NATIONAL TAXPAYER ADVOCATE 2007 ANNUAL REPORT TO CONGRESS

EXECUTIVE SUMMARY

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to describe at least 20 of the most serious problems encountered by taxpayers. This year's report describes 26 problems and provides status updates on three other issues: the IRS's Private Debt Collection (PDC) initiative, its collection strategy, and its Questionable Refund Program (QRP). Each of the most serious problems includes the National Taxpayer Advocate's description of the problem, the IRS's response, and the National Taxpayer Advocate's final comments and recommendations. This format provides a clear picture of which steps have been taken to address the most serious problems and which additional steps the National Taxpayer Advocate believes are required.

The issues described in the report are as follows:

1. The Impact of Late-Year Tax-Law Changes on Taxpayers. In recent years, Congress has made significant changes to the tax code in December that apply to the current tax year (*e.g.,* the "extenders bill" in December 2006 and the Alternative Minimum Tax (AMT) "patch" in December 2007). The IRS currently finalizes Form 1040 and its accompanying instructions in early November, and tax software companies finalize their shrink-wrapped software packages around the same time. If Congress changes the law after those products have been finalized, significant problems arise. Because of systemic limitations and to minimize taxpayer confusion, the IRS generally does not update Form 1040 or its accompanying instructions after initial publication. As a result, taxpayers filing paper returns are particularly likely to complete their returns without taking into account late-year changes. Taxpayers who purchase shrink-wrapped software have the option of downloading a "patch" to update their software, but some taxpayers do not do so. As a result, some taxpayers who prepare their returns electronically also do not take late-year changes into account. In Tax Year 2006, Congress waited until after the Form 1040 package and shrink-wrapped tax software products had been finalized to "extend" several popular tax deductions. Taxpayers ultimately claimed these deductions about 1.4 million times less frequently than in tax year 2005, when the deductions were included in the Form 1040 instructions and built into all tax software. Thus, it appears that numerous taxpayers did not claim tax deductions to which they were entitled simply because they did not know about them.

Late-year tax-law changes also place enormous stress on the IRS's ability to deliver a successful filing season. The IRS must develop updated forms, develop training materials for its telephone assistors and field assistance personnel, provide instruction for Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites and, most significantly, write programming code that allows the IRS to accept returns and perform numerous automated reviews of returns. The programming challenges are particularly time-consuming and have delayed the start of the filing season for millions of taxpayers. Delays in the filing season can create severe hardships. The overwhelming majority of tax returns (more than 100 million) result in refunds, and a delay in processing returns means a delay in issuing refunds to taxpayers, including low income taxpayers who rely on tax refunds to pay essential bills. Among taxpayers claiming refunds and receiving the Earned Income Tax Credit (EITC), the average refund equals *20 percent* of their yearly income. To ensure that

members of Congress better understand the filing-season impact of late tax legislation, the National Taxpayer Advocate recommends that the Treasury Department and the tax-writing committees create a formal process by which IRS estimates of the filing-season impact of significant tax legislation are transmitted to the tax-writing committees at several points during the year, perhaps on June 30, September 30, and monthly thereafter.

2. Tax Consequences of Cancellation of Debt Income. When a taxpayer is unable to pay a debt and the creditor cancels some or all of it, the amount of the canceled debt is generally treated as taxable income to the taxpayer. Debt cancellation arises in numerous contexts, such as when a taxpayer defaults on an automobile loan or a credit card bill, and affects a significant number of taxpayers. In 2006, creditors issued to borrowers nearly *two million* Forms 1099-C, Cancellation of Debt, reporting canceled debts. The tax treatment of canceled debts is extremely complex and poses a significant challenge to affected taxpayers. If the lender incorrectly values property, the amount of canceled debt it reports will be wrong. If the taxpayer is insolvent (*i.e.*, the taxpayer's liabilities exceed the taxpayer's assets), the canceled debt is excludable from gross income up to the amount of insolvency. If the debt is nonrecourse (*i.e.*, the lender's only remedy in case of default is to repossess the property to which it relates), the canceled debt is not income. Our review of IRS forms, instructions, and publications reveals that the IRS does not provide adequate guidance to taxpayers or practitioners. The IRS also has declared the subject of canceled debts "out-of-scope" at its walk-in sites. As a result, IRS personnel at walk-in sites will not answer general taxpayer questions about the tax treatment or reporting of canceled debts, and IRS personnel will not prepare tax returns for taxpayers who have received a Form 1099-C even if the taxpayers are otherwise eligible for such assistance. The National Taxpayer Advocate makes 11 recommendations to provide greater assistance to taxpayers, including a recommendation that the IRS treat questions about canceled debts as "in scope" at its walk-in sites and a recommendation that the IRS develop a publication on the tax treatment and reporting of cancellation of indebtedness income that consolidates all relevant information in one place.

3. The Cash Economy. Income from the "cash economy" – taxable income from legal activities that is not subject to information reporting or withholding – is the type of income most likely to go unreported. Unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over $100 billion per year. Noncompliance in the cash economy is difficult for the IRS to detect. Thus, the IRS should be using different strategies to address this problem than it uses to address noncompliance in other areas. The National Taxpayer Advocate has identified a number of steps that the IRS can take to address this problem without additional legislation. While the IRS can never achieve full compliance, these recommendations should help the IRS make significant progress in improving compliance in the cash economy.

4. User Fees: Taxpayer Service For Sale. The IRS lacks a consistent strategy for the user fees charged to taxpayers. This makes many basic services unaffordable to the public, in part because the IRS often neglects or is slow to waive fees for lower income taxpayers. The IRS collects about $180 million in user fee receipts annually, mostly from the installment agreement fee, and it uses this revenue to pay for taxpayer services, information technology, and other program costs. The National Taxpayer Advocate believes that the IRS should employ strong criteria for establishing and setting fees, along with vigilant oversight and review of existing fees. Otherwise, taxpayers' access to service may be reduced and their rights harmed as the IRS establishes new fees and raises others to make up for budgetary shortfalls. The National Taxpayer Advocate makes several recommendations to assist the IRS in establishing and setting fees in the future.

Privacy and Protection of Taxpayer Information

5. The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential. Tax return preparers use the preparation process to sell a variety of products to their clients. The sale of certain commercial products, such as refund anticipation loans (RALs), refund anticipation checks (RACs), and audit insurance, is disproportionately targeted toward low income taxpayers and may exploit those taxpayers' trust in their preparers and their own lack of financial sophistication. Some preparers who market RALs also have a financial incentive to inappropriately inflate refund amounts. To the extent that problems arise with a RAL or similar product, taxpayers may incorrectly assume there are problems with the administration of the tax laws. However, despite concerns repeatedly expressed by both internal and external stakeholders, the IRS has declined to conduct any significant research into the impact of commercial products on tax compliance or taxpayer exploitation. Within the existing statutory framework of IRC § 7216, the Treasury Department has the discretion to restrict the ability of preparers to obtain taxpayer consent to either use or disclose tax return information in the marketing of RALs, audit protection, and similar products.

6. Identity Theft Procedures. The National Taxpayer Advocate first raised her concerns about the IRS's identity theft procedures in her 2005 Annual Report to Congress. While the IRS has made some improvements, it has not done enough to improve procedures for victims of identity theft or to secure its filing system from fraudulent filers. The IRS's identity theft measures are reactive rather than proactive and require taxpayers to contact the IRS and work their way through layers of employees until they reach someone with authority to adjust their accounts. Too often, victims of identity theft receive more scrutiny from the IRS than perpetrators, such as those who use the electronic filing system and bank account direct deposit to commit refund fraud. The IRS should make a PIN process mandatory for all electronic filers, increase the security of direct deposits, and generally take a more taxpayer-centric approach to identity theft and put procedural and preventive changes on a fast track.

7. Mortgage Verification. When closing on a mortgage, borrowers often must consent to disclose certain tax information in order to verify their income, including signing a *blank* copy of Form 4506-T, Request for Transcript of Tax Return, which gives the lender access to four years of tax information for 60 days from the date on the form. However, the information disclosed is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. The IRS should revise Forms 4506, 4506-T, and 8821 (and their instructions) to state in clear and plain language that taxpayers should not sign a blank or incomplete form. The IRS should also revise the forms to allow a taxpayer to specify the purpose for which the information can be used by third parties.

Tax Return Preparers and Representatives

8. Transparency of the Office of Professional Responsibility. The IRS's Office of Professional Responsibility (OPR), which is charged with regulating tax practitioners, has not published sufficient guidance or procedures to assure the public that it operates fairly and independently. If there is any question about OPR's independence from the IRS, practitioners (and taxpayers) may fear OPR will serve as an extension of the IRS enforcement function and arbitrarily target practitioners who are appropriately advocating for taxpayers. This belief would chill zealous advocacy by practitioners and harm taxpayers as well. OPR should improve both the reality and perception of its independence and establish

reasonable limits on its discretion by issuing guidance on which practitioners can rely. This guidance should more directly address who is subject to regulation by OPR, what conduct is prohibited, how OPR follows up on referrals, how OPR will adjudicate an allegation (including policies governing practitioner access to information that could bear on the result), and what penalties OPR will seek for a given offense. OPR should develop such guidance quickly using an open process.

9. Preparer Penalties and Bypass of Taxpayers' Representatives. The IRS should more effectively use the tools at hand to address incompetent or unscrupulous tax return preparers. It has collected just slightly more than 20 percent of the preparer penalties it has assessed under IRC §§ 6694 and 6695 during the past six years, and that is inadequate. The IRS also places taxpayers at risk by failing to enforce the civil and criminal penalties under IRC §§ 6713 and 7213. The IRS should also find a way to systemically check whether all individuals identified on Electronic Return Originator (ERO) applications as Principals, Responsible Officials, and Delegated Users have unpaid preparer penalties assessed against them. The IRS's authority to bypass taxpayer representatives exists to protect taxpayers against incompetent or unethical practitioners. By not providing proper guidance to employees or following its own bypass procedures, the IRS risks depriving taxpayers of their fundamental right to representation. Finally, the National Taxpayer Advocate is concerned about the higher standards of conduct recently added to IRC § 6694, which may affect the way tax preparers dispense advice and create conflicts of interest between preparers and their clients.

Taxpayer Service Issues

10. Taxpayer Service and Behavioral Research. The IRS has more quality research on taxpayer service at its disposal than ever before. As part of the Taxpayer Assistance Blueprint (TAB), the IRS conducted extensive research on taxpayers' needs, preferences, behavior, and willingness to use certain services. The National Taxpayer Advocate has also commissioned studies to identify ways to improve the tax system. The IRS now needs to test and apply the findings of these studies. The IRS should develop a behavioral research lab that can test and enhance IRS products, thereby improving taxpayer service. By applying existing findings and developing a better understanding of taxpayer behavior, the IRS can also improve voluntary compliance. This approach, in the long run, is likely to result in a more fair and balanced system tax administration.

11. Service at Taxpayer Assistance Centers. The development of the TAB helped the IRS learn more about taxpayer needs, preferences, and willingness to use services at the Taxpayer Assistance Centers (TACs or "walk-in sites"). Despite this blueprint and the knowledge that some taxpayers will always need face-to-face service, taxpayers who visit TACs continue to experience difficulties making appointments, obtaining return preparation assistance, and making payments. The National Taxpayer Advocate commends the IRS for a recent change to the Internal Revenue Manual (IRM) allowing any taxpayer visiting a TAC to receive a copy of his or her account transcript (up to the last three years) regardless of urgency or reason. However, the National Taxpayer Advocate recommends that the IRS also take other steps to help taxpayers who travel to TACs, such as providing same-day service and not turning them away or referring them elsewhere.

12. Outreach and Education on Disability Issues for Small Business/Self-Employed Taxpayers. People with disabilities have always struggled to find employment, largely because of the numerous barriers facing this population. Some professionals believe there

is an increasing trend among people with disabilities to address these barriers by becoming self-employed or owning their own small businesses. One of the most significant obstacles facing these individuals in starting their own businesses is the inaccessibility of business materials and information. Therefore, it is vital that the IRS take steps to ensure that tax administration is not a barrier to disabled individuals entering business, but rather, is a resource for these entrepreneurs.

13. Exempt Organization Outreach and Education. The U.S. tax-exempt sector consists of more than 1.6 million organizations (not including most churches). These exempt organizations (EOs) are diverse in size, ranging from large hospitals and universities to small volunteer-run charities. Approximately half of all EOs have all-volunteer staffs and another third have fewer than ten employees. Smaller EOs frequently lack professional tax guidance. The IRS has increased enforcement actions against EOs and the resources dedicated thereto. However, resources devoted to EO education and outreach, which were never adequate, have continued to decline. Existing IRS outreach and education programs for EOs are beneficial. However, the National Taxpayer Advocate believes the IRS can and should do more to help EOs, particularly small organizations, comply with the complex requirements to which they are subject. The National Taxpayer Advocate urges the IRS to conduct research to assess the service needs and preferences of the spectrum of EOs and to develop a strategic plan to enhance the scope and effectiveness of its outreach to these organizations.

14. Determination Letter Process. Unreasonable delays in the processing of applications for exemption from federal income tax have persisted for several years. Three years after the National Taxpayer Advocate raised concerns about these delays in the 2004 Annual Report to Congress, the processing time for many organizations' applications still exceeds the IRS's goal. These delays can have a serious, detrimental effect on charitable organizations' finances and activities. The IRS has employed a number of measures to fix the problem but must do more to eliminate processing delays and keep organizations informed about the status of their applications.

Examination Issues

15. EITC Examinations and the Impact of Taxpayer Representation. Many taxpayers have difficulty navigating the IRS examination process, particularly in regard to the EITC. A study requested by the National Taxpayer Advocate found that taxpayers retain significantly more of their EITC if they have representation during the examination. The results suggest the IRS examination strategy is flawed. Changes to the existing strategy are necessary to ensure that procedural barriers do not prevent taxpayers from receiving the EITC to which they are entitled. To ease the process, the IRS should increase communication with taxpayers, simplify correspondence, address the needs of English as a Second Language (ESL) and disabled taxpayers, adopt the use of affidavits, and improve the process of transferring cases from campuses to field offices. In addition, the IRS should work to promote available taxpayer services, including the Low Income Taxpayer Clinics (LITCs), TAS, and TACs.

16. Nonfiler Program. In fiscal year (FY) 2006, the IRS established an executive group to oversee an enterprise-wide strategy to address nonfilers, but it has not implemented sustainable plans to increase filing compliance. The present IRS emphasis on automated systems and reductions in face-to-face service contributes to high rates of default assessments (in the Automated Substitute for Return program), low collection percentages,

and downstream consequences in the form of TAS casework. The National Taxpayer Advocate urges the IRS to develop a more balanced strategy of research, service, and enforcement to increase filing compliance.

17. Automated Underreporter Program. The Automated Underreporter (AUR) program plays a critical role in reducing the nation's tax gap by verifying reporting compliance for taxpayers who have filed returns and potentially failed to report all income. In FY 2007, AUR closed more than 4.5 million cases and assessed $5.1 billion in additional tax. Given that AUR maintains an inventory of over 15 million cases at any given time, it is important for both the IRS and the taxpayer that the program be as accurate and effective as possible. Yet AUR has the highest rate of abatement of any compliance program and generates large numbers of TAS cases, most of which result directly from the IRS's failure to adequately or timely address taxpayer responses to AUR contacts. The National Taxpayer Advocate recommends that the IRS make every effort to ensure that only those taxpayers who have underreported income are affected by the program, respond timely to correspondence, promptly process amended returns, and significantly improve the level of service on the AUR toll-free telephone lines.

18. The Accuracy-Related Penalty in the Automated Underreporter Units. The IRS has been increasing its reliance on the AUR program to systemically match payments that third parties report on Forms W-2s, 1099s, and similar documents against income that taxpayers report on their tax returns. The AUR program is vital to tax administration and reducing the nation's tax gap. However, the AUR's practice of automatically imposing the negligence penalty without the exercise of discretion by IRS personnel is problematic. The law requires IRS managerial approval of all penalties before assessment unless the IRS is able to "automatically calculat[e] the penalty through electronic means." The IRS takes the position that if within the past three years the taxpayer failed to report amounts from the same type of information return which is at issue in the current year, the AUR may automatically impute negligence. This is a *per se* negligence standard. Negligence is a finding that requires an analysis of the taxpayer's intent and a review of whether the taxpayer had reasonable cause. It is doubtful that Congress, which sought to ensure managerial review for penalty determinations in general, intended to provide a different rule for the negligence penalty. Taxpayers and the IRS would clearly benefit from some form of human review. Further, data suggests that while the AUR is proposing negligence penalties more frequently, the AUR experiences a high reversal rate – substantially higher than the IRS campuses or Field Examination units. The National Taxpayer Advocate urges the IRS to add a level of human review to the proposed AUR negligence penalty and develop a comprehensive program to review the overall effectiveness of utilizing the AUR to assess the penalty.

19. Audit Reconsiderations. In FY 2006, the IRS closed audit reconsiderations of tax assessments exceeding $1.7 billion by abating over $1.2 billion of those original audit assessments. The audit reconsideration process constitutes rework, since the IRS previously audited the taxpayers and assessed tax on the same tax period(s). The IRS's strategic goals of reducing cycle time and improving detection of noncompliance need to be balanced against taxpayers' need to receive clear communication and accurate resolution of tax controversies. The IRS's failure to convey its goals to employees in a balanced fashion results in rework in the form of audit reconsiderations. The National Taxpayer Advocate urges the IRS to promote one-stop customer service among employees and to utilize the most effective means of communication to resolve tax issues in a timely manner.

20. Audits of S Corporations. While the IRS is struggling to develop a comprehensive strategy to address S corporation noncompliance, taxpayers are burdened by the S corporation election process and K-1 matching program errors. In addition, a significant number of S corporations classify all payments to their officers as "distributions" rather than "wages," effectively avoiding employment tax liabilities. The National Taxpayer Advocate urges the IRS to increase the number of S corporation asset ranges to improve classification and return selection, and establish a tracking system to assess the final tax effect of S corporation adjustments and related issues such as employment tax results. The IRS also should establish an outreach campaign and a soft contact letter test to address the officer compensation issue.

Collection Issues

21. FPLP Levies on Social Security Benefits. The IRS has a legal right to attach federal payments of taxpayers not meeting their tax obligations through the Federal Payment Levy Program (FPLP). However, the IRS must employ proper safeguards to ensure that taxpayers with the greatest potential for hardship are identified and removed from the program before the IRS issues a levy. Although the IRS agreed to conduct additional research to address the National Taxpayer Advocate's longstanding concerns with the FPLP, these efforts are not keeping pace with the rapid increase in FPLP levies on taxpayers' Social Security benefits. In FY 2007, the IRS received in excess of 1.74 million levy payments that attached to Social Security benefits – an increase of almost 24 percent from FY 2006. Yet rather than developing an automated process to screen out low income or other taxpayers who are experiencing economic hardship, the IRS is actually seeking to expand the FPLP to other federal payments commonly associated with a taxpayer's sole or primary source of income. The National Taxpayer Advocate strongly recommends that the IRS postpone FPLP expansion on any payments associated with retirement income until a suitable "low income and hardship" filter has been created and successfully tested.

22. Third Party Payers. When third party payers do not file required employment tax returns or make required deposits, employers remain liable for the underlying tax, interest, and penalties and may face significant economic difficulties. The IRS generally has no recourse other than to initiate collection of unpaid employment taxes from the employers. Not only are employers forced to pay the amount of their employment tax liability twice (once to the failed third party payer and again to the IRS), but they may also be liable for interest and penalties. The National Taxpayer Advocate recommends that the IRS assume a greater role in protecting taxpayers' interests and assisting taxpayers in third party payer cases by developing "global" remedies for situations where large numbers of taxpayers share common facts. A global approach would provide a common starting point for relief, regardless of where the case is worked within the IRS.

23. Employment Tax Treatment of Home Care Service Recipients. Many elderly and disabled individuals receive home care and support services administered through a variety of state and local government health and welfare programs. Often, elderly and disabled home care service recipients (HCSRs) who participate in these programs fall into the category of common law employers, and they are required to apply highly technical and complex employment tax rules to determine their employer tax status and responsibilities. Elderly and disabled HCSRs can suffer substantial financial hardships when state and local government agencies contract out program responsibilities, including payroll functions, to intermediary service organizations (ISOs) that fail to properly report, file, and pay employment taxes. As a result, the elderly and disabled HCSRs – as the common law

employers – remain liable for the tax, interest, and penalties. The National Taxpayer Advocate proposes a legislative change and a series of administrative steps that, if adopted, will complement and bolster the actions taken by the IRS to significantly mitigate the problems affecting HCSRs and minimize the downstream impact of ISO failures on elderly and disabled individuals.

24. Offers in Compromise. The IRS's Offer in Compromise (OIC) program is no longer being used to any significant extent as a viable collection alternative. Between FY 2001 and FY 2007, offer receipts declined by 63 percent and the number of accepted offers declined by 70 percent. The National Taxpayer Advocate believes that the long-term success of the OIC program is best served by maximizing the number of cases in which the IRS is able to complete the investigation and make a decision to accept or reject the offer on its merits. However, for the IRS to achieve its policy goals and reap the benefits of a successful OIC program, it must first minimize the extent to which policies intended to deter taxpayers from submitting incomplete or unrealistic offers do not also discourage taxpayers from submitting good ones. In order to do so, the National Taxpayer Advocate recommends the IRS ensure all IRS Collection employees can identify when accepting an OIC is a "win-win" situation for taxpayers and the government. Moreover, the IRS should revitalize its OIC outreach efforts to taxpayers and practitioners to better assist them with the submission of reasonable and appropriate offers. The key to success of the OIC program is to identify those taxpayers for whom an offer is an appropriate collection alternative and ensure they are aware of the OIC process and do not face unreasonable barriers in the submission of an offer.

25. Inadequate Training and Communication Regarding Effective Tax Administration Offers. Although the IRS has the ability to accept an OIC on the basis of "effective tax administration" (ETA), it has done very little to educate the public or its employees about how or when it will use this authority. As a result, eligible taxpayers may not be applying for OICs based on ETA, and IRS employees may not recognize situations when these offers are appropriate. Thus, the IRS needs to do more to ensure that all collection employees know when an ETA offer may be a viable collection alternative. The IRS also needs to conduct more in-depth external outreach to educate taxpayers and practitioners about when the IRS will accept an ETA offer.

26. Assessment and Processing of the Trust Fund Recovery Penalty (TFRP). Employers are responsible for withholding and remitting to the IRS certain trust fund taxes, including income and Federal Insurance Contributions Act (FICA) taxes from payments to employees, as well as certain federal excise taxes. When these monies are not paid as required, the law provides for the assessment of a TFRP, which can have disastrous economic consequences for those deemed to be responsible persons. However, the IRS has failed to consistently adhere to its own quality standards for investigating these cases. Despite almost a decade of negative findings by the Government Accountability Office (GAO), the IRS has yet to implement an effective or reliable system for the accounting and application of payments, credits, and offsets. The National Taxpayer Advocate makes several recommendations designed to improve the timeliness, fairness, and quality of the process.

Status Updates

27. Private Debt Collection. The Private Debt Collection initiative is failing in most respects. It is not meeting revenue projections; its return on investment is dismal; the private collection agencies (PCAs) are no better at locating or collecting tax liabilities than the IRS

itself; the IRS has failed to require the PCAs to disclose their taxpayer-related procedures to the public to the same extent as the IRS, which shields the program from adequate congressional and public scrutiny; and the IRS is sending the PCAs new cases (because the number of "easy" cases is smaller than projected) and these new cases may require the exercise of discretion and judgment in collection matters that is appropriately the sole province of the IRS. For these reasons, the National Taxpayer Advocate once again calls for the initiative's repeal.

28. IRS Collection Strategy. The National Taxpayer Advocate has continually urged the IRS to employ a collection strategy that effectively and efficiently balances the goals of tax collection, taxpayer service, and tax compliance. We are mindful of the difficulties the IRS faces when carrying out its collection strategy and properly administering the tax system, which requires a delicate balance between customer service and enforcement. Although the IRS's collection strategy has improved over the past year, significant work remains to be done. We continue to believe that more emphasis by the IRS on providing timely service to taxpayers with tax delinquency problems and employing more flexibility in the use of available collection payment alternatives (*e.g.,* installment agreements, partial payment installment agreements, and OICs), are necessary to deliver an effective, balanced, and service-oriented program. By better understanding the needs of taxpayers and its own employees, the IRS can make significant headway toward fostering voluntary compliance and achieving maximum revenue.

29. Questionable Refund Program. The IRS established the Questionable Refund Program (QRP) in 1977 to prevent the payout of false refund claims. Historically and presently, the IRS's Criminal Investigation (CI) function has managed the program, though the vast majority of the work is civil. In the 2005 Annual Report, the National Taxpayer Advocate identified the QRP as the second most serious problem facing taxpayers, and documented fundamental flaws with the program. While CI and the IRS responded with improvements, QRP cases still rank among the top five reasons that taxpayers seek TAS assistance. The National Taxpayer Advocate recommends that the IRS expeditiously transfer oversight of the program to the civil side of the IRS and further reduce the volume of legitimate taxpayer refunds that the QRP inappropriately delays. In an effort to further improve the program, CI and the IRS have agreed to support a TAS study in 2008 to determine whether refund claims that the QRP concluded were false were correctly decided.

LEGISLATIVE RECOMMENDATIONS

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(VIII) requires the National Taxpayer Advocate to recommend legislative changes to resolve or mitigate problems encountered by taxpayers. This year's report presents seven proposals classified as Key Legislative Recommendations and six proposals classified as Additional Legislative Recommendations.

KEY LEGISLATIVE RECOMMENDATIONS

1. Taxpayer Bill of Rights and *De Minimis* "Apology" Payments. The United States tax system is based on a social contract between the government and its taxpayers – taxpayers agree to report and pay the taxes they owe and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so. The National Taxpayer Advocate believes that it is in the best interest of taxpayers and tax administration for this unspoken agreement to be articulated in a formal Taxpayer Bill of Rights, which should incorporate a clear statement of taxpayer rights as well as a statement of taxpayer obligations. Moreover, since the U.S. tax system is a mature system, the rights and obligations articulated in the Taxpayer Bill of Rights should be generally derived from provisions that are already part of the tax laws or procedures. Further, a fair and just tax system should acknowledge IRS mistakes and delays in taxpayer issue resolution, and where such situations cause excessive expense or undue burden on a taxpayer, make a *de minimis* "apology" payment. Accordingly, the National Taxpayer Advocate recommends that Congress enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers. Congress should require the Secretary to publish these fundamental rights and obligations in a document that also links specific statutory protections to the Taxpayer Bill of Rights. The National Taxpayer Advocate also recommends that Congress grant the National Taxpayer Advocate the discretionary, nondelegable authority to provide *de minimis* compensation to taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer and the taxpayer meets the IRC § 7811 definition of significant hardship. Discretionary payments should be excluded from gross income and range from a minimum of $100 up to a maximum of $1,000, indexed for inflation.

2. Measures to Address Noncompliance in the Cash Economy. Income from the "cash economy" – income from legal activities that is not reported to the IRS by third parties – is the type of income most likely to go unreported. Unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over $100 billion per year. Because significant noncompliance by some taxpayers is not fair to those who timely pay their taxes, we must do more to address this problem. We can improve voluntary compliance by making it easier for taxpayers to understand and meet their tax obligations and enhancing the tools available to the IRS for enforcing the tax laws when necessary in ways that are minimally intrusive, impose the least possible burden, and protect taxpayer rights. Based on these considerations and a survey of existing tax compliance research, the National Taxpayer Advocate recommends that Congress adopt the following measures to address noncompliance in the cash economy:

1. Increase use of the IRS's electronic payment system for estimated tax payments;
2. Authorize voluntary withholding agreements;

3. Eliminate the corporate exception to information reporting for small corporations if the IRS's National Research Program shows significant noncompliance;
4. Accelerate the taxpayer identification number validation process;
5. Provide for withholding on payments to noncompliant contractors;
6. Require information reporting by financial institutions on credit and other "payment card" receipts; and
7. Require financial institutions to report all accounts to the IRS by eliminating the $10 minimum on interest reporting.

3. Home Office Business Deduction. The tax laws regarding the home office deduction are considered by many to be too complex and the recordkeeping responsibilities associated with the deduction to be too time-consuming. It is questionable whether most taxpayers who are eligible to take the deduction actually do so. In addition, the process of reporting the deduction differs based on the type of business conducted and whether the taxpayer is an employee or self-employed. Congress should amend IRC § 280A to create an optional standard home office deduction. The legislative provision would direct the Secretary of the Treasury to draft regulations which calculate the deduction by multiplying an applicable standard rate, as determined and published by the Commissioner of the IRS on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in IRC § 280A(c).

4. Eliminate Tax Strategy Patents. Tax strategy patents grant private citizens monopolies on the application of our public tax laws. They may mislead taxpayers into believing the government has approved them, undermine congressionally-created tax incentives, create conflicts of interest between tax advisors and their clients, increase tax compliance costs, and reduce respect for the tax system along with tax compliance. They also provide additional incentives for tax advisors to "invent" tax minimization strategies, an activity with no redeeming social value. While tax strategy patents have the potential to increase the amount of publicly available information about tax strategies, they are more likely to stifle public discussion of strategies by those who fear they might be sued for infringement. The National Taxpayer Advocate recommends that Congress bar tax strategy patents and limit their enforceability. If Congress does not bar them, it should require the United States Patent and Trademark Office (PTO) to send any tax strategy patent applications to the IRS so that it can quickly address any abuse they may present and help the PTO identify tax strategies that should not be eligible for patents.

5. Extend Exempt Organizations' Advance Ruling Periods in Cases of Extreme Application Processing Delays. An advance ruling provides that an organization will be treated as a publicly supported organization for its first five taxable years. Delays in processing Forms 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, result in some organizations' receiving advance ruling letters only months before the advance ruling period ends. Organizations unable to obtain a favorable determination letter until shortly before the expiration of the advance ruling period are likely to have difficulty garnering financial support and therefore are likely to be reclassified as private foundations. Private foundations are subject to various operating restrictions and excise taxes for failure to comply with such restrictions, making private foundation status far less favorable than public charity status. The National Taxpayer Advocate recommends that Congress provide for the extension of the advance ruling period by one year when, as a result of a delay of 270 days or more in the processing of an exemption application, an advance ruling letter is issued not more than eight months prior to the end of the advance ruling period.

6. Legislative Recommendations to Reduce the Compliance Burden on Small Exempt Organizations. More than 73 percent of public charities reported annual expenses of less than $500,000 in 2004. Approximately half of all exempt organizations (EOs) have all-volunteer staffs and another third have fewer than ten employees. The National Taxpayer recommends that Congress lessen the burden on these small EOs by (i) amending the Code to provide that non-private foundations with gross receipts not normally more than $25,000 may submit a short-form application for recognition of IRC § 501(c)(3) status (*i.e.*, a Form 1023-EZ), (ii) requiring the IRS to continue to offer a separate short-form ("EZ") version of Form 990 that may be filed by small organizations in lieu of the long-form Form 990 or parts thereof, and (iii) requiring the IRS to create a broad-based, formal, and ongoing voluntary compliance program for EOs similar to those offered in the areas of employee plans, tax-exempt bonds, and Indian tribal governments.

7. Taxpayer Protection from Third party Payer Failures. In recent years, a number of third party payers have gone out of business or embezzled their customers' funds. Because employers remain liable for payroll taxes, self-employed and small business taxpayers who fall victim to these situations can experience significant burden. This burden includes not only being forced to pay the amount twice – once to the third party payer that absconded with or dissipated the funds and a second time to the IRS – but also being liable for interest and penalties. Some small businesses may not be able to recover from these setbacks and will be forced to cease operations. This issue demonstrates the vital need for taxpayer protection in the payroll service industry, particularly for small business taxpayers that hire smaller third party payers. The National Taxpayer Advocate recommends that Congress amend the Code to define a third party payer; make a third party payer jointly and severally liable for the amount of tax collected from client employers but not paid over to the Treasury, plus applicable interest and penalties; authorize the IRS to require third party payers to register with the IRS and be sufficiently bonded; include third party payers within the definition of a "person" subject to the Trust Fund Recovery Penalty (TFRP); and clarify that TFRP survives bankruptcy when the debtor is not an individual.

ADDITIONAL LEGISLATIVE RECOMMENDATIONS

1. Expand Definition of Taxpayer Identification Number (TIN) to Include Internal Revenue Service Numbers (IRSN). The IRS assigns a temporary TIN, referred to as an IRSN, to victims of identity theft while the IRS determines who is the true owner of the Social Security number in dispute. Under current regulations, identity theft victims who file tax returns using IRSNs cannot claim an exemption or the Earned Income Tax Credit (EITC) because the IRS does not consider an IRSN to be a valid TIN. The IRS's policy of denying tax benefits, such as an exemption or the EITC, to a taxpayer using an IRSN is inequitable and perpetuates the harm suffered by an identity theft victim. The National Taxpayer Advocate recommends that Congress amend IRC §§ 151(e), 32(c)(1)(F), and 32(c)(3)(D) to require a taxpayer to provide a valid TIN or IRSN in order to claim an exemption and the EITC. This recommendation would enable an identity theft victim who files a tax return using an IRSN to claim an exemption or the EITC.

2. Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers. IRC § 6713 has historically been identified as the civil counterpart to the criminal penalty imposed on tax return preparers under IRC § 7216. Like IRC § 7216, IRC § 6713 provides a

broad prohibition against the use and disclosure of tax return information. The current statutory framework seemingly requires that exceptions be made either to both the criminal and civil statutes or to neither. The Treasury Department is understandably reluctant to subject preparers to criminal sanctions except for egregious conduct, so it has used its regulatory authority to carve out broad exceptions from the general prohibition on the use or disclosure of tax return information set forth in IRC § 7216. The National Taxpayer Advocate believes taxpayer protections would be stronger if the Treasury is given the flexibility to promulgate regulations applicable only to the civil penalty without concern that the criminal penalty would also apply.

3. Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions. In her 2006 Annual Report to Congress, the National Taxpayer Advocate proposed the following changes to IRC §§ 6015 and 66 to make the so-called "innocent spouse" provisions consistent and fair:

1. Direct the IRS to include the last date to file a petition with the Tax Court in innocent spouse final determination letters;
2. Suspend the period for filing a U.S. Tax Court petition during bankruptcy;
3. Require the IRS to establish a reconsideration process for innocent spouse determinations;
4. Provide the Tax Court with jurisdiction to review community property relief determinations under IRC § 66(c);
5. Provide that a taxpayer may request equitable relief from liabilities at any time the IRS could collect such liabilities; and
6. Expand the availability of refunds to taxpayers granted innocent spouse relief.

In this report, we reiterate these recommendations and propose an additional one. While taxpayers may raise IRC § 6015 relief in a Collection Due Process, deficiency, or bankruptcy proceeding, or a refund suit, a number of recent United States District Court opinions have held that such relief cannot be raised as a defense in a collection suit in district court. We recommend that Congress amend IRC §§ 6015 and 66 to clarify that taxpayers may raise relief under those sections as a defense in a proceeding brought under any provision of Title 26 (including §§ 6213, 6320, 6330, 7402, and 7403) or any case under title 11 of the United States Code.

4. Referrals to Low Income Taxpayer Clinics. The National Taxpayer Advocate has discussed at length the impact that representation has on the outcome of a taxpayer's case, particularly in EITC examinations. One opportunity for taxpayers to obtain representation before the IRS is through Low Income Taxpayer Clinics (LITCs). However, the Treasury Standards of Conduct for IRS employees prohibit the recommendation or referral of specific attorneys or accountants. The Office of Government Ethics' Standards of Ethical Conduct for Employees in the Executive Branch further limit IRS employees' ability to refer taxpayers to representatives. The National Taxpayer Advocate recommends amending IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance.

5. Consent-Based Disclosures of Tax Return Information Under Internal Revenue Code Section 6103(c). When closing on a mortgage, borrowers often must consent to disclose certain tax information in order to verify their income. In practice, this consent often

involves signing a *blank* copy of Form 4506-T, Request for Transcript of Tax Return, which gives the lender access to four years of tax information for 60 days from the date shown on the form. However, the information disclosed is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. The National Taxpayer Advocate recommends that IRC § 6103(c) be amended to limit the disclosure of tax returns and tax return information requested through taxpayer consent solely to the extent necessary to achieve the purpose for which consent was requested. Congress should further amend IRC § 6103(p)(3)(C) to require the Treasury Department to include in the Secretary's annual disclosure report to the Joint Committee on Taxation detailed information about the number and types of disclosures pursuant to taxpayer consent. To provide a deterrent to misusing taxpayer return information obtained pursuant to an IRC § 6103(c) consent, IRC §§ 7213A and 7431 should be amended to apply criminal and civil sanctions.

6. Home Care Service Workers. Home Care Service Workers (HCSWs) help disabled or elderly persons with personal care or household chores. Generally, state and local government health and welfare programs determine that a Home Care Service Recipient (HCSR) is eligible to receive in-home support services, and the HCSR receives services from an HCSW in accordance with the terms of the program. Notwithstanding that the government provides funds for and is often extensively involved in managing the programs, HCSWs generally are considered domestic employees of HCSRs. Because HCSRs in these programs are elderly and disabled, and thus are often unable to comply with the complicated payment and reporting requirements imposed on employers, a variety of third party payroll reporting and payment arrangements have arisen. These arrangements may cause problems for the HCSRs, who are among the least able taxpayers to successfully navigate IRS account resolution and collection processes. The National Taxpayer Advocate recommends that Congress amend IRC § 3121(d)(3) to provide that a HCSW is the statutory employee of the administrator of the HCSW funding (defined as states, localities, their agencies, or intermediate service organizations, regardless of the original funding source).

The Most Litigated Tax Issues

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts and to classify those issues by the category of taxpayer affected. The cases we reviewed were decided during the 12 months that began on June 1, 2006, and ended on May 31, 2007.

1. Appeals from Collection Due Process (CDP) Hearings Under Internal Revenue Code Sections 6320 and 6330. CDP hearings provide taxpayers with an independent review by the Office of Appeals of the IRS's decision to file a lien or its proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for a meaningful hearing in front of an independent appeals officer *before* the IRS deprives them of property. Since 2003, CDP has been the tax issue most frequently litigated in the federal courts and analyzed for the Annual Report to Congress. This year continues the trend, with the courts issuing at least 217 opinions during our review period. Some critics have argued that the CDP process stalls the IRS collection process and allows taxpayers to raise frivolous arguments. However, the National Taxpayer Advocate remains convinced that the process serves an important function by providing taxpayers with a forum to raise legitimate issues prior to the IRS's depriving them of property. The opinions reviewed this year support this view. Many of the reviewed decisions provided useful guidance on substantive issues, while others appropriately imposed or warned taxpayers about the possibility of sanctions being imposed in the future.

2. Gross Income Under Internal Revenue Code Section 61 and Related Sections. When preparing tax returns, taxpayers must make the crucial calculation of gross income for the taxable year in order to determine the tax that must be paid. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress. Common issues in the 112 cases we identified include damage awards, discharge of indebtedness income and disability and Social Security benefits.

3. Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609. The IRS has the authority to summon the production of books, records, other data, or testimony from witnesses when investigating a civil or criminal tax liability, and may serve a summons directly on the subject of the investigation or on a third party recordkeeper. A person who has a summons served upon him or her may contest the legality of the summons if the government brings a proceeding to enforce the summons and may raise appropriate defenses at that time. Once a summons is served upon a third party recordkeeper, that person can challenge the legality of the summons by filing a motion to quash it or intervening in a proceeding. Generally, the burden on the IRS to establish the validity of the summons is minimal and the burden on the taxpayer to establish the illegality of the summons is formidable. The taxpayer or the third party recordkeeper prevailed in only four of the 109 cases we identified and reviewed.

4. Civil Damages for Certain Unauthorized Collection Actions Under Internal Revenue Code Section 7433. This is the first year that damages for unauthorized collection actions under IRC § 7433 have appeared as a Most Litigated Issue. IRC § 7433 establishes jurisdiction for United States District Courts (and, in certain circumstances, bankruptcy

courts) to hear cases for damages sustained in connection with the wrongful collection of any federal tax because an IRS employee recklessly or intentionally, or by reason of negligence, disregarded any provision of the IRC, any IRS regulations, or certain provisions of the Bankruptcy Code. We identified 100 opinions that involved a claim for damages for unauthorized collection action under IRC § 7433. The courts affirmed the IRS position in almost all cases. Taxpayers did not win a single case. However, in four cases, taxpayers prevailed on at least one issue.

5. Frivolous Issues Penalty and Related Appellate-Level Sanctions Under Internal Revenue Code Section 6673. The federal courts issued decisions in at least 70 cases involving the IRC § 6673 penalty and at least 17 cases involving an analogous penalty at the appellate level. These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies. In 16 of the 70 cases involving IRC § 6673, the U.S. Tax Court decided not to impose the penalty but warned taxpayers they could face sanctions in the future for similar conduct. Similarly, we identified one case at the appellate level where the government did not request nor did the court impose a sanction under IRC § 7482(c)(4) or any other authority, but the court did warn the taxpayer that similar conduct in the future would result in a sanction.

6. Failure to File Penalty Under Internal Revenue Code Section 6651(a)(1) and Estimated Tax Penalty Under Internal Revenue Code Section 6654. We identified 82 decisions issued by the federal courts regarding the addition to tax under IRC § 6651(a)(1) for failure to file a timely tax return or the addition to tax under IRC § 6654 for failure to pay estimated income tax. The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return is a result of reasonable cause and is not due to willful neglect. The estimated tax penalty is mandatory unless the taxpayer can meet a statutory exception. Among the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid these penalties. Taxpayers prevailed in full in only three of the 82 cases, although seven others resulted in split decisions. Forty-one cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, while only one case involved the estimated tax penalty without simultaneous imposition of the failure to file penalty.

7. Trade or Business Expenses Under Internal Revenue Code Section 162 and Related Sections. The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 77 cases that included a trade or business expense issue. The courts affirmed the IRS position in full in nearly two-thirds of the cases, while taxpayers prevailed five percent of the time. The remaining cases resulted in split decisions.

8. Accuracy-Related Penalty Under Internal Revenue Code Sections 6662(b)(1) and (2). IRC § 6662(b)(1) and (2) authorizes the IRS to impose a penalty if, under (b)(1), a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax or if, under (b)(2), an underpayment of tax exceeded a computational threshold called a "substantial understatement." IRC § 6662(b) also authorizes the IRS to impose three other accuracy-related penalties. However, taxpayers litigated these other penalties less frequently than they litigated the negligence and substantial understatement penalties; this analysis does not address the three other accuracy-related penalties.

9. Relief from Joint and Several Liability Under Internal Revenue Code Section 6015. Spouses filing joint tax returns are jointly and severally liable for any deficiency or tax due, enabling the IRS to collect the entire amount due from either taxpayer. However, IRC § 6015 provides three avenues for relief from joint and several liability. We identified 46 federal court opinions involving relief under IRC § 6015, in which the jurisdiction of the court and the taxpayer's knowledge were frequent subjects of litigation. In December 2006, Congress enacted legislation proposed by the National Taxpayer Advocate in her 2001 Annual Report, providing that the Tax Court has jurisdiction in stand-alone cases to review IRC § 6015(f) determinations where no deficiency had been asserted. The National Taxpayer Advocate has also recommended eliminating joint and several liability and the consequent need to inquire about one spouse's knowledge.

10. Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151. Family status issues involve exemptions, credits, and filing status claimed by taxpayers on their federal income tax returns. Litigated cases often involve multiple family status issues with similar factual determinations, including head-of-household filing status, the child tax credit, Earned Income Tax Credit, and the dependency exemption. More than two-thirds of the 41 cases we identified dealt with multiple family status issues, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will result in the summary denial of the child tax credit and may jeopardize eligibility for head-of-household filing status.