appeals told me today that they are not allowed, under any circumstances, to forward a CDP case that involves collection alternatives for a face-to-face hearing without having all relevant information about the collection alternative in hand (in my case, an OIC). They told me they are not allowed to give me more than 10 days (!) to get them a 433-A, 656, and all supporting documentation information for an OIC. The appeals officer and manager I spoke to referenced this memo when pressed for a policy number:

<http://www.irs.gov/pub/irs-utl/ap-08-1010-06.pdf>

It outlines a policy with a lot of loopholes:

Background: Appeals ordinarily grants a request for a face-to-face CDP conference if the taxpayer wishes to discuss any relevant, nonfrivolous issue. Except in certain circumstances, Appeals may require a Collection Information Statement as a condition to granting a face-to-face conference if the sole purpose of the conference is to discuss a collection alternative which requires a Collection Information Statement. The Collection Information Statement needs to be completed in sufficient detail to enable Appeals to productively discuss the viability of the proposed collection alternative. Appeals must consider a number of factors before denying a face-to-face conference.

In my case, an OIC is not the sole purpose of the hearing. However, appeals said that it did not matter- this is their policy in all collection alternative cases. They disregarded the language in the memo.

In the past, when an OIC was involved, we presented the OIC at the hearing. My understanding is that the appeals officer then makes a preliminary determination and the OIC goes to the OIC unit mainly for that unit to verify asset and income information. It then comes back to appeals and the hearing officer makes a final determination.

Now, the officer and manager I talked to told me that they are sending everything to the OIC unit first. When that unit is done with a case, they will issue a preliminary determination. The case will then go to local appeals. If any new information is presented at the face-to-face hearing, the case has to go back to the OIC unit, then back to local appeals. It sounds like this will take forever.

I don't think this particular office's interpretation of the IRS memo is correct. Is this a rogue office or are other people seeing this?

In response to this posting, another LITC Director posted the following:

Yes this is their new posture and I believe it is contrary to the regulation or at least overreaching. If I were you and you cannot get a Form 433-A prepared in time, write a detailed letter explaining why so you have it in the record, then appeal the notice of determination for abuse of discretion.

E-mail posting to the ABA's LITC listserv, Dec. 20, 2010 (on file with National Taxpayer Advocate).

⁹⁰ The IRS response states that the distinction between the ACS and the ACSS functions "is not to such an extent that a taxpayer would be able to complete a survey regarding ACS Support as a distinct function; therefore, there is no separate survey for ACS Support." However, W&I already completed a survey for its ACSS functions at the Fresno and Kansas City campuses. See IRS, *ACS Correspondence Support Customer Satisfaction Survey National Report, October - December 2009* 4 (Mar. 2010). While SB/SE may not complete a survey for its ACSS function, the National Taxpayer Advocate believes SB/SE and W&I should work with Appeals to obtain survey data from a pool of taxpayers after ACSS transfers its CDP cases to Appeals.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. The IRS should require substantial efforts at telephone or in-person contacts before proposing levies or filing liens, to identify taxpayers who are able to pay;
2. 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 taxpayers' rights to review of collection actions and the balancing provided under the law;
3. ACSS should obtain customer satisfaction survey data for the CDP cases it works by partnering with Appeals to add questions regarding ACSS services to the Appeals customer satisfaction survey;
4. Appeals should revise its notices and procedures to clearly inform taxpayers about the types and alternative location of hearings, including Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, to allow taxpayers to select their preferred type of hearing; and
5. Appeals should track field and campus CDP sustention and taxpayer default rates following CDP determinations.

MSP
#10**Third-Party Reporting of Cancellation-of-Debt Events is
Not Always Accurate, and the IRS's Reliance on Such Reporting
May Burden Taxpayers****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

A taxpayer whose debt is canceled must generally include the amount canceled in his or her income when filing a tax return, while a creditor that cancels a debt is generally required to report that amount to the IRS on Form 1099-C, *Cancellation of Debt*.¹ Creditors issued Forms 1099-C to approximately two million taxpayers for 2008, almost half of whom were low income.² The canceled debt was more likely to be credit card debt than any other kind, and was usually for less than \$10,000.³

The IRS uses the information on Form 1099-C to determine whether a debtor had cancellation of debt income, but Form 1099-C differs from other types of third-party reporting in ways that make it unreliable by comparison. For example:

- Because creditors may issue a Form 1099-C independently of whether they are canceling a debt, creditors may continue to collect the debt from the taxpayer even as the IRS is collecting tax from the taxpayer for cancellation of that debt.
- Creditors may threaten to “sic the U.S. government” on a debtor by issuing a Form 1099-C as a means of pressuring a debtor to pay.
- Creditors often make errors in preparing Forms 1099-C, and debtors are rarely able to obtain a correction.
- IRS automated systems do not identify taxpayers who receive a Form 1099-C but do not owe additional tax because they are insolvent. Taxpayers are burdened by IRS contact, and they may also unnecessarily lose significant earned income tax credits.

These problems are impacting significantly more taxpayers as a result of current economic conditions. Creditors went from writing off four percent of the dollars they loaned for

¹ Internal Revenue Code (IRC) §§ 61(a)(12), 6050P(a). Treas. Reg. §1.6050P-1(a) requires creditors that discharge an indebtedness of at least \$600 during any calendar year to file a Form 1099-C information return with the IRS. The National Taxpayer Advocate twice identified cancellation of debt as a serious problem faced by taxpayers (National Taxpayer Advocate 2007 Annual Report to Congress 13; National Taxpayer Advocate 2008 Annual Report to Congress 39), and recommended simplifying the tax treatment of cancellation of debt income (National Taxpayer Advocate 2008 Annual Report to Congress 391).

² Creditors issued Forms 1099-C to 1,938,520 taxpayers for tax year 2008. IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax Year 2008); out of 380 taxpayers in a TAS sample, 180 taxpayers, or 47 percent, were low income. See analysis of TAS Form 1099-C sample, discussed *infra* note 23.

³ Analysis of TAS Form 1099-C sample, discussed *infra*; IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax year 2008).

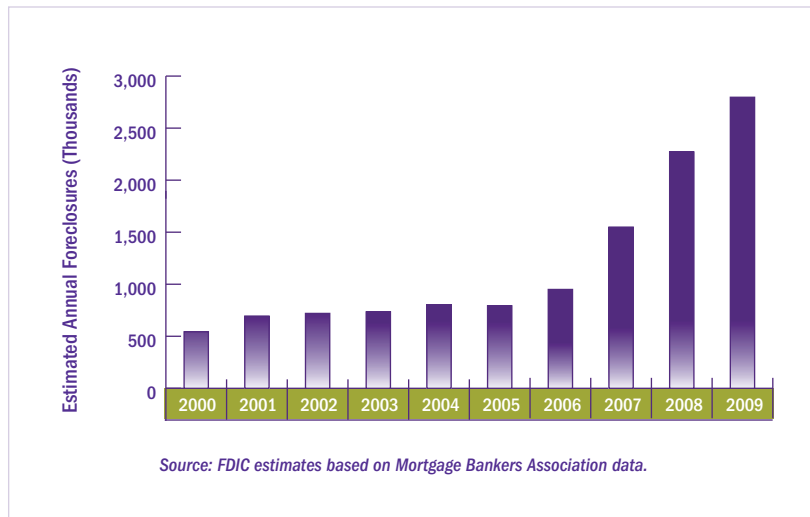
credit card debt in the first quarter of 2007 to nearly 11 percent in the second quarter of 2010.⁴

ANALYSIS OF PROBLEM

Background

According to the Federal Deposit Insurance Corporation (FDIC), home foreclosures soared from 780,000 in 2005 to about three million in 2009.⁵ Figure 1.10.1 depicts the trend in foreclosures over the past ten years.

FIGURE 1.10.1, Estimated Home Foreclosures, 2000 - 2009⁶



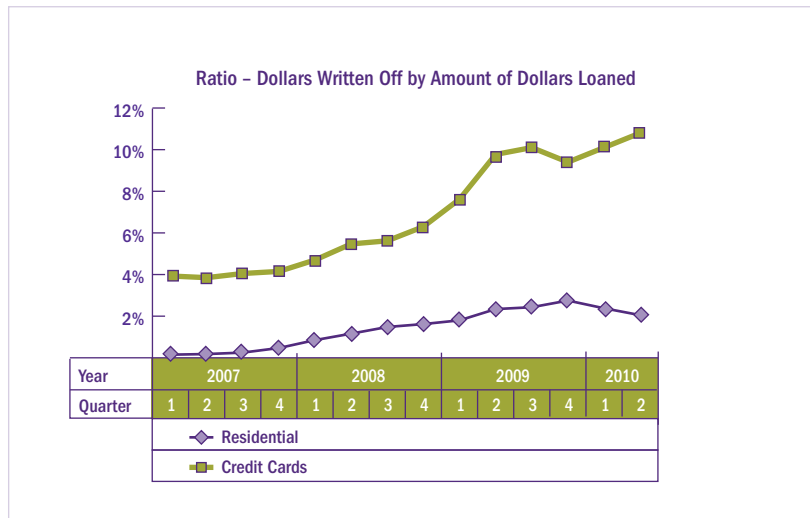
As Figure 1.10.2 (below) shows, the rate of credit card write-offs, historically already larger than home mortgage loan write-offs, rose even more precipitously than mortgage write-offs in 2009 and continued at historic levels in 2010.

⁴ Federal Reserve Statistical Release, *Charge-off Rates on Loans and Leases at Commercial Banks* (Not Seasonally Adjusted), available at <http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm> (last visited Oct. 7, 2010).

⁵ FDIC, *Measuring Progress in U.S. Housing and Mortgage Markets*, available at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_1/latest.html.

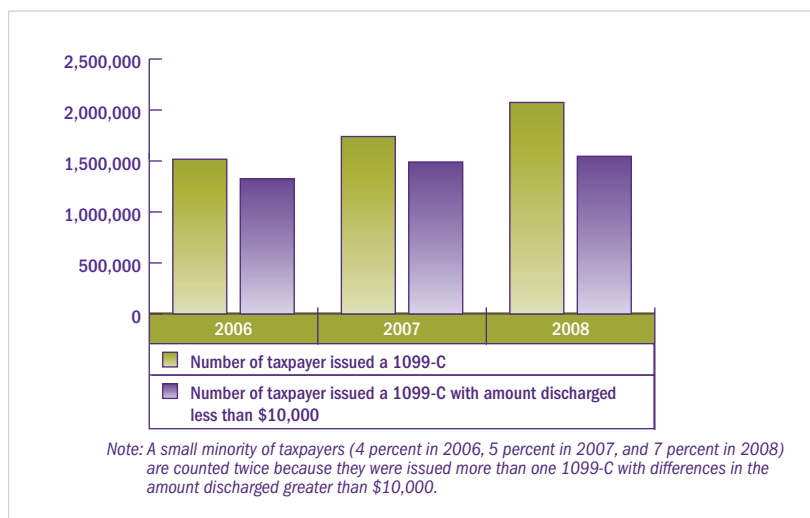
⁶ *Id.* at Table 9.

FIGURE 1.10.2, Proportion of Residential Real Estate and Consumer Loans Written Off⁷



To report debtors' potential income from cancellation of debt, creditors issued Forms 1099-C to a record number of taxpayers for 2008. As Figure 1.10.3 illustrates, most taxpayers' debts were less than \$10,000.

FIGURE 1.10.3, Taxpayers Issued Form 1099-C⁸

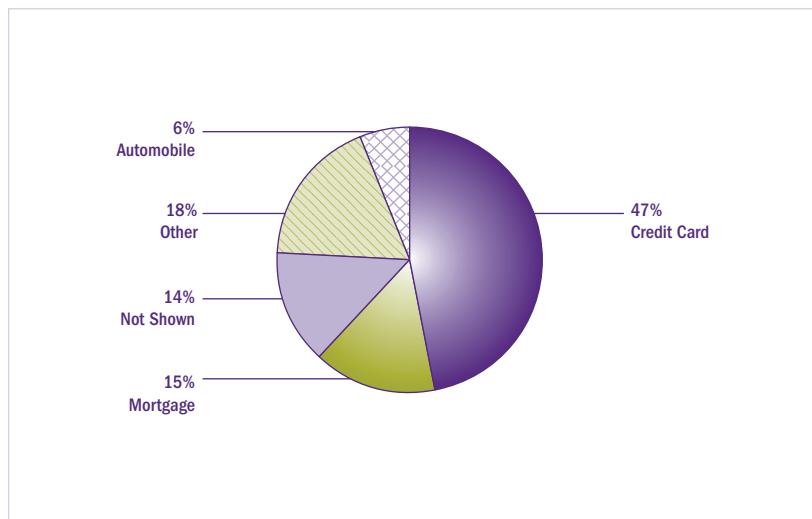


⁷ Federal Reserve Statistical Release, *Charge-off Rates on Loans and Leases at Commercial Banks (Not Seasonally Adjusted)*, available at <http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm> (last visited June 18, 2010). Credit cards are consumer loans. Creditors write off loans (i.e., treat them as an expense in their accounting records) because they do not expect to collect them.

⁸ IRS Compliance Data Warehouse, *Individual Returns Master File (Tax years 2006, 2007, and 2008)*.

Of the nearly two million Forms 1099-C issued for 2008, TAS analyzed a random sample of 424 forms issued to 380 taxpayers (the TAS Form 1099-C sample). As Figure 1.10.4 shows, more Forms 1099-C were issued for credit card debt than for any other category.

FIGURE 1.10.4, 2008 Forms 1099-C Sources of Debt⁹



A Creditor that Issues a Form 1099-C Is Not Necessarily Canceling a Debt, Yet the IRS Assumes that Form 1099-C Reflects Taxable Income to the Debtor.

Although Box 2 of Form 1099-C is captioned “Amount of Debt Canceled,” Treasury regulations require creditors to issue a Form 1099-C upon the occurrence of an “identifiable event” as defined in the regulation, “whether or not an actual discharge of indebtedness has occurred.”¹⁰ Of the eight identifiable events, seven describe circumstances in which the creditor cannot, or clearly intends not to, collect the debt.¹¹ However, the simple passage of time (generally 36 months) with no payment from the debtor may also be an identifiable event that triggers the creditor’s reporting obligation.¹²

⁹ TAS Research, Form 1099-C sample. Credit card (95 percent confidence = 0.42 - 0.52); Other (95 percent confidence = 0.14 - 0.22); Mortgage (95 percent confidence = 0.12 - 0.18); Not shown (95 percent confidence = 0.11 - 0.17); Automobile (95 percent confidence = 0.04 - 0.08).

¹⁰ Treas. Reg. § 1.6050P-1(a)(1).

¹¹ These seven identifiable events are: (1) a discharge in bankruptcy; (2) cancellation in the context of asset transfers in corporate reorganizations pursuant to bankruptcy; (3) expiration of the statute of limitations if the debtor’s affirmative statute of limitations defense is upheld in a final judgment or decision of a judicial proceeding, and the period for appealing the judgment or decision has expired; (4) cancellation pursuant to an election of foreclosure remedies that statutorily extinguishes or bars the creditor’s right to pursue collection of the indebtedness; (5) cancellation that renders a debt unenforceable pursuant to a probate or similar proceeding; (6) discharge pursuant to an agreement between the creditor and the debtor; or (7) discharge pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge the debt. Treas. Reg. § 1.6050P-1(b)(2)(i)(A)-(G).

¹² Treas. Reg. § 1.6050P-1(b)(2)(i)(H). Treas. Reg. § 1.6050P-1(b)(2)(iv) defines a “testing period,” generally 36 months, and provides that if the testing period expires without payment by the debtor, a presumption arises that an identifiable event has occurred. The presumption may be rebutted by the creditor as described in the regulation (i.e., a creditor that does not issue a Form 1099-C may rebut the presumption that an identifiable event occurred, thereby justifying the failure to report). See Legislative Recommendation: *Remove the 36-Month “Testing Period” Reporting, infra.*

The IRS can recognize from Form 1099-C neither the identifiable event that triggered its issuance, nor whether the creditor is actually canceling a debt. Nevertheless, if the taxpayer does not report the canceled debt on a return, he or she may receive a Notice CP 2000, *Notice Proposing Adjustments to Income, Payments, or Credits*, which is the IRS's first step toward assessing the tax.¹³ Moreover, because Form 1099-C is issued independently of whether a debt has actually been discharged, *a creditor may attempt to collect a debt even after issuing a Form 1099-C*. This may place the taxpayer in the position of being told by the creditor to pay the debt while simultaneously being told by the IRS to pay tax on the income from cancellation of the debt. Worse still, a creditor may threaten to issue Form 1099-C as a means of coercing a debtor to pay, because “there’s no better dog to sic on a debtor than the U.S. government.”¹⁴

Creditors Often Prepare Form 1099-C Improperly, and It Is Difficult for Taxpayers to Correct.

Form 1099-C contains a field for the creditor to report the “fair market value of property,” which is particularly relevant in real estate foreclosures.¹⁵ The amount of canceled debt, which the debtor is expected to report as income, should be reduced by the fair market value of the property taken (*i.e.*, the amount of debt canceled is the amount owed less the fair market value of property applied toward satisfaction of the debt). More than 20 percent of the 2008 Forms 1099-C in the TAS Form 1099-C sample were issued for real estate or automobile debt, so we would expect to see a fair market value reported for this underlying property.¹⁶ However, creditors almost always report the fair market value of property as zero.¹⁷

Another difficulty taxpayers encounter is that they may never receive the Form 1099-C because the address on the form is no longer current. In the TAS Form 1099-C sample, more than 40 percent of 2008 forms showed an address for the debtor different from the one on the debtor’s 2008 tax return.¹⁸

¹³ See National Taxpayer Advocate 2008 Annual Report to Congress 47 for a description of the IRS’s Automated Underreporter (AUR) program, which matches a Form 1099-C against the taxpayer’s return. See also IRM 4.19.3.7.19.1 (Oct. 15, 2008).

¹⁴ Jacob Barron, *Leveraging Uncle Sam, Getting the Threat of the IRS Behind Your Collection Effort*, National Association of Credit Management, *Business Credit*, June 2008. For consumer views pertaining to unfair debt collection practices involving Form 1099-C, see Debt Consolidation Care Forum, *available at* <http://www.debtconsolidationcare.com/collection-agencies/latest-scam-2.html>. *McCormick v. Comm’r*, T.C. Memo. 2009-239, illustrates another incorrect use of Form 1099-C. In *McCormick*, there was no discharge of indebtedness at all, but rather settlement of a disputed amount. However, the creditor issued a Form 1099-C, and on that basis alone the IRS asserted that the taxpayer had cancellation of debt income and determined a deficiency. The taxpayer ultimately prevailed.

¹⁵ See *Instructions to Form 1099-C*, which reference “gross foreclosure bid price” or “appraised value” in cases of abandonment or “conveyance to the lender in lieu of foreclosure.”

¹⁶ As shown in Figure xx.xx.xx, *supra*, 15 percent of the Forms 1099-C were for mortgage debt and six percent were for automobile loans. Moreover, as Figure xx.xx.xx, *supra*, indicates, in 2008, between one and two percent of every dollar loaned for residential real estate loans was written off.

¹⁷ Of the 1,938,520 taxpayers that were issued a Form 1099-C in 2008, 1,752,170, or 90 percent, were issued a Form 1099-C showing zero fair market value of the property. IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax Year 2008). Similarly, in the TAS Form 1099-C sample, of the 380 taxpayers issued a Form 1099-C, 351, or 92 percent were issued a Form 1099-C showing zero for fair market value of the property. (95 percent confidence = 0.89 - 0.95).

¹⁸ In the sample, the “mismatch” occurred in 183 out of 424 Forms 1099-C, for a rate of 43 percent (95 percent confidence = 0.38 - 0.48).

When taxpayers receive a Form 1099-C that contains an error, they may attempt to obtain a corrected form from the creditor. The National Taxpayer Advocate recommended in her 2007 Annual Report to Congress, and the IRS agreed, to revise Form 1099-C to include issuers' phone numbers (in addition to their addresses) to make it easier for the taxpayer to contact the issuer. However, in the TAS 1099-C sample, approximately 13 percent of the Forms 1099-C were issued by creditors that appear to no longer exist.¹⁹

Taxpayers who are issued an inaccurate Form 1099-C may not receive it, may not attempt to ask for a correction, or may not succeed in obtaining a correction. In any event, of the nearly two million Forms 1099-C the IRS received for 2008, only 315 indicated that they were corrected.²⁰

IRS Automated Systems Do Not Recognize when Form 1099-C Does Not Signal Additional Taxable Income Due to Taxpayer Insolvency.

Pursuant to IRC § 108(a)(1)(B), a taxpayer may exclude canceled debt from income if the taxpayer is insolvent when the debt is canceled. The term "insolvent" means the excess of liabilities over the fair market value of assets.²¹ The IRS does not routinely capture information about the level of taxpayers' assets and liabilities, but information reported on taxpayers' returns may signal insolvency. For example, a taxpayer who has income of less than 250 percent of the federal poverty guidelines may also be insolvent.²² In the TAS Form 1099-C sample, 47 percent of taxpayers had adjusted gross income of less than 250 percent of federal poverty guidelines.²³

A taxpayer who does not report cancellation of debt income as shown on the Form 1099-C may receive a Notice CP 2000, the first step toward assessment of the tax.²⁴ The IRS issued 214,858 such notices in 2007 and TAS analyzed a random sample of 316 taxpayers

¹⁹ Issuers of 54 out of the 424 Forms 1099-C in the TAS Form 1099-C sample either did not file separate (unconsolidated) business returns (*i.e.*, income tax returns or employment tax returns) after Dec. 31, 2008, or the employer identification number on the Form 1099-C does not correspond to any entity in IRS records. This yields a rate of 13 percent (95 percent confidence = 0.10 - 0.16).

²⁰ IRS Compliance Data Warehouse, *Individual Returns Master File* (Tax Year 2008).

²¹ IRC § 108(a)(1)(d). The IRS, in collaboration with TAS, developed additional language for inclusion in paragraph 72 of the Notice CP 2000 advising taxpayers of this exclusion. See IRM Exhibit 4.19.3-12 (Sept. 1, 2010).

²² The Department of Health and Human Services issues poverty guidelines each year that are used to determine financial eligibility for certain federal programs, including the low income taxpayer clinic (LITC) program. See Dept. of Health and Human Services, Annual Update of the Poverty Guidelines, 73 Fed. Reg. 4199 (Jan. 23, 2009), *available at* <http://aspe.hhs.gov/poverty/09fedreg.shtml> (extended until at least May 31, 2010). Under the guidelines, the 2009 poverty level for a single person is \$10,830. Pursuant to IRC § 7526(b)(1)(B), taxpayers with income of less than 250 percent of the poverty level are low income taxpayers for purposes of qualifying for LITC assistance. Taxpayers with household income between 100 percent and 400 percent of the poverty line will qualify for tax credits pursuant to the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §1401, 124 Stat. 119, 213 (Mar. 23, 2010).

²³ In the TAS Form 1099-C sample, 180 out of 380 taxpayers had adjusted gross income less than 250 percent of the federal poverty level, for a rate of 47 percent (95 percent confidence = 0.42 - 0.52). An additional 94 of the 380 taxpayers, or 25 percent, had adjusted gross income of less than 400 percent of federal poverty guidelines. This makes a total of 180 + 94 = 274 taxpayers out of 380, or 72 percent, who had adjusted gross income below 400 percent of federal poverty level (95 percent confidence = 0.67 - 0.77).

²⁴ A Notice CP 2000 may also result where there is a mismatch between amounts shown on a taxpayer's return and information on other types of third-party reports (e.g., a Form W-2 reporting wage income, a Form 1099-Div reporting dividend income, and Form 1099-Int reporting interest income). See IRM 4.19.3.1(4), (5), and (11) (Sept. 1, 2010).

to whom they were issued (TAS Notice CP 2000 sample).²⁵ The Notice CP 2000 was issued *solely* on the basis of a Form 1099-C to 71 taxpayers in the Notice CP 2000 sample. Almost all of these 71 taxpayers claimed the Earned Income Tax Credit (EITC)²⁶ and had adjusted gross income of less than 250 percent of federal poverty guidelines.²⁷ However, close to half of the 71 taxpayers did not respond to the Notice CP 2000 or to the ensuing statutory notice of deficiency and additional tax was assessed by default.²⁸ Almost as many of the 71 taxpayers responded by agreeing with the Notice CP 2000 or with a statutory notice of deficiency.²⁹ Both of these measures suggest that taxpayers may not understand that they are not required to include canceled debt in income if they were insolvent when the debt was canceled. IRS initiatives to identify insolvency would benefit these taxpayers, especially because the cancellation of debt income, in addition to increasing adjusted gross income, reduced or eliminated the earned income tax credit that most of these taxpayers claimed. The average amount of lost EITC was \$893 for the 71 taxpayers that were issued a Notice CP 2000 solely because they reportedly had cancellation of debt income.³⁰

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should revise the IRC § 6050P regulations to better align the Form 1099-C reporting requirements with actual cancellation of debt.
2. The IRS should revise Form 1099-C to require the creditor to specify the identifiable event that triggered issuance of the form, to specify the type of debt it was issued for (*e.g.*, real estate, automobile, credit card, or other debt), and to affirmatively state whether a debt was actually canceled.
3. The IRS should adjust its document-matching program (Automated Underreporter) to identify taxpayers who are not required to include in income amounts shown on a Form 1099-C because they are insolvent.

²⁵ The IRS issued 225,189 Notices CP 2000 in 2006, 214,858 in 2007, and 253,095 in 2008. IRS response to TAS research request (June 7, 2010).

²⁶ The EITC is a refundable federal income tax credit for low to moderate income working individuals and families. See IRC § 32. Increases in income, such as from cancellation of debt, decrease the amount of credit allowed. Out of 316 taxpayers in the sample, 282 claimed the EITC for a rate of 89 percent (95 percent confidence = 0.86 - 0.92). Of the 71 taxpayers issued a Notice CP 2000 solely on the basis of the Form 1099-C, 66 taxpayers, or 93 percent (95 percent confidence = 0.87 - 0.99), claimed the EITC and 67 taxpayers had income less than 250 percent of federal poverty guidelines. The average EITC claimed was \$2,490 (95 percent confidence level = \$1,914 - \$2,490).

²⁷ Out of 316 taxpayers in the sample, 290 had gross income of less than 250 percent of federal poverty guidelines for a rate of 92 percent with a confidence level of 95 percent and a margin of three percent.

²⁸ Of the 71 taxpayers, 33, or 46 percent (95 percent confidence = 0.34 - 0.58), were assessed deficiencies by default. Out of 316 taxpayers in the sample, 164 were assessed deficiencies by default, for a rate of 52 percent (95 percent confidence = 0.46 - 0.58).

²⁹ Of the 71 taxpayers, 32, or 45 percent (95 percent confidence = 0.33 - 0.57), agreed with the CP 2000 or the statutory notice of deficiency. Out of 316 taxpayers in the sample, 109 agreed with the CP 2000 or the statutory notice of deficiency, for a rate of 34 percent (95 percent confidence = 0.29 - 0.39).

³⁰ 95 percent confidence level = \$797 - \$989.

IRS COMMENTS

The IRS recognizes the burden placed on taxpayers when the Form 1099-C is not adequately completed and reported by third party sources. The IRS has taken several steps to reduce unnecessary taxpayer contact by reviewing case selection criteria of underreported cancellation of debt, providing training and IRM instructions for determining when to pursue COD, and updating our notices to provide additional instructions to taxpayers.

The National Taxpayer Advocate's research findings show that taxpayer insolvency is not recognized in the AUR program. AUR resolves discrepancies between income or credits reported on filed income tax returns and information reported by third parties on information returns. The IRS cannot determine a taxpayer's insolvency during case selection based on the data currently available to the IRS. However, the IRS does look at several factors prior to issuing a CP 2000 notice. For example, employees are instructed to compare Fair Market Value to the amount of the cancelled debt as reported on Form 1099-C to establish the COD taxable amount. Employees also look for evidence of a bankruptcy.

The IRS, in collaboration with the Office of the Taxpayer Advocate, created a clarifying paragraph in the CP 2000 notice that instructs taxpayers that under certain conditions, canceled or forgiven debt should be included on the return as income. This paragraph also states if the taxpayer claims insolvency, they should provide a breakdown of total assets and liabilities immediately before the cancellation of debt.

The National Taxpayer Advocate makes three specific recommendations in the report to improve the COD processes and procedures. The IRS is taking or has taken the following actions with respect to these recommendations:

The IRS agrees with the National Taxpayer Advocate's recommendation that IRC § 6050P regulations should better align the Form 1099-C reporting requirements with actual cancellation of debt. In 2009, the regulations were amended, narrowing the scope of the 36-month rule, so it only applies to the entities originally subject to IRC § 6050P, such as banks and credit unions. We will continue to assess whether additional changes are appropriate.

The regulations expressly state that discharged indebtedness must be reported regardless of whether the debtor is subject to tax on the discharged debt under IRC §§ 61 and 108 or otherwise by applicable law. The instructions for the debtor on the Form 1099-C also state that some canceled debts may not be included in income. We believe this makes it clear to the creditor, debtor, and the IRS, that receipt of a 1099-C does not necessarily translate into a receipt of income.

The IRS agrees to take into consideration the recommendation to revise Form 1099-C to require the creditor to specify the type of debt for which it was issued. The AUR program currently utilizes the information provided on box 4 (Debt Description) of the Form 1099-C

to determine the type of debt the creditor considers canceled. Note that while a more specific description of the debt may be useful, it will not allow the IRS to determine insolvency.

We currently disagree with the second half of the recommendation to revise Form 1099-C to require the issuer to affirmatively state whether a debt was actually cancelled. Regulations specifically state that a discharge is deemed to have occurred if an identifiable event has taken place. Any statement on Form 1099-C that the debt has not actually been cancelled would be contrary to this position and would require a regulatory change. We will forward this recommendation to the Office of Chief Counsel for further consideration.

Finally, the National Taxpayer Advocate recommends the IRS adjust its AUR document-matching program to identify taxpayers who are not required to include income amounts shown on a Form 1099-C because they are insolvent. At this time, data available to AUR do not allow the IRS to determine insolvency and using income alone as an exclusion criterion is not a valid indicator of taxpayers' assets and liabilities. We will continue to explore opportunities to assist us in determining insolvency.

The IRS has taken a number of steps to improve AUR case selection of underreported cancellation of debt since the National Taxpayer Advocate first addressed this in the 2007 Annual Report to Congress. Several of those recommendations have been implemented. For example, we worked in close coordination with the National Taxpayer Advocate to develop Publication 4681, *Canceled Debts, Foreclosures, Repossessions and Abandonments*. This publication provides guidance to taxpayers to determine the extent of their insolvency by completing a worksheet to compute total assets and liabilities. In addition, the IRS revised the AUR CP 2000 notice with language provided by the Office of the Taxpayer Advocate to help taxpayers better understand if they are impacted by cancelled debt.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate acknowledges and appreciates the IRS's past collaboration with TAS in easing some cancellation of debt reporting burdens. We are pleased the IRS recognizes that taxpayers continue to be burdened by incorrectly prepared Forms 1099-C, and that the regulations under IRC § 6050P should be revised to better align the Form 1099-C reporting requirements with actual cancellation of debt. We look forward to working with the IRS to improve the reporting requirements, particularly in revising Form 1099-C.

As the IRS acknowledges, every *identifiable* event triggers the obligation to issue a Form 1099-C, but not every Form 1099-C signifies that a *taxable* event occurred. The IRS previously revised the form to accommodate this reporting regime, specifically with regard to nonrecourse debt, so it is unclear why the IRS hesitates to adopt our recommendations this year. As we explained in the 2007 Annual Report to Congress, cancellation of nonrecourse debt is an identifiable event that requires issuance of a Form 1099-C, yet is generally not included in the debtor's income.³¹ Noting that there was no difference in the way canceled recourse debts and canceled nonrecourse debts were reported on Form 1099-C, the National Taxpayer Advocate recommended, and the IRS agreed, to revise Form 1099-C to show whether the canceled debt was recourse or nonrecourse.³² Requiring a creditor to state whether a debt was actually canceled is no different than requiring an indication as to whether the debt was nonrecourse. Providing the information would not contradict the regulations but would simply allow the IRS to differentiate between a report of a *taxable* event and a report of an *identifiable* event. Thus, Form 1099-C should be revised to require the creditor to state whether a debt was actually discharged, independently of whether the regulations are revised.

The National Taxpayer Advocate is pleased that the IRS is willing to explore opportunities to assist in determining insolvency. An immediate step the IRS could take would be to include the insolvency worksheet that appears in Publication 4681 when it sends taxpayers a Notice CP 2000 based on a Form 1099-C. In addition, TAS's analysis of income data is consistent with the hypothesis that many taxpayers who receive a Notice CP 2000 on the basis of a Form 1099-C are insolvent. The IRS should test this hypothesis by analyzing a sample of these taxpayers and determining how often their liabilities exceed their assets, and then adjusting its document-matching program accordingly.³³ TAS is willing to work with the IRS on this project.

³¹ See Treas. Reg. § 1.1001-2(a)(1) & (c), Example (7). However, any reduction in the principal balance of a nonrecourse debt that occurs outside the context of a foreclosure or other disposition of the property (e.g., as part of a loan modification, or "workout") generally gives rise to taxable cancellation of indebtedness income. Rev. Rul. 91-31, 1991-1 C.B. 19.

³² See National Taxpayer Advocate 2007 Annual Report to Congress 18, 27. The 2008 Form 1099-C was revised to include the question "Was borrower personally liable for repayment of the debt?"

³³ As the IRS notes, requiring a specific description of the debt on Form 1099-C will not allow the IRS to determine insolvency. However, a description of the debt will allow the IRS to detect some patent errors on a Form 1099-C (e.g., fair market value of property shown as zero where the debt is mortgage or automobile debt). In any event, it does not appear that the IRS objects to including this additional information on the form.

Recommendations

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Revise the IRC § 6050P regulations to better align the Form 1099-C reporting requirements with actual cancellation of debt.
2. Revise Form 1099-C to require the creditor to specify the identifiable event that triggered issuance of the form, to specify the type of debt it was issued for (*e.g.*, real estate, automobile, credit card, or other debt), and to affirmatively state whether a debt was actually canceled.
3. Include the insolvency worksheet that appears in Publication 4681 when it sends taxpayers a Notice CP 2000 based on a Form 1099-C.
4. Analyze, in collaboration with TAS if preferred, a sample of taxpayers who were issued a Notice CP 2000 on the basis of a Form 1099-C. To the extent there is a correlation between income and insolvency for that population, adjust the document-matching program (Automated Underreporter) to identify taxpayers who insolvent and are therefore not required to include in income amounts shown on a Form 1099-C.

MSP
#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****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF 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.¹ In recent years, the number of audit reconsiderations has increased about 190 percent, from nearly 164,000 cases in fiscal year (FY) 2006 to over 474,000 in FY 2009.² Audit reconsiderations now comprise about ten percent of the IRS's total examination inventory.³ Tax abatements, which are one possible result of an audit reconsideration, have increased 315 percent during the same period, from \$1.2 billion in FY 2006 to \$5.1 billion in FY 2009.⁴

In the absence of effective measures and clear guidance, audit reconsiderations remain burdensome for taxpayers and ineffective from a tax administration standpoint.⁵ The National Taxpayer Advocate has identified the following problems with IRS processes and procedures:

- The IRS's inability to measure the impact of the growing number of audit reconsiderations and use the outcomes to improve procedures for original audits;
- The omission of abatements and rework data that inflates audit results and cost effectiveness measures;

¹ Internal Revenue Manual (IRM) 4.13.1.2 (Oct. 1, 2006). The IRS also uses the audit reconsideration process when a taxpayer disputes a Substitute for Return (SFR) assessment by filing an original delinquent return.

² IRS, Enforcement Revenue Information Systems (ERIS) SBD 721 Database (July 27 & 28, 2010). All years are presented as of tax cycle 201026. ERIS is a cross-functional database administered by the Office of Revenue Analysis. It tracks the amount and timing of revenue from all IRS enforcement actions.

³ Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 4, 23 (Aug. 6, 2009). Discretionary examinations are correspondence examinations.

⁴ IRS, ERIS SBD 721 Database (July 27 & 28, 2010). All years are presented as of tax cycle 201026. Calculations include Earned Income Tax Credit (EITC) assessments, and abatements. See also TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* 6 (Mar. 2001); National Taxpayer Advocate 2007 Annual Report to Congress 287.

⁵ The National Taxpayer Advocate, TIGTA, and the Government Accountability Office (GAO) have found the process is ineffective and burdensome to taxpayers and IRS employees. See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 287; TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 6 (Aug. 6, 2009); TIGTA, Ref. No. 2004-40-028, *The Wage and Investment Division Does Not Have a Reliable System for Identifying Trends Related to Automated Underreporter Reconsideration Cases* 6-7, 21 (Dec. 2003); TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden and the Internal Revenue Service* 4-5 (Mar. 2001); GAO, GAO-01-328, *IRS Can Help Taxpayers Reduce the Need for Tax Abatement* 2, 7 (Mar. 2001).

- Automated processes with less human interaction and mail handling delays that burden taxpayers and increase the likelihood that they will seek audit reconsiderations; and
- Inconsistent, ambiguous, and often contradictory forms and publications, and confusing IRM provisions that create a potential for error and excessive taxpayer burden.

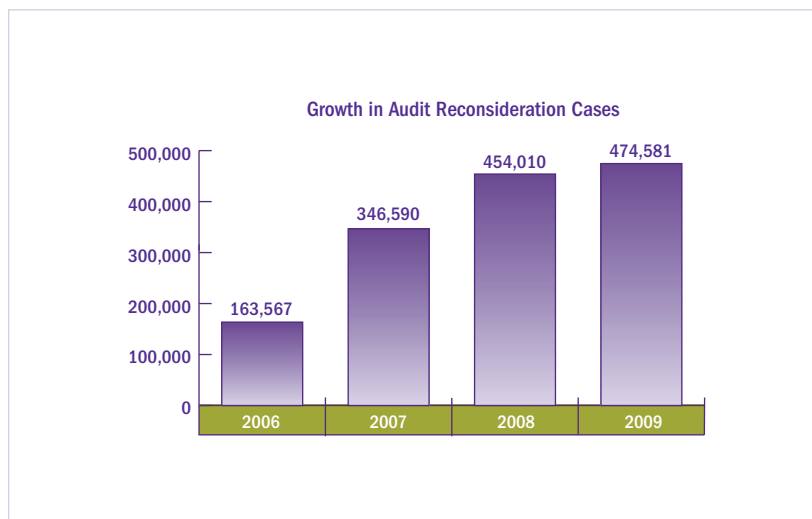
ANALYSIS OF PROBLEM

Background

Taxpayers who disagree with the outcome of an audit may ask the IRS to reconsider the examiner's determination if they have information that was not considered during the initial audit.⁶ This includes situations in which taxpayers missed their opportunity to request an appeal or seek relief in the U.S. Tax Court.⁷ For these taxpayers, the reconsideration process represents a final opportunity to dispute the outcome of an audit without having to pay the tax and file a formal claim for refund.⁸

Audit reconsideration cases have increased about 190 percent, from 163,567 in FY 2006 to 474,581 in FY 2009, as illustrated in Chart 1.11.1 below.⁹

FIGURE 1.11.1, Audit Reconsiderations in FY 2006 - FY 2009¹⁰



⁶ See generally Internal Revenue Code (IRC) § 7605(b); Treas. Reg. § 1.7605-1(h).

⁷ IRC § 6404(a) gives the IRS discretionary authority to abate any unpaid tax it determines to be excessive, upon reconsideration. See also IRM 1.2.12.1.15, *IRS Policy Statement P-2-89* (Sept. 20, 1999).

⁸ IRC § 6511(a). See also IRM 4.13.4.4(1) (Oct. 1, 2006).

⁹ IRS, ERIS SBD 721 SBD 721 Database (July 27 & 28, 2010). All years are presented as of cycle 201026.

¹⁰ *Id.* All years are presented as of cycle 201026.

During this period, the Taxpayer Advocate Service's (TAS) audit reconsideration inventory has ranged from about 22,000 to about 27,000 cases or about ten percent of overall TAS inventory.¹¹ It has been in the top ten TAS case receipts since at least FY 2003.¹²

The IRS does not measure or analyze the growing number of audit reconsiderations or use the outcomes to improve processes for original audits.

Because audit reconsiderations constitute rework, the dramatic growth in these cases calls into question the effectiveness of IRS policies, procedures, and processes that gave rise to the original audit assessments. However, the IRS does not analyze the reasons why these assessments increasingly result in reconsiderations.

The IRS controls all initial examinations on the Automated Information Management System (AIMS). It uses AIMS to assign returns, track audit results, cycle time, case dispositions, and generate management reports.¹³ However, the IRS does not use AIMS for managing audit reconsiderations, which originate from many assessment sources.¹⁴ Instead, it generally controls them on the Correspondence Examination Automation Support (CEAS) system,¹⁵ which reports inventory counts but cannot track audit results, cycle time, and overage cases.¹⁶

The CEAS system cannot produce accurate reports showing the total volume of cases, original audit assessments, and tax abatement results.¹⁷ In 2009, the Treasury Inspector General for Tax Administration (TIGTA) noted that these limitations distort the data used to develop the IRS's annual Examination work plan and lead to the omission of audit reconsideration results and cycle time from operational reports furnished to the IRS Oversight Board.¹⁸ As a result, these reports overstate total assessments and program yield (*i.e.*,

¹¹ See IRM 4.13.1.5 (June 14, 2010); TAMIS research request (June 3, 2010). TAS audit reconsideration case receipts were 21,753 in FY 2006, 26,279 in FY 2007, 26,881 in FY 2008, and 22,286 in FY 2009. Total TAS receipts were 242,173 in FY 2006, 247,839 in FY 2007, 274,051 in FY 2008, and 272,404 in FY 2009. TAS cases were extracted from the Taxpayer Advocate Management Information System (TAMIS) database using issue codes (IC) IC 620, audit reconsideration receipts; IC 639, EITC audit reconsideration receipts; IC 670 AUR audit reconsideration receipts; and IC 680 OIC doubt-as-to-liability audit reconsideration receipts.

¹² National Taxpayer Advocate 2009 Annual Report to Congress 499; National Taxpayer Advocate 2008 Annual Report to Congress 546; National Taxpayer Advocate 2007 Annual Report to Congress 642; National Taxpayer Advocate 2006 Annual Report to Congress 636; National Taxpayer Advocate 2005 Annual Report to Congress 549; National Taxpayer Advocate 2004 Annual Report to Congress 573; National Taxpayer Advocate 2003 Annual Report to Congress 424.

¹³ IRM 4.4.1.2 (May 19, 2009). AIMS is a computer system used by Examination and Appeals to control returns, input assessments and adjustments to the Master File, and generate management reports.

¹⁴ Examples of assessment sources include Automated Substitute for Return (ASFR), Automated Underreporter (AUR), EITC, and Correspondence Examination. An exception exists for audit reconsiderations transferred to the field, which the IRS controls on AIMS using Source Code 73, Aging Reason Code 53.

¹⁵ CEAS is a suite of web-based applications developed to enhance the campus examination process.

¹⁶ Teleconference with Small Business/Self-Employed (SB/SE) and Wage and Investment (W&I) division staff (June 14, 2010). The IRS did not establish program goals for audit reconsiderations by work stream for FY 2007 through FY 2009. SB/SE, *Business Performance Review* 11-17 (Aug. 12, 2008).

¹⁷ TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 8 (Aug. 6, 2009); TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* ii-iii, 4-5 (Mar. 2001).

¹⁸ TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 2, 4, 9, 16 (Aug. 6, 2009). TIGTA based its findings on a statistical sample with a 95 percent confidence level, (+/-) six percent precision, and eight percent expected error rate.

assessments per case), and understate cycle time on case closures.¹⁹ These limitations also impede the IRS's ability to determine why so many taxpayers requested reconsideration and to lessen taxpayer burden by reducing inappropriate audit assessments and future reconsiderations.²⁰

The IRS disagreed with TIGTA's recommendation to modify its operational reports to include reconsideration cycle time in the closure results, citing cost-prohibitive programming.²¹ The National Taxpayer Advocate believes the IRS should accurately assess the costs associated with the programming changes needed for AIMS, which is technically capable of tracking audit results and cycle time, and generating management reports.²² The failure to track this information perpetuates the depletion of audit resources the IRS could redirect to productive compliance work. It also causes TAS employees to devote considerable time and effort to assisting taxpayers in audit reconsideration cases.²³

Automated processes and mail handling delays burden taxpayers and increase the likelihood of taxpayers seeking audit reconsiderations.

The IRS's Wage and Investment (W&I) Division recently enhanced the Automated Underreporter (AUR) program, a computerized document-matching system, with automatic purging and batch processing capabilities.²⁴ Batch processing moves cases through the examination process automatically. If a taxpayer fails to respond precisely within the prescribed period, the case moves to the next phase in the process.²⁵

The Small Business/Self-Employed (SB/SE) Division also announced plans to use batch processing in audits.²⁶ Its Campus Compliance Services Initiative is designed to automate processing of the initial contact letters sent to taxpayers in examination cases, requesting

¹⁹ TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 2, 4, 9, 16 (Aug. 6, 2009). TIGTA based its findings on a statistical sample with a 95 percent confidence level, (+/-) six percent precision, and eight percent expected error rate.

²⁰ *Id.* at 12. See also TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* 4-5 (Mar. 2001).

²¹ TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 2, 4, 9, 16 (Aug. 6, 2009).

²² For example, audit reconsiderations may be tracked on AIMS as a reopening of the case – reversing the AIMS status code from status 90 (closed), to an open examination status (e.g., status 12 or one uniquely created specifically for audit reconsiderations). Currently some audit reconsiderations are reassigned from the Central Reconsideration Unit to campuses and field offices because of complexity using AIMS source code 73, with an aging reason code 53 (reason codes are used for tracking purposes).

²³ TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* 4-5 (Mar. 2001); TAMIS research request (June 3, 2010). TAS audit reconsideration case receipts were 26,279 in FY 2007, 26,881 in FY 2008, and 22,286 in FY 2009.

²⁴ Auto-purging accommodates “virtual” cases and significantly reduces case handling. It eliminates delays in case movement by aging and batching them for the next phase in processing. Each step in the process has a pre-established period programmed into the system. Auto-batching applies to processing of approximately 2.5 million electronic returns. W&I, *Compliance FY 2010 Program Letter 1* (Oct. 18, 2010); IRM 4.19.13.6 (Jan. 24, 2006). See also National Taxpayer 2008 Advocate Annual Report to Congress 248.

²⁵ IRM 4.19.2.2.25 (Sept. 1, 2010) lists the established suspense times for notices and letters in the batch processing system. The AUR generates a “Suspense Aged Batch Report” that shows which suspense batches have met the appropriate suspense times during the previous week. The system checks for the required conditions, such as foreign address, disaster end dates, and new transactions, and allows the appropriate suspense time.

²⁶ See SB/SE, *FY 2008-2009 Plan* 33, 35, 36, 39, 44, 55, 61 (Oct. 2007).

information and responses.²⁷ The CEAS Project is designed to implement unattended case processing for discretionary inventories, workload resolution, issue documentation, and inventory management.²⁸ These processes focus on greater automation and less human interaction and could increase the likelihood of taxpayers seeking audit reconsideration.

In addition, mail processing delays impede taxpayers' ability to timely respond to automated IRS correspondence and hinder IRS employees who try to help the taxpayers.²⁹ Both taxpayers and IRS employees have voiced concerns about the IRS's mail handling problems, as the following remarks illustrate:

- "Send the documents in, they don't get it, so I had to send again. I mailed and faxed them."³⁰
- "The mail process does not work, it takes three weeks to receive correspondence from the mailroom or a fax from the clerical group."³¹

The National Taxpayer Advocate remains concerned that "efficiency-driven" initiatives that accelerate the audit process and reduce human contact, coupled with the IRS's mail handling problems, burden taxpayers and fuel the growth of audit reconsiderations.³²

Inconsistent, ambiguous, and often contradictory forms and publications, and confusing IRM provisions create a potential for error and excessive taxpayer burden.

The IRS requires taxpayers to request audit reconsiderations in writing.³³ However, although the IRS has a form for almost everything imaginable, it does not have one designed specifically for taxpayers requesting audit reconsideration. Taxpayers can seek reconsideration by letter, original return (Form 1040, *U.S. Individual Income Tax Return*), amended return (Form 1040X, *Amended U.S. Individual Income Tax Return*), or by filing a claim for refund and request for abatement (Form 843, *Claim for Refund and Request for Abatement*). In addition, IRS employees can initiate requests for audit reconsideration using Form 3870,

²⁷ The CCS Initiative is designed to automate the CP 2501, *Initial Contact to Resolve Discrepancy Between Income, Credits, and/or Deductions Claimed on Return and Those Reported by Payer*, purge process and expand auto-batching processes. See IRM 21.3.1.4.63 (Aug. 17, 2010).

²⁸ See SB/SE, *FY 2008-2009 Plan* 33, 35, 36, 39, 44, 55, 61 (Oct. 2007).

²⁹ See Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*, and Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail to Taxpayers, infra/supra*. See also TIGTA, Ref. No. 2009-40-099, *The Discretionary Examination Program Performance Results Are Incomplete; Therefore, Some Measures Are Overstated and Inaccurate* 6 (Aug. 6, 2009). TIGTA found that mail handling delays contributed to the average 159 days examiners took to close audit reconsideration cases in FY 2007. IRS, *Lean Six Sigma Exam Mail Project Oversight Board Briefing* 3 (Mar. 24, 2010). The IRS has acknowledged there are many inconsistencies among its campuses in handling aged mail, and is working to expedite mail handling.

³⁰ IRS, *Lean Six Sigma Exam Mail Project Oversight Board Briefing* 3 (Mar. 24, 2010) (quoting taxpayer from phone focus groups).

³¹ *Id.*

³² See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 287; TIGTA, Ref. No. 2001-40-053, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* 1-3 (Mar. 2001); IRS, *Lean Six Sigma Exam Mail Project Oversight Board Briefing* 2, 5 (Mar. 24, 2010).

³³ IRS, Pub 3598, *What You Should Know About the Audit Reconsideration Process* (Aug. 2008); IRM 4.13.2.3 (Dec. 31, 2009); IRM 5.1.15.6 (Oct. 3, 2006).

Request for Adjustment. The numerous ways to open an audit reconsideration make the process overly complicated and cumbersome for both taxpayers and IRS employees.

IRS Publication 3598, *What You Should Know About the Audit Reconsideration Process*, recommends (but does not require) that taxpayers submit copies of their examination reports (Form 4549, *Income Tax Examination Changes*) with requests for audit reconsideration. The mailing instructions, however, direct taxpayers to send requests to the IRS campuses shown on the reports. As a result, taxpayers who have lost or misplaced the reports may have difficulty in determining where to mail their requests.

Instructions for appealing an audit reconsideration are disjointed, circular, and difficult to follow.

Taxpayers who disagree with the outcome of an audit reconsideration may appeal the decision. Examiners are required to provide Publication 3598, *What You Should Know About the Audit Reconsideration Process*, and Publication 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree*.³⁴ Publication 3598 instructs taxpayers to file a written “small case request” or a “written protest” and directs them to the section of Publication 5 entitled “Protests.” However, Publication 5 makes no actual mention of the audit reconsideration process. It further implies that taxpayers may have recourse in the courts if they disagree with the IRS Appeals function, and directs them to follow the instructions in the audit reconsideration denial letters they received from the IRS – which direct taxpayers back to Publication 5. This roundabout flow of information fails to provide taxpayers with any additional guidance for requesting an appeal.³⁵

IRM guidance on audit reconsiderations may confuse IRS employees and taxpayers, and cause excessive taxpayer burden.

Audit reconsiderations differ from claims for refunds in that they generally do not result in refunds.³⁶ However, IRM guidance explaining audit reconsiderations may be confusing to taxpayers and IRS employees as demonstrated by some excerpts below:

- “An informal claim known as an Audit Reconsideration.”³⁷

³⁴ IRM 4.13.4.4(2) (Oct. 1, 2006); IRM 4.13.6 (Dec. 31, 2009); IRM 4.13.3.16 (Oct. 1, 2006); IRM 4.13.4.4 (Oct. 1, 2006); IRS, Publication 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree* (Jan. 1999).

³⁵ IRS Letter 3340C, *Audit Reconsideration Denial Letter* (Sept. 6, 2005); Letter 2726 (DO), *Audit Reconsideration Denial Letter* (Sept. 2000); Letter 2737 (DO), *Audit Reconsideration Partial Disallowance Letter* (Sept. 2000). See also National Taxpayer Advocate 2004 Report to Congress vol. 2, 19 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*) (stating that many EITC taxpayers cannot understand the IRS letters they receive).

³⁶ To file a claim, a taxpayer must pay the tax and request a refund, not merely request an abatement of an unpaid tax as with an audit reconsideration. However, the reconsideration of audit deficiencies involving the disallowance of refundable tax credits, such as the EITC or the Additional Child Tax Credit (ATC), can result in refunds. Audit reconsiderations also can generate refunds if taxpayers have paid down their liabilities, e.g., through installment payments or refund offset.

³⁷ IRM 4.2.6.4(1) (June 1, 2007). In response to an inquiry by TAS and the Special Counsel to the National Taxpayer Advocate, the IRS has agreed to correct the inaccurate language in this provision.

- “An informal claim is one that is submitted by the taxpayer either on a non-standard form (written request) or by some other means....”³⁸
- “A claim for abatement is NOT an informal claim.”³⁹
- “Audit reconsiderations are not formal claims since the tax liability in dispute has not been paid.”⁴⁰

Guidance for employees is also confusing regarding the suspension of collection activity when taxpayers request audit reconsideration. For example, an IRS Memorandum of Understanding states that SB/SE campus and area office employees must take the appropriate action to suspend collection while taxpayers prepare their requests for reconsideration.⁴¹ However, IRM guidance instructs these same employees not to suspend collection action until taxpayers provide documentation to support their requests.⁴² At the same time, the general guidance for SB/SE field collection employees (*i.e.*, revenue officers) requires them to suspend collection, but only on amounts they are considering for adjustment.⁴³ The National Taxpayer Advocate is concerned that these disparities may result in inconsistent treatment of similarly situated taxpayers, causing significant taxpayer burden.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations for improving the audit reconsideration processes and procedures:

1. Reprogram AIMS to control and track audit reconsideration results from all assessment sources;
2. Standardize and consolidate IRM procedures to provide for consistent and uniform treatment of audit reconsiderations;
3. Create a separate form and instructions for taxpayers requesting audit reconsideration;
4. Revise Publication 5 and Publication 3598 as well as Letters 3340C, 2626 (DO), and 2738 (DO), 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
5. Clarify guidance regarding collection holds during an audit reconsideration.

³⁸ IRM 4.10.8.9 (Aug. 11, 2006).

³⁹ *Id.*

⁴⁰ IRM 8.7.7.13.1 (Oct. 26, 2007).

⁴¹ Conference call with SB/SE (May 27, 2010); IRS, *Memorandum of Understanding Between Small Business/Self-Employed Division and Area Office Examination Concerning Area Office Audit Reconsideration Cases 1* (July 27, 2008).

⁴² IRM 4.13.1.4 (Oct. 1, 2006) and 4.13.2.3 (Dec. 31, 2009).

⁴³ IRM 5.1.15.3.1 (Apr. 16, 2010).

IRS COMMENTS

The IRS acknowledges an increase in the number of correspondence examination audit reconsiderations, and continues to analyze ways to improve the initial correspondence examination process to reduce reconsiderations. Reducing taxpayer burden is an essential part of providing top quality customer service to the public. This goal, as well as increasing the effectiveness of voluntary compliance, is always on the forefront of IRS programs. Each year, new initiatives are established to refine the correspondence examination process to improve effectiveness and meet taxpayer needs. For example, we have actively worked with the Office of Taxpayer Correspondence (OTC) to improve the language and content of our letters and look forward to implementation of these improvements once system issues are resolved.

During the reconsideration process, taxpayers are given a second opportunity to reduce their tax obligations by providing information needed to address the additional tax liability assessed. This information is considered, along with previously submitted documentation, and is another way the IRS ensures all taxpayers pay the correct tax due. This process is considerably less time consuming than the correspondence exam audit process, which also provides the taxpayer several opportunities to reply.

The National Taxpayer Advocate's report makes five specific recommendations to improve the audit reconsideration processes and procedures. The IRS is taking, or has taken, the following actions with respect to these recommendations:

The IRS requested programming changes to enhance the current CEAS reconsideration reports to reduce current system limitations.⁴⁴ Campus Examination elected to utilize CEAS for all reconsideration cases since cycle time, as well as the time to resolve the issues, is reduced. Using AIMS would require additional time for the AIMS record to be created, or AIMS extractions to be completed, before any subsequent adjustments can post to close the case. By eliminating this step, case resolution time is reduced.

However, due to the small volume of audit reconsideration cases transferred to Field Examination, they are controlled on AIMS. While AIMS is utilized for tracking the Field cases, the Field cycle time is very different than the cycle time on Correspondence Examination cases and the impact to the Field cases is minimal. CEAS reports are not available to Field Examination to effectively track cases using this method.

While the IRS agrees reprogramming AIMS may be the optimal method to track reconsideration case measures, because of current budget constraints, doing so is not a viable solution at this time. The IRS is exploring other options, such as the use of the Enforcement Revenue Information System. The IRS is currently communicating with ERIS programmers and determining requirements for testing. In the interim, the IRS is

⁴⁴ FY 2011 Report Generating Software, Unified Work Request, WEX1000280TH.

utilizing RGS/CEAS reports for volume of cases, original audit assessments, and tax abatement results to monitor the Audit Reconsideration program. In addition, the IRS considers feedback received from taxpayers and/or their representatives from multiple sources such as Tax Forums and customer satisfaction surveys, to improve programs and procedures making voluntary compliance easier.

The IRS strives for consistency in IRM procedures and uniform treatment of audit reconsiderations. In doing so, IRMs are reviewed and updated annually. Feedback from all sources, including IRM users, is taken into consideration by the IRM authors and used in determining IRM areas needing further clarification or correction. The areas for possible improvement noted in the National Taxpayer Advocate's report have been elevated to the appropriate IRM authors for consideration during the next IRM update.

In an effort to make the audit reconsideration process as easy as possible for taxpayers, the IRS does not require taxpayers to submit a standardized form. However, Form 12661, *Disputed Issue Verification*, is currently available for use as part of the reconsideration process. This form is designed to allow taxpayers to identify the issue(s) in dispute, provide reason for disagreement, and identify the amount per the return and the amount allowed during the audit process.

The IRS continually strives to ensure guidance is clear, providing taxpayers with the information they require. Publication 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree*, clearly defines the process to request an appeal of a decision made by the IRS. It further defines the process to file a claim for refund in District Court of Federal Claims. Publication 3598, *What You Should Know About the Audit Reconsideration Process*, contains the mailing addresses for the ten IRS campuses. If a request for reconsideration is mailed to an incorrect address, the request will be routed to the correct area.⁴⁵ Letter 3340C explains the taxpayer's right to appeal the decision made on his/her reconsideration within 30 days of the date of the letter. While we believe these documents provide taxpayer's understandable instructions, we will continue to review and revise our taxpayer correspondence and publications and make revisions where necessary.

The IRS believes that guidance regarding collection holds is clearly defined in the Reconsideration and Collection IRMs.⁴⁶ When reconsiderations are received in Examination, collection activities are suspended until an examiner reviews the case to determine if the taxpayer has provided the additional documentation for all issues requiring reconsideration. Upon completion of the review of the reconsideration request, the collection activity suspense is reviewed to determine subsequent actions.

⁴⁵ IRM 4.13.3.4 (Oct. 1, 2006).

⁴⁶ IRM 4.13.1.4 (Oct. 1, 2006); IRM 5.1.15 (Apr. 16, 2010).

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased with the IRS's commitment and increased focus on reducing taxpayer burden and providing top quality customer service to taxpayers during audit reconsiderations. Despite the efforts of the IRS to stem the number of audit reconsiderations by working to improve correspondence examination letters and processes, audit reconsiderations have reached an all time high and continue to grow. The audit reconsideration process remains confusing and overly burdensome to the ever-growing number of taxpayers and the IRS employees working to assist them.

The IRS contends that the audit reconsideration process affords taxpayers a second chance to reduce their liabilities and is considerably less time-consuming than the correspondence examination process. While we agree that audit reconsiderations do allow taxpayers a second chance to present arguments that may reduce their liabilities, such a process comes at a significant cost. Audit reconsiderations constitute rework that IRS employees must perform after conducting and closing original examinations. Reconsiderations are time-consuming, costly, and prevent the IRS from directing resources to other productive compliance work.⁴⁷

The National Taxpayer Advocate is pleased that the IRS recognizes the need to track audit reconsideration case measures. She also acknowledges that budget constraints must be considered in system reprogramming requests. However, while the IRS acknowledges reprogramming AIMS is the optimal method to track reconsiderations, it has opted to pursue other methods such as programming modifications to CEAS and retooling ERIS without offering any analysis of the cost-effectiveness of these system enhancements compared to the costs associated with reprogramming AIMS. It is also unclear whether the suggested programming changes would enable RGS/CEAS or ERIS to measure audit reconsideration cycle time and closure results.⁴⁸ The National Taxpayer Advocate would support any cost-effective alternative method of measuring audit reconsideration closure results and cycle time, and offers TAS's assistance in developing such a method. To improve the effectiveness of correspondence examinations, the IRS should routinely pull a representative sample of audit reconsiderations from CEAS to analyze the outcomes and direct appropriate policy changes for original audits.

The National Taxpayer Advocate appreciates the IRS's willingness to clarify IRM provisions regarding audit reconsiderations and looks forward to reviewing the changes. However, she remains concerned that the IRS perceives the absence of a standardized form, designed specifically for taxpayers requesting audit reconsideration, as making the process "as easy as possible" for taxpayers. The variety of methods for requesting an audit reconsideration

⁴⁷ TIGTA, Ref. No. 2009-40-099, at 4, 6, 23.

⁴⁸ The IRS disagreed with TIGTA's recommendation that operational reports should be modified to include audit reconsideration cycle time, citing cost prohibitive programming changes. See TIGTA, Ref. No. 2009-40-099, at 9-10, 23.

can confuse taxpayers. For example, in its comments the IRS points to Form 12661 (9-2000), *Disputed Issue Verification Resolution*, as yet another way taxpayers can initiate an audit reconsideration. The form allows taxpayers to state why they disagree with the IRS's decisions in an audit. It has entries for the disputed item, why the item is in dispute, and a comparison of the amount claimed on a return versus the amount allowed on the audit report. However, the IRS does not describe the form in Publication 3598, *What You Should Know About the Audit Reconsideration Process*, nor does it mention it in the associated IRM provisions that address audit reconsiderations. Creating a separate, standardized form for audit reconsideration, or at least identifying Form 12661 as a method of requesting audit reconsideration, and revising taxpayer correspondence and publications to provide clear, non-circular instructions that refer to such a form, will alleviate taxpayer burden and improve the audit reconsideration process.

Finally, the National Taxpayer Advocate believes the IRM guidance regarding the suspension of collection activity in reconsideration cases can be improved to address the mechanical aspects of collection holds in these cases. The IRS should revise and consolidate this guidance to cross-reference specific collection hold instructions to employees in different functions.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Develop a method to control and track audit reconsideration results including the cycle time from all assessment sources.
2. Institute a program of reviewing representative samples of audit reconsiderations from CEAS to analyze the reasons for and the outcomes of audit reconsiderations and identify program and policy changes for underlying correspondence examination procedures.
3. Clarify guidance in publications and instructions that taxpayers can use Form 12661, *Disputed Issue Verification Resolution*, to request audit reconsideration in writing.
4. Revise Publications 5 and 3598 as well as Letters 3340C, 2626 (DO), and 2738 (DO), to provide clear, non-circular instructions for appealing an audit reconsideration denial and a mailing address to submit requests for audit reconsideration and appeal.
5. Clarify guidance regarding collection holds during an audit reconsideration.

MSP
#12**Persistent Breakdowns in Power of Attorney Processes Undermine
Fundamental Taxpayer Rights****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
 Chris Wagner, Commissioner, Small Business/Self-Employed Division
 Karen Hawkins, Director, Office of Professional Responsibility

DEFINITION OF PROBLEM

The Internal Revenue Code (IRC) sets forth a basic taxpayer right to representation before the IRS.¹ Yet IRS processes and systems designed to recognize and record power of attorney (POA) information continue to frustrate taxpayers and their representatives attempting to comply with filing and payment responsibilities. For example, in early 2010 the IRS's Centralized Authorization File (CAF) unit, which is responsible for processing POA requests, experienced significant delays.² In April 2010, the delays became so overwhelming that the IRS suspended normal processing timeframes (two to three days for faxed receipts) and extended processing timeframes to 15 days upon receipt, even for Taxpayer Advocate Service (TAS) priority cases.³

Between 2004 and 2009, the number of POA forms filed by individual taxpayers jumped from nearly one million to 1.8 million, an increase of 83 percent.⁴ While the IRS has not identified the cause of this increase, staffing dedicated to POA processing has declined by nearly 20 percent since 2004.⁵ The Treasury Inspector General for Tax Administration (TIGTA) recently estimated that 60,675 taxpayer representatives may not have been provided lien notices between June 30, 2008 and June 30, 2009, potentially violating the taxpayers' right to have their representatives notified of a lien filing.

When the IRS fails to timely or properly record a valid POA request on its CAF, or link common databases such as the Automated Lien System (ALS) to the CAF, taxpayers may experience difficulties including:⁶

- Lack of or impaired representation;
- Adverse IRS action, such as unnecessary liens and levies;

¹ IRC § 7521(c) provides that taxpayers have the right to be represented in their tax matters.

² The CAF assigns unique identifiers to authorized representatives (Form 2848) and appointees (Form 8821) and maintains the data with linkages to the appropriate taxpayer accounts and tax modules. This system is part of the Integrated Data Retrieval System (IDRS).

³ Internal Revenue Manual (IRM) 21.3.7.1.7 (Oct. 26, 2009); Servicewide Electronic Research Program (SERP) Alert 100232 (Apr. 27, 2010).

⁴ IRS, Compliance Data Warehouse (CDW) Individual Master File (IMF) Transaction File, Processing Years 2004-2009 (Aug. 2010).

⁵ IRS, Wage and Investment (W&I) division response to TAS questions (Oct. 19, 2010). In fiscal year (FY) 2004, the CAF unit had a total of 252 employees and in FY 2009 the number had declined to a total of 206 CAF Unit employees. W&I stated that all CAF sites have trained additional staff to assist when inventory spikes.

⁶ The ALS generates Notices of Federal Tax Lien (NFTL) and releases of liens, and maintains a database of all pertinent lien information.

- Lengthy delays in processing of tax returns and associated refunds; and
- Inadvertent disclosure of personal tax information.

Additionally, POA processing delays and systemic setbacks also hamper the ability of Low Income Taxpayer Clinics (LITCs) to represent taxpayers before the IRS.⁷ Because many LITCs rely on student assistance, delays in POA processing affect staff levels and limit the effectiveness of LITC representation.

ANALYSIS OF PROBLEM

Background

A taxpayer must file a Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*, with the CAF to appoint a third party to represent him or her in dealings with the IRS.⁸ The unit assigns a unique identifier to the authorized representative (Form 2848) or appointee (Form 8821), and maintains the data with links to the appropriate taxpayer accounts and tax modules that make up the Integrated Data Retrieval System (IDRS).⁹

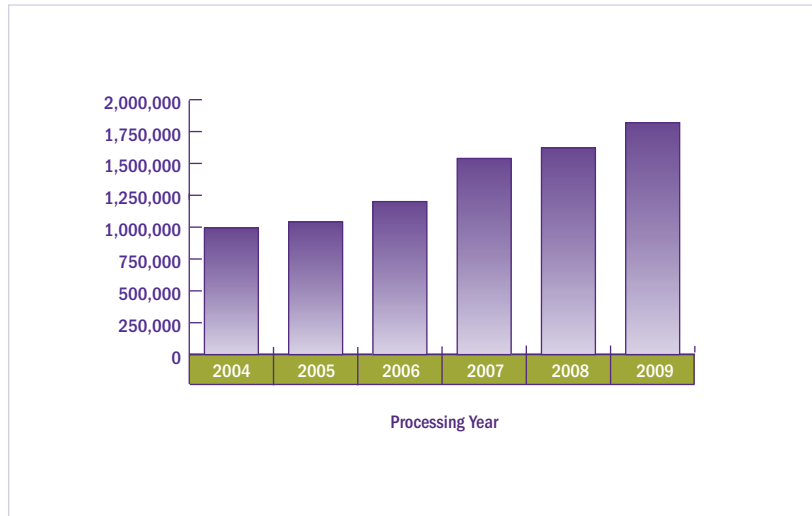
During the past six years, the number of POA forms filed by individual taxpayers grew 83 percent as shown in Chart 1.12.1 below.¹⁰

⁷ See generally IRC § 7526. The LITC program serves individuals whose income is below a certain level and require assistance with the IRS. LITCs are independent from the IRS and most LITCs can provide representation before the IRS or in court on audits, tax collection disputes, and other issues for free or for a nominal fee.

⁸ See generally IRM 21.3.7 (Apr. 17, 2009).

⁹ IDRS consists of databases and operating programs that support IRS employees working active tax cases within each business unit. This system manages data retrieved from the Master File, allowing employees to take actions on account issues, track status, and post updates back to the Master File.

¹⁰ IRS, CDW IMF Transaction File, Processing Years 2004-2009 (Aug. 2010).

FIGURE 1.12.1, Volume of Power of Attorney Filings¹¹**CAF Unit Delays and Unlinked Databases Harm Taxpayers***IRS Databases are not Linked*

When the IRS has a valid POA on file, it is required to send all original correspondence to the taxpayer and provide a copy to the representative unless the taxpayer has indicated otherwise on Form 2848.¹² However, two key IRS databases – the Automated Offer in Compromise (AOIC)¹³ system and the ALS – are not linked to the CAF, and therefore do not systemically copy IRS correspondence to taxpayers’ representatives.¹⁴

In her 2009 Annual Report to Congress, the National Taxpayer Advocate expressed concern about the impact of systemic POA processing errors on a POA’s ability to effectively represent his or her client.¹⁵ These consequences range from taxpayers missing important deadlines, such as filing for a Collection Due Process (CDP) hearing, to small businesses going out of business because of a lien or levy.¹⁶ A recent TIGTA report states that while the IRS error rate for notices of federal tax lien has declined from 76 percent in FY 2006 to 26 percent in FY 2010, the potential for violations still exists in approximately one out of every four cases requiring taxpayer representative notification.¹⁷

¹¹ This chart includes individual taxpayer POAs filed with either Form 2848 or Form 8821.

¹² Treas. Reg. § 601.506; IRM 13.1.10.3.1 (Oct. 31, 2004).

¹³ The AOIC application tracks and controls almost all IRS offer in compromise activity.

¹⁴ TIGTA, Ref. No. 2010-30-072, *Additional Actions Are Needed to Protect Taxpayers’ Rights During the Lien Due Process* (July 9, 2010). IRC § 6320 requires the IRS to notify taxpayers in writing, at their last known address, about filings of a NFTL within five business days of the lien filings.

¹⁵ National Taxpayer Advocate 2009 Annual Report to Congress 256-271.

¹⁶ The filing of an NFTL negatively affects taxpayer credit and may preclude access to business financing. IRM 5.1.9.3.1 (Nov. 28, 2008).

¹⁷ TIGTA, Ref. No. 2010-30-072, *Additional Actions Are Needed to Protect Taxpayers’ Rights During the Lien Due Process* (July 9, 2010).

As a result of TAS and TIGTA recommendations, the IRS changed its programming to improve the rate at which representatives receive required tax lien notices. The corrective actions, which affect the Integrated Automation Technologies (IAT) tool used by IRS employees,¹⁸ will allow for a systemic upload of representative information directly from the CAF to the ALS and will submit taxpayer representative notifications to ALS for each lien when the IRS requests multiple liens. Although the IAT tool will not interface with AOIC, procedures are in place to ensure that a representative will receive a copy of the offer in compromise (OIC) correspondence when authorized by the taxpayer.¹⁹ The National Taxpayer Advocate applauds the IRS for committing to these changes but remains concerned about the timelines for entering POAs onto the CAF system.

CAF Unit Experiences Significant Delays, Impeding Practitioners Ability to Represent Their Clients

In 2009, the IRS's Wage and Investment division stated that its Correspondence Imaging System (CIS), a paperless fax system, would be implemented in 2010.²⁰ When the system did not materialize as promised, the IRS informed TAS that budgetary constraints were preventing implementation. Yet as necessary technological upgrades are put on hold, so is vital service to taxpayers.

For example, between January and June 2010, the normal three-day CAF processing timeframe for faxed receipts extended to a month or longer.²¹ In addition to the numerous concerns discussed with the National Taxpayer Advocate during practitioner meetings throughout the country, unresolved and ongoing delays have generated more than 100 POA related submissions through TAS's Systemic Advocacy Management System (SAMS) since 2001.²²

When the CAF unit does not acknowledge that it received fax submissions, practitioners may send duplicates, which exacerbates the backlog problem. Use of the CIS would enhance efficiency in the CAF unit by timely and accurately processing POA submissions via electronic inventory management. An electronic system also would eliminate inefficiency associated with fax breakdowns and lost or misplaced paper submissions. Along with providing immediate acknowledgements, such a system would allow the IRS to reduce the large backlogs and avoid costly rework and potential adverse actions for taxpayers.

¹⁸ Formerly known as the IDRS Decision Assisting Program (IDAP), IAT supplies automated tools to IRS employees to simplify research, reduce keystrokes, and increase the accuracy of regular work processes.

¹⁹ New POA information that is received with the offer but not on IDRS is forwarded to the CAF unit and loaded on AOIC. Once authorized representative information is loaded on AOIC, all correspondence generated by the system will include a copy for the POA.

²⁰ W&I response to TAS questions (June 22, 2009). The Correspondence Imaging System (CIS) captures images of letters, returned notices and standard forms, which are scanned and electronically routed to employees.

²¹ TAS LITC Academic Clinic Conference Call discussion on May 2, 2010, and Sept. 30, 2010 ("Actual CAF processing delays were a month or longer during the CAF backlog timeframe January through June 2010.").

²² SAMS is a TAS application and acts as the primary method of receiving and prioritizing systemic issues and problems submitted by IRS employees and the general public.

To illustrate how processing delays can cause taxpayer and practitioner harm and frustration during a time sensitive tax crisis, consider the following example:

Example: A taxpayer receives a Notice of Intent to Levy requiring a response in 30 days. The taxpayer seeks professional help from an attorney, who immediately files a Form 2848 with the IRS. The attorney attempts to respond to the IRS using the number provided on the levy notice, and calls the Automated Collection System (ACS). However, there is no record of the POA form on the CAF system so the ACS employee advises the tax practitioner that she cannot talk to him. A copy of the Form 2848 is then faxed to the ACS site (per IRM 21.1.3.3 guidance) but the employee still refuses to discuss the tax matter until the POA form shows up on the CAF. The practitioner then waits for the POA form to be processed, which takes over a month. In the meantime, the IRS levies upon the taxpayer's bank account. The attorney's POA form is ultimately processed, and the IRS returns the levied proceeds. The IRS's untimely POA processing along with confusion over internal procedures impedes the attorney's ability to provide effective representation and creates rework for the IRS.²³

These types of problems became critical in April 2010 when a processing backlog required the IRS to tell its employees that normal POA processing timeframes would be suspended. These timeframes applied to both the Practitioner Priority Service (PPS) and TAS,²⁴ were far outside normal processing guidelines, and severely affected practitioners' ability to represent their clients.²⁵

TAS urged the IRS to revise its guidance to employees to include an exception to the 15-day timeframe for PPS and TAS priority cases, thereby permitting the IRS to expedite the processing of time-critical tax issues where potential adverse actions existed. The National Taxpayer Advocate is pleased that the IRS issued revised guidance for TAS requests.²⁶

Taxpayers Are Harmed When Low Income Taxpayer Clinics Are Unable to Provide Timely Service.

The National Taxpayer Advocate is pleased with the recent dialogue established between TAS and W&I about LITC POA issues, but remains concerned by the IRS's stance regarding this vital program's representation of low income taxpayers. LITC directors have the primary responsibility to monitor their student POAs, and a duty to their clients and the IRS according to Circular 230.²⁷ Students derive their authority through the LITC director (a Circular 230 representative) and must be cleared by the IRS Office of Professional Responsibility (OPR)

²³ Although the IRS states that this example "ignores the reality of how the majority of POAs interact with the Service," TAS's experience suggests otherwise. TAS has cases in its inventory, a SAMS submission on the issue, and regularly hears complaints from practitioners that when it has not processed POA forms, the IRS sometimes refuses to deal with the attorney and the taxpayer essentially must proceed unrepresented until the IRS processes the form.

²⁴ IRS, SERP Alert 100232 (Apr. 27, 2010).

²⁵ IRM 21.3.7.1.7 (Oct. 26, 2009). Receipts received in the CAF are processed in 24 hours from receipt for priority faxes originating from Practitioner Priority Services, TAS, and large corporations, and two business days from receipt in the CAF function for all other fax receipts.

²⁶ SERP Alert 100232 Revision (July 2, 2010).

²⁷ Treas. Dept. Cir. No. 230, 31 CFR, Subt. A, Pt. 10.

before being added to a POA form.²⁸ Moreover, the LITCs operate under the scrutiny of TAS, the Government Accountability Office (GAO), and TIGTA, and all clinic grantees are required to attend an annual week-long conference conducted by the IRS.²⁹

For all of these reasons, LITCs with student representatives require special rules to protect taxpayers without placing additional burden on taxpayers, clinics, and the CAF unit. If the taxpayer authorizes the clinic director to substitute a student as a POA, the director must submit a second Form 2848, with a copy of the initial Form 2848 signed by the taxpayer, *for each student representative*.³⁰ Once the second Form 2848 has been processed, the student's POA status will remain valid for only 130 days from the time it is received in the CAF unit.³¹ When this period expires, the clinic must resubmit the form. The student's POA status often expires at the end of the semester. However, some clinics' semesters go beyond the 130 days, paralyzing the student's ability to work cases.

Requiring clinics to repeatedly resubmit forms is burdensome and time-consuming, and exacerbates the tax problems facing low income clients.³² The IRS should revise Form 2848 (or create a POA form specifically for LITCs) to allow the LITC director, as a primary representative, to substitute student POAs at the end of an academic term with new students without submitting a second form should the student's term end before the taxpayer's problem is fully resolved. LITC directors should have authority to simply submit a letter (or a simplified POA form) with attached new OPR special orders to a designated CAF unit employee for substitution of these student POAs or delegation of authority to new student POAs.³³ By adopting this proposal, the IRS would improve clinics' service to their low income clients and save scarce resources that the clinics could then use to help the clients.³⁴ This would solve a problem that has frustrated student tax clinics and LITC services for decades.

²⁸ IRS, Publication 4134 (Mar. 2010). There are currently 160 LITCs. A copy of the OPR special order authorizing practice before the IRS must be attached to the power of attorney form (Form 2848) and submitted to the CAF unit. IRM 21.3.7.9.6 (Oct. 26, 2009); IRM 5.1.10.5.2 (Aug. 21, 2006). Some non-academic clinics also utilize student interns under arrangements with law or business schools.

²⁹ IRS, Publication 3319, *Low-Income Taxpayer Clinics Grant Application Package Book* (May 2010). TAS oversight includes six-month and annual reviews, and site visits at least once every three years. All clinics grantees are required to attend an annual weeklong conference conducted by the IRS.

³⁰ Form 2848, *Power of Attorney and Declaration of Representation* (June 2008). Under current procedures, the taxpayer may authorize his or her representative (including LITC directors) to substitute or delegate authority to another representative by adding this authority in the space provided on line 5 of Form 2848, however, entering information on Line 5 constitutes a modification that will prevent the representative from using e-services.

³¹ IRM 13.2.2.6.1 (July 16, 2009).

³² National Taxpayer Advocate 2009 Annual Report to Congress 260-262 (see specifically recommendation 3 on page 262).

³³ LITCs are required to enter into "Pro Bono Representation Agreements" with all clients, setting out the terms of representation (including naming the issue(s) and that indicating that there is no or nominal fee). Therefore, the clinics could be required to add a line to the *pro bono* representation agreement informing the taxpayer that at the end of the semester another student may be substituted, the taxpayer has the right to request another student, and the clinic director or other faculty member remains the primary representative.

³⁴ IRM 21.3.7.9.6 (Oct. 26, 2009); IRM 5.1.10.5.2 (Aug. 21, 2006).

IRS Employees Often Do Not Adhere to Taxpayer Representative Designations, Thus Violating the Direct Contact Provisions of IRC § 7521.

The Code generally prohibits disclosure of tax return information to third parties unless the taxpayer has given the IRS consent to disclose this information to a designated representative.³⁵ The Code's direct contact provisions specifically require IRS employees to:

- Stop a taxpayer interview whenever a taxpayer asks to consult with a representative; and
- Obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if the representative is unreasonably delaying the completion of an examination or investigation.³⁶

Between October 2008 and September 2009, TIGTA reported four instances in which employees improperly bypassed taxpayer representatives.³⁷ However – for the 12th consecutive year – TIGTA said it could not give an opinion on how well the IRS is complying with IRC restrictions on direct contact because of limitations within the IRS's management information systems. In considering the significance of this limitation, TIGTA reported, "it is important to recognize that the evidence obtained and evaluated over the years suggests potential direct contact violations are very small considering that thousands of IRS enforcement personnel routinely interact with millions of taxpayers and their representatives each year."³⁸ However, there was no evidence that a representative or taxpayer complaint was ever filed in the four instances where TIGTA confirmed that IRS personnel improperly bypassed taxpayer representatives.

Practitioners from the LITC program and the American Institute of Certified Public Accountants (AICPA) have raised concerns that IRS employees in various functions have bypassed representatives without reason and without regard for the bypass procedures.³⁹ In an informal review cited in the 2009 Annual Report, the National Taxpayer Advocate found eight potential POA bypass violations, of which only one was elevated to TIGTA for investigation.⁴⁰

Between FY 2009 and FY 2010, the IRS hired nearly 1,200 compliance employees.⁴¹ While the IRS recently revised its new hire training curriculum to include more emphasis on taxpayer rights, and requires its managers to conduct regular reviews that measure

³⁵ See generally IRC §§ 6103(c) and 7521(b)(2) and (c); Treas. Reg. § 301.6103(c)-1; IRM 11.3.3 (Mar. 18, 2008); IRM 4.11.55.3 (Jan. 15, 2005); and IRM 5.1.1.7.7 (Aug. 21, 2006).

³⁶ IRC §§ 7521(b)(2) and (c).

³⁷ TIGTA, Ref. No. 2010-30-060, *Statutory Review of Restrictions on Directly Contacting Taxpayers* 7 (June 3, 2010).

³⁸ *Id.*

³⁹ TAS Teleconference with AICPA (Aug. 18, 2009) and ABA LITC Teleconferences (Sept. 21, 2009; May 27, 2010; and Sept. 30, 2010).

⁴⁰ National Taxpayer Advocate 2009 Annual Report to Congress 261.

⁴¹ 1,193 new IRS compliance employees (job series 1169 (revenue officer (RO)); 512 (revenue agent (RA)); 526 (tax compliance officer (TCO)); and 962 (ACS customer service representative (CSR)) were hired between August 29, 2009 and August 28, 2010. IRS Human Resources website, <http://persinfo.web.irs.gov/track/workorg.asp> (last visited Oct. 13, 2010).

conformance with POA guidelines, it needs better education and management controls to increase awareness of these procedures.⁴² Further, the National Taxpayer Advocate remains concerned that, in the absence of an effective measurement system, violations are going undetected. She reiterates her prior recommendations for the IRS to establish a process of gathering and tracking taxpayer and POA complaints on direct contact violations and provide, at minimum, mandatory annual training for all contact employees.⁴³

The IRS Should Send Dual Confirmation Letters for Address Changes of Taxpayers Using Third Parties.

When a POA changes a taxpayer's address of record with the IRS and the IRS does not notify the taxpayer, he or she may be left unaware of any tax delinquencies created by the representative's actions. For example, in the *Firstpay* case,⁴⁴ a third party payer (TPP) routinely asked its customers to sign a POA on Form 2848, and then changed the customers' addresses on Forms 941, *Employer's Quarterly Federal Tax Return*, to its own. Thus, the affected employers did not receive delinquency notices from the IRS.⁴⁵ The IRS Criminal Investigation function found thousands of such notices at the defunct TPP's place of business.⁴⁶ Acting on the National Taxpayer Advocate's recommendation that the IRS should implement dual address change letters alerting employers that a third party has initiated a change of address in cases where the third party payer has access to the client employer's funds, the IRS's Small Business/Self-Employed (SB/SE) Collection Policy function, Office of Chief Counsel, and TAS created a team in 2009 to work on these so-called "Are You There?" letters. This team is studying the viability of and funding for adopting the National Taxpayer Advocate's recommendation.⁴⁷ TAS applauds the IRS's efforts and encourages the IRS to resolve the issue in FY 2011.

CONCLUSION

Although the IRS has improved POA processing, practitioners are still plagued by delays and errors often caused by inefficient and outdated systems, along with inadequate staffing. As illustrated, these POA processing problems impair practitioners' ability to represent their clients, thereby undermining fundamental taxpayer rights.

⁴² All compliance employees are trained on Publication 1, *Your Rights as a Taxpayer*, which discusses the taxpayer's right to representation.

⁴³ National Taxpayer Advocate 2007 Annual Report to Congress 140-155.

⁴⁴ *Wolff v. U.S. (In re: Firstpay, Inc.)*, No. 03-30102, 2006 Bankr. LEXIS 2339 (Bankr. D. Md. Aug. 17, 2006).

⁴⁵ Present law does not define the term "third party payer," nor does it specifically authorize the IRS to promulgate regulations to that effect. Generally, IRC § 3504 allows employers to designate agents to act on their behalf to perform duties such as payment of employee wages and company payroll taxes. The IRS regulates only designated Form 2678 agents and reporting agents. See generally IRC § 3504; Treas. Reg. § 31.3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Rev. Proc. 2007-38, 2007-1 C.B. 1442; Notice 2003-70, 2003-2 C.B. 916.

⁴⁶ FirstPay, Inc., a payroll service provider business, defrauded its clients of millions of dollars in employment taxes. It routinely asked its clients to sign a Form 2848 appointing FirstPay a recognized representative, and then changed clients' addresses on file with the IRS so that the clients did not receive delinquency notices and correspondence. National Taxpayer Advocate 2007 Annual Report to Congress 337.

⁴⁷ IRS Office of Chief Counsel Memorandum, Ref. No. PRESP-116879-09, *Use of Dual Confirmation Letters for Address Changes of Form 941 Filers Who Use Reporting Agents or Other Third Parties* (Aug. 19, 2009). The Office of Chief Counsel found no legal prohibition under IRC § 6103(e) to the IRS sending such dual confirmation letters to the taxpayer's prior and new addresses.

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. The IRS should establish a process of gathering and tracking taxpayer and POA complaints on direct contact violations and provide mandatory annual training for all contact employees.
2. The IRS should implement a Correspondence Imaging System (*i.e.*, a paperless fax) to prevent lengthy CAF delays and potential adverse actions to taxpayers.
3. The CAF unit should timely acknowledge receipt of all POA forms to prevent costly rework when a POA cannot determine if his or her request is being processed in a reasonable time.
4. The IRS should implement dual address change letters alerting employers that a third party has initiated a change of address in cases where the third party payer has access to the client employer's funds.
5. The IRS should create a POA form specifically for LITCs to allow the clinic director, as a primary representative, to substitute student POAs at the end of an academic term with new students.
6. W&I should conduct research to determine the cause of the increase of POA requests by individuals.

IRS COMMENTS

The IRS acknowledges that it experienced delays in processing POAs earlier this year. Due to an unexpected increase in receipts, processing timeframes were temporarily extended to 15 days. The IRS took immediate actions to address the situation including training additional staff to process overage inventory as quickly as possible. Since mid-July, the IRS has maintained a ten-day or less processing timeframe on all receipts except TAS priority cases, which continued to be processed within 24 hours of receipt.

The IRS revised IRM 21.3.7 procedures related to processing POAs and made significant updates to instructions, simplified procedures and streamlined timeframes to improve the process to avoid future delays. We appreciate the National Taxpayer Advocate for acknowledging these steps were taken.

The IRS also partnered with the practitioner community to educate tax practitioners on Power of Attorney and Other Third Party Authorizations, including procedural changes and ways to avoid processing delays or rejections when submitting POAs. Delays often occur when third-party representatives submit incomplete forms or send multiple submissions to the IRS. We conducted nationwide phone forums and delivered presentations through our annual Tax Forums to assist tax professionals in correctly preparing and submitting Power of Attorney Form 2848 and Tax Information Authorization Form 8821. The following

topics were covered in depth and a question and answer session was included at the end of each presentation.

- Differences between Form 2848 and Form 8821;
- Overview of Authorization Forms 2848 and 8821;
- Unenrolled return preparers and Authorization Forms;
- Joint and separate Authorizations;
- Processing Authorization Forms, including processing timeframes;
- Common reasons for rejection of Authorization Forms; and
- Authorization for ordering transcripts.

While it is true that the overall number of dedicated CAF staffing declined from 2004 to 2009, the decrease is substantially due to attrition and a reduction in clerical staff. There has been only a two percent decrease in employees who actually work or process POAs. Each CAF processing site has trained alternate staff (Toll-free Customer Service Representatives (CSRs) and Inventory Control Team Clerks) to assist with processing during periods of high inventory.

Submission of a POA to the CAF is not a requirement for representation before the IRS. Any recognized representative may represent a taxpayer before any officer or employee of the IRS by providing that officer or employee with a copy of a valid POA, regardless of whether the POA has been recorded on the CAF. Recording a POA on the CAF is intended to enable IRS personnel who do not have access to the actual POA to act upon the POA (See Conference and Practice Requirements, Statement of Procedural Rules § 601.506(d)).

Although it is IRS policy to send copies of taxpayer correspondence to the taxpayer's Power of Attorney under Statement of Procedural Rules § 601-503(a), this policy does not create a representative's legal right to receive taxpayer correspondence directly from the IRS. The IRC does not mandate that the IRS provide a taxpayer's POA with copies of taxpayer correspondence.

Low Income Taxpayer Clinics

Although many students are assigned to a clinic for more than one semester, we were not aware of any clinics which have a semester that goes beyond 130 days. When a student works for the clinic for more than one semester, OPR currently requires the LITC to resubmit the student's name for approval each new semester. The 130-day period, therefore, is consistent with the period of time for which each student's special orders are approved.

The IRS generally accepts powers of attorney that satisfy the POA requirements. However, the IRS cannot record a POA on the CAF unless the POA is on a Form 2848 or a completed

Form 2848 has been attached to the document.⁴⁸ Thus, if the taxpayer authorizes the LITC director to substitute representatives on the initial POA, the LITC director may substitute the student POAs at the end of the academic term by completing a document that contains all of the necessary requirements of a POA. However, if the LITC director wants the new student POA recorded on the CAF, the Conference and Practice Requirements require that a completed Form 2848 signed on the taxpayer's behalf by the LITC director be completed. All persons who practice before the IRS are subject to these same requirements.

Taxpayer Representative Designations

Preservation of taxpayer rights is of utmost importance to the IRS and we continue to take steps to ensure our employees are aware of direct contact provisions. The IRS published a new IRM 5.1.23 (Oct. 12, 2010), *Taxpayer Representation*, that contains guidance regarding bypassing a taxpayer's representative. All compliance employees receive training on Publication 1, *Your Rights as a Taxpayer*, which discusses the taxpayer's rights to representation. In fact, the new revenue officer (RO) hire training curriculum,⁴⁹ currently in revision, will address the taxpayer's right to representation and the right to select a qualified person to represent him/her before the IRS. The RO On-the-Job Training Workshop 6,⁵⁰ offered to group managers and on-the-job instructors as part of the recruit's on-the-job training, will continue to reinforce this information. This workshop recommends discussion on the contents of Publication 1, part of which also discusses the taxpayer's right of representation as well as the IRC § 7521 requirements. These provisions are also reinforced in case studies that are contained throughout the curriculum. IRM 1.4.50.5.12 (Sept. 14, 2010), *Resource Guide for Managers*, requires group managers to ensure their group is in conformance with IRC § 7521 through meetings, reviews, visitations, or taxpayer/representative inquiries.

Preliminary Recommendations

The National Taxpayer Advocate recommends that the IRS establish a process of gathering and tracking taxpayer and POA complaints on direct contact violations and provide mandatory annual training for all contact employees. The IRS recognizes that a single violation of the provisions of IRC § 7521 is a matter of concern. However, due to the very small number of complaints involved, establishing a separate and dedicated system to gather and measure complaints on this issue, and provide mandatory annual training for all contact employees, would entail significant costs that outweigh the potential benefits. The IRS dedicates a significant amount of guidance, training, and monitoring for employees and will continue to take steps to ensure employees are adhering to the rules regarding taxpayer rights and POA procedures.

⁴⁸ Conference and Practice Requirements, Statement of Procedural Rules § 601.503(b)(2).

⁴⁹ Training Publication 11568-102 (*Workshop 6: Publication 1 and Other Publications*).

⁵⁰ *Id.*

The IRS agrees in part with the National Taxpayer Advocate's recommendations to implement a Correspondence Imaging System (paperless fax) for use by the CAF unit. As the National Taxpayer Advocate states, we were unable to implement such a paperless fax system in 2010 due to budgetary constraints. However, the IRS is currently exploring other options, such as the Enterprise e-Fax Solution, to find alternative methods that would allow electronic inventory management and enhance the efficiency of the CAF unit in 2011.⁵¹ This would also allow for the IRS to fully automate acknowledgement of POA receipts, as the National Taxpayer Advocate also recommends.

There is an alternative to the traditional methods for submitting POAs (mail and fax) available for eligible tax professionals. Disclosure authorization is offered through e-Services and allows tax professionals to electronically submit Form 2848 and Form 8821. This e-service expedites processing and issues a real-time acknowledgment of accepted submissions. Eligible tax professionals can complete authorization forms, view and modify existing forms, and receive acknowledgement of accepted submissions immediately.

The National Taxpayer Advocate also recommends the implementation of dual address change letters alerting employers when a third party has initiated a change of address in cases where the third party payer has access to the client employer's funds. As noted by the National Taxpayer Advocate, the IRS assembled a team comprised of Collection, Specialty Tax, TAS, Submission Processing, Office of Chief Counsel, and SB/SE Research personnel to address this issue. The team received Office of Chief Counsel advice noting that the change of address notices may only be sent in limited circumstances when the IRS has reason to believe that the address change was not authorized by the taxpayer. Once this advice was received, the team began discussing options for more accurately identifying employer accounts involving third party payers and determining how many changes of address are input yearly. The team is currently working to determine the scope of the problem and discuss various approaches to addressing the change of address issue.

The National Taxpayer Advocate also recommends that the IRS create a POA form specifically for LITCs to allow the clinic director, as a primary representative, to substitute student POAs at the end of an academic term with new students. As previously stated, the IRS cannot record a POA on the CAF unless the POA is on a Form 2848 or a completed Form 2848 has been attached to the document.

Finally, the IRS agrees with the National Taxpayer Advocate's final recommendation to conduct research to determine the cause of the increase of POAs by individuals. We believe a better understanding of increasing volumes will allow us to further enhance and improve our systems and processes.

⁵¹ The Enterprise e-Fax Solution will provide an electronic fax solution that can send, receive, route, and deliver electronic fax documents. This will allow the IRS to reduce its reliance on paper records and eliminate the need for standalone fax hardware and consumables. The solution will act as a 'fax utility' or edge service that provides the fax-handling infrastructure.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS has taken steps to improve processing of POA forms by simplifying procedures laid out in the IRM and partnering with the practitioner community through phone and tax forums. She is also encouraged that the IRS will conduct research to determine the cause of the recent increases in POA CAF requests. Identifying these causes should provide valuable information, including the appropriate staffing levels, and prevent lengthy delays in the future. However, as long as POA processing problems exist, practitioners' ability to represent their clients will be impaired and fundamental taxpayer rights will be undermined.

While the 2010 spike in POA CAF requests appears temporary, the POA processing timeframes are still longer than normal, possibly due to reductions in CAF unit staffing.⁵² The IRS states in its response that CAF staffing (employees who process POAs) has decreased by only two percent, compared to the previously reported 20 percent decrease in CAF unit staffing between 2004 and 2009.⁵³ However, the two percent figure does not include the unit's attrition rate or reductions in support staff, and does not truly reflect CAF unit staffing or its decline since 2004. Further, as demonstrated by Chart 1.12.1, Volume of Power Attorney Filings, CAF unit inventory has increased by 83 percent during the same time. It is logical to assume a correlation between staffing, inventory, and efficiency. Given the importance of the CAF unit's function, a skilled, dedicated staff is essential to maintain accurate and reasonable processing timeframes

We agree that a recognized representative may represent a taxpayer before any IRS officer or employee by providing that employee with a copy of a valid POA form (regardless of whether the POA form has been recorded on the CAF). However, there have been numerous reports from practitioners and LITCs that even when time sensitive tax issues are present, some IRS employees will not speak with a student or practitioner until the CAF records the POA form. Further, not all frontline employees have the technical expertise to validate a POA form or its submitter. Establishing an adequate, permanent staff will permit the IRS to address the increase in inventory and prevent spikes in processing time seen in the past few months. This proactive approach will also prevent the IRS from having to remove employees from its other functions to process POAs.

In its response, the IRS states that the Statement of Procedural Rules § 601-503(a) does not create a representative's legal right to receive taxpayer correspondence directly from the IRS. However, Treasury Regulation 601.506(a) expressly requires the IRS to send all original correspondence to the taxpayer and provide a copy to the representative when there is

⁵² IRM 21.3.7.1.7 (Oct. 26, 2009).

⁵³ W&I response to TAS questions (Oct. 19, 2010). In FY 2004, the CAF unit had a total of 252 employees and in FY 2009 the number had declined to a total of 206 CAF unit employees. W&I stated that all CAF sites have trained additional staff to assist when inventory spikes, but if POA requests spike during filing season or other periods where campus work is high, these additional personnel may not be available to the POA unit.

a valid POA form on file, unless the taxpayer has indicated otherwise on Form 2848.⁵⁴ The IRS's attempt to ignore or explain away this regulation demonstrates its failure to grasp that the taxpayer's right to representation is a key component to a fair and just tax system. Additionally, violation of this regulation may be a cause of action for damages under IRC § 7433 for negligence in collection.⁵⁵

Low Income Taxpayer Clinics

The National Taxpayer Advocate and the LITCs have for years advised the IRS that each clinic's semester is different, and some extend beyond the 130-day period in which a student's POA remains valid. While the OPR approves special orders, it does not regulate time for which a POA form is valid, a policy that is nonetheless burdensome for clinics in situations where a student's representation expires before the end of the semester or before a taxpayer's problem is fully resolved. Adopting the National Taxpayer Advocate's recommendation to extend the 130-day time period via a revised POA form 2848, or a newly developed LITC-specific POA form, would allow for seamless representation by LITCs and their students without violating any statutory guidelines.⁵⁶ Reducing these burdens is crucial because low income taxpayers may not have access to any other form of representation.

The National Taxpayer Advocate believes creating a POA form for the LITCs may reduce some of the burden. She understands that current procedures do not permit such a solution, but encourages the IRS to explore the possibility of designing a new form and procedures specifically for LITCs.

Taxpayer Representation Designation

The National Taxpayer Advocate is pleased that the IRS is taking steps to protect a taxpayers' right to representation. However, practitioners with the LITC program and the AICPA have raised concerns that IRS employees in various functions have bypassed representatives without reason and without regard for the bypass procedures.⁵⁷ In an informal review cited in the 2009 Annual Report, the National Taxpayer Advocate found eight potential POA bypass violations, of which only one was elevated to TIGTA for investigation.⁵⁸ Moreover, the TIGTA report states "for the 12th consecutive year it could not give an opinion on how well the IRS is complying with IRC 7521 restrictions on direct contact because of limitations within the IRS's management information systems."⁵⁹

⁵⁴ Treas. Reg. § 601.506(a). The 601 part of the regulations is signed by the Commissioner of the IRS without the approval of the Secretary of the Treasury, and therefore does not have the force and effect of law as regulations issued by the Secretary. IRC § 7805(a).

⁵⁵ IRC § 7433(a) permits taxpayers to sue for civil damages in District Court when the IRS has taken an unauthorized collection action by way of an IRS employee recklessly or intentionally, or by reason of negligence has disregarded any provision of the Internal Revenue Code or any regulations promulgated there under.

⁵⁶ National Taxpayer Advocate 2009 Annual Report to Congress 260-262 (see specifically recommendation 3 on page 262).

⁵⁷ TAS Teleconference with AICPA (Aug. 18, 2009) and ABA LITC Teleconferences (Sept. 21, 2009; May 27, 2010; and Sept. 30, 2010).

⁵⁸ National Taxpayer Advocate 2009 Annual Report to Congress 261.

⁵⁹ TIGTA, Ref. No. 2010-30-060, *Statutory Review of Restrictions on Directly Contacting Taxpayers 7* (June 3, 2010).

The National Taxpayer Advocate fully understands the IRS's budget constraints and its competing priorities. However, considering the significance of an IRC § 7521 violation, the National Taxpayer Advocate remains concerned that, in the absence of an effective measurement system, violations will continue to go undetected. The National Taxpayer Advocate encourages the IRS to work with TAS to establish a process of gathering and tracking taxpayer and POA complaints on direct contact violations. This process will enable the IRS to develop better training for its employees and provide more effective oversight. At a minimum, the IRS should provide mandatory annual training for all contact employees.⁶⁰

The National Taxpayer Advocate is encouraged to learn that the IRS agrees with her on the importance of implementing a Correspondence Imaging System or a substantially similar alternative that enhances the efficiency of the CAF. Fully automating the acknowledgment of POA receipts can effectively eliminate the backlog created by duplicate filings. The National Taxpayer Advocate applauds the IRS for taking these steps and is optimistic that they will help reduce processing time and burden for practitioners and IRS employees.

However, National Taxpayer Advocate is concerned about the alternative method of filing a POA form referenced in the IRS response – the electronic submission of Forms 2848 and 8821 through the IRS e-Services system. Several LITC directors have encountered problems with the system. For example, practitioners cannot electronically modify Form 2848 by substituting a tax representative on line 5 of Form 2848. Additionally, qualified practitioners who do not have a filing history cannot obtain access to e-Services. This policy affects students even though they derive their authority through the LITC director (a Circular 230 representative) and receive clearance by the OPR. Every e-Services user must register with the IRS's Management Information Technology Services (MITS) division. The registration process requires an ID check, including verification of the person's adjusted gross income (AGI) from his or her most recent tax return. Since many students do not have a filing requirement and therefore have no AGI to report, they cannot complete the process and are essentially excluded from the e-Services program. Both of these problems are barriers to the use of e-Services, especially for the LITCs.

Finally, the National Taxpayer Advocate is pleased that the IRS is collaborating with TAS to implement dual address change letters which will alert employers when a third party initiates a change of address (in cases where the third party payer has access to the client employer's funds). Through these efforts, she is optimistic that the IRS and TAS will achieve implementation by the close of 2011.

⁶⁰ National Taxpayer Advocate 2007 Annual Report to Congress 140-155.

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. The IRS should establish a process of gathering and tracking taxpayer and POA complaints on direct contact violations and provide mandatory annual training for all contact employees.
2. The IRS should implement a Correspondence Imaging System (*i.e.*, a paperless fax) or alternative system to prevent lengthy CAF delays and potential adverse actions to taxpayers.
3. The CAF unit should timely acknowledge receipt of all POA forms to prevent costly rework when a POA cannot determine if his or her request is being processed in a reasonable time.
4. The IRS should, by the close of FY 2011, finalize implementation of dual address change letters alerting employers that a third party has initiated a change of address in cases where the third party payer has access to the client employer's funds.
5. The IRS should create a POA form specifically for LITCs to allow the clinic director, as a primary representative, to substitute student POAs at the end of an academic term with new students.

MSP
#13**IRS Collection Policies Channel Taxpayers Into Installment Agreements They Cannot Afford****RESPONSIBLE OFFICIALS**

Chris Wagner, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

If a taxpayer owes \$25,000 or less and agrees to pay the liability in full within five years (and before the collection statute expiration date or CSED), the IRS may accept a “streamlined” installment agreement (IA) without analyzing the taxpayer’s ability to pay.¹ While streamlined IAs are appropriate for many taxpayers, an IRS study found that of the requests for streamlined IAs received by IRS toll-free Customer Service Representatives (CSR) or Automated Collection System (ACS) personnel, about 42.3 percent and 28.3 percent, respectively, were from taxpayers who *could not afford the payments*.²

The following IRS policies and procedures are likely to channel some taxpayers into streamlined IAs they cannot afford in lieu of more appropriate alternatives (*e.g.*, IAs with lower payments, offers in compromise (OIC), or currently not collectible (CNC) designations):

- The IRS generally requires extensive financial documentation and files a lien when taxpayers request alternatives to streamlined IAs;³
- The IRS uses computers and non-collection employees to process streamlined IAs in less than five minutes without asking if the taxpayer can afford the proposed payments or discussing alternatives;⁴ and
- When the IRS receives a written request for an IA that does not include an acceptable payment amount, the IRS puts the taxpayer into a streamlined IA with payments sufficient to satisfy the liability within five years – without first obtaining the taxpayer’s express consent – even though this practice may *violate the law*.⁵

These and other policies that channel taxpayers into streamlined IAs may divert them from more appropriate collection alternatives, prompt them to go without basic living expenses, or cause them to fall behind on taxes due in the future.

¹ “Streamlined,” “guaranteed,” and “in-business trust fund express” IAs are all very similar and none of them require an analysis of the taxpayer’s ability to pay. See Internal Revenue Manual (IRM) 5.14.5 (June 5, 2010). We do not discuss them separately.

² Small Business/Self-Employed Division (SB/SE) Research, Ft. Lauderdale/Greensboro, Project 04.08.002.03, *The Impact on the Installment Agreement Default Rate When Using a “Financial Calculator”* 9 (June 2005). Surprisingly, the study concluded the IRS should not identify payment amounts that taxpayers could afford because it estimated that such a procedure would not significantly decrease short-term default rates. *Id.* at iii.

³ See IRM 5.12.2.4.1 (Oct. 30, 2009); IRM 5.14.1.4.2 (June 1, 2010); IRM 5.8.4.13 (June 1, 2010); IRM 5.16.1.1(4) (May 5, 2009).

⁴ IRM 5.19.1.3.5.1(1) (May 14, 2008).

⁵ IRS response to TAS information request (Aug. 18, 2010); National Office Program Manager Technical Advice, PMTA-2009-2032 (Nov. 26, 2008).

ANALYSIS OF PROBLEM

Background

Collection alternatives allow the IRS to avoid creating economic hardships, collect what is feasible, and improve voluntary compliance.

Collection alternatives allow the IRS to avoid inflicting economic hardships as it attempts to collect taxes. If a taxpayer cannot pay without experiencing an economic hardship, the IRS may classify the taxpayer's account as CNC and suspend collection.⁶ If the taxpayer can pay over time, the IRS may accept an IA. If payments the taxpayer can afford will not fully satisfy the liability before the CSED, the IA is called a "partial payment" installment agreement (PPIA).⁷ Another option is for the IRS to accept an offer in compromise to settle the tax debt for an amount that reflects the debtor's "reasonable collection potential."⁸ These collection alternatives make sense from the government's perspective because they allow the government to collect what is feasible while promoting future compliance.⁹ They also allow the IRS to focus its limited enforcement resources on other taxpayers who refuse to try to pay what they owe.

Most collection alternatives require taxpayers to submit detailed financial information and prompt the IRS to file liens.

The IRS generally requires taxpayers to provide detailed financial information before accepting a non-streamlined IA or an offer, or classifying a taxpayer's account as CNC based on hardship.¹⁰ However, taxpayers who cannot pay their taxes are often hesitant to provide such information to the IRS.¹¹ In addition, standard procedures generally require the IRS to file a lien upon receipt of a request for any of these collection alternatives, particularly if the taxpayer owes \$5,000 or more.¹² Thus, both taxpayers and the IRS may seek other alternatives, such as streamlined IAs.¹³

⁶ See, e.g., IRM 5.16.1.2.9 (May 5, 2009).

⁷ See, e.g., IRM 5.14.2 (Aug. 5, 2010).

⁸ See Internal Revenue Code (IRC) § 7122. For a discussion of the IRS's reluctance to use OICs, see, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 374; National Taxpayer Advocate 2009 Annual Report to Congress 196.

⁹ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 374 (Most Serious Problem: *Offer in Compromise*).

¹⁰ See, e.g., IRM 5.14.5 (Aug. 5, 2010) (IA); IRM 5.16.1.2.9 (May 5, 2009) (CNC); IRM 5.8.1.1.3(1) (Sept. 23, 2008) (OIC).

¹¹ One survey of taxpayers eligible for TAS services but not using them found that about 43 percent are intimidated by the IRS and 31 percent are distrustful of the IRS. See Russell Marketing Research, *Findings from Task 149 – Taxpayer Advocate Service Research Program, With A Focus on the Detailed Study of the Underserved Segment, Phase II, Study #3*, 18-21 (July 2002). Moreover, about 11 percent are "income secretive" and refuse to discuss their income. *Id.*

¹² See IRM 5.12.2.4.1 (Oct. 30, 2009) (non-streamlined IA processing); IRM 5.14.1.4.2 (June 1, 2010) (same); IRM 5.8.4.13 (June 1, 2010) (offer processing); IRM 5.16.1.1(4) (May 5, 2009) (CNC processing). For a discussion of problems with the IRS's lien filing policies, see National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

¹³ For a discussion of policies and procedures that discourage taxpayers from utilizing most collection alternatives, see, e.g., National Taxpayer Advocate 2006 Annual Report to Congress 83 (Most Serious Problem: *IRS Collection Payment Alternatives*).

The IRS Restructuring and Reform Act of 1998 expanded the availability of IAs.

In 1997, the National Commission on Restructuring the IRS concluded that collection alternatives such as IAs and OICs increase IRS revenues and improve voluntary compliance.¹⁴ However, taxpayers in certain geographic areas found it difficult to obtain them.¹⁵ The Commission recommended requiring the IRS to enter into these alternatives if certain requirements were satisfied.¹⁶ In 1998, Congress responded by generally requiring the IRS to enter into so-called “guaranteed” IAs if the taxpayer owed \$10,000 or less, had a clean compliance history, was financially unable to pay the liability timely, and would repay the liability within three years under the agreement.¹⁷

In 1998, the IRS further expanded the availability of IAs by allowing taxpayers who owed \$15,000 or less to enter into three-year “streamlined” agreements if they met certain other requirements, without requiring them to submit any financial information.¹⁸ In 1999, the IRS expanded the streamlined IA threshold and increased the repayment period.¹⁹

Streamlined IAs generally do not require an analysis of detailed financial information or prompt the IRS to file liens.

Under current procedures, if a taxpayer owes \$25,000 or less and agrees to pay the liability in full within five years (and before the CSED), the IRS may accept a “streamlined” IA without analyzing his or her ability to pay.²⁰ A taxpayer can easily obtain a streamlined IA online, by submitting a one-page form or sending a letter, or calling a customer service representative.²¹ In addition, the IRS generally does not file a lien in connection with routine streamlined IA processing.²² Thus, the IRS provides significant incentives for taxpayers to use streamlined IAs.

Streamlined IAs also require few IRS resources because the IRS does not need to analyze the taxpayer’s financial situation. The IRS will not request the financial information necessary to determine the most appropriate resolution of a delinquent account unless no other options appear feasible.²³ If it did, it would have to either train customer service

¹⁴ Report of the National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 51-52 (June 25, 1997) (Appendix I).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3467, 112 Stat. 685 (1998) (codified at IRC § 6159(c)). This legislation codified the IRS’s standard practice. Conf. Rep. No. 105-599, at 292-93 (1998).

¹⁸ Memorandum from Assistant Commissioner (Collection), *Increase in Streamlined Installment Agreement Dollar Authority* (Mar. 31, 1998), reprinted as, *Memo on Streamlined Installment Agreements Released*, 1999 TNT 111-26 (June 10, 1999).

¹⁹ See IRM 5.14.2.2 (Oct. 18, 1999); Memorandum from Assistant Commissioner (Collection), *Increase in Streamlined Installment Agreement Authority* (Mar. 17, 1999), reprinted as, *Memo on Streamlined Installment Agreements Released*, 1999 TNT 111-24 (June 10, 1999). However, this guidance contemplated a conversation between the IRS and taxpayers. *Id.* (noting “[t]axpayers should be questioned on the amount they can pay every month...”).

²⁰ See IRM 5.14.5 (Sept. 26, 2008). If a taxpayer is ineligible for a streamlined IA because he or she owes more than \$25,000, the IRS encourages the taxpayer to pay amounts in excess of \$25,000 so that he or she can avoid submitting financial information. IRM 5.14.5.2(9) (Aug. 5, 2010).

²¹ See IRM 5.14.5 (Sept. 26, 2008); IRS, *Online Payment Agreement Application*, <http://www.irs.gov/individuals/article/0,,id=149373,00.html> (last updated Dec. 7, 2010); IRS Form 9465, *Installment Agreement Request* (Dec. 2009) (one-page form with two pages of instructions).

²² See IRM 5.12.2.4.1 (Oct. 30, 2009); IRM 5.14.5.2 (Aug. 5, 2010).

²³ See, e.g., IRM 5.19.1.5(4) (Dec. 4, 2009).

representatives in financial analysis (a higher-graded duty) or move the streamlined IA work to other employees.²⁴ Thus, streamlined IAs allow the IRS to use non-collection personnel and to close cases quickly – often in five minutes or less – without spending the time and resources that would be needed to determine if other collection alternatives are more appropriate.²⁵

The IRS sometimes puts taxpayers into streamlined IAs without express consent, notwithstanding legal concerns with this practice.

The IRS sometimes puts taxpayers into streamlined IAs without their express consent. For example, if the IRS receives correspondence from a taxpayer offering to pay in installments, but not specifying a monthly payment amount, it sets up a streamlined IA with monthly payments equal to the liability divided by 60.²⁶ The IRS may do this for up to a quarter of all IAs because during the peak filing season in fiscal year (FY) 2009, 25 percent of all IA requests did not include a proposed amount.²⁷ The IRS may also initiate a streamlined IA without express consent if the taxpayer proposes a monthly amount insufficient to repay the debt within 60 months and does not include the financial information the IRS needs to process a non-streamlined IA.²⁸

In 2008, the IRS Office of Chief Counsel identified legal concerns with the practice of initiating IAs with payment terms to which the taxpayer had not expressly agreed.²⁹ Its main concern was that the practice may violate the statutory requirement under IRC § 6159(a) that the Secretary enter into “written agreements” for the payment of tax by installment. The Chief Counsel opinion reasons that even if the taxpayer actually makes the payment proposed by the IRS, the taxpayer has not agreed to it in writing. According to the opinion, the same concern is not present when a taxpayer requests an IA by submitting Form 9465, *Installment Agreement Request*, with a blank payment amount, because language on the form authorizes the IRS to compute the amount.³⁰ However, many taxpayers do not use

²⁴ In FY 2009, about 40 percent of the IAs accepted by the IRS (1,270,239/3,197,862) originated from Toll-Free Accounts Management rather than collection. IRS, Collection Activity Report (CAR) NO-5000-6 (May 25, 2010).

²⁵ See IRM 5.19.1.3.5.1(1) (May 14, 2008) (indicating that a streamlined IA processing is an example of work that should be completed in less than five minutes by persons opening the mail in connection with the “Collection First Read Process”).

²⁶ If an IRS employee receives “[c]orrespondence or Forms 433 without a proposed amount, or the amount proposed was insufficient to meet SIA” criteria, then IRS guidance directs the employee to “[s]end Letter 2274C advising the taxpayer of the minimum amount that could be accepted.” IRM 5.19.1.5.5(16) (Dec. 4, 2009). One paragraph of this letter states: “Your request for an Installment Agreement was received with no proposed monthly payment amount. The minimum payment we can accept without a review of your financial information is \$____. We have approved an Installment Agreement for this amount.” Letter 2274(c), *Your Request for Installment Agreement Has Been Granted*, ¶G (Apr. 2010). A similar form letter provides: “The minimum payment we can accept without a review of your financial information is \$[____]. We’ve approved an agreement for this amount.” Letter 2273(c), *Installment Agreement Accepted; Terms Explained*, ¶N (July 2010).

²⁷ IRS response to TAS information request (Aug. 18, 2010).

²⁸ Another paragraph of the IRS letter states: “We cannot accept the monthly payment amount you proposed without a review of your financial information. The minimum payment we can accept at this time is \$____. We have approved an Installment Agreement for this amount.” Letter 2274(c), *Your Request for Installment Agreement Has Been Granted*, ¶H (Apr. 2010).

²⁹ National Office Program Manager Technical Advice, PMTA-2009-2032 (Nov. 26, 2008) (raising concerns the practice may (1) violate the statutory requirement that IAs be in writing, (2) cause collection of the IA user fee to be improper, and (3) create uncertainty as to when a levy is prohibited).

³⁰ The form states: “If a payment amount is not listed on line 11, one will be determined for you by dividing the balance due by 60 months.” Form 9465, *Installment Agreement Request* (Dec. 2009).

this form to request an IA. While we understand the IRS may revise these procedures, it has not done so. In August of 2009, the IRS estimated that changing the practice would require it to send out 281,000 more letters in FY 2010, which would generate 94,400 more incoming calls that it was not necessarily prepared to receive.³¹

The IRS puts more taxpayers into streamlined IAs than any other collection alternative.

Given the strong incentives for taxpayers and the IRS to favor streamlined IAs in lieu of other collection alternatives, it is not surprising that in FY 2009 the IRS accepted more streamlined IAs (3,031,163) than offers (10,665), PPIAs (33,274), regular IAs (166,699), and CNC hardship determinations (217,135) combined.³² Moreover, streamlined IAs represented about 95 percent of all IAs.³³

The IRS does not know if its streamlined IA default rates are high or low.

The streamlined IA default rate is slightly lower than the non-streamlined or “regular” IA default rate. According to IRS figures, for FY 2009 it was about 17.4 percent, as compared to a regular IA default rate of about 22.6 percent.³⁴ However, the non-streamlined IA default rate may not provide an appropriate comparison. The IRS’s financial analysis methodology overestimates the amount a taxpayer can pay by disallowing (*i.e.*, ignoring) payments due to certain junior creditors.³⁵ As a result, in some cases the IRS requires regular IA or PPIA payments that exceed what the taxpayer can reasonably pay. Because it is difficult to find an appropriate benchmark, the IRS does not really know if the streamlined IA default rate is high or low.³⁶

The IRS does not know the impact of accepting streamlined IAs that taxpayers cannot afford.

A 2002 Booz Allen Hamilton study recommended the IRS use an Excel spreadsheet that it developed (called a “financial calculator”) to allow employees to identify streamlined IAs that taxpayers could not afford.³⁷ For taxpayers who could not afford the proposed

³¹ IRS, *Impact Assessment: New CSCO Installment Agreement Letter Containing the CAS AM Phone Number* (Aug. 3, 2009).

³² IRS, CAR NO-5000-6 (Oct. 5, 2009); IRS, CAR NO-5000-108 (Oct. 7, 2009) (reflecting offers accepted in FY 2009); IRS, Compliance Data Warehouse Individual Master File (IMF) (cycle 201033) (CNC figures). We computed the number of regular IAs by starting with the total number of IAs and then subtracting streamlined IAs and PPIAs.

³³ Of the 3,197,862 IAs accepted in FY 2009, 3,031,163 (*i.e.*, 94.8 percent) were streamlined IAs. IRS, CAR NO-5000-6 (Oct. 5, 2009).

³⁴ IRS, CAR NO-5000-6 (Oct. 5, 2009). The IRS computes IA default rates on a yearly basis by dividing the number of IAs that defaulted in a given period by the total number of opportunities to default. *Id.* However, it does not default an IA when a taxpayer fails to make a tax payment during the IA repayment period, provided the taxpayer agrees to roll the additional liability into the IA repayment schedule. IRM 5.19.1.5.5.22 (May 10, 2010); IRM 5.19.1.5.5.22 (May 10, 2010); IRM 5.19.1.5.5.21 (May 10, 2010). If it did, the FY 2009 default rates would rise to 36.1 percent for streamlined IAs and 63.2 percent for regular IAs. Compliance Data Warehouse (Sept. 10, 2010).

³⁵ This may be because the IRS disallows debt when computing how much a taxpayer can pay. See *The IRS Does Not Know the Impact of Ignoring Non-IRS Debt When Analyzing a Taxpayer's Ability to Pay an IRS Debt*, *supra*.

³⁶ Regardless of the benchmark, however, a 17.4 percent default rate is burdensome for the taxpayer because the IRS will charge another user fee and hold the default against him or her when he or she seeks another IA or other collection alternative, as described below. See, *e.g.*, IRM 5.14.3.2(3)(d) (June 12, 2009).

³⁷ SB/SE Research, Ft. Lauderdale/Greensboro, Project 04.08.002.03, *The Impact on the Installment Agreement Default Rate When Using a “Financial Calculator”* (June 2005).

streamlined IA, the study recommended the IRS either reduce the monthly payments or find a more appropriate collection alternative.

A 2004 IRS study designed to follow up on these recommendations found that in communications with employees at IRS toll-free and ACS sites, a significant number of taxpayers proposed to enter into IAs that (according to the financial calculator) they could not afford – approximately 42.3 and 28.3 percent, respectively, for toll-free and ACS.³⁸ Of the cases where taxpayers proposed amounts they could not afford, most – 86.3 and 82.1 percent, respectively – could not even afford a payment that would pay the liability within 60 months.³⁹ For purposes of the study, the IRS would accept the amount the calculator determined the taxpayer could afford.⁴⁰ While IA default rates over a ten-month period were lower for taxpayers who could afford the payments than for those who could not, the differences were not statistically significant.⁴¹ Thus, the study concluded the IRS should not use the financial calculator because it did not reduce IA default rates by a statistically significant amount.

However, the extent to which IRS policies prompt taxpayers to do without reasonable basic living expenses or promote future noncompliance is just as important as, if not more important than, the default rates. Even with respect to default rates, the study raised more questions than it answered. It looked at IA default rates over ten months, rather than over the life of the IAs.⁴² Although the calculator did prompt users to consider some non-tax debts in determining a taxpayer's ability to pay, it did not collect information about many common debts, such as payments on student loans or state and local tax delinquencies.⁴³ Thus, it may have overestimated the amount a taxpayer could afford. This problem could help to explain the study's conclusion that a taxpayer's financial condition, as determined by the financial calculator, had no statistically significant impact on the IA default rate.

Taxpayer attempts to avoid defaulting on unrealistic streamlined IAs may trigger economic hardship and noncompliance.

Taxpayers have significant incentives to avoid defaulting on streamlined IAs. For example, a taxpayer who defaults is likely to be subject to an IRS lien or levy more quickly than others, and is ineligible for another IA unless an IRS manager considers the reason for the

³⁸ SB/SE Research, Ft. Lauderdale/Greensboro, Project 04.08.002.03, *The Impact on the Installment Agreement Default Rate When Using a "Financial Calculator"* 9 (June 2005).

³⁹ *Id.* at 10.

⁴⁰ *Id.* Normally the IRS does not allow certain "conditional expenses," including most junior debts, unless the taxpayer can fully pay the liability within 60 months. IRM 5.15.1.10 (Oct. 2, 2009).

⁴¹ SB/SE Research, Ft. Lauderdale/Greensboro, Project 04.08.002.03, *The Impact on the Installment Agreement Default Rate When Using a "Financial Calculator"* iii, 8-12 (June 2005) ("Although there appears to be a slightly lower default rate for the test group, the control and test group default rates are not statistically different.... The 'financial calculator' should not be used since the test results indicate that using it will not help reduce the installment agreement default rate.").

⁴² In FY 2009, taxpayers made payments on IAs for 56 weeks, on average – significantly longer than the 10 months covered by the study. IRS, CAR NO-5000-6 (Oct. 5, 2009) (cumulative data for FY 2009). Ten months is also too short a time to assess the impact of the IA on future compliance.

⁴³ For a discussion of debts that the IRS typically ignores for purposes of its financial analysis, see *The IRS Does Not Know the Impact of Ignoring Non-IRS Debt When Analyzing a Taxpayer's Ability to Pay an IRS Debt*, *supra*.

default and analyzes the taxpayer's ability to pay.⁴⁴ He or she is more likely to be subject to seizure because of the IRS's inference that the default means he or she "won't pay" voluntarily.⁴⁵ In addition, if the taxpayer requests another IA, the IRS is more likely to determine that the request is "solely to delay collection," in which case it will ignore the request and continue collection activity.⁴⁶ To live up to the agreement and avoid these consequences, some taxpayers are likely to make payments on IAs they cannot afford.

When taxpayers enter into IAs they cannot afford, they are more likely to experience economic hardship or default on current or future tax liabilities. While the law does not expressly prevent the IRS from using streamlined IAs to create economic hardship, it does prevent the IRS from using levies to do so.⁴⁷ The IRS should not use streamlined IAs to undermine the rules applicable to levies. In addition, channeling taxpayers into IAs they cannot afford when other payment alternatives are more appropriate sets them up for failure, rather than future compliance.

CONCLUSION

The IRS does not know the consequences of encouraging taxpayers to enter streamlined IAs they cannot afford. Some taxpayers will make the payments even if they create economic hardships while others will default on their agreements or future tax liabilities. The IRS needs to know the extent to which streamlined IAs prompt taxpayers to do without reasonable basic living expenses or to fall behind on taxes due in future periods.

The National Taxpayer Advocate offers these preliminary recommendations:

1. Discontinue the practice of putting taxpayers into streamlined IAs without their express consent, as recommended by the IRS Office of Chief Counsel;
2. Revise the streamlined IA acceptance form letter to explain that the taxpayer should contact the IRS to request another collection alternative such as a regular IA, PPIA, or offer if he or she cannot make the payments for any reason (including any extenuating circumstances);⁴⁸ and
3. Study the impact of collection alternatives, including streamlined IAs, on future compliance by various taxpayer segments. As part of this study, survey taxpayers who default on IAs to find out why.

⁴⁴ See, e.g., IRM 5.19.5.3.2(1)(d) (Aug. 1, 2008) (levy); IRM 5.14.11.5(2) (Aug. 9, 2010) (lien); IRM 5.14.9.2 (Aug. 5, 2010) (new IA requires managerial approval); IRM 5.14.11.5 (Aug. 5, 2010) (new IA requires analysis of reasons for default and ability to pay). The taxpayer also becomes ineligible for a "guaranteed" IA. IRC § 6159(c)(2)(C).

⁴⁵ See, e.g., IRM 5.10.1.6(2) (July 3, 2009).

⁴⁶ See IRM 5.14.3.2(3)(d) (June 12, 2009).

⁴⁷ See, e.g., IRC § 6343(a)(1)(D) (requiring the IRS to release a levy if it is creating an "economic hardship"). An economic hardship exists when a taxpayer is unable to pay his or her "reasonable basic living expenses." See Treas. Reg. § 301.6343-1(b)(4).

⁴⁸ See, e.g., Letter 0681C (Mar. 2010); Letter 2840C (Mar. 2010); Letter 3217C (Mar. 2009). In redesigning the letters, the IRS can draw on the principles described in Siegel & Gale's recent review of the OIC form. See Siegel & Gale, *Offer in Compromise, Strategic Recommendations* 10-13 (July 31, 2009).

IRS COMMENTS

The streamlined installment agreement process allows the IRS to serve a greater number of taxpayers by reducing the burden of both the taxpayer and the government in resolving balance due accounts. The process is beneficial to both the taxpayer and the IRS. The streamlined installment agreement provides taxpayers with an easy method with minimal burden by which to return to compliance with their tax responsibilities. These agreements may be processed quickly, without financial analysis or managerial approval, and do not require the filing of the Notice of Federal Tax Lien. Streamlined installment agreements are set up for a monthly payment amount that the taxpayers have determined is reasonable and affordable.

The qualification criteria to be considered for a streamlined agreement include:

- Types of accounts – Individual, in-business (income tax only) or out of business accounts;
- Unpaid balance of assessments not to exceed \$25,000; and
- Agreement must full pay within 60 months (or within the collection statute).⁴⁹

The IRS provided streamlined installment agreements to over three million taxpayers in fiscal year 2010. These streamlined agreements accounted for 94 percent of all installment agreements granted by the IRS during that period.⁵⁰

The IRS provides information on the installment agreement process through various publications, notices and the IRS.gov website to educate the public about the process. In September 2008, the Taxpayer Communications Taskgroup (TACT) program was established to develop strategies and solutions to increase the clarity, accuracy, and effectiveness of the IRS written communications associated with taxpayer accounts.⁵¹ All correspondence to taxpayers related to installment agreements were reviewed. Several installment agreement letters were revised to provide additional clarity and increase customer satisfaction.

The IRS disagrees with the National Taxpayer Advocate that collection policies related to streamlined agreements channel taxpayers into agreements they cannot afford and create hardship. The streamlined agreement process allows the taxpayer to make the decision to enter into an agreement to resolve the liability without requiring the IRS to analyze the taxpayer's personal finances. The taxpayer determines whether the payment amount is appropriate for them given their current income and expenses. If the payment amount does not meet the requirements of the streamlined installment agreement, the IRS explores other payment alternatives to resolve the liability.

⁴⁹ IRM 5.19.1.5.5 (Dec. 4, 2009) ("Installment Agreements") and IRM 5.14.5.2 (Aug. 5, 2010) ("Streamlined Installment Agreements").

⁵⁰ IRS, CAR NO-5000-6 (Sept. 2010).

⁵¹ TACT Charter (Nov. 20, 2008).

Taxpayers who have installment agreements are informed in various forms, publications, and letters that if they cannot meet the terms of their agreement that they should contact the IRS. Changes in financial condition can impact the taxpayer's ability to make installment payments on an existing agreement. The IRS will assist the taxpayer in determining the best resolution depending on the current circumstances. If taxpayers have set up unrealistic streamlined agreements, this process will help them to revise their agreements as well.

The report makes three preliminary recommendations to improve streamlined installment agreement process. The IRS is taking or has taken the following actions with respect to these recommendations:

The IRS worked with the National Taxpayer Advocate to develop procedures and a response letter for situations when a taxpayer requests an installment agreement and either they do not propose an amount or the amount does not meet the streamlined installment agreement criteria.⁵² The letter explains to taxpayers that either no amount or an insufficient amount was proposed. In the letter, the IRS proposes a monthly payment sufficient to meet the streamlined installment agreement criteria. The taxpayer can either accept the amount proposed, or contact the IRS to make other arrangements. The Office of the Taxpayer Advocate was involved in the development of this policy and was supportive of it.⁵³

The IRS agrees to consider revising the installment agreement acceptance letters and other publications and letters to further educate taxpayers about other collection alternatives. The IRS recently revised many of the letters and forms to make them easier to understand as part of the TACT program. The IRS agrees to review suggestions for improvements to installment agreement correspondence to ensure sufficient educational material is provided.

The IRS agrees to research the impact of collection alternatives on future compliance. We will consult with research on the appropriate method, which may include contacting taxpayers that have defaulted.

⁵² Letter 2274(c), *Your Request for Installment Agreement Has Been Granted* (Apr. 2010).

⁵³ E-mails from TAS Office of Systemic Advocacy and National Taxpayer Advocate Attorney-Advisor (Dec. 9, 2008).

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for recognizing the need to study the impact of collection alternatives on future compliance. She is also pleased that the IRS acknowledges the need to improve communications with taxpayers about collection alternatives. In addition, she appreciates the IRS's effort to seek TAS comments on a 2008 draft version of a letter it planned to send to taxpayers who requested an IA without proposing a specific amount.⁵⁴

However, the IRS's comments mischaracterize the National Taxpayer Advocate's office as being supportive of putting taxpayers who requested specific IA payment amounts into IAs that require higher payments than they proposed.⁵⁵ Moreover, the IRS's response does not address the conclusion by attorneys in the IRS Chief Counsel's office that this practice may violate the law.⁵⁶ To be clear, the National Taxpayer Advocate does not support this practice. When a taxpayer contacts the IRS seeking to pay in installments, but proposes an insufficient monthly amount, the IRS should attempt to contact the taxpayer by phone and by letter. If it cannot reach the taxpayer, it should reject the proposed IA rather than placing the taxpayer into an IA with a higher monthly payment or deeming the proposed IA as "not processable."

The IRS comments also assert, "[S]treamlined installment agreements are set up for a monthly payment amount that the taxpayers have determined is reasonable and affordable." Of course, some taxpayers may determine that streamlined IA payments are affordable. However, there are many reasons (discussed above), which we will not repeat here, that may prompt taxpayers to enter into streamlined IAs requiring monthly payments that they cannot afford. Even the IRS's multifunctional Collection Process Study Team concluded:

Due to concerns that taxpayers will agree to enter into SLIAs they cannot afford to avoid liens, IRS employees should confirm verbally that the taxpayer can make monthly payments at the level required; if the taxpayer cannot make the minimum monthly payment, the IRS should discuss other payment options.⁵⁷

The National Taxpayer Advocate agrees.

⁵⁴ The draft letter computed the streamlined IA payment that would be acceptable to the IRS and requested that the taxpayer contact the IRS if he or she could not afford the payment. If the IRS did not receive a response within 30 days, it would initiate the proposed IA.

⁵⁵ The 2008 draft version of the Letter 2274C that TAS reviewed did not address situations where taxpayers proposed IA amounts that were too low to meet the streamlined IA criteria. TAS voiced concerns when it learned about this practice in 2009.

⁵⁶ While TAS itself had questions about the analysis contained in the opinion, the IRS appears to be ignoring the opinion rather than raising its own concerns.

⁵⁷ IRS Collection Process Study § 6.3.3.6 (Sept. 30, 2010). One recent report by the Treasury Inspector General for Tax Administration (TIGTA) was also critical of the IRS's practice of initiating streamlined IAs without contacting the taxpayer or considering if the taxpayer could pay. TIGTA, Ref. No. 2010-30-019, *Processing and Monitoring of Balance Due Notice Cases Needs Improvement 2* (Mar. 1, 2010).

Recommendations

The National Taxpayer Advocate offers these recommendations:

1. Discontinue the practice of putting taxpayers who have requested a specific IA payment into IAs that require a higher payment without the taxpayers' express consent;
2. Work with the Office of Chief Counsel to ensure the IRS is processing IAs lawfully;
3. Revise the streamlined IA acceptance form letter to explain that the taxpayer should contact the IRS to request another collection alternative such as a regular IA, PPIA, or offer if he or she cannot make the payments for any reason;⁵⁸ and
4. Collaborate with TAS to study the impact of collection alternatives, including streamlined IAs, on future compliance by various taxpayer segments. As part of this study, survey taxpayers who default on IAs to find out why.

⁵⁸ See, e.g., Letter 0681C (Mar. 2010); Letter 2840C (Mar. 2010); Letter 3217C (Mar. 2009).

MSP #14

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

RESPONSIBLE OFFICIAL

Chris Wagner, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Every year, the IRS assesses penalties on millions of taxpayers, many of whom ask that the penalties be abated.¹ To promote consistent and fair abatement decisions, the IRS requires its employees to use software called the Reasonable Cause Assistant (RCA) for Failure to File (FTF), Failure to Pay (FTP), and Failure to Deposit (FTD) penalty abatement requests.² The IRS designed the RCA to assist employees in determining whether to abate a penalty for reasonable cause.

However, IRS data illustrate that employees do not receive proper training in tax law to make accurate abatement determinations using the RCA. A 2010 usability test shows that employees using the RCA determined penalty abatement requests correctly in only 45 percent of the cases.³ What is perhaps more telling is that *all* of the employees in the study believed they were making correct legal determinations based on reasonable cause.⁴

Thus, a tool originally designed to encourage consistency is having the opposite effect. The National Taxpayer Advocate attributes this problem to the following factors:

- Employees charged with using the RCA lack adequate knowledge or training about reasonable cause;⁵
- IRS policies do not encourage employees to use the override feature when they believe an RCA determination is incorrect;⁶

¹ In fiscal year (FY) 2009, the IRS assessed at least one of the following penalties – Failure to File, Failure to Pay, or Failure to Deposit – against 12.2 million taxpayers, including both individuals and businesses. A taxpayer may have been assessed more than one of these penalties or had these penalties assessed on more than one tax module (counted as one taxpayer). IRS, Enforcement Revenue Information System (ERIS) (Sept. 2009).

² RCA can only consider FTF or FTP penalties on certain individual tax returns, and the FTD penalty only on certain business returns.

³ IRS, *Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 4* (May 28, 2010), hereinafter 2010 Usability Report.

⁴ 2010 Usability Report. TAS and the Government Accountability Office (GAO) have previously voiced concerns about inaccurate penalty assessments and abatements. In her 2008 Annual Report to Congress, the National Taxpayer Advocate reported that IRS miscalculations of FTP penalties and interest affected 8.3 percent, or approximately two million, of the taxpayers involved. National Taxpayer Advocate 2008 Annual Report to Congress 306. In 2009, the GAO recommended that the IRS take numerous actions, including ensuring that penalties are effectively, efficiently, fairly, and consistently administered to achieve the purpose of encouraging voluntary compliance. GAO, GAO-09-567, *IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts* 15 (June 2009).

⁵ See IRS Enterprise Learning Management System (ELMS) Course 17907, *Reasonable Cause Assistant (RCA) for AMS*; ELMS Course 25261, *SB-CO-RO Reasonable Cause Assistant for Revenue Officers*; Student Guide, *Accounts Management CPE IMF Issues, Lesson 11 – Penalties and Penalty Relief* (Catalog No. 10342-102). While these training materials mention reasonable cause, they do not specify the criteria for a reasonable cause determination.

⁶ On September 24, 2010, the IRS added a section to the Internal Revenue Manual (IRM) explaining the override feature. IRM 20.1.1.3.6.10.1 (Sept. 24, 2010). The National Taxpayer Advocate is hopeful that this new section will encourage IRS employees to use the override when appropriate.

- The RCA does not incorporate a feedback system to improve both human knowledge of reasonable cause and programming accuracy; and
- Taxpayers must initiate contact with the IRS to receive a First-Time Abatement (FTA), even though this function can be automated, freeing IRS employees to spend more time on reasonable cause determinations.

The result is that the RCA is not supplementing human judgment as intended – it is supplanting it. Without proper training and safeguards to ensure employees arrive at appropriate abatement decisions using the RCA, the IRS continues to unnecessarily harm taxpayers and create unnecessary re-work for itself.

ANALYSIS OF PROBLEM

Background

The IRS assesses penalties when taxpayers fail to timely file their returns, pay amounts due, or make required tax deposits.⁷ These penalties are assessed automatically once the IRS's computer system detects a return filed after a due date or with an underpayment of tax.⁸ The IRS removes (abates) these penalties if the taxpayer can show reasonable cause for the delinquency (*e.g.*, death, serious illness, fire, natural disaster, casualty, or loss).⁹ The IRS also abates penalties for reasonable cause when taxpayers exercise ordinary business care and prudence in determining tax obligations but are unable to comply with those obligations due to circumstances beyond their control.¹⁰ When taxpayers seek to have penalties abated, they must contact the IRS directly. Each case is judged on its individual facts and circumstances.¹¹

What Is the Reasonable Cause Assistant?

The RCA is an interactive decision support program used by IRS employees to evaluate a taxpayer's request for penalty relief due to reasonable cause. Even though the RCA guides the user through the determination process, the employee must still be trained and proficient in evaluating requests that cite reasonable cause criteria.¹² In 1998, the IRS Penalty Task Group led an effort to expand the RCA from a limited-use program to an enhanced version that was implemented in 2001.¹³ The task group recommended that RCA use be

⁷ See Internal Revenue Code (IRC) §§ 6651(a), 6656(a). IRC § 6651(a) refers to the failure to file and failure to pay penalties as "additions to tax," while IRC § 6656(a) refers to the failure to deposit penalty as a "penalty." For the sake of simplicity, all references to "penalties" also refer to "additions to tax."

⁸ A "manual" assessment of penalties typically follows tax audits, investigations, or other post-filing account adjustments.

⁹ IRC §§ 6651(a), 6656(a); *Sanders v. Comm'r*, 225 F.2d 629 (10th Cir. 1955), *cert. den.* 350 U.S. 967 (1956); *Ferrando v. United States*, 245 F.2d 582 (9th Cir. 1957); Treas. Reg. §§ 301.6651-1(c), 301.6656-1; IRM 20.1.1.3.2.2.1 (Dec. 11, 2009).

¹⁰ See *United States v. Boyle*, 469 U.S. 241 (1985) (holding that the IRS's correlation of "reasonable cause" with "ordinary business care and prudence" is consistent with Congress' intent and with case law as well, and such interpretation merits deference).

¹¹ IRM 20.1.2.1.3 (Sep. 4, 2009).

¹² IRM 20.1.1.3.2 (Dec. 11, 2009).

¹³ Office of Servicewide Penalty (OSP) response to TAS information request (July 1, 2010). RCA was limited in use in that it did not interact with other IRS systems as it does today. *Id.*

mandatory because previous reviews found that the IRS was not consistent in granting relief from penalties when employees used their own discretion. Currently, the IRS requires use of the RCA for all employees who decide whether to abate FTF, FTP, and FTD penalties based on reasonable cause criteria.¹⁴ As indicated by a 2010 RCA usability test, the use of the tool continues to generate inconsistent determinations.¹⁵

The RCA User Accuracy Rate Is Unacceptably Low.

Since 2002, TAS has received reports through its Systemic Advocacy Management System (SAMS) that the RCA program promotes unfair bias against taxpayers.¹⁶ These reports led to discussions between TAS and the IRS Office of Servicewide Penalties, resulting in a 2010 RCA usability study.¹⁷ The IRS's Usability Lab¹⁸ found that RCA users have varying levels of system skills and ability to analyze the penalty request, identify the applicable information, and apply the reasonable cause criteria that are critical for a correct determination.¹⁹ Despite a mere 45 percent accuracy rate, *all* participants thought they were working reasonable cause issues correctly, and using the system as intended. In fact, the Usability Lab study found a majority of employees were using RCA incorrectly and making erroneous determinations over half the time.²⁰

Employees Charged with Using the RCA Do Not Have Adequate Knowledge or Training about Reasonable Cause.

The initial training required of all RCA users covers the use of the RCA software in detail, but does not address issues of substantive law and reasonable cause criteria.²¹ In other words, the IRS trains RCA users on how to work the machine, but it leaves the thinking and judgment to the computer. Moreover, the 2010 Usability Lab report concludes that to

¹⁴ IRM 20.1.1.3.6(1) (Dec. 11, 2009).

¹⁵ 2010 Usability Report 4.

¹⁶ National Taxpayer Advocate Fiscal Year 2010 Objectives Report to Congress 66-67 ("Since 2002, there have been 35 RCA-related submissions on SAMS."). SAMS is a TAS application that acts as the primary method of receiving and prioritizing systemic issues and problems submitted by IRS employees and the public. TAS employs SAMS to facilitate taxpayers' ability to submit issues, suggestions, and ideas to help reduce or eliminate the burdens facing taxpayers.

¹⁷ Although the IRS assigns overall responsibility for its penalty programs to the OSP, which is part of the Small Business/Self-Employed (SB/SE) operating division, many IRS functions have a role in promoting voluntary compliance through penalty administration. The IRS's goal is to maintain consistent coordination of penalty programs so the information can be used to identify and respond to compliance problems. IRM 20.1.1.1.3 (Dec. 11, 2009). The OSP is responsible for administering policy and procedures that ensure consistency with the penalty policy statement; reviewing and analyzing penalty information; researching penalty effectiveness on compliance trends; and determining how to promote voluntary compliance. IRM 20.1.1-1 (Dec. 11, 2009); Penalty Policy Statement 20-1. The servicewide approach to penalties is embodied in the IRS Penalty Policy Statement 1.2.20.1 (Aug. 28, 2007); IRM 20.1.1-1 (Dec. 11, 2009). See also National Taxpayer Advocate 2008 Annual Report to Congress 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*) vol. 2, 2-45 (*A Framework for Reforming the Penalty Regime*); Department of the Treasury, Office of Tax Policy, *Report to the Congress on Penalty and Interest Provisions in the Internal Revenue Code* (Oct. 1999); Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (July 22, 1999).

¹⁸ The IRS Ogden (Utah) Usability Lab staff provides a variety of usability services for product development and is well versed in all phases of usability methodology. IRM 2.25.14.5 (Sept. 10, 2004).

¹⁹ 2010 Usability Report 4.

²⁰ *Id.* ("When de-briefing the participants, most thought they were working reasonable cause issues correctly and utilizing the system the way it was intended, yet, the majorities were not working the scenarios correctly").

²¹ See IRS ELMS Course 17907, *Reasonable Cause Assistant (RCA) for AMS*; ELMS Course 25261, *SB-CO-RO Reasonable Cause Assistant for Revenue Officers*; Student Guide, *Accounts Management CPE IMF Issues, Lesson 11 – Penalties and Penalty Relief* (Catalog No. 10342-102).

properly use RCA, employees must first possess a basic understanding of the application of reasonable cause criteria, in addition to computer training to input data into the program.²² Consequently, the IRS operates a penalty abatement practice that charges untrained and often inexperienced employees with the task of deciding which facts and circumstances legally constitute reasonable cause. Not surprisingly, untrained employees do not question the machine's results, thereby harming taxpayers by failing to abate penalties where reasonable cause does in fact exist.

The IRS Should Encourage Appropriate Use of the Override Feature.

The IRS programmed an override feature for employees to use at their discretion when RCA recommendations do not properly reflect a taxpayer's unique facts and circumstances.²³ Therefore, the IRS did not initially intend RCA to remove all human discretion from penalty abatement determinations, nor did it intend for RCA to address every potential issue raised by a taxpayer.

Although, the RCA override rate increased from one percent in 2005 to two percent in 2009, the low usage rate suggests that the IRS's failure to educate employees about the override option may result in its underutilization.²⁴ Since the purpose of the RCA is to generate fair and unbiased conclusions, the IRS should not discourage employees from overriding the RCA when human judgment, common sense, and limited RCA options make overriding appropriate.²⁵

The RCA Needs a Corrective Feedback Feature to Increase Program Accuracy and User Proficiency.

The 2010 Usability Test also revealed that the RCA program does not educate users about their mistakes and how to prevent them in the future.²⁶ After completing the initial computer software training, users do not receive adequate follow-up instruction.²⁷ Thus, it is understandable why users continue to believe they are making correct reasonable cause determinations, even though the report showed inaccurate results 55 percent of the time. The RCA program should incorporate an online feedback link exclusively for RCA users to ask questions, improve competency, and identify programming errors or policy discrepancies.²⁸

²² See 2010 Usability Report 7.

²³ Until September 24, 2010, an IRS employee could only override RCA's recommendation with a manager's approval. IRM 5.1.15.16.1(4) (Apr. 16, 2010); *but see* IRM 20.1.1.3.6.10.1 (Sept. 24, 2010) (stating that managerial approval is recommended, but not required).

²⁴ See OSP response to TAS Information request (July 1, 2010); 2010 Usability Report 4. See National Taxpayer Advocate 2005 Annual Report to Congress 363.

²⁵ A 2005 report by the Treasury Inspector General for Tax Administration (TIGTA) noted "judgment decisions are high-risk transactions because Revenue Officers use discretion in determining if a taxpayer is eligible for the [penalty] abatement based on the taxpayer's circumstances." However, TIGTA found no inconsistencies or erroneous determinations associated with decisions based upon employee judgment and discretion. TIGTA, Ref. No. 2005-30-139, *Collection Field Function Penalty Abatements Need Proper Documentation and Coding 2* (Sept. 23, 2005).

²⁶ 2010 Usability Report 4.

²⁷ *Id.*

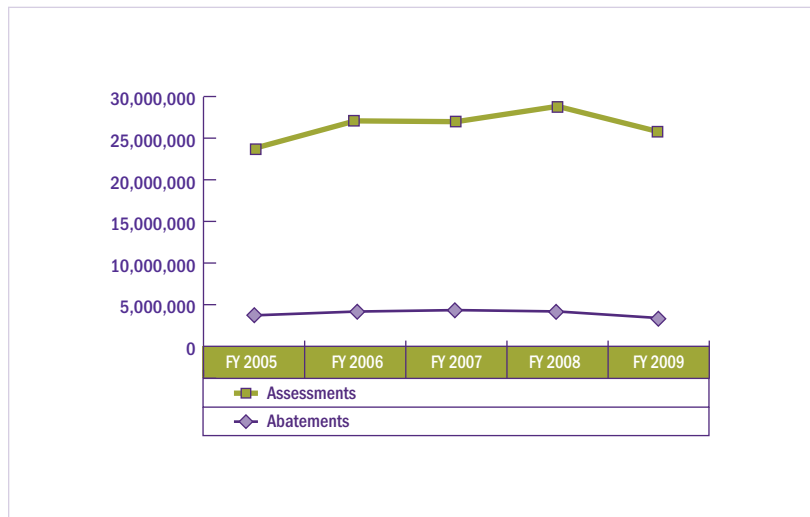
²⁸ *Id.* at 5 ("[C]onsistent review/feedback could have a positive effect for employees utilizing RCA").

First-Time Abatement Policies Should Be Expanded to Automatically Abate Penalties for Compliant Taxpayers.

The RCA provides an additional option for penalty relief under an administrative waiver known as First-Time Abatement.²⁹ FTA grants relief to certain taxpayers who receive a penalty but have a compliant tax history for the three prior years.³⁰ Since the FTA is an administrative waiver and not technically an abatement for reasonable cause, an IRS employee is not required to go through a reasonable cause analysis if a taxpayer was compliant for the three years immediately preceding the penalty year.³¹ The IRS implemented this waiver in response to the National Taxpayer Advocate's 2005 Annual Report to Congress on the RCA.³² The IRS stated the waiver would reduce both penalty assessments and abatements.³³ However, the IRS still assesses the penalty first, and then requires the taxpayer to request an abatement before it will perform a three-year compliance check and abate the penalty.

Although the FTA is a positive change and is now part of the IRM,³⁴ the IRS can improve the efficiency and effectiveness of the FTA program.³⁵ The fact that the FTA is not systematically generated *before* a penalty assessment has limited the results the IRS attempted to achieve. Figure 1.14.1 indicates that neither the number of penalty assessments nor the number of abatements has significantly changed since the IRS implemented the FTA.

FIGURE 1.14.1, FTF, FTP, and FTD Penalty Assessment and Abatement Counts, FY 2005 – FY 2009



²⁹ IRM 20.1.1.3.6.1 (Dec. 11, 2009).

³⁰ *Id.*

³¹ *Id.*

³² National Taxpayer Advocate 2005 Annual Report to Congress 364.

³³ *Id.*

³⁴ IRM 20.1.1.3.6.1 (Dec. 11, 2009).

³⁵ See National Taxpayer Advocate 2005 Annual Report to Congress 364.

The IRS is actually abating relatively fewer penalties now than it did before implementing the FTA policy. Of all penalties assessed for each fiscal year, the IRS abated 15.6 percent in 2005, 15.4 percent in 2006, 16.1 percent in 2007, 14.5 percent in 2008, and 13.2 percent in 2009.³⁶ It is logical to hypothesize that penalty assessments are not decreasing even with the FTA policy because taxpayers must still contact the IRS after the assessment to receive an FTA abatement.

Moreover, 82 percent of all FY 2009 penalties abated under the RCA were attributable to the FTA waiver. This is down only slightly from 85 percent for both FY 2008 and FY 2007.³⁷ This means that eight out of ten penalty abatements could have been granted automatically without the IRS expending valuable human resources to receive the taxpayer's abatement request, process it, and then manually access the RCA to perform a three-year compliance check. These employees could have used their time more constructively to determine abatement requests that require human discretion; namely, requests based on reasonable cause.³⁸

The National Taxpayer Advocate recommends programming IRS systems to waive penalties based on FTA before they are assessed, without requiring taxpayers to contact the IRS first. By waiving penalties before assessment and following up with a "soft notice" that explains the reason for the waiver, the IRS can reduce the cost of administering RCA-related penalty requests, while educating taxpayers and encouraging voluntary compliance.

Expand RCA Programming to Check Primary and Secondary Tax Identification Numbers.

Another concern is that IRS systems only check the tax identification number (TIN) of the primary taxpayer when performing a three-year compliance check, which means the IRS fails to consider the compliance history of the spouse when married couples file jointly.³⁹ The IRS should consider programming its systems to automatically perform a three-year compliance check on both the primary and secondary TINs when considering an FTA abatement.⁴⁰

³⁶ ERS (Dec. 2009).

³⁷ OSP response to TAS information request (July 1, 2010).

³⁸ OSP recently began a study to consider future compliance behavior as it relates to expansion of the FTA. OSP expects to have results by the end of calendar year 2010.

³⁹ The IRS computer system searches for prior delinquencies under the primary taxpayer's tax identification number assigned to the Master File Transaction (MFT) code. See IRM 20.1.1.3.6.1(1) (Dec. 11, 2009) ("RCA provides an option for penalty relief for the FTF, FTP, and/or FTD penalties if no prior penalties have been assessed on the same MFT in the prior 3 years."); see, e.g., IRM 2.3.2.2.2, Tax Information File (TIF). The TIF provides taxpayer account information which is accessed using the primary taxpayer's identification number. As TIF is the data dictionary for RCA, RCA only researches the primary taxpayer's Social Security number in the case of a married couple filing jointly.

⁴⁰ For further discussion on this topic, see Most Serious Problem: *IRS Policy Implementation Through Systems Programming Lacks Transparency and Precludes Adequate Review*, *supra*.

CONCLUSION

The National Taxpayer Advocate recognizes the importance of penalty administration on tax compliance. However, she is concerned that complete reliance on the RCA may lead to incorrect penalty abatement decisions. Further, she is concerned that the RCA may discourage IRS employees from exercising judgment in appropriate situations, thereby causing taxpayer harm. These issues undermine the IRS's mission of promoting fair tax administration.

In conclusion, the National Taxpayer Advocate offers the following preliminary recommendations:

1. Review all training and guidance materials to determine whether they provide the user with the ability to analyze the penalty request, select the applicable information, and apply reasonable cause criteria.
2. Train all RCA users in tax law and reasonable cause criteria, with frequent continuing education to keep users abreast of developments in the law.
3. Train those who manage RCA users in tax law and reasonable cause criteria so that management approvals of abatement decisions are accurate.
4. Encourage employees to use the override feature when they believe the RCA's recommendation is inappropriate based on the facts and circumstances of the case.
5. Review and report RCA functionality findings to improve communication between users by incorporating an online feedback link exclusively for RCA users to ask questions and identify programming errors or policy discrepancies.
6. Program IRS systems to identify compliant taxpayers prior to a penalty assessment, automatically grant FTA waivers if taxpayers meet the compliance criteria, and send "soft notices" to the taxpayers explaining the reason for the waiver to encourage future compliance.
7. Program systems to search primary and secondary taxpayer identification numbers when checking compliance history.

IRS COMMENTS

The RCA is an interactive decision-support program used by IRS employees when it is determined that a taxpayer has requested penalty relief due to reasonable cause. RCA applies the information input by the users against the reasonable cause standards outlined throughout IRM 20.1.1.3.2 to make the determination. RCA users are trained to be proficient in evaluating reasonable cause requests utilizing the reasonable cause criteria to ensure the correct determinations are reached.

The IRS agrees it is important for penalty administration to promote tax compliance through accurate, fair, and equitable treatment of taxpayers. As such, we are taking steps to ensure users of RCA properly enter information into the system and make screen selections

that result in appropriate RCA determinations. In furtherance of this goal, the IRS conducted a RCA Usability Test, working with the Office of the National Taxpayer Advocate in preparation for the test.

Usability testing is designed to observe the users' selections, and how they interact with the system, to determine if enhancements need to be made. The two types of usability metrics that were captured during this test are performance (how users react to the RCA selection screens) and preference (what users think when working through a scenario and how much they like using the system).⁴¹ Results from the test indicated a 45 percent success rate. This means that users made appropriate screen selections in 45 percent of the scenarios presented to them. The 55 percent unsuccessful rate means that users did not make a correct screen selection or input correct information in 31 out of 56 scenarios. This test did not capture, nor were the users asked, if the RCA determination was correct. The IRS recognizes that the 55 percent unsuccessful rate for screen selection is an issue warranting improvement. However, the fact that a user may not use the RCA screens correctly does not necessarily mean the ultimate RCA determination is incorrect.⁴² During actual use in a non-testing environment, a user may use their judgment to abort the RCA determination if they feel the system determination is legally incorrect.⁴³

The usability test revealed the most significant areas of concern are:⁴⁴

1. Users' interpretation of taxpayer correspondence may result in inconsistent category selections, and
2. Users need consistent feedback.

The IRS is taking a number of steps to address these concerns. While the results of the usability test do not mean that employees did not originally receive proper training, the results show that some users may need refresher training. In response to the first concern listed above (that users' interpretation of taxpayer correspondence may result in inconsistent category selections), the IRS provided a refresher training tool to management and users identifying:⁴⁵

- What to do prior to accessing RCA;
- What RCA can and cannot do;
- What is reasonable cause; and
- How to use RCA.

⁴¹ IRS, *Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 4* (May 28, 2010) hereinafter 2010 Usability Report.

⁴² 2010 Usability Report page 4.

⁴³ ELMS Course 17907, *Reasonable Cause Assistant (RCA) for AMS*.

⁴⁴ 2010 Usability Report page 4.

⁴⁵ RCA Usability Test Results memo dated October 4, 2010, for managers and RCA users included 2010 Usability Report and RCA Training Tool.

In response to the second concern that users need consistent feedback, the IRS created a dedicated e-mail address for questions and/or feedback.⁴⁶ The IRS communicated this to Collection executives on August 31, 2010.⁴⁷ This feedback system will also be offered to other RCA users. Users' questions will be promptly answered. RCA users may continue to use the Servicewide Electronic Research Program (SERP) feedback method as well.

As a result of the Usability Test, the IRS is working with RCA programmers to modify RCA by beginning each session with the RCA's 'Guided Selection' feature. 'Guided Selection' is currently optional and was seldom used by test participants. Mandatory use of 'Guided Selection' should significantly increase correct and consistent reasonable cause category selection by users. RCA programmers are exploring options to test the effectiveness of the programming change before implementing it into production.

The IRS also formed and funded an RCA project team to make programming changes to the system to make it more user-friendly. These enhancements to the system are currently scheduled for deployment in late 2011.

The National Taxpayer Advocate makes seven preliminary recommendations to improve the Reasonable Cause Assistant. The IRS is taking, or has taken, the following actions with respect to these recommendations:

The IRS routinely reviews training and guidance material to determine whether they provide the user with the ability to analyze the penalty request, select the applicable information, and apply reasonable cause criteria. We will continue to take these steps.

The IRS trains RCA users in reasonable cause and tax law as a prerequisite to RCA training.⁴⁸ The IRS will continue to ensure that all users understand the prerequisite to taking ELMS course #17907, Reasonable Cause Assistant (RCA) for AMS. We will continue to train users to keep abreast of developments in law.

⁴⁶ SB/SE RCA Help.

⁴⁷ E-mail dated August 31, 2010 – Subject Line: "Reasonable Cause Assistant Tool," announcing the development of a quick reference guide, an electronic mailbox for RCA questions, and a RCA tool to answer questions immediately.

⁴⁸ See IRS Forms and Pubs Training Course:

- 11138-102 = BMF Balance Due Modules A-D; Module B - Penalties;
- 28254-102 = Resolution of IMF Unagreed Balance Due; Module C - Penalties and Interest;
- 28683-102 = BMF Employment Taxes; Module A, Lesson 2-30 - Interest and Penalties and Lesson 3-23 - FTD Penalty
- 31921-102 = IMF Penalties and Interest (includes Lesson 3 - Navigating the Reasonable Cause Assistant).

Included within all these training courses is comprehensive information for all aspects of the penalties, in particular the ones RCA can consider (FTF, FTP, and FTD) and including penalty relief provisions primarily related to reasonable cause. Of note, every training course includes references to applicable IRM 20.1 sections and all employees are responsible for following IRM policies and procedures. Students must complete basic penalty training (though not all-inclusive, the penalty training from the above referenced courses are far more comprehensive than just 'basic') before completing ELMS course 17907, Reasonable Cause Assistant (RCA) for AMS.

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The IRS developed a quick reference guide for revenue officers and group managers to answer the most frequently asked questions to help ensure abatement decisions are accurate. This document will be distributed as soon as it has been finalized.

The IRS issued IRM 20.1.1, SERP Interim Procedural Update, to remind employees of the appropriate use of the abort function. The alert advised users the abort feature can be used when RCA's determination is incorrect based on the facts and circumstances and reasonable cause criteria.

The IRS created an RCA training Tool to immediately answer some user questions and established an electronic mailbox for questions about RCA. This will improve communication with users and will assist in identifying programming errors or policy discrepancies.

We are in the process of studying whether FTA waivers promote tax compliance. If the results of the study indicate FTA is increasing compliance, we will explore the feasibility of programming the system to grant FTA waivers prior to assessment, pending programming resources.

We will consider exploring the feasibility of programming the system to search both primary and secondary taxpayer identification numbers when checking compliance history, pending programming resources. However, if implemented, it is expected that both the primary and secondary taxpayers would be required to have a clean compliance history to be considered eligible for FTA to ensure fair and equitable treatment of both single and married taxpayers.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for taking steps to enhance training for users of RCA, such as usability testing and issuing a SERP Alert to remind employees of the appropriate use of the abort function. However, the National Taxpayer Advocate remains concerned about the IRS's lack of commitment to resolve the fundamental need for RCA user technical training. Before using the RCA, employees should be proficient in tax law and reasonable cause criteria to correctly interpret taxpayer correspondence. Without such basic knowledge, the user may rely too heavily on automation, rather than sound judgment and discretion, when considering the facts of a case. Although the IRS developed a "quick reference" guide for revenue officers and group managers, the National Taxpayer Advocate believes more substantive training is necessary to ensure abatement decisions are accurate.

The National Taxpayer Advocate acknowledges that usability testing is an excellent means of assessing whether employees understand a particular system and if the system is functioning as designed. For example, the recent RCA test revealed that interpretation of taxpayers' correspondence and RCA user feedback are significant areas of concern. However, the test also indicates that RCA users need further technical training on the Failure to Deposit penalty.⁴⁹ The IRS should adequately train its employees to analyze penalty requests, select the applicable information, and apply reasonable cause criteria to interpret taxpayer requests correctly.

The IRS states that RCA users need only refresher training. While revenue officers receive technical tax instruction and would likely benefit from refresher training, most reasonable cause abatement requests are handled by the Accounts Management function at various IRS campuses. Campus RCA users and managers should also be proficient in tax law and reasonable cause criteria to properly assess penalty abatement requests. This training should include case studies and examples of when an override election would be appropriate. This allows the trainees to think through actual scenarios. The National Taxpayer Advocate offers her assistance in developing this training. Further, the IRS needs a review process for field and campus employees to monitor quality and consistency. The National Taxpayer Advocate encourages the IRS to provide dedicated technical training in reasonable cause criteria and evaluating correspondence, and then consider a follow-up usability test to determine if its training has been effective.

The National Taxpayer Advocate is pleased that the IRS has initiated a dedicated e-mail address for questions or feedback. However, it should also develop a continuous feedback link exclusively for RCA users to ask questions. This approach would allow programmers and policy analysts to quickly identify errors or discrepancies and inform users. Although the IRS did publish a SERP alert regarding the abort function of RCA, and campus employees typically use SERP alerts, field revenue officers are not likely to receive important

⁴⁹ IRS, *Reasonable Cause Assistant (RCA) Usability Test Final Report Summary 7* (May 28, 2010).

information through this medium. It is important that the IRS also find ways to update field RCA users on the system. Additionally, OSP should incorporate a human feedback loop where analysts review cases that users chose to abort the RCA recommendation. These analyses might identify circumstances that are not properly addressed by the RCA programming and can be improved. Human intelligence should inform RCA instead of being supplanted by the computer system.

The National Taxpayer Advocate looks forward to ongoing dialogue with OSP as it explores the feasibility of programming the system to grant FTA waivers prior to assessment. Since 82 percent of all FY 2009 penalties abated under the RCA were attributable to the FTA waiver, waiving penalties before assessment and following up with a "soft notice" of explanation will allow the IRS to reduce the cost of administering RCA-related penalty abatement requests, while educating taxpayers and encouraging voluntary compliance. OSP states that it will only explore the feasibility of granting automatic FTA penalty relief if its study shows that doing so will promote future compliance. However, as the GAO wrote in its 2009 report, the IRS should examine the relationship between penalties and voluntary compliance and determine whether any penalty promotes future compliance.⁵⁰ Postponing RCA to grant automatic FTA relief based on some proof of future compliance only makes sense if OSP looks at future compliance rates of all penalties and all abatements as a baseline. Consequently, the National Taxpayer Advocate disagrees that exploring the feasibility of granting automatic FTA relief should be contingent on a future study of FTA compliance rates and urges OSP to begin its exploration of this relief now.

OSP states it will consider programming its computer system to search both the primary and secondary taxpayer identification numbers when checking compliance history for the FTA. However, OSP concludes that if it does reprogram its system to check both taxpayer identification numbers, it will require both taxpayers to have a clean compliance history before granting FTA relief from the penalties. The National Taxpayer Advocate disagrees with this policy and wonders why both taxpayers need to be in compliance for the IRS to grant the FTA to one. Such a policy reflects an antiquated understanding of the marital unit. The IRS already has policies to meet the needs of married individuals who become divorced, separated, or widowed to provide different relief for the primary and secondary taxpayers.⁵¹ The National Taxpayer Advocate sees no reason why the IRS cannot adopt similar policies when granting FTA relief from jointly assessed penalties.

RCA is designed to encourage consistency. Therefore, proper guidance on reasonable cause, tax law training, and safeguards to ensure that employees arrive at appropriate abatement decisions are all vital to avoid harm to taxpayers and unnecessary rework for the IRS.

⁵⁰ GAO, GAO-09-567, *IRS Should Evaluate Penalties and Develop a Plan to Focus Its Efforts* 10 (June 2009); see also National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, *A Framework for Reforming the Penalty Regime*, 5-12.

⁵¹ See, e.g., IRC § 6015 (innocent spouse relief); IRM 21.6.8 (Nov. 16, 2010) (split assessments for innocent spouses); IRM 5.19.1.5.4.21 (Aug. 5, 2010) (manually-monitored installment agreements for separate spouses with joint liabilities); and IRM 5.16.1.3.2(2) (May 5, 2009) (offers in compromise accepted to compromise the tax debt of the spouse who made the offer).

Recommendations

The National Taxpayer Advocate recommends that the IRS take the following specific actions:

1. Partner with the Taxpayer Advocate Service to develop case studies for use in basic and refresher training to develop employees' skills in recognizing and analyzing facts, including those requiring override of RCA.
2. Train those who manage RCA users in tax law and reasonable cause criteria so that management approvals of abatement decisions are accurate.
3. Establish a human feedback system that analyzes override cases and e-mail feedback, and program "lessons learned" into the system to enhance its accuracy and scope.
4. Program IRS systems to identify compliant taxpayers prior to a penalty assessment, automatically grant FTA waivers if taxpayers meet the compliance criteria, and send "soft notices" to the taxpayers explaining the reason for the waiver to encourage future compliance.
5. Program systems to search primary and secondary taxpayer identification numbers when checking compliance histories, and permit separate FTA abatements of each spouse in certain circumstances.

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State Domestic Partnership Laws Present Unanswered Federal Tax Questions

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DEFINITION OF PROBLEM

While numerous tax provisions turn on individual and family relationships, state domestic relations law has outpaced federal tax law. In recent years, 11 states have established domestic partnerships or civil unions between individuals of the same gender,¹ while eight states,² as well as ten foreign countries,³ have recognized marriage between individuals of the same gender. Generally, marriages are valid if recognized where celebrated,⁴ but under the Defense of Marriage Act (DOMA), “marriage” for federal purposes does not encompass same-gender spouses.⁵ DOMA does not disregard domestic partnerships, which may create parent-child relationships, property rights, and obligations under state law. Consequently, numerous federal tax questions arise for domestic partners, as well as same-gender spouses, whose marriages are disregarded under DOMA, but who nevertheless may have relationships, rights, and obligations under state law with ambiguous federal tax consequences. The IRS has not provided answers to these questions, requiring many taxpayers to file returns without knowing which rules apply and potentially subjecting them to audits and penalties, as well as costs for tax advice.

According to demographic research, the populations of individuals in same-gender marriages and domestic partnerships were 63,658 and 174,760, respectively, in 2008, when only three states authorized same-gender marriages and ten recognized domestic partnerships.⁶ Nationwide, more than a million individuals are estimated to be living as same-gender

¹ See Calif. Fam. Code § 297; Conn. Gen. Stat. § 46b-38aa *et seq.*; D.C. Code § 32-702; Haw. Rev. Stat. § 572C-1 *et seq.* (establishing reciprocal beneficiary relationships); Me. Rev. Stat. tit. 22, § 2710; Nev. Rev. Stat. § 122A.010 *et seq.*; N.H. Rev. Stat. § 457-A:1 *et seq.*; N.J. Stat. § 37:1-1 *et seq.*; Or. Rev. Stat. § 432.405; Vt. Stat. tit. 15, § 1201 *et seq.*; Wash. Rev. Code § 26.60.010 *et seq.*

² See *Strauss v. Horton*, 46 Cal. 4th 384 (2009) (preserving marriages performed in 2008); *Kerriigan v. Comm’r of Public Health*, 289 Conn. 135, 957 A.2d 407 (2008); D.C. Code § 46-401; *Varnum v. Brien*, 763 N.W.2d 862 (Iowa 2009); *Goodridge v. Dep’t of Public Health*, 440 Mass. 309, 798 N.E.2d 941 (2003); N.H. Rev. Stat. § 457:1-a; *Martinez v. County of Monroe*, 50 A.D.3d 189, 850 N.Y.S.2d 740 (4th Dep’t 2008), *cert. den’d* 10 N.Y.3d 856, 889 N.E.2d 496 (2008) (recognizing same-gender marriage performed out-of-state); Vt. Stat. tit. 15, § 8.

³ Netherlands, Belgium, Canada, Spain, South Africa, Norway, Sweden, Iceland, Portugal, Argentina. See Dan Fastenberg, *International Gay Marriage*, Time, July 22, 2010.

⁴ See Restatement of Conflict of Laws § 121.

⁵ Pub. L. No. 104-199, 110 Stat. 2419 (1996).

⁶ The 2008 same-gender marriage states were California, Connecticut, and Massachusetts; domestic partnership states were California, Connecticut, District of Columbia, Hawaii, Maine, Massachusetts, New Jersey, Oregon, Vermont and Washington. See Gary J. Gates, *Same-Sex Spouses and Unmarried Partners in the American Community Survey, 2008*, Williams Institute, Univ. of Calif. at Los Angeles (Oct. 2009) Table 1 at 4, App. Table 2 (reporting 31,829 same-gender marriages and 87,380 other couples with non-marital legal recognition). Because these same-gender married and partnered couples cannot file jointly for federal tax purposes, the relevant number of individual taxpayers is twice the number of couples.

couples (whether or not registered), over 20 percent of which are raising children.⁷ Consequently, hundreds of thousands of taxpayers need guidance.

ANALYSIS OF PROBLEM

Background

Certain States Recognize Domestic Partnerships and Same-Gender Marriages While the Federal Government Disregards the Latter

Domestic partnerships or civil unions between adults of the same gender continue to be established in California, Hawaii, Maine, Nevada, New Jersey, Oregon, and Washington. Additional states, even those that preclude performance of same-gender marriages, may offer more limited rights to domestic partners.⁸ In some states, these couples are entitled to the benefits of marriage.⁹ In other states, statutes set forth certain rights and obligations and may grant domestic partners the same rights and responsibilities as spouses, including attendant relationships, such as those of in-laws.¹⁰ Some states permit certain persons of opposite gender to register as domestic partners.¹¹

Connecticut, Iowa, Massachusetts, New Hampshire, Vermont, and the District of Columbia authorize same-gender marriages. During 2008, California issued licenses for approximately 18,000 such marriages, which still are valid.¹² Additionally, New York recognizes same-gender spouses whose marriages were performed out of state.¹³ Five of these states allowed domestic partnerships (or civil unions) before recognizing same-gender marriages. In some states, same-gender spouses are constitutionally guaranteed the right to marry,¹⁴ while other states legislatively grant marriage rights with attendant responsibilities.¹⁵

As enacted in 1996, DOMA states that in “determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word ‘marriage’ means only a legal union between one man and one woman as husband and wife, and the word ‘spouse’ refers only to a person

⁷ See Gary J. Gates, *Same-Sex Spouses and Unmarried Partners in the American Community Survey, 2008*, Williams Institute, Univ. of Calif. at Los Angeles (Oct. 2009) App. Table 1.

⁸ See, e.g., Md. Code, Tax-Prop. Art. § 12-101(e-2); Wis. Stat. § 770.001 *et seq.*

⁹ See *Lewis v. Harris*, 188 N.J. 451, 908 A.2d 196 (2006).

¹⁰ See, e.g., Wash. Rev. Code § 26.60.015.

¹¹ See, e.g., Calif. Fam. Code § 297(b)(5)(B); Haw. Rev. Stat. § 572C-5; Wash. Rev. Code § 26.60.030(6).

¹² See *Strauss v. Horton*, 46 Cal. 4th at 385 (upholding “the estimated 18,000 marriages of same-sex couples that were performed” between June 17 and November 4, 2008). In August 2010, a federal district court ruled California’s Prop. 8, which had suspended performance of same-gender marriages, unconstitutional under the Equal Protection Clause of the 14th Amendment, holding that it denied a fundamental right without a legitimate reason. See *Perry v. Schwarzenegger*, 704 F. Supp. 2d 921 (N.D. Calif. 2010). The Ninth Circuit court has granted a stay pending appeal. See Order, No. 10-16696 (9th Cir. Aug. 16, 2010).

¹³ See *Martinez v. County of Monroe*.

¹⁴ See *Varnum v. Brien*; *Kerrigan v. Comm’r of Public Health*; *Goodridge v. Dep’t of Public Health*.

¹⁵ See D.C. Code § 46-401; N.H. Rev. Stat. § 457:1-a; Vt. Stat. tit. 15, § 8.

of the opposite sex who is a husband or a wife.”¹⁶ In July 2010, the federal district court in Massachusetts declared DOMA unconstitutional under the Equal Protection Clause of the Fifth Amendment because the court could not discern a rational basis for denial of federal recognition to same-gender spouses.¹⁷ Appeal to the First Circuit court is anticipated, with the federal government defending the constitutionality of DOMA even though the current Administration “does not support DOMA as a matter of policy, believes that it is discriminatory, and supports its repeal.”¹⁸

At this point, same-gender spouses do not know whether they should continue to take certain tax positions as if DOMA applies and whether they will have to amend their returns if an appellate court reaches a contrary conclusion. The discussion below assumes that DOMA continues to apply.¹⁹

The Effect of State Laws on Federal Taxation Is Unclear

Generally, it has been well settled that “federal income tax liability follows ownership” which “state law controls,”²⁰ along with domestic relations.²¹ However, DOMA calls the latter proposition into question, while previous IRS advice appears inconsistent with the general rule. In particular, domestic partners in California have community property.²² In 2006, the IRS Chief Counsel nonetheless advised California domestic partners that they must report all earned income individually because of the inapplicability “of a state’s community property law outside the context of a husband and wife.”²³ Four years later, the Office of Chief Counsel effectively reversed this result, concluding that a California domestic partner now must report half of community income.²⁴ A retrospective rationale for the 2006 advice was that although earned income of a California partner was community property for state property law purposes, earned income had not been treated as community income for California income tax filing until 2007.²⁵ This pre-2007 treatment may have created symmetry with federal tax filing, but in any case, the 2006 advice appeared inconsistent with the principle that “Federal tax law generally respects state property law

¹⁶ 1 U.S.C. § 7 (1996).

¹⁷ See *Gill v. Office of Personnel Management (OPM)*, 699 F.Supp.2d 374 (D. Mass. 2010). In a companion case, the district court held that DOMA was unconstitutional under the Tenth Amendment (reserving unenumerated powers to the states) and the Spending Clause. See *Commonwealth of Mass. v. Dep’t of Health & Human Services (HHS)*, 698 F. Supp. 2d 234 (D. Mass. 2010).

¹⁸ *Gill v. OPM*, Memo. of Law in Support of Def.s’ Mot. Dismiss 1.

¹⁹ Under IRC § 6013(a), same-gender spouses file singly for federal tax purposes. In the eight states that recognize same-gender marriage, same-gender spouses reformulate their tax returns as married for state purposes, a function that may require overriding commonly available software.

²⁰ See *United States v. Mitchell*, 403 U.S. 190, 197 (1971).

²¹ See *Elk Grove United School District v. Newdow*, 542 U.S. 1 (2004).

²² As of 2005, registered “domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, court rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses.” Calif. Family Code § 297.5.

²³ CC Advisory 2006-08-038 (issued Feb. 24, 2006).

²⁴ See CC Advisory 2010-21-050 (issued May 5, released May 28, 2010). Chief Counsel Advice memoranda are not precedential. IRC § 6110(k)(3).

²⁵ See *id.* at n. 1. A companion piece that was silent on the state tax treatment of earned income in 2005-2006 but pertained to collection potential for purposes of IRC § 7122 (regarding offers in compromise) stated that “California state law provides that both domestic partners have an equal interest and liability in the community property.” CC Advisory 2010-21-049 (issued May 6, released May 28, 2010).

characterizations and definitions.²⁶ Uncertainty surrounding the government's observance of fundamental principles, not to mention particular results, of federal taxation makes legal guidance necessary here.²⁷

Uncertainty Leaves Taxpayers in an Untenable Position

Uncertainty concerning the federal taxation of same-gender spouses or domestic partners could put taxpayers and their return preparers in an untenable position. Generally, a taxpayer may take a filing position to which a penalty would not attach if there is substantial authority, such as a court case (not overruled by the U.S. Court of Appeals).²⁸ Thus, there may be substantial authority for same-gender spouses to take certain tax positions as married as long as the Massachusetts district court's opinion stands.²⁹ At the same time, DOMA itself may constitute substantial authority to continue to avoid numerous provisions that result in a marriage penalty.³⁰ Presumably, same-gender spouses and domestic partners need not file jointly, even if their underlying state law relationship is conjugal, under provisions requiring married couples to file jointly in order to claim a tax benefit.³¹

On the other hand, a return preparer faces a penalty unless a position would more likely than not be sustained on the merits.³² Given the constitutional uncertainty of DOMA as well as the reversal of IRS advice between 2006 and 2010, it is unclear which position would be sustained. Meanwhile, hundreds of thousands of taxpayers need advice.³³

Although the Office of Chief Counsel has issued a Private Letter Ruling (PLR) as well as the Chief Counsel advice on domestic partners discussed above,³⁴ it is unclear that this non-precedential type of guidance would be effective here. A PLR can cost hundreds or thousands of dollars, while many of the tax provisions at issue are targeted at low and moderate-income families who lack the resources to pay the fee.³⁵ Moreover, the relevant questions could be answered by the application of federal taxation to state law, rather

²⁶ CC Advisory 2010-21-050.

²⁷ See Dennis J. Ventry, Jr., *No Income Splitting for Domestic Partners: How the IRS Erred*, 110 Tax Notes 1221 (2006). Moreover, the National Taxpayer Advocate 2005 Annual Report to Congress at 407, observing inequities in taxation of family income, proposed legislation to repeal the rule of *Poe v. Seaborn*, 282 U.S. 101 (1930), that each spouse is taxed on half of community income. If enacted, this previous proposal would resolve this particular issue.

²⁸ See Treas. Reg. § 1.6662-4(d)(3)(iii).

²⁹ See *Gill v. OPM*; *Mass. v. HHS*.

³⁰ See Theodore P. Seto, *The Assumption of Selfishness in the Internal Revenue Code: Reframing the Unintended Tax Advantages of Gay Marriage*, Loyola Legal Studies Paper No. 2005-33.

³¹ See, e.g., IRC §§ 21(e)(2) (child-care credit), 32(d) (Earned Income Tax Credit), 25A(g)(6) (Lifetime Learning, Hope Scholarship, and American Opportunity Tax Credits), 221(f)(2) (student loan interest deduction), 135(d)(3) (U.S. savings bond interest exclusion for college expenses), 163(h)(4)(A)(ii) (home mortgage interest deduction), 36(c)(5) (First-Time Homebuyer Credit), 23(f)(1) (adoption credit), 137(e) (adoption exclusion), 22(e)(1) (elderly or disabled credit).

³² See IRC § 6694.

³³ See Patricia A. Cain, *Taxing Families Fairly*, 48 Santa Clara L. Rev. 805, 848 (2008) (noting that lawyers have requested IRS guidance).

³⁴ See PLR 2010-21-048 (issued May 5, released May 28, 2010); CC Advisory 2010-21-050.

³⁵ See Rev. Proc. 2010-1, 2010-1 I.R.B. 1, 67, App. A (including reduced user fee of \$625 for individual with gross income of less than \$250,000, or \$2,000 for gross income between \$250,000 and \$1 million). A general "information letter" would be free but would relate only to "a well-established interpretation or principle of tax law." See *id.* at 7, 69.

than unique facts posed by taxpayers. Given the scope of the concerns, the Office of Chief Counsel should issue guidance of general applicability.

Taxation Affects Family Costs

Under substantive tax provisions, discussed below, the following questions arise for same-gender spouses or domestic partners:

- Does a parent-child relationship persist even if DOMA disregards the parent's marriage?
- Is a domestic partner or same-gender spouse in a community property state deemed to provide, for dependency purposes, the support that he or she earns?
- Is alimony under state domestic partnership or same-gender marriage law includible by the recipient and deductible by the payer?
- Is community property created upon marrying or partnering with an individual of the same gender a taxable gift?
- Do same-gender tenants by the entirety have a qualified joint interest for estate tax purposes?

Tax Law Contains Provisions for Children and Other Dependents

Federal tax law contains various provisions for costs of child care, health care, and education. Central to these provisions is the definition of "child," which figures in eligibility for head of household filing status and the dependency deduction,³⁶ as well as the child-care credit,³⁷ child tax credit (CTC),³⁸ and earned income tax credit (EITC).³⁹ These provisions have significant tax consequences, and taxpayers need guidance to determine their applicability.⁴⁰ In pertinent part, all of these provisions depend on whether the taxpayer has a child, which may include a stepson or stepdaughter.⁴¹ A taxpayer who is a same-gender spouse may have a stepchild by virtue of marriage to the child's parent. The applicable definition of "child" does not refer to marriage, nor does DOMA define a child. Nevertheless, if

³⁶ IRC § 2(b) head of household filing status generally provides favorable income tax rates under § 1(b) for an unmarried individual who maintains a home for a child. IRC §§ 151 and 152 allow a personal exemption deduction (\$3,650 in 2010) for a child or other dependent.

³⁷ The IRC § 21 child-care credit, which in conjunction with the § 129 exclusion of employer-provided child care historically has "represented the largest source of federal financial support for child care," generally allows a credit up to \$2,100 in 2010 for household and dependent care services necessary for gainful employment of a taxpayer. Mary Louise Fellows, *Rocking the Code: A Case Study of Employment-Related Child-Care Expenditures*, 10 Yale J. L. & Feminism 307, 310 n. 11 (1998).

³⁸ The IRC § 24 CTC allows a credit of \$1,000 per child, a portion of which the IRS may refund to a low-income parent even in excess of any tax owed.

³⁹ The IRC § 32 EITC, popularly recognized as "the nation's largest anti-poverty program," operates as a refundable wage supplement of up to \$5,666 in 2010 to working parents (with reduced benefits to workers without children). Daniel P. Gitterman, Lucy S. Gorham & Jessica L. Dorrance, *Expand the EITC for Single Workers and Couples Without Children*, Pol'y Brief Prepared for the Ctr. on Poverty, Work & Opportunity, Univ. of N.C. at Chapel Hill 1 (Jan. 2007).

⁴⁰ The child-care credit, the CTC, and the EITC provide tax benefits worth, nationwide, an estimated \$3.75, \$23.45, and \$6.19 billion, respectively, in 2010. See *Budget of the United States Government* (USG) FY 2011, Analytical Perspectives, Ch. 16, Table 16-1, lines 122, 121 & 159, at 211-212 (noting significant additional outlay effects of \$30.29 and \$51.50 billion, respectively, for refundable portions of the CTC and EITC). Additionally, IRC § 129 excludes employer-provided child care, which results in an estimated \$1.21 billion expenditure for 2010. See *USG Budget, loc. cit.*, line 116.

⁴¹ See IRC § 152(f)(1)(A)(i).

DOMA has the effect of disregarding the marriage, the question arises whether the child is no longer a stepchild of this taxpayer for federal tax purposes.

In another section, the federal tax law defines “parent” by reason of “parental rights and duties in respect of the child.”⁴² Moreover, state law may stipulate that a parent-child relationship is not dependent on the persistence of either a marriage or a domestic partnership.⁴³ On the other hand, if a taxpayer has a stepchild by virtue of a domestic partnership with the parent under state law, DOMA, which applies only to marriage, presumably would not call this parent-child relationship into question. In any case, the fundamental issue of the parent-child relationship needs clarification before same-gender spouses can comply with significant provisions of federal tax law.

Another type of dependency deduction is the spousal exemption, for which a same-gender spouse or domestic partner is categorically ineligible.⁴⁴ Nonetheless, a dependent may be deductible as a qualifying relative in the household if, among other requirements, one same-gender spouse or domestic partner provides over half of the other’s support for the year.⁴⁵ In a community property state, however, would half the support be deemed to belong to each same-gender spouse or domestic partner such that one could never be a dependent of the other? Clarification is necessary to allow these taxpayers to file correct returns.

Tax Law Contains Health and Education Provisions

The definition of “dependent” similarly has consequences for tax-favored health care and education provisions. With respect to medical care expenses of dependents, the tax law excludes from gross income certain employer reimbursements, allows a deduction, and provides for Flexible Spending Accounts, Archer Medical Savings Accounts, and Health Savings Accounts.⁴⁶ With respect to a dependent’s college tuition, student loan interest, and related expenses, the tax law allows Lifetime Learning, Hope Scholarship, and American Opportunity Tax Credits, certain deductions and exclusions.⁴⁷ All of these are major federal programs for which eligibility should be clarified. While the policy of DOMA may be to discourage same-gender spouses, it is unclear how the law should affect health, education, and welfare provisions for domestic partners and children.

Taxation Pertains to Life Events such as Separation and Death

The federal tax law contains a number of provisions for the separation of individuals presumably attendant to divorce. For example, if married individuals in a community

⁴² IRC § 73(c).

⁴³ See, e.g., D.C. Code § 16-908.

⁴⁴ See IRC § 151(b).

⁴⁵ See IRC § 152(d)(1)(C).

⁴⁶ See IRC §§ 105, 213, 125, 220, 223.

⁴⁷ See IRC §§ 25A, 221, 222, 135.

property state live and file separately, their income is proportionately divided for federal tax purposes.⁴⁸ However, this provision does not apply to similarly situated same-gender spouses or domestic partners. Should they each report half of community income? Under a divorce or separation agreement, certain amounts paid and received are defined for federal tax purposes as alimony includible in gross income by the recipient and deductible by the payer.⁴⁹ Presumably, individuals not married for federal purposes cannot be divorced, but can they have “a written separation agreement”?⁵⁰ In another context, the U.S. Tax Court has held that individuals who never had been married could come within a provision that encompassed divorcees or individuals with “a written separation agreement” as well as parents living apart for the last half year.⁵¹ On the other hand, before enactment of the alimony tax law, the U.S. Supreme Court held that alimony was neither includible nor deductible.⁵² Similarly, federal tax law defines a Qualified Domestic Relations Order (QDRO) for division of employee plan benefits relating to child support, alimony, or otherwise.⁵³ Would a QDRO apply to same-gender spouses or domestic partners? Again, answers to these questions would enable taxpayers to comply with the law.

Under the federal transfer tax, a marital deduction does not apply to same-gender spouses or domestic partners,⁵⁴ but other provisions are ambiguous. For example, would the creation of community property as a consequence of marriage or partnership result in a federally taxable gift within same-gender couples? For married couples, courts have not viewed the creation of community property as a taxable transfer.⁵⁵

In some cases, the federal estate tax deems half of spousal property to be included in the decedent’s gross estate.⁵⁶ However, it is unclear if same-gender spouses or domestic partners who own property by the entirety in common law states have a “qualified joint interest” even though the federal tax law defines that term in part by reference to tenants by the entirety.⁵⁷ While federal tax law ordinarily designates the treatment of “interests or rights, so created” by state property law,⁵⁸ the statutory terms may have ambiguous consequences in this context.

⁴⁸ See IRC § 66(a).

⁴⁹ See IRC §§ 71, 215.

⁵⁰ See IRC § 71(b)(2)(B).

⁵¹ See *King v. Comm’r*, 121 T.C. 245 (2003) (relating to IRC § 152(e)(1)(A)). The result was codified in Treas. Reg. § 1.152-4(b)(2)(i)(C). See 72 Fed. Reg. at 24,194 (May 2, 2007).

⁵² See *Gould v. Gould*, 245 U.S. 151 (1917).

⁵³ See IRC § 414(p). The Dep’t of Labor has regulatory authority under IRC § 414(p)(13).

⁵⁴ See IRC §§ 2056, 2523.

⁵⁵ See *Poe v. Seaborn*, 282 U.S. 101; see also PLR 2010-21-048 (ruling privately in a format not precedential under IRC § 6110(k)(3)).

⁵⁶ See IRC § 2040(b)(2).

⁵⁷ See IRC § 2040(b)(2)(A).

⁵⁸ *Morgan v. Comm’r*, 309 U.S. 78, 80 (1940).

CONCLUSION

DOMA and various state laws regarding domestic partnerships and same-gender marriages give rise to a large number of unintended or unforeseen federal tax law ambiguities, making it possible for hundreds of thousands of taxpayers to take inconsistent positions in good faith. The National Taxpayer Advocate believes that it is a basic responsibility of government to provide taxpayers with sufficient guidance to enable them to comply with the law.

In conclusion, our preliminary recommendation is the IRS Office of Chief Counsel should publish a revenue ruling, establish adequate safe harbors, or issue other precedential guidance of general applicability.

IRS COMMENTS

As the National Taxpayer Advocate indicates in the report, states vary in the degree to which they recognize same-sex relationships. Some states recognize same-sex marriage, others provide for civil unions, and others permit couples to register as domestic partners. The IRC, on the other hand, generally categorizes individuals for federal income tax purposes either as unmarried individuals or as married individuals (“spouses”). The Defense of Marriage Act prohibits the IRS from publishing guidance that recognizes same-sex couples as “married” individuals or “spouses” for purposes of federal tax law.

The Office of Chief Counsel focuses its published guidance resources on resolving uncertain tax issues that affect a significant number of similarly-situated taxpayers. The existence of DOMA and the litigation over its validity, the wide variation among states in the extent of rights and obligations provided to same-sex couples, and the evolving nature of state laws make it unlikely that published guidance could provide a uniform set of rules that resolve the issues facing same-sex couples nationwide.

In the absence of legislation resolving these issues, the IRS and the Office of Chief Counsel intend to continue, where appropriate, to respond to taxpayer requests for advice tailored to their particular state’s law. As the National Taxpayer Advocate’s report recognizes, the Office of Chief Counsel provided advice in response to inquiries about California’s domestic partner statute. In addition, the IRS and the Office of Chief Counsel will continue to monitor developments in state and federal law to ensure that federal tax laws are applied correctly to same-sex couples. The IRS and the Office of Chief Counsel will consider publishing guidance on discrete issues arising under a particular state’s domestic relations laws if we determine that published guidance is necessary to ensure that federal tax laws are applied correctly to same-sex couples.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS will continue monitoring developments to ensure the correct application of federal tax laws to same-gender couples, and that the Office of Chief Counsel will consider publishing guidance on discrete issues arising under a state's domestic relations laws.⁵⁹ IRS responsiveness to taxpayer requests, illustrated in the discussion above by a Private Letter Ruling and other cited advice, will continue to be helpful.

Nevertheless, the National Taxpayer Advocate remains concerned that a significant number of individual taxpayers will face these issues, yet lack the resources to formulate a request for clarification of federal tax law. Among other examples, there are specific questions concerning the qualification of children and domestic partners for a dependency deduction. Even if Congress were to enact legislation clarifying the federal status of same-gender marriages, issues such as these likely would remain in the realm of administrative rule-making.

On domestic relations, property rights, and many other subjects, state laws vary significantly, yet taxpayers generally have been able to rely on the principle that interests or rights created by state law serve as the basis for federal taxation. In this case, however, both legislative and other legal pronouncements have called this principle into question. It is precisely because of the resulting uncertainty that guidance is necessary. While uniformity of result is neither requested nor particularly desirable, guidance could establish consistent principles of interpretation. Under current law, same-gender marriages do not create "spouses" for federal tax purposes. Should taxpayers therefore conclude that a federal tax statute referring to "spouses" is inapplicable, even if the relevant state law interest otherwise fits the requisite description, as, for instance, a tenancy by the entirety?

If a taxpayer takes a position on an ambiguous federal tax question on which the IRS has declined to issue guidance, any subsequent reversal by the IRS could create a perception of unfairness, frustrating taxpayers and ultimately undermining voluntary compliance. In any case, it is a basic responsibility of government to provide taxpayers with sufficient guidance to enable them to comply with the law.

⁵⁹ In its response, the IRS noted that the Office of Chief Counsel focuses resources on guidance for a significant number of taxpayers. Nonetheless, guidance has been published for relatively discrete populations. See, e.g., Rev. Proc. 2010-41, 2010-48 I.R.B. 781 (including guidance for return preparers without a Social Security Number due to religious objection); Rev. Proc. 2010-31, 2010-40 I.R.B. 413 (setting forth guidance on when a foreign adoption is final for parents who claim a tax credit for expenses of adopting a child); Notice 2010-30, 2010-18 I.R.B. 650 (containing guidance for military spouses who are civilians working in a U.S. territory but claiming residence in a state); Rev. Rul. 2004-71, 2004-2 C.B. 74 (applying IRC § 6402 to community property in Arizona and Wisconsin); Rev. Rul. 2004-72, 2004-2 C.B. 77 (applying IRC § 6402 to community property in California, Idaho, and Louisiana); Rev. Rul. 2004-73, 2004-2 C.B. 80 (applying IRC § 6402 to community property in Nevada, New Mexico, and Washington); Rev. Rul. 2004-74, 2004-2 C.B. 84 (applying IRC § 6402 to community property in Texas); Rev. Rul. 68-277, 1968-1 C.B. 526 (disregarding anti-miscegenation statutes as unconstitutional); Rev. Rul. 58-66, 1958-1 C.B. 60 (recognizing common-law marriage).

Recommendations

The National Taxpayer Advocate recommends that the IRS, through published guidance:

1. Clarify the qualification of children, same-gender spouses, and domestic partners for the dependency deduction.
2. Establish consistent principles of interpretation to answer various other questions associated with state domestic partnership and related laws.