NATIONAL TAXPAYER ADVOCATE

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This Report is dedicated to

Etoile Beller

and

Keith Restaino

whose concern for taxpayers

and personal courage inspired

everyone they met.

Honorable Members of Congress,

It is my pleasure to submit to you for your review the National Taxpayer Advocate's 2002 Annual Report to Congress. Throughout this report, you will note an emphasis on taxpayer rights. This emphasis is intentional. With the increase in collection and other compliance activities and the increased use of automated processes to efficiently handle volumes of taxpayer correspondence and cases, the question arises whether these initiatives will undermine taxpayer protections and the confidence taxpayers have in the U.S. tax system.

Over the last year, the Internal Revenue Service (IRS) has made significant progress on a number of fronts – launching initiatives involving corporate technical tax shelters, abusive tax schemes, and off-shore accounts; improving its toll-free telephone service; and even eliminating some of the offer-in-compromise backlog. The IRS has also been more responsive to taxpayer and tax professional groups, including them in discussions *before* final decisions are made. The Taxpayer Advocate Service is pleased with these developments even as we acknowledge that there is much more to be done.

Surely, taxpayers will be pleased to read or hear in the media about the IRS's continuing efforts to identify and collect from taxpayers who are actively avoiding (even evading) reporting and payment of their correct tax liabilities. But will they continue to be pleased when they themselves cannot reach the IRS to discuss a problem, or can't locate the right person to help them, or receive confusing notices that result in the denial of a tax credit without access to the United States Tax Court, or have their offer-in-compromise rejected because the IRS is not available to talk with them on the phone in order to clarify a question? The difficulty taxpayers and IRS employees face in navigating the IRS is the number one "Most Serious Problem."

The IRS will be tempted to rely on automated processes as it has more social policy programs heaped on it, even as it is criticized for inadequately implementing its current programs (e.g., the earned income tax credit). These initiatives drive the IRS to use devices such as math error authority (where the taxpayer is summarily assessed a tax and must request abatement in order to obtain access to the Tax Court) or "combination letters" (where the taxpayer receives a request from an examination or offer-in-compromise employee for additional information simultaneous with a less than clear notice of appeal rights). We address both of these issues in the "Most Serious Problems" section of this report. We also submit for your consideration a legislative proposal about math error authority.

As a member of the IRS senior leadership, I am very cognizant of the need for the IRS to use its available resources wisely. Clearly, the IRS should use automated services where effective, efficient and appropriate. The Taxpayer Advocate Service is not advocating for face-to-face contact with all taxpayers, or even the majority of them. We will, however,

continue to point out that effective tax administration is a two-way street – the IRS must be open for business for all taxpayers, available for them to communicate – whether in person (Taxpayer Assistance Centers), in writing (prompt processing of and response to correspondence; clear and understandable notices); via telephones (toll-free, EITC, automated underreporter, offer-in-compromise), or through the internet (IRS employee and program locator; electronic delivery of transcripts and employer identification numbers; electronic tax law assistor). All of these issues are discussed in this report as aspects of the Most Serious Problems encountered by taxpayers.

The concept of "access" is fundamental to universal achievement of taxpayer rights. For taxpayers to feel that they should comply with their tax obligations and tax responsibilities, taxpayers must feel that they have –

- Access to information,
- Access to the IRS,
- Access to the Taxpayer Advocate Service,
- Access to representation, and
- Access to return preparation.

Access to information

Taxpayers must not only be able to find out what is happening with their own accounts; they should also know what the IRS is doing to resolve systemic as well as specific taxpayer problems. Greater transparency is needed in the tax system – the "Most Serious Problems" section of this report is the Taxpayer Advocate Service's attempt to shine some light on the operations of the IRS. We are pleased with the responses we received from the IRS about each problem and appreciate the Service's willingness to engage in an open dialogue about very difficult issues.

In order to achieve a truly first class tax system, the IRS needs to have both the freedom to try innovative solutions and the courage to admit that it has failed, without fearing that it will be "punished" in the next appropriations cycle. It must invest in fundamental research about taxpayer behavior *before* it designs compliance systems. Beyond simply convening focus groups and conducting surveys, the IRS must test new systems on taxpayers (the users) and observe their experiences and reactions. The Service must communicate its initiatives, goals, plans, and direction clearly and forcefully, and Congress as well as the taxpaying public must exercise restraint and patience while the IRS implements complex programs. Patience will not, however, be exercised if Congress and taxpayers do not receive reliable and timely information. This is a tall order, but in the 21st century it is an absolutely necessary one.

Access to the IRS

Taxpayers must be able to determine who in the IRS they need to talk to about their problems or their questions and they must be able to locate those employees. They must be able to determine the management chain of command and locate the program area for their concerns. Once they find the right program and person, they must receive a clear response. Without such access, taxpayers will be unable to avail themselves of their rights, regardless of how many protections Congress enacts. In this report we identify several issues relating to access to the IRS, including the inability to navigate the IRS and the operation of the Taxpayer Assistance Centers.

Access to the Taxpayer Advocate Service

Taxpayers must know that the Taxpayer Advocate Service (TAS) exists and what its mission is in order to avail themselves of its assistance. TAS must provide taxpayers with timely service, correct responses, and effective advocacy. The Taxpayer Advocate Service must live up to its role as the conscience of the IRS in terms of specific taxpayer cases and systemic problems.

The Taxpayer Advocate Service is often the taxpayer's last chance for problem resolution. As such, taxpayers must be confident that their communications with TAS are not routinely shared with the rest of the IRS. In this report, we discuss several legislative enhancements to the Office of the Taxpayer Advocate, including the creation of an independent Counsel to the National Taxpayer Advocate and authority for the National Taxpayer Advocate to intervene in federal tax litigation as an *amicus curiae*, as well as expanded confidentiality provisions.

Access to Representation

It is a truism that taxpayers fare better with problem resolution and avail themselves of taxpayer rights when they have representation. The discussion of *pro se* representation in the "Most Litigated Issues" section of this report demonstrates the truth behind this truism. Not all of the 59 percent of taxpayers who represent themselves before the United States Tax Court (and by extension, the Internal Revenue Service) do so willingly. Many simply cannot afford the cost of representation.

Funding for low income taxpayer clinics under IRC § 7526 and the provision of free or nominal fee tax representation is a significant step toward a more equitable system. But funding alone will not provide representation – what is required is the dedication of many volunteer tax professionals to undertake these cases in addition to their "regular" work.

Four years ago I wrote,

> We are a nation of laws. And if those laws are only within reach of the rich or the powerful, then we become a nation of laws for the few and injustice for the many. This is not a recipe for a healthy democratic society.
>
> This oligarchy of justice also distorts the quality of the law. When the man or woman on the street is denied access to the courts, then the [decisions] handed down by the courts reflect the problems of the privileged few. Law loses its relevance to the problems of everyday life and ultimately most of the populace loses its respect for law.[1]

I believe we are seeing an erosion in the confidence and compliance of the taxpayer on the street with the tax system because the tax system has lost its relevance to that taxpayer. It has become, in both its processes and its substance, the domain of those who have access to representation. As National Taxpayer Advocate, I will be committing the resources of my office toward increasing taxpayers' access to representation by individually and systemically encouraging tax professionals to dedicate at least two percent of their professional time to *pro bono* representation of taxpayers who cannot afford representation.

Access to Preparation

The Office of the Taxpayer Advocate supports the creation of an IRS-administered grant program for free tax preparation for low income taxpayers. We do not want funding of tax preparation to dilute the funding for *pro bono* representation in tax controversies, nor do we want such funding to siphon off programs that are already providing free tax preparation such as Volunteer Income Tax Assistance (VITA) sites.

In this report, we submit a legislative proposal for the regulation of unenrolled return preparers. We note that there are several factors that drive low income taxpayers to pay for tax preparation, including:

- Inconvenient location or hours of VITA sites;
- Lack of bank accounts for direct deposit of refunds;
- Need or desire for immediate cash; and
- Inability to prepare one's own taxes due to limited language, literacy, or computer skills.

[1] Nina E. Olson, *Why Pro Bono Service?*, The Virginia Lawyer, Vol. 47, No. 5 at 19 (December 1998).

The grant program I envision would require programs to address these obstacles. Specifically, grants would be made for demonstration projects as seed money to attract other grants, much like the awards being made under the Violence Against Women Act and welfare to work legislation. The grant would be issued to an organization that is serving as the lead for a coalition of groups, including banks, city or state economic development agencies or heath and human services offices, welfare groups, and other social service organizations. The programs would target a significant number of taxpayers (either in a concentrated urban area or more dispersed throughout a larger geographic area).

These coalitions would not only provide free tax preparation, but they would support the IRS's goal (and need) to have returns electronically filed. However, electronic filing alone is not sufficient to draw taxpayers to these sites – taxpayers must be able to open low fee accounts in which refunds may be electronically deposited. Thus, the coalitions must include banking partners.

Many low income taxpayers receive all or part of their refund through refund anticipation loans (RALs) or pay a fee for a third party to receive a direct deposit of their tax refund check. RALs will largely disappear *when* the IRS is able to return refunds within two to four days *if* low income taxpayers are *banked*. If these taxpayers do not have some sort of account in which to receive a direct deposit, then RALs will never go away. Without banking, there will always be customers for the product.

No matter how successful Volunteer Income Tax Assistance, Tax Counseling for the Elderly, or a new low income taxpayer preparation grant program is, these initiatives will not make a dent in tax preparation for the 19 million taxpayers eligible for the Earned Income Tax Credit (EITC). Over one half of these taxpayers pay a professional preparer to obtain what is essentially a federal benefit transfer. No other means-tested federal benefit program requires its beneficiaries to pay an application fee for the benefit. Yet this is essentially what we require of EITC recipients.

The next few years provide Congress, consumer and low income taxpayer advocates, and commercial tax preparers with an opportunity to do some creative thinking about how to deliver the EITC to eligible low income taxpayers for free or for a nominal charge. It is an opportunity to develop innovative partnerships to educate low income taxpayers about the tax system and provide them with the basics of financial literacy. Engagement and education will also bring about better compliance with the tax system's often inexplicable rules.

With these comments as a backdrop, I am pleased to submit to you the National Taxpayer Advocate's FY 2002 Annual Report to Congress. This report is the product of many Taxpayer Advocate Service employees who worked hard and wrote thoughtfully, and I am grateful for their efforts. I also wish to thank the labors of the many IRS employees (including the IRS research staff), taxpayers, and tax professionals who responded to our questions quickly and insightfully. In the dialogue between the Taxpayer Advocate Service and the IRS, you will see an attempt to provide a window to the workings of the IRS, even where we disagree as to the proper course of action. I believe we have made a good start toward greater transparency in IRS operations.

Respectfully Submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2002

TABLE OF CONTENTS

CONTENTS

PREFACE

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS 2

INTRODUCTION 2

NAVIGATING THE IRS *(concerns individual & business taxpayers)* 7

PROCESSING OF OFFER-IN-COMPROMISE CASES *(individual & business taxpayers)* 15

MATH ERROR AUTHORITY *(individual & business taxpayers)* 25

IRS INFORMATION REPORTING PROGRAM *(individual & business taxpayers)* 32

PROCESSING CLAIMS FOR REFUND *(individual & business taxpayers)* 42

EITC ELIGIBILITY DETERMINATION CAN BE MADE LESS BURDENSOME *(all EITC issues concern individual taxpayers)* 47

PROCEDURES FOR EXAMINING EITC CLAIMS CAUSE HARDSHIP AND INFRINGE ON APPEAL RIGHTS 55

LACK OF RESPONSE DURING EITC EXAMS 64

IRS OVERSIGHT OF EITC RETURN PREPARERS CAN BE IMPROVED 69

THE LENGTH OF EITC AUDITS CONTRUBUTES TO TAXPAYER CONCERNS 75

EITC RECERTIFICATION COMPOUNDS TAXPAYER BURDEN 81

LANGUAGE & CULTURAL BARRIERS IMPACT TAXPAYER COMPLIANCE *(individual taxpayers)* 88

FREE U.S. INDIVIDUAL INCOME TAX RETURN PREPARATION *(individual & business taxpayers)* 95

ACCESS TO ACS (AUTOMATED COLLECTION SYSTEM) *(individual & business taxpayers)* 104

COLLECTION DUE PROCESS *(individual & business taxpayers)* 110

AWARENESS AND UNDERSTANDING OF FEDERAL TAX DEPOSITS *(business taxpayers)* 116

TOLL-FREE ACCURACY *(individual & business taxpayers)* 122

TOLL-FREE LEVEL OF SERVICE (ACCESS) *(individual & business taxpayers)* 125

REFUND INQUIRIES *(individual & business taxpayers)* 131

OBTAINING EMPLOYER IDENTIFICATION NUMBERS (EINS) *(business taxpayers)* 135

DELAY IN RECEIVING REQUESTED DOCUMENTS *(individual & business taxpayers)* 140

MISAPPLIED/LOST PAYMENTS *(individual & business taxpayers)* 147

RELIEF FROM JOINT & SEVERAL LIABILITY (FOLLOW-UP REPORT ON FY 2001 PROBLEM) *(individual taxpayers)* 150

THE NATIONAL TAXPAYER ADVOCATE'S LEGISLATIVE RECOMMENDATIONS 156

INTRODUCTION 156

KEY RECOMMENDATIONS 160

ATTORNEY FEES IN NONPHYSICAL PERSONAL INJURY CASES 160

MARRIED COUPLES AS BUSINESS CO-OWNERS 172
MATH ERROR AUTHORITY 185
THE OFFICE OF THE TAXPAYER ADVOCATE 198
REGULATION OF FEDERAL TAX RETURN PREPARERS 216
CHILDREN'S INCOME 231
ADDITIONAL RECOMMENDATIONS 243
CHANGE OF WITHHOLDING PROCEDURE UNDER IRC § 3402 (I) 243
COLLECTION DUE PROCESS 244
DE MINIMIS EXCEPTION TO PASSIVE LOSS AND CREDIT LIMITATIONS 245
ELECTION TO BE TREATED AS AN S CORPORATION 246
LEVY ON MUTUAL FUNDS INCLUDING MONEY MARKET FUNDS 247

THE MOST LITIGATED TAX ISSUES 248
INTRODUCTION 248
PRO SE LITIGATION 252
NONFILER/UNREPORTED & UNDERREPORTED INCOME 258
COLLECTION DUE PROCESS 272
TRADE OR BUSINESS EXPENSES 283
VALUATION 304
EARNED INCOME TAX CREDIT (EITC) 312
ABUSIVE TRUSTS 333
ITEMIZED DEDUCTIONS 344
CAPITAL GAIN AND LOSS 350
CIVIL FRAUD PENALTY 360
JOINT AND SEVERAL LIABILITY 367
BARRED REFUNDS 380

TAXPAYER ADVOCATE SERVICE CASE ADVOCACY AND SYSTEMIC ADVOCACY 386

APPENDICES
CRITERIA USED TO RANK MOST SERIOUS PROBLEMS
APPENDIX A 400
TAMIS LIST OF TAXPAYER PROBLEMS
APPENDIX B 402
TAS DIRECTORY
APPENDIX C 403

PROBLEMS

INTRODUCTION

The scope and complexity of the U.S. tax code make it virtually certain that U.S. taxpayers will face procedural, technical and bureaucratic obstacles in meeting their tax obligations. Although the Internal Revenue Service has consistently and commendably sought to ease the process for all taxpayers, each tax season brings new problems. Some older problems stubbornly resist solution.

The Taxpayer Advocate Service (TAS) is responsible for helping to resolve and prevent such problems at the specific taxpayer and systemic levels. These dual roles complement each other: taxpayer disputes with the IRS alert us to larger issues, while our efforts to deal with these matters systemically can improve the IRS and reduce specific taxpayer problems.

The IRS has recently refocused its compliance initiative, the ongoing program to ensure that all taxpayers pay the correct amount of tax. This effort includes additional focus on abusive tax shelters, trusts and other schemes. The Taxpayer Advocate Service fully supports these efforts. We believe that fairness, justice and personal responsibility are building blocks of an equitable and effective tax system. However, it is equally vital that the problems of law-abiding taxpayers, who do their best to cope with an often frustrating tax code, are handled promptly and fairly under IRS policies and procedures.

Many individuals and businesses come to TAS for help because the IRS has not provided prompt or appropriate assistance through normal channels.[1] Just navigating the bureaucracy can be exhausting and time-consuming; indeed, that particular issue tops our list of the Most Serious Problems Encountered by Taxpayers in the 2002 fiscal year.

The Internal Revenue Code requires the National Taxpayer Advocate to discuss at least 20 of these serious issues in each Annual Report to Congress; this year we have analyzed and commented on 22 of them.[2] The list includes familiar concerns such as late refunds and the accuracy of information dispensed over IRS toll-free customer service lines. We have also considered more complex issues including offers in compromise and the lengthy audits facing some taxpayers who claim the Earned Income Tax Credit (EITC). We have listed one item, Claims for Relief from Joint and Several Liability, that dropped off the list submitted for FY 2001. Because this issue is of great interest to Congress, practitioners, and taxpayers alike, we included a detailed discussion of IRS progress on this program.

[1] In FY 2002, TAS closed 34,015 economic hardship cases and 196,261 systemic hardship cases.

[2] IRC §7803(c)(2)(B)(ii)(III).

SOLUTIONS TO TAXPAYER PROBLEMS

The National Taxpayer Advocate believes that none of the problems discussed in this section is too large to overcome or too small to ignore. Further, all 22 issues can and should be resolved with the help of the IRS leadership, and in some cases, Congress. It is significant to note that the resolution of issues often requires more resources – either monetary or technological.

The National Taxpayer Advocate is aware that Congress and taxpayers alike may be skeptical of the IRS' perennial plea for more resources. She is not advocating that money be simply thrown at a problem. She is, however, suggesting that Congress consider the impact of placing more and more programs and requirements upon the IRS, while not proportionately increasing IRS resources to meet those demands.

Three factors are essential to the IRS's success in quickly identifying and solving systemic taxpayer problems –

- Executive and congressional commitment to adequately fund the IRS to accomplish the initiatives and goals it is required or expected to implement and achieve.
- The commitment of IRS senior management to acknowledge systemic problems, commit creative energy and attention to the solution of those problems, and integration of those solutions into the strategic plan.
- The continued oversight of the IRS by its various stakeholders, including Congress and the Oversight Board, with respect to immediate and long-term solutions of taxpayer problems.

The National Taxpayer Advocate's Annual Report to Congress can serve as an organizing principle and the beginning of a dialogue about taxpayer problems. The Taxpayer Advocate Service believes that this year's "Top 20" section sets a new standard in the exchange of information about these problems, and although we may not always agree with the IRS's assessment of the proposed solutions, we commend the IRS for its tireless efforts in seeking answers and its open discussion of the problems. All of us – Congress, taxpayers, IRS and other federal employees – can learn a great deal about the complex problems facing the IRS and taxpayers in the discussion that follows.

LONG TERM STRATEGY AND SOLUTIONS

As this report goes to press, the IRS is commencing its 2005 Strategic Planning and Budget cycle. This process requires each IRS Operating Division and Function to identify strategies, operating priorities, and improvement initiatives for the forthcoming fiscal year

as well as adjust the current year's strategic plan. Early on in the cycle, all Functions and Operating Divisions comment on one another's strategies through informal consultations and in a series of day-long meetings.

For this year's strategic planning cycle, the Acting Commissioner has asked each Operating Division and Function to consider the problems identified by the National Taxpayer Advocate in her 2002 Annual Report. Each Operating Division and Function must address these problems in some manner in its strategic plan. Further, the IRS oversight board is committed to evaluating the IRS's progress toward problem resolution.[3]

CONCLUSION

The National Taxpayer Advocate believes systemic taxpayer problems will always be with us – it is in the nature of complex systems. However, she also believes it is possible to systemically identify and resolve those problems, quickly, as they arise. Even where the problem is difficult and requires a multi-year solution, immediate identification and planning is critical.

[3] IRS Oversight Board, "Oversight of the Office of the Taxpayer Advocate: Principal Findings and Actions," September 2002, page 13.

METHODOLOGY OF THE MOST SERIOUS PROBLEM LIST

Our analysts began researching these issues in the spring of 2002. We originally selected almost 30 issues for examination. While several of them are not presented here, the National Taxpayer Advocate intends to pursue them as potential advocacy projects and for inclusion in next year's report.

To arrive at the final list of problems and to determine the order of issues within the list, we objectively evaluated and ranked each taxpayer problem according to the following factors:

- Impact on taxpayer rights
- Percentage of taxpayers affected
- Barriers to taxpayer compliance, including expense, time, and burden
- Impact of noncompliance on tax revenue
- Congressional interest
- National Taxpayer Advocate interest
- External stakeholders interest
- Frequency of issue in TAS case advocacy database

The list reflects both positive and negative effects of the IRS reorganization that began five years ago. Some of the problems described in the National Taxpayer Advocate's 2001 report, such as delays in processing claims for joint and several liability relief, have lessened to the point where they no longer appear on the list. The IRS has also made progress toward reducing the burden taxpayers face in obtaining Employer Identification Numbers (EINs). However, this issue still appears on our list because of its impact on the many taxpayers who each year start new businesses or must handle the estates of deceased relatives and associates. Other issues, such as the growing volume of Collection Due Process (CDP) cases, appear on the list for the first time.

We were attempting to show that we balance our concern between the problems affecting individuals and businesses. Most of these issues affect both types of taxpayer; some apply to individuals exclusively while others impact only business.

TAMIS LIST

We have also prepared a second list of taxpayer problems based solely on TAS case inventories as reflected by the Taxpayer Advocate Management Information System (TAMIS). This list, which appears as Appendix B, details the 25 issues that generated the most con-

tacts with TAS from October 1, 2001 through September 30, 2002. While some of the same topics appear on both lists of taxpayer concerns, the tracking codes used in TAMIS can encompass a variety of issues and may not reveal the underlying causes of problems. Further, taxpayers who contact TAS are a small subset of taxpayers who encounter problems with the IRS. For these reasons, we consider the Most Serious Problems list to be the most comprehensive account of the difficulties facing taxpayers (and IRS employees) in fiscal year 2002.

IRS RESPONSE

The Taxpayer Advocate Service shared its definition and analysis of each problem with the IRS Operating Division Commissioners to give them a chance to comment on the issues.[4] Their responses are published in full under the headings "IRS Comments" and "IRS Initiatives to Address the Problem." We have also listed the "IRS Responsible Official" for each problem, although we recognize that other officials or Operating Division Commissioners may be involved in these issues. The National Taxpayer Advocate then comments on the IRS response.

[4] IRC §7803(c)(2)(B)(ii)(IV).

PROBLEM TOPIC #1 NAVIGATING THE IRS

IRS RESPONSIBLE OFFICIALS

David R. Williams – Chief, Communications & Liaison Function
John Dalrymple – Commissioner, Wage and Investment Division
Joe Kehoe – Commissioner, Small Business and Self-Employed Division
Larry Langdon – Commissioner, Large and Mid-Size Business Division
Evelyn Petschek – Commissioner, Tax-Exempt and Government Entities Division
David Robison – Chief, Appeals
John Reece – Deputy Commissioner/Chief Information Officer for Modernization, Information Technology and Security Services
David B. Palmer – Chief, Criminal Investigation

DEFINITION OF PROBLEM

Taxpayers and practitioners often cannot locate the person at the IRS who has the responsibility and authority for resolving a particular tax problem. Even IRS employees have difficulty determining who is accountable for program areas within the reorganized IRS.

ANALYSIS OF PROBLEM

The IRS mission of providing taxpayers with top quality service is impaired by the difficulty of identifying the particular employee who can resolve the taxpayer's problem. One consequence of this is that taxpayers and practitioners seek assistance from the Taxpayer Advocate Service (TAS) on matters that normally would not require TAS intervention.

For example, if a taxpayer disagrees with a revenue agent, the taxpayer may have trouble reaching the agent's supervisor because that person is in another state. If a problem involves two IRS functions such as Examination (auditing) and Collection, the taxpayer's case may be passed back and forth because it is not clear who has authority to decide the issue. Local IRS representatives, who replaced District Directors, often do not have the same powers formerly vested in District Directors.

IRS employees are also frustrated by the lack of a clear understanding of the chain of command in the reorganized agency and by the difficulty of locating the person with authority to act. There is no published chart describing the IRS chain of command. Nor is there an internal or public directory with names, addresses, telephone numbers, and job descriptions that clearly indicate which employee deals with each program and how to reach that person.

The IRS planned to provide point of contact information in one location via an Interactive Organizational Directory (IOD) on the internet, but this directory is not yet online, even though work began many months ago. The IRS is currently working on "The IRS Directory for Practitioners" in lieu of the IOD. The IRS is trying to improve the search capabilities of this directory before its online debut, which was initially scheduled for early October 2002 but is now planned for 2003.

An IRS web page entitled "Information for Our Partners" provided names, titles, telephone numbers and addresses, primarily for those in IRS leadership positions. However, the site was not well advertised and was missing key information. The Wage and Investment Division contacts were available at one time but then eliminated; the site did not permit a choice between Examination and Collection; nor did it offer appropriate details for those officials it listed, such as "assistance with offers-in-compromise," or "office can establish an installment agreement," or "office works EITC cases." Currently, the entire web page has been temporarily withdrawn from the site.

The IRS public web site contains another option entitled "Around the Nation" with information on how to contact the IRS state by state and IRS toll-free phone numbers. However, callers must navigate a complicated menu system to reach live assistors – and when they finally connect to "real people," taxpayers and practitioners report they are transferred from one employee to another and must explain their problems several times. Practitioners find that contacts established over the years have changed or vanished in the reorganized agency. Callers often need numbers for specific problems; for questions about an Offer-in-Compromise (OIC), a taxpayer may wish to contact an OIC manager, the local lien desk, or the bankruptcy hotline.

IRS employees too are frequently confused about who is responsible for providing assistance. Information about program responsibility is available internally through intranet sites; however, they lack uniform design or navigation protocols, are not widely publicized, and in some cases contain outdated information. Another problem is the lack of uniform nomenclature in referring to IRS organizational units. For example, Wage and Investment (W&I) Remote Examination, or auditing, has a counterpart in the Small Business/Self Employed (SB/SE) division called Service Center Examination, which may be collectively referred to as "Examination," "Service Center Examination," "Correspondence Examination," or even "Corr Exam" within the IRS.

IRS COMMENTS

We have made substantial progress in building a network of tools and services that will simplify the process of navigating the modernized IRS for taxpayers, practitioners and employees. However, we must recognize that this is a long-term and continuing effort. The IRS organization remained substantially unchanged for many years prior to the legislated reorganization of RRA 98 and practitioners and employees were quite familiar with how to navigate through the system. It is certainly understandable that a restructure on the massive scale experienced in the IRS would cause some confusion and require a significant period of adjustment. A natural resistance to change and the shift to customer-based rather than geographical organizations also complicated communication challenges. In addition, even without the reorganization, there have been changes, in both the public and private sectors, in preferred methods of interaction and information sharing with customers, requiring adjustments to familiar practices by both our customers and employees.

IRS INITIATIVES TO RESOLVE PROBLEM

Taxpayers

For most taxpayers, the primary method of communicating with and getting information from the IRS is the telephone. To make this easier, the IRS has numerous general and specific toll-free lines to get tax help and resolve accounts, including lines for people with special needs, such as Spanish language or hearing impaired services. We also have new local numbers for over 400 Tax Assistance Centers, primarily aimed at making appointments in these offices. These are being published in local directories and are also on the IRS.gov web site. We realize that as we try to provide more diversified services, there can be confusion about what number to call.

In January 2003, IRS is implementing a significant improvement in its toll-free system that will assist taxpayers who might be confused about which number to call. In addition to segmenting our services by customer type and need, we will now be able to automatically transfer taxpayers' calls to the appropriate numbers that are dedicated to their particular service needs. Prior to this, for some specialized numbers, our assistors could provide the number, but the taxpayer had to make a separate call.

Increasingly, taxpayers are also using the Internet to communicate with and get information from the IRS. The newly reconfigured IRS.gov (http://www.irs.gov/) makes this process much easier by reflecting taxpayer segments and highlighting frequently used services. There is a key word search on the main page that can quickly take a taxpayer to the

requested subject. Finding out the status of a refund – probably one of the most frequently asked questions – is highlighted on the front page. An additional prominent feature is the ability to search for forms and publications – another one of the most frequently used services during tax season. Additionally, a taxpayer can find the phone number and address of a local office by accessing "Help". This feature also offers the ability to submit e-mail questions and comments, get the phone number for the Help Desk or interact in real time with the help desk on the Chat Line.

Tax Professionals

Feedback through our National Public Liaison office, the main office that works with tax professionals on a daily basis, indicates that tax professionals are well aware of "IRS.gov" and the services offered to them there. IRS.gov features an easily identifiable direct link for tax professionals on its first page. In addition to information on subjects such as the latest news, local filing locations and changes in legislation or procedures, the Tax Professionals' page clearly highlights "Practitioner Priority Service." This is a new toll-free, accounts-related service for all tax practitioners nationwide at 1-866-860-4259 that serves as the practitioners' first point of contact for assistance regarding taxpayers' account-related issues. This replaces the former Practitioner Hotline. There is also a page that aligns the states to practitioner priority service sites so that tax professionals can locate the office that deals with their issues.

The IRS Directory For Practitioners (IDFP), planned for implementation in 2003, is a web-based, interactive directory for practitioners allowing them to search for point of contact information. Searches can be performed using keywords, contact demographics, or operating division or functional unit. This was tested with three practitioner groups in September 2002 to positive response.

For those taxpayers and practitioners who are dealing directly with a field agent or other IRS employee working a case, there should be little difficulty in contacting a supervisor or securing information about procedures, taxpayer rights, etc. from that employee. We believe that the new organization has matured enough so that difficulties are the exception rather than the rule.

Employees

We recognize that one of the most important keys to navigating the new IRS lies with employees. When employees are knowledgeable about the organization, they are better able to assist taxpayers and practitioners who have questions. A number of tools have been or are being developed to assist employees, including the Corporate Authoritative Directory Service, (CADS) and the Discovery Directory.

The CADS system currently collects data in three categories: People, Business Units, and Location information. Eventually the categories will expand to encompass all of our resources. The Discovery Directory allows any employee with access to the IRS intranet to find information on people, business units and geographic location. However, the currency of information in the Directory is a recognized problem since employees are responsible for making sure their information is up to date. The IRS will reinforce that responsibility to all employees.

An additional tool, the Program Responsibility Matrix, gives the employee the ability to find the part of the IRS that has the responsibility for a specific program area, providing a phone number for primary contact, links to other involved functions and the relevant Internal Revenue Manual (IRM) sections. The Program Responsibility Matrix is located on the IRS Intranet and is two clicks from the Home Page. We agree that this information needs to be updated and maintained more rigorously. The IRS Office of Servicewide Policy, Directives and Electronic Research will be responsible for this task, which we hope to have accomplished by the end of the second quarter 2003.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud the IRS for its efforts at building a network of tools for taxpayers, tax practitioners and IRS employees to make the agency's organization more understandable and to increase access to it and within it. The size and complexity of the IRS, together with the changes brought about by the recent reorganization, make the task especially challenging. Despite these efforts, however, taxpayers and the tax practitioner community remain frustrated when communicating with the reorganized IRS. The IRS modernization realigned many program responsibilities. A single, all-encompassing tool is needed to identify the business unit and office primarily responsible for each IRS operational and support program. This tool must contain easily identifiable information to allow customers to make the right contact to resolve their tax problems.

The Taxpayer Advocate Service is pleased that taxpayers and tax professionals can use the IRS toll-free telephone service and the IRS web site to determine the status of a refund, to request tax forms and publications, and to obtain IRS toll-free telephone assistance. With the newly reconfigured "IRS.gov" many tax professionals appear to be well informed about the services available on the IRS web site. However, TAS continues to be concerned about accessibility when more in-depth assistance is needed to resolve a problem. The IRS' very successful "Problem Solving Days" showed the benefits of accessibility to IRS managers and technical assistance for solving taxpayer problems.

The IRS began work on an Interactive Organizational Directory (IOD) more than a year ago, but it has not been delivered. Putting the IOD online was hindered by the inability to keep the directory

updated as employees changed jobs in the evolving IRS. Alternatively, the IRS worked to replace the concept of an organizational directory with an IRS Directory for Practitioners (IDFP). This was designed to automatically update IRS employee information from the "Discovery Directory," an internal source for locating IRS employees. TAS was involved in these efforts and reported that while the IDFP had potential when users knew who they were looking for, the IDFP keyword search feature was lacking.

In October 2002, the directory was promoted and available online for a few days, and then was removed from the IRS web site. During the short time this directory was accessible, it was difficult to find on the web site. The IRS plans to re-introduce the IDFP in 2003, but TAS is concerned about further delays in putting it into effect. A specific date for implementation is imperative. Furthermore, we believe that taxpayers and IRS employees should have access to that (or a similar) site.

The IRS has referenced a number of tools for identifying the employee or part of the organization that can solve particular problems. Although TAS appreciates the ongoing efforts of the IRS to improve the functionality and visibility of these products, these tools provide taxpayers with only limited ability to gain greater access to IRS officials who can solve problems. Our specific comments on the IRS initiatives are as follows:

- *Publishing telephone numbers for Taxpayer Assistance Centers (TACs) on the web and in telephone directories is not very helpful when a customer wants to speak to a person, because the calls go to an answering machine rather than to "live" assistance. Furthermore, TAC assistance will be scaled back in filing season 2003.*
- *The telephone number on the web for customers calling from Canada is listed as Puerto Rico when a Philadelphia Service Center number is given. Canadian customers may be reluctant to contact this number because they anticipate prohibitive long distance charges to Puerto Rico.*
- *The keyword search features of the internal and external web sites can be helpful, but often require the user to wade through a large number of search results. The results are sometimes irrelevant; for example, a search for installment agreements resulted in primary references for installment sales. Taxpayer-friendly naming conventions should be resident throughout any directory.*
- *The "Help" and "Chat Line" features address technical problems in use of the web site rather than account or tax law questions.*

- *As of the date this report went to press, the IRS web page entitled "Information for Our Partners," which provided names, titles, telephone numbers, addresses and broad job descriptions for IRS leadership positions, has been removed from the web site. This web page was not well advertised and was lacking in specificity regarding program responsibility for the listed officials. However, it was a source that customers could use to determine initial points of contact in the IRS. This ability has been lost by its removal from the web.*
- *IRS employees can obtain information about program responsibility from business unit web sites, but complain that the sites are difficult to navigate because they lack uniform protocol and nomenclature. Some employees are unaware of these directories and how to use them because of training limitation and time constraints. Employees need a uniformly designed directory, accessible from one location.*
- *The IRS highlights the Discovery Directory and the Program Responsibility Matrix as tools that map out the new IRS. The Discovery Directory provides names, phone numbers, business units and geographic locations, but lacks information about program responsibility, while the Matrix helps with program responsibility but does not provide names of the responsible officials. A blend of these two tools to provide one enhanced tool is needed.*

Taxpayers, practitioners and IRS employees need to know the IRS chain of command. An easy-to-access, user-friendly list is needed, one that clearly displays who reports to whom and includes names, addresses, and telephone numbers, as well as IRS roles and responsibilities. The IRS should ensure that directory information is continually updated as needed. Uninformative, broad categories such as "leadership" or "compliance" offered in the "Information for Our Partners" on the IRS web site should be avoided. To help guide customers to determine where to go on first contact, specific IRS processes should be clearly identified. For example:

TABLE 1.1.1
IRS PROCESSES

Power of Attorney	Employer Identification Numbers
Return Photocopies	Audit Reconsiderations
Records of Account	Amended Returns
Address Changes	Estate & Gift Tax
Innocent Spouse Claims	Employment Taxes
Highway Use Tax	Estimated Taxes
Appeals	Federal Tax Deposits
Tracing Payments	Underreported Income

In addition to a customer directory, a list of contacts for local issues is needed. This list could be accessed by state and should include local phone numbers for the lien desk, the bankruptcy liaison, the practitioners' complaint line, the coordinator for return preparers, and the state's income tax customer service line. Fax numbers for Offer-in-Compromise (OIC), Employer Identification Number (EIN), and Centralized Authorization File (CAF) should also be part of this local list.

Clearly, the IRS must continue to give priority attention to a customer directory for taxpayers, practitioners and IRS employees. The IRS modernization began nearly four years ago. The efforts to provide a directory have fallen short of goals. Communicating the changes in organizational structure to taxpayers as well as to IRS employees is an important aspect of this effort. The reorganization is undermined by not getting this information out to the public. Practitioners and taxpayers often seek out the Local Taxpayer Advocate when they do not know where to go, consuming the limited resources of TAS on matters that normally should not require TAS' intervention.

Accessibility and transparency are critical elements for a representative government and enhance confidence in the tax administration system. The IRS is clearly attempting to meet these goals, but a sustained effort, and commitment from senior leadership down to the front-line employees, is necessary. Customer service requires that taxpayers be able to navigate the system and locate the appropriate people for assistance.

PROBLEM
TOPIC #2 **PROCESSING OF OFFER-IN-COMPROMISE (OIC) CASES**

IRS RESPONSIBLE OFFICIAL

Joe Kehoe – Commissioner, Small Business/Self-Employed (SB/SE) Division

DEFINITION OF PROBLEM

Policy Statement P-5-100 provides, in part, that offers-in-compromise are discussed as a collection alternative, receive prompt and fair decisions, that they are negotiated, that they are an acceptable alternative to a protracted installment agreement or reporting that the liability is currently not collectible, and that they promote future compliance.[5] The current offer process, while having made progress toward achieving these goals over the past year, has yet to fully realize the terms of the policy statement.

ANALYSIS OF PROBLEM

History

Since the adoption of Policy Statement P–5-100 in 1992, the IRS has struggled with the design and administration of the offer-in-compromise program. Such a program must balance the efficient processing of over 113,700[6] offers received per year with the need to carefully review each offer in accordance with the terms of the policy statement.

Prior to August 2001, all offers regardless of their level of complexity were handled in the field by revenue officers, generally known as offer specialists. In that month, the IRS commenced a new approach to processing offers, the Centralized OIC (COIC) initiative. The initial processing of all offers, and complete processing of wage earner offers, is now handled in two campus locations. The number of revenue officers investigating offers in the field has been reduced from over 1,000 in April 2001 to approximately 500 in October 2002.[7] While SB/SE implements measures to improve the timeliness of decisions as required by the policy statement, it must also ensure that all taxpayers have the

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[5] Policy Statement P-5-100 provides:

> The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An offer in compromise 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. In cases where an offer in compromise appears to be a viable solution to a tax delinquency, the Service employee assigned the case will discuss the compromise alternative with the taxpayer and, when necessary, assist in preparing the required forms. The taxpayer will be responsible for initiating the first spe cific proposal for compromise. The success of the compromise program will be assured only if taxpayers make adequate compromise proposals consistent with their ability to pay and the Service makes prompt and reasonable decisions. Taxpayers are expected to provide reasonable documentation to verify their ability to pay. The ultimate goal is a compromise that is in the best interest of both the taxpayer and the Service. Acceptance of an adequate offer will also result in creating for the taxpayer an expectation of and a fresh start toward compliance with all future filing and payment requirements.

[6] SB/SE, *IRS Commissioner Update on Offer-in-Compromise*, September 25, 2002.

[7] Id.

opportunity to negotiate their offers fairly and that those offers remaining in the field receive prompt consideration.

Discussion of the Offer as an Alternative

The volume of offer receipts indicates that taxpayers are being apprised, either by SB/SE or practitioners, of the OIC alternative. However, high return and rejection rates also indicate that taxpayers and practitioners may not understand when offers are an appropriate alternative. Though SB/SE has committed to significant revision of the Form 656, Offer-in-Compromise, and its instructions in FY 2003, additional outreach is necessary to gauge customer expectations and to garner specific feedback on customer satisfaction as required by IRS' balanced measures approach.

Prompt Offer Determinations

As of September 10, 2002, the Automated OIC (AOIC) database indicates that 65.1 percent of field inventory remains over its target timeframe of six months.[8] SB/SE needs to continue to monitor field inventory and receipts before making any further reductions in field staffing. As the COIC initiative promised more efficient processing, SB/SE needs to establish and communicate shorter timeframes for those cases totally processed within COIC, as well as establish an easy way for taxpayers and practitioners to stay apprised of the status of their case.

Fair Offer Determinations

SB/SE uses its Collection Quality Measurement System (CQMS) to measure its employees' compliance with Internal Revenue Manual (IRM) requirements. According to the October 2002 closed case review reports, cumulative quality scores for "financial analysis" were at 67.2 percent, "ability to pay" at 60.2 percent, and "correct determination of the offer amount" at 60.2 percent.[9] As a result, significant numbers of taxpayers may have their cases returned or rejected in error. SB/SE needs to conduct further analysis to tie its quality results to business measures, and must set objectives for reducing rejections and returns of offer cases. In addition, operating procedures now in the form of "Desk Guides" at the COIC sites should be made part of the IRM so that those procedures are subject to the CQMS review.

Negotiating the Offer

Taxpayers and practitioners frequently complain to TAS that their offers are rejected when a single telephone call from IRS would have resolved any questions. The IRS uses a "combination" letter that simultaneously rejects the taxpayer's offer, and gives the taxpayer 30 days to either provide additional information to support the offer, or to request an

[8] AOIC Database Reports, *Inventory Listing for Areas* 1-18, September 10, 2002.

[9] SB/SE, Collection Quality Measurement System Report, September 30, 2002.

administrative appeal. In some instances, it appears that these letters are received by the taxpayer well into the 30-day period, and that requests for additional time are not routinely granted. This combination letter saves processing time and postage costs over the practice of sending an interim analysis/request for information followed by a final determination and appeals notice letter. However, the latter procedure gives meaning to the policy statement's concept of a negotiated offer. Taxpayers often need the opportunity to explain their case, including special circumstances and variances from the national standard expenses, before their case is rejected. SB/SE's failure to recognize and address special circumstances was previously cited in a May 2001 TIGTA report.[10] Failure to negotiate the offer in SB/SE does not resolve the collection case, causes re-work, and increases burden on the taxpayer and Appeals. SB/SE must continually review the cases being received in Appeals to determine if, by better communication, they might have been resolved in Operations.

Offers as an Acceptable Alternative

The policy statement says that an offer-in-compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. However, SB/SE has not collected data on the collection outcome of cases in which offers are rejected, and routinely secures waivers to extend collection statutes beyond 10 years to accommodate installment agreements. Without such specific data, SB/SE's compliance with offer policy as it relates to collection alternatives cannot be measured.

Future Compliance

An often overlooked by-product of an offer is providing a fresh start toward compliance. The IRS requires the taxpayer to agree to remain in compliance with tax obligations for the five years immediately following acceptance of the offer. Failure to satisfy this compliance commitment may result in default of the offer and a reinstatement of the tax liability. As part of SB/SE's automation of post-acceptance processing, we recommend tracking the taxpayer's ongoing compliance over a five-year period in order to measure the effectiveness of this objective.

CURRENT IMPROVEMENT INITIATIVES

Overview

SB/SE placed an executive in functional command of the OIC Program, reporting directly to the Deputy Commissioner, SB/SE. The executive has sought input from internal stakeholders, including TAS and Appeals, on proposed procedural issues. Specifically, TAS has provided significant input on revisions to Form 656, user fee implementation,

[10] Treasury Inspector General for Tax Administration, *The IRS Needs to Consistently Use Special Circumstances in the OIC Program*, TIGTA-2001-30-096, May 31, 2001.

Effective Tax Administration (ETA) offers, taxpayer correspondence, batch processing, the type of cases to be worked in COIC, extensions due to hardship, documentation requirements and messages to external stakeholders. We anticipate that an executive will remain in charge until specific OIC business objectives are realized.

Form 656

A team is working on a complete revision of the Form 656 to clearly state IRS Offer policy and to simplify instructions, particularly on the conditions for acceptance, on the worksheet for computing the offer amount, and on financing the offer. Additionally, there will be an opportunity for the taxpayer to certify prerequisite compliance and/or lack of requirement to file. Success of this initiative can be measured by a reduction in the percentage of offers returned to taxpayers.

Effective Tax Administration (ETA) Offers

Form 656 will be revised to clearly identify offers submitted on the basis of Effective Tax Administration (ETA).[11] However, many taxpayers and representatives believe that the IRS will only consider equity and public policy issues under the ETA regulations, which apply to taxpayers who can fully pay the tax liability. Form 656 should be revised to instruct those taxpayers who cannot afford to fully pay the liability to identify any special circumstances that would qualify them for acceptance of an offer under doubt as to collectibility for less than the reasonable collection potential.

User Fee

SB/SE is continuing to work closely with internal stakeholders on the implementation of a user fee within the next year. This fee will help to offset the costs associated with offer processing and discourage inappropriate offers. Under the proposed fee, some low income taxpayers are exempt as are taxpayers submitting offers under doubt as to liability.[12] The fee for taxpayers whose offers are accepted under ETA provisions will be refunded. The new fee, if adopted, will be explained in an addendum to Form 656. Public hearings are scheduled in early February 2003.

[11] The Conference Report to RRA 98 states that "the conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration." H.R. Conf. Rep. No. 105-999, 1998. A final Treasury Regulation published on July 18, 2002 clarified the bases for ETA offers. T.D. 9007.

[12] The National Taxpayer Advocate had advocated that taxpayers whose income is at or below 250 percent of the federal poverty guidelines be exempt from the user fee, which is the eligibility cap for persons receiving assistance from Low Income Taxpayer Clinics under IRC § 7526. The proposed regulations exempt taxpayers with incomes at 100 percent of the federal poverty guidelines. Prop. Treas. Reg. §300.3(6)(1)(ii).

Post-Processing of Accepted Offers

TAS has received customer complaints concerning SB/SE's post-processing of accepted offers. Sometimes taxpayers fail to understand that the IRS will keep any refund they are due in the year that the offer is accepted. This needs to be more clearly explained in the Form 656 instructions. Other complaints concern establishing separate accounts where joint liabilities are involved, including the adjusting of accounts and posting payments. SB/SE has committed to enhance automation to improve post-processing and monitoring of compliance and collateral agreements. Target dates for implementing these improvements need to be established.

Documentation Requirements

In an attempt to reduce taxpayer burden, certain taxpayer documentation requirements have been eliminated where the IRS can obtain the information from internal sources. SB/SE has committed to conduct ongoing analysis of the documentation requirements and require substantiation only for those items that have a significant probability of affecting the outcome.

IRS COMMENTS

Fiscal year 2002 was a year of significant accomplishment for the Offer in Compromise (OIC) Program. The centralized OIC (COIC) operations at the Memphis and Brookhaven campuses became fully operational. Staffed by 342 process examiners and 237 offer examiners, these sites now receive almost all new offers for initial processing. Only the most complex new cases are sent to the field for investigation. Meanwhile, during much of FY 2002, revenue officer staffing was maintained in the two sites to focus on the backlogged cases. By the end of the year, the OIC inventory had been reduced by more than 20,000 cases, or 21 percent.

As part of the effort to focus more attention on the needs of the OIC Program, in April 2002, IRS assigned an executive to lead the OIC Team. Under this new leadership, we implemented a number of process changes in the centralized sites to realize greater efficiency from economies of scale:

- Implemented a screening process to identify taxpayers who have the financial ability to "full pay" early in the OIC process. (In approximately 14 percent of all submissions the taxpayers are inappropriately requesting compromise because, by their own financial statements with no verification, they can clearly pay in full.)
- Identified and transferred complex cases to the field earlier in the process.
- Determined which OIC cases should be handled in the field offices based on the taxpayer's current sources of income, rather than on the amount of the liability.

- Reduced the amount of information required for the typical investigation. For example, wage earners need only provide pay statements, bank statements, and verification of insurance cash value, retirement accounts, investments, and loan balances.
- Determined reasonable collection potential by using the taxpayer's submitted information and available electronic verification techniques. This practice reduces the need for additional requests for information and for negotiation. Offers may now be "rejected with options" when the offer is clearly insufficient.

The temporary regulations published in 1999 were made permanent in 2002 with minor modifications. Under these regulations, an independent administrative review is required of all offers before a decision to reject is communicated to the taxpayer. The regulations also clarify that the Effective Tax Administration (ETA) standard for economic hardship applies only to individual taxpayers and not to other (business) entities. In addition, under ETA the standard for public policy and equity (non-hardship) places the responsibility on the taxpayer to demonstrate why his or her special circumstances justify a compromise, even though a similarly situated taxpayer must pay the full liability. Finally, for cases in which the unpaid tax liability is directly attributable to the acts of others, and was incurred although the taxpayer made every effort to comply, compromise is authorized.

IRS INITIATIVES TO RESOLVE PROBLEM

Discussion of the Offer as an Alternative

As one component of our communication and education strategy, we are revising the Form 656 to clearly state IRS Offer policy and to simplify instructions, particularly on the conditions for acceptance, on the worksheet for computing the offer amount, and on financing the offer. The Office of Performance, Research and Analysis (OPERA) has been directed to study the specific attributes of not processable offers so as to improve communication initiatives and identify other improvement possibilities.

We maintain a high level of engagement with the major practitioner groups. Recently, we held a one-day session with the IRS Advisory Committee (IRSAC) at the COIC site in Brookhaven. This session included a tour of the facility, a detailed explanation of the process, interaction with front-line employees, and detailed discussions involving analysis of rejected/returned cases. We are developing web-based applications to assist practitioners in the analysis of potential offer candidates. We are working with our Toll Free and Automated Collection System operations to ensure a clear understanding of how an offer-in-compromise fits into the overall collection strategy. We even are exploring the feasibility of a stand-alone Offer toll free number staffed by specially trained employees.

As noted by the National Taxpayer Advocate, IRS is taking steps to implement a new user fee next year. This fee will help to offset the costs associated with offer processing and discourage

inappropriate offers. Under the proposed fee, some low income taxpayers are exempt, as are taxpayers submitting offers under doubt as to liability. The new fee will be explained in an addendum to Form 656. Public hearings are scheduled in early February 2003.

Prompt Offer Determinations

In the COIC operation, we have standardized and reduced the amount of financial verification required from a taxpayer. If a wage earner submits all the required documentation (which is described clearly on the Form 433), he or she receives a prompt decision based on the merits of their case. If the taxpayer does not provide the required documentation, a detailed letter is issued describing exactly what is needed to make a determination. The letter includes a toll free number the taxpayer may call to get additional information. As mentioned earlier, a "full pay" screening process has been instituted, which utilizes the taxpayer's unqualified financial information submission early in the process. The approach helps us to reduce taxpayer burden through early identification and resolution of cases that do not qualify for the OIC option.

During FY 2002 we experienced dramatic gains in the currency of the field inventory. The older cases are being worked on a first-in/first-out basis, which has reduced the percentage of field inventory aged beyond six months from 80 percent in March 2002, to 57 percent at the end of the fiscal year. The field offer inventory has continued to decline in the early weeks of FY 2003, even as we reassign revenue officers from OIC to traditional duties in the field. We are currently forming a team to transfer best practices learned in COIC to field operations.

Fair Offer Determinations

We are developing balanced measures for the offer program, including quality and timeliness. Although the current Collection Quality Measurement System (CQMS) reviews do sample COIC cases, the review criteria we are using were developed for field cases. Consequently, we are developing unique COIC quality review standards and reports, as well as updating the traditional CQMS standards used in field reviews. In the interim, the COIC sites are conducting ad hoc quality reviews of the offer inventory. We concur with the need to update the IRM and are in the process of doing that.

We are not satisfied with the level of accuracy for our screening process. More analysis of the quality results is needed to interpret these findings. It should be noted that a failure to meet this quality standard can not only mean that the taxpayer's case OIC request was returned or rejected in error, but in some cases indicates that an OIC request was accepted in error.

We disagree that we should set objectives for reducing rejections and returns of cases at this point. Each case should be closed based on its individual merits, and setting outcome-based targets could result in inappropriate case decisions. The OPERA study will be critical to determine why OIC cases are returned or rejected. We expect the outcome of that study will help us to formulate program changes to improve customer service and the overall OIC process.

Negotiating the Offer

An offer is returned or rejected when a taxpayer does not provide the minimal amount of financial documentation after two requests (once on the initial submission, and again in a follow-up letter). In these rejection cases, we provide the taxpayer with a letter communicating several options. These include calling the offer examiner or revenue officer to try reaching a resolution, providing additional documentation that could impact the financial analysis, or requesting that the case go to Appeals. The taxpayer can choose one or more of these options. All rejections are subject to an independent administrative review. All "special circumstance" offers are also subjected to secondary management reviews, and in addition we are working with the Taxpayer Advocate's office to develop a secondary review process for all non-hardship ETA offers.

TAXPAYER ADVOCATE SERVICE COMMENTS

We appreciate the continuing efforts of SB/SE to improve OIC processing. The function is trying to resolve a backlog of offer cases that accumulated over an extended period of time. A permanent correction will take longer than a short term fix. Placing an executive with functional oversight over the program was certainly a step in the right direction. SB/SE must ensure that all of its efforts are directed toward fulfillment of the terms of Policy Statement P-5-100. Though SB/SE has competing resource objectives including a reduction of revenue officer staffing in the OIC program, it must take actions to ensure that taxpayers' right to fair and prompt consideration are paramount.

SB/SE indicates it has reduced its total inventory by 21 percent over the last fiscal year and reduced aged field inventory from 80 to 57 percent over the last six months of the fiscal year. We urge SB/SE to be cautiously enthusiastic about its achievements and to balance that measure with commensurate increases in the quality of its work product. Quality results that indicate 40 percent of taxpayers may not have had a correct determination of their ability to pay, or a correct determination of their offer, color the achievement of increases in offer dispositions. These cases may also consume resources in other programs, since the taxpayer has not resolved his or her case.

Certainly, increased dispositions will increase the number of determinations being appealed. SB/SE must look closely at the final case determinations by Appeals as a further indicator of the quality of its achievements. Neither Appeals nor TAS wants taxpayers coming to them because they could not have

their issues addressed in SB/SE. We strongly urge the function to adopt measures to monitor this concern. SB/SE needs to ensure that the finding of the May 2001 TIGTA report mentioned earlier, citing its failure to recognize special taxpayer circumstances, is not a continuing problem. Additional managerial review of those cases where the special circumstances are denied is of no value if the special circumstances are not first identified and addressed. Though the IRS requires measurement of customer satisfaction, SB/SE continues to make operational decisions with only anecdotal knowledge of customer concerns with the OIC program. Specific measures of customer satisfaction for the OIC program must be implemented to clearly identify opportunities for improvement.

SB/SE has expressed concerns over our suggestion to set objectives for reducing rejections and returns. Although it may not be desirable to measure rejections if that would cause SB/SE's employees to make incorrect determinations, the same cannot be said for returns. Offers are ***returned*** *to taxpayers* ***without appeal rights*** *when taxpayers do not comply with Form 656 instructions and/or fail to submit required information. Offers are* ***rejected with appeal rights*** *when, after analysis of the case, it is determined that the offer should not be accepted. SB/SE indicates it has found that 14 percent of offers are rejected in the screening process because the taxpayers' own figures do not support the offers. As SB/SE has begun work with OPERA to determine the attributes of returned offers, it is clear that a reduction of returned offers is a desirable and measurable objective. Although efforts are underway to improve the Form 656 instructions and worksheets and provide interactive web site assistance, we also encourage additional outreach that will further assist the taxpayer in preparing the required forms, as required by the policy statement.*

SB/SE indicates that offers are returned after two requests for the information, a statement that is only true if the Form 656 is considered the first request. Taxpayers actually only receive one request to provide additional information after the offer has been filed. Cases received by TAS and practitioners indicate that such requests for the information were mailed late, and did not effectively allow the full 30 days to provide the additional information.

We note that SB/SE has not addressed the National Taxpayer Advocate's concern about the use of the confusing "combination" letter, which offers the taxpayer three options. Two of these options involve communicating with offer personnel about the specifics of the case and one involves the request for an administrative appeal. This letter truncates what used to be a two-step process – first, asking for additional information and later informing the taxpayer of a final rejection with notification of the right to appeal that determination. The National Taxpayer Advocate believes that combining these two steps sacrifices clear notification of a taxpayer's rights, eliminates an opportunity to submit additional documentation, and leads to re-work of cases by other functions.

SB/SE's manual processes for completing adjustments to accounts after the acceptance of an offer and for monitoring future compliance are cumbersome, labor-intensive and, as TAS receipts have shown, prone to error. We encourage SB/SE to set a target date for completing automation of post-processing

to prevent problems with accounts and to facilitate monitoring of future income collateral agreements and compliance. In addition, efforts must be initiated to determine the eventual collection outcome of those offers that are rejected in order to determine if the reasonable collection potential (RCP) formula now in use is an accurate tool for determining whether an offer should be accepted.

Effective Tax Administration Offers

The National Taxpayer Advocate believes that the recently issued final regulation on offers-in-compromise[13] contains more than "minor" changes, at least with respect to non-hardship Effective Tax Administration (ETA) offers. The regulations make clear, as does the legislative history, that ETA offers may be accepted on the basis of hardship, equity, and public policy. It is the latter two categories that the IRS has had difficulty administering.

*The final regulation and its preamble make clear that an attempt to list eligibility factors for a non-hardship ETA offer would have the effect of limiting its application. It is desirable (for both taxpayer compliance **and** confidence reasons) that non-hardship offers be reviewed not only closely but also with an open mind. It is also true that the regulation places the burden on the taxpayer to demonstrate why he or she should be relieved of part of a tax liability that is both collectible and due, where all other taxpayers go about their business and pay their tax liabilities in full.[14]*

The National Taxpayer Advocate and SB/SE agree that these non-hardship ETA offers will be unusual and limited in number. The final regulation clearly states that a taxpayer's ETA offer will not be considered unless the taxpayer does not qualify for an offer on any other basis (collectibility or liability). However, when such an offer is filed, SB/SE must have in place a system to recognize it and process it appropriately.

The National Taxpayer Advocate is pleased that SB/SE has agreed to assign all non-hardship ETA offers to a small team of revenue officers who will, over time, identify common factors that can lead to additional guidance in this area. In recognition of the entire Service's keen and diverse interests in this unusual and fact-specific relief provision, SB/SE has agreed to establish a cross-functional team, including representatives from TAS, Appeals, and Counsel as well as SB/SE, that will review all non-hardship ETA offers. This cross-functional approach will lead to non-hardship ETA offer determinations that balance compliance, fairness, hardship, equity, and public policy considerations.

We thank SB/SE for considering our input as they improve the offer program and we look forward to working with them to achieve a program that fulfills the IRS offer policy. The National Taxpayer Advocate views her and her office's working relationship with OIC and COIC personnel as a model for systemic problem-solving within the IRS.

[13] Treas. Reg. § 301.7122-1.

[14] The National Taxpayer Advocate is aware that not all taxpayers pay their tax liabilities. The excuse that "other people do it" is not sufficient justification for a non-hardship ETA offer, nor should it dilute the foundational expectation that taxpayers comply with their tax obligations.

PROBLEM
TOPIC #3 MATH ERROR AUTHORITY

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joe Kehoe – Commissioner, Small Business/ Self-Employed Division

DEFINITION OF PROBLEM

The IRS issued approximately seven million math error notices in fiscal year 2001.[15] There are four major deficiencies in the current program:

- Taxpayers find the notices confusing, offering inadequate explanations about the items that the IRS modified or denied on their tax returns.
- Taxpayers have difficulty reconciling the adjustments with their originally filed tax returns.
- Taxpayers are not sure how to correct the notice of adjustment
- Taxpayers are not sure how to challenge the notices, nor do they understand their rights to challenge them.

ANALYSIS OF PROBLEM

Under math error authority, taxpayers are issued notices identifying the mathematical or clerical errors on their tax returns. The notice identifies the correct amount of tax, as opposed to what was reported on the original return, and indicates the additional tax assessed. If the taxpayer wants an abatement of the IRS adjustment, the request must be made within 60 days.[16] If the taxpayer provides information that justifies abatement, the abatement is completed and the taxpayer is informed. If the taxpayer responds, but the information is inadequate, the taxpayer is notified and the case referred to Examination (auditing) under deficiency procedures.[17]

The term “mathematical or clerical error” in IRS processing has taken on a new meaning in the past several decades. Originally, the term meant “errors limited to those inconsistencies where it can be determined from the face of the return which inconsistencies are correct.”[18] The math error procedure has expanded beyond its original usage. In 1976, two significant modifications occurred.[19] First, Congress ratified IRS practice by expanding the scope of the provisions of Internal Revenue Code section 6213(g) to include “clerical

[15] IRS Notice Volume Reports.

[16] IRC § 6213(b).

[17] Internal Revenue Manual 21.4.4.4 (Rev. 10/01/2001), Math Error Substantiated Protest Processing, and Internal Revenue Manual 21.5.4.4.5 (Rev. 10/01/2001), Math Error Unsubstantiated Protest Processing.

[18] General Counsel Memorandum G.C.M. 39131; 1984 IRS GCM LEXIS 18, page 4.

[19] Tax Reform Act of 1976, Pub. L. No. 94-455, Section 1206(a).

errors," listing the types of errors in some detail.[20] Second, taxpayers were granted authority regarding abatement rights in a new Internal Revenue Code section 6213(b)(2).[21] Before this amendment, taxpayers had no statutory right to request abatement or receive judicial review before paying the tax. In practice, the IRS agreed to abate the assessment if taxpayers could explain timely and satisfactorily that there was in fact no error on their tax return.

Over the years, the IRS has encouraged the expansion of math error processing to encompass issues that in the past were treated under traditional audit deficiency procedures. Because of this expansion of authority, taxpayers lose the fundamental appeal rights and access to judicial review that are inherent in traditional IRS audit procedures.

The notice process is intimidating, especially for low income and underrepresented taxpayers. Consequently, these taxpayers frequently fail to respond, respond inadequately or do not have their alternatives clearly explained to them when they do respond. For example:

> Taxpayer A calls the IRS 1-800 telephone number and advises the telephone assistor that he does not understand why the adjustment was made to his account. After the telephone assistor explains the adjustment, and Taxpayer A states "I don't agree," many times the assistor will inform the taxpayer they need to file a claim, and offer no further explanation.

The possible loss of access to administrative appeal and judicial review is of particular concern to the National Taxpayer Advocate. If a taxpayer timely requests an abatement of tax, the IRS is obligated to make the adjustment and make any reassessment through audit deficiency procedures.[22] Unless the taxpayer proactively requests abatement and is

[20] IRC § 6213(g) (2) The current definitions of "mathematical or clerical error" include various issues such as:
- A simple math error,
- Use of the wrong tax table or line from tax table,
- Errors entering information from schedules to the tax return,
- Omission of required entries on the return,
- Entries that exceed the statutory limit,
- Claim for credit related to self-employment tax where the tax on net earnings has not been paid,
- Omission of correct taxpayer identification number(s) as statutorily required, and
- Inclusion of an incorrect taxpayer identification number(s) where statutorily required.

[21] IRC § 6213(b) Exceptions to restrictions on assessment. (2) Abatement of assessment of mathematical or clerical errors.
(A) Request for abatement. Notwithstanding section 6404(b), a taxpayer may file with the Secretary within 60 days after notice is sent under paragraph (1) a request for an abatement of any assessment specified in such notice, and upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by this subchapter.
(B) Stay of collection. In the case of any assessment referred to in paragraph (1), notwithstanding paragraph (1), no levy or proceeding in court for the collection of such assessment shall be made, begun, or prosecuted during the period in which such assessment may be abated under this paragraph.

[22] IRC § 6213(b).

granted entry into audit deficiency procedures, the right to petition the United States Tax Court in a deficiency proceeding (the only pre-payment tax judicial forum) is lost.[23]

The IRS has made progress in redesigning math error notices, yet many taxpayers remain confused about explanations of adjustments, which are difficult to follow within the notices and do not correlate to specific line numbers on returns. The following is a current explanation on a math error notice:

> "We lowered your tax because you subtracted your deductions from your adjusted gross income incorrectly."
>
> *A better explanation would be: "We lowered your tax because you subtracted your total itemized deductions 'line 36, Form 1040,' from your adjusted gross income 'line 34, Form 1040' incorrectly."*

Under current guidelines, the process of revising notices can take 17 months, but it often takes longer.[24] At the current pace, redesigning the remaining notices will take a decade or more. Correcting math error notices should be a priority because of the number of taxpayers affected. Notice clarification would improve compliance and IRS productivity as well.[25]

The IRS continues to expand math error processing without a clear understanding of the true downstream costs. The IRS estimates that notice processing operations cost $472 million annually, with about 60 percent ($281 million) attributable to the downstream impact of issued notices (i.e. handling subsequent correspondence, telephone calls, and remittances from taxpayers).[26] The Treasury Inspector General for Tax Administration (TIGTA) recommended that the IRS implement a management information system to track abatements, incorrect assessments, or audit reconsiderations. [27] It has not yet done so. The IRS is working on a reporting system, with a scheduled fiscal year 2003 rollout, to record audit reconsideration information. However, that system will not cover cases abated through non-audit procedures such as math error processing. By excluding math error abatements, IRS cannot accurately calculate the actual administrative costs of the math error program.

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[23] IRC § 6213(b).

[24] Notice Modernization Team, Phase I: Notice Operations Baseline – Atlanta, GA February 7, 2001.

[25] Treasury Inspector General for Tax Administration Report, *Increased Management Attention is Needed to Ensure the Success of Future Notice Redesign Efforts*, #2002-30-040, December 2001, page 3.

[26] Id. page 1.

[27] Treasury Inspector General for Tax Administration Report, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service*, #2001-40-053, March 2001, page 8.

The IRS plans to include cases subject to the Federal Case Registry in math error processing.[28] This expansion has the potential to cause thousands of taxpayers the burden of undoing an erroneous tax adjustment by IRS. State departments of health and human services are required to submit updates to the Federal Case Registry in June and December of each year. States do not report data in a uniform fashion, and database records do not reflect dates of the state's submissions into the Federal Case Registry. Outdated or inaccurate records may result in tax assessments, which taxpayers must take affirmative steps to correct. The proposed expansion of math error processing to include Federal Case Registry cases will substantially increase the number of math error notices in 2004. Under present circumstances, if math error authority is expanded to include FCR cases, The National Taxpayer Advocate believes that a high percentage of math error notices will require correction at significant resource cost to the IRS and burden to the taxpayer.

IRS COMMENTS

IRS administration of math error authority is, and has been, in accordance with the provisions of the Internal Revenue Code. The specificity with which this authority is described in IRC § 6213(g) clearly reflects Congressional intent to authorize IRS to dispose of these taxpayer errors without resorting to examination deficiency procedures. This allows IRS to prevent issuance of erroneous or fraudulent refunds when taxpayers' returns contain the enumerated missing or incorrect entries.

However, we do agree that taxpayers can sometimes find math error notices confusing and that in some cases these notices offer inadequate explanations regarding items that the IRS modified or denied on tax returns.

There are currently four standard notice types that are used primarily to correspond with individual taxpayers regarding errors where math error authority is applied to individual tax returns. Tax Examiners in Submission Processing's Error Correction function may select from approximately 500 predefined and programmed taxpayer notice "literals" (paragraphs) that have been predefined and programmed to explain math errors on individual income tax returns. In an effort to better define the math error conditions, the Service has unintentionally hindered our employees' ability to quickly and correctly identify appropriate notice literals, and thus may contribute to taxpayer confusion.

We also recognize that many low income, elderly or unrepresented taxpayers may be intimidated when they receive any notice from the IRS. This condition is often not resolvable; however, every effort is being made to increase the clarity and accuracy of our notices and improve the math error process.

[28] The Economic Growth and Tax Relief Reconciliation Act; Pub. L. No. 107-016 (H.R. 1936); Title III, Section 303. Amended IRC § 6213(g) to use the math error authority in conjunction with the Federal Case Registry of Child Support Orders to identify non-custodial parents in connection with the earned income tax credit claims.

Regarding taxpayer claims for reversing math error changes on original return processing, Internal Revenue Manual procedures comply with the Internal Revenue Code. Customer Service Representatives are instructed to determine if a claim is unsubstantiated (can not be validated) or substantiated (can be validated). If a taxpayer requests a reversal, up to the amount claimed on the original return and within 60 days of the notice, it is allowed even if it is unsubstantiated. The case is made available for further examination. A substantiated claim can be made at any time. A legislative change would need to occur to change this process. In addition, we are unaware of any reliable management information or quality review data to support the statement in this report that when taxpayers call the IRS 1-800 number and state that they do not agree, "…many times the assistor will inform the taxpayer they need to file a claim, and offer no further explanation."

With regard to IRS use of the Federal Case Register, a Research Team is currently working on the procedures to implement use of this data to preclude duplicate or fraudulent claims of qualifying dependents by non-custodial parents' for purposes of the EITC. IRC § 6213(g), as amended by Public Law 107-016, mandates that the IRS use Federal Case Register data. Potential issues, such as those raised in the National Taxpayer Advocate's report, are being considered as IRS moves to implement this new authority.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has short and long-term initiatives designed to improve taxpayer correspondence and math error authority procedures.

The Notice Process Improvement Initiative Team – Taxpayer Notice Codes/Reasons Codes project is a jointly sponsored effort by Wage & Investment and Small Business/Self Employed to improve the clarity of notices. Since September 2002, the team has eliminated more than 100 obsolete and vague codes. They also identified another 42 codes that can be eliminated during the next phase of the project beginning in January 2003. This will significantly improve field employees' ability to select the correct code with the result that taxpayer understanding of these notices will be improved significantly. The next phase of this project includes re-sequencing notice literals for Error Correction processing to correspond to the tax return. Phase II is expected to be implemented in January 2004 and will assist Error Correction tax examiners in selecting the correct literals for taxpayer notices. Adapting the remaining explanations to individually fit specific taxpayer situations will be extremely challenging due to systemic limitations and may be delayed until modernized computer systems are available.

Over the past few years all of the Math Error Notices have been redesigned. In addition, a separate effort based on Notice Error Rate data will provide ongoing improvements.

The IRS does not have a management information system for tracking non-audit abatements, however during 2002, a research team in Indianapolis was tasked to perform an in-depth analysis of the math error authority process. Information from this analysis will be used to determine the effectiveness of the math error process. Preliminary data from the analysis indicates that some math error conditions have a high rate of reversal due to subsequent taxpayer contact. After the final report is submitted, the data will be used to make improvements to the current process. While not yet final, under consideration are such things as:

- Adding manual research requirements prior to corresponding with the taxpayer.
- Initiating taxpayer contact during return processing to resolve potential math errors prior to applying math error authority.
- Refining the Error Correction programming to eliminate conditions that result in erroneous application of the math error authority.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS on its initiatives to improve the clarity of notices. The Taxpayer Advocate Service will continue to support the IRS in developing clearer explanations on math error notices. A member of the Taxpayer Advocate Service will serve on the Notice Process Improvement Initiative Team (NPIIT) to ensure that our concerns are addressed.

Continued support of the IRS' information systems modernization efforts is essential to resolving this problem. Information systems improvements will provide the IRS greater flexibility to improve its notices in a more timely fashion.

However, we remain concerned that the IRS has not yet placed enough emphasis on the process and there are still major weaknesses in its improvement efforts. The current initiatives do not provide for specific information on notices related to a taxpayer's error. We believe the IRS should implement a notice process that uses the line number from the tax return to relate to the math error. Until the IRS implements such a system, taxpayers will continue to experience problems using the math error notice codes to determine the mistakes made on their returns.

We look forward to reviewing a copy of the math error study performed by the Office of Research. However, we feel that without implementing a management information reporting system to track abatements to the type of notice/program of the original tax change, the IRS will not be able to readily identify error trends. These trends are critical to providing the proper educational efforts for taxpayers and IRS employees.

The burdensome process of reversing math error assessments continues to be a major source of taxpayer contacts within TAS.[29] *Data from our Taxpayer Advocate Management Information System (TAMIS) supports this conclusion.*[30] *Providing additional training to Accounts Management employees to assist them in making a determination regarding math error responses received from taxpayers (i.e. substantiated or unsubstantiated) will ensure that taxpayer rights are protected. Revision of the Internal Revenue Manual and associated job aids to reflect clearer guidance on math error determination will also provide greater protection of these rights.*

(NOTE: For further discussion of the Service's mathematical and clerical error assessment authority, see Key Legislation Recommendation #3, herein.)

[29] The total case receipts for major issue codes related to all math error issues were 21,656. (Major Issue Codes 470, 471, 472, 473 and 476) This accounts for 8 percent of all TAS receipts.

[30] The TAS sample review consisted of 414 cases of major issue code 473–Unprocessed Returns with Math Error Issues, between October 1, 2001, and August 30, 2002. The major emphasis of this review was on non-EITC Math Error issues. The review reflected: (1) Taxpayers are unable to identify the errors they made on their returns from the math error notices they receive; and (2) Once the taxpayers identify the errors made, they have difficulty navigating the IRS to correct the errors.

PROBLEM

TOPIC #4 IRS INFORMATION REPORTING PROGRAM

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Information Reporting Program (IRP) produces a high volume of tax assessments that the IRS later abates, placing an unnecessary burden on taxpayers.[31] The IRP is by far the largest single source of abatements.[32] The Taxpayer Advocate Service (TAS) has identified other issues that contribute to the problem:

- The IRS has not fully implemented the Management Information System (MIS) to capture vital statistics about audits and abatements, as recommended by the Treasury Inspector General for Tax Administration (TIGTA).
- Based on a sample of Taxpayer Advocate Service (TAS) cases, five of the top six tax issues where the Automated Underreporter (AUR) assesses additional taxes are the result of taxpayers being uneducated about income reporting requirements.[33]
- The IRS continues to experience problems associating documents and recording the timely receipt of taxpayer correspondence, corrected Forms W-2, and 1099, and Forms 1040X to eliminate unnecessary taxpayer contact.
- Taxpayers are unable to contact IRS employees who are working their IRP cases.
- AUR employees fail to screen original returns to ensure that the underreported item is not reported on some line on the tax return other than the correct line before issuing the CP 2000.[34] Further, they fail to check prior or subsequently filed returns to determine if the unreported item was reported there.
- The IRS inconsistently notifies other taxing authorities of increased tax liabilities and is not required to notify them of changes to taxpayer's accounts.

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[31] An abatement is a formal bookkeeping entry to record a reduction of tax, penalty, or interest assessments on a taxpayer's account. Abatements reduce the amounts that taxpayers owe and that IRS has a right to collect. Internal Revenue Code section 6404 authorizes IRS to abate an assessment under certain conditions. For example, IRS can abate an assessment because of errors made. A taxpayer can make an error on the original tax return, such as not claiming a deduction. Or, IRS may assess incorrect tax amounts when auditing a return or matching income reported by taxpayers with income reported by third parties (such as employers) on payments made to the taxpayers.

[32] Treasury Inspector General for Tax Administration (TIGTA) Report, *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service*, #2001-40-053, March 2001, page iii.

[33] The TAS sample consisted of Major Issue Code 430, Underreporter process, and includes both open & closed cases. The sample size of 235 was based on a population size of 3,693. The sample was completed on July 12, 2002.

[34] Internal Revenue Manual 4.19.3, IMF Automated Underreporter Program. A CP 2000, or Notice of Proposed Adjustment or Overpayment, shows the changes to a taxpayer's income tax return. It is a proposal based on a comparison of the income, payments, credits and deductions reported on taxpayer's tax return with information on these items reported to the IRS by employers, banks, businesses and other payers.

ANALYSIS OF PROBLEM

The Automated Substitute for Return (ASFR) and Automated Underreporter (AUR) assessments are part of the IRS Information Reporting Program. The ASFR program is responsible for securing tax returns from individuals who, based on third-party information, received taxable income but did not file a return. The AUR program is responsible for reconciling third-party information to income and certain deductions reported on filed tax returns.[35]

The Information Reporting Program (IRP) contacted more than 2.5 million taxpayers in fiscal year 2001 and assessed a total of $3.88 billion.[36] A significant portion of these assessments will be subsequently abated when the IRS acts on taxpayer correspondence, processes amended returns (Forms 1040X), or receives corrected Forms W-2 and Forms 1099. Some assessments result from taxpayers' lack of knowledge about how to properly report income, and many will be subject to abatement. Taxpayers find that understanding the errors, gathering any supporting documents, communicating changes with IRS employees, and otherwise responding to IRS notices is burdensome.[37] In addition, taxpayers' problems are compounded when the IRS notifies the appropriate state or other taxing authority of increased tax liabilities, but does not notify the state or authority of countervailing reductions in tax or income. As a result, many taxpayers are required to prove the abatement to these local taxing authorities. The IRS currently shares information with state tax agencies through mutually negotiated implementing agreements pursuant to Internal Revenue Code section 6103(d).[38]

Taxpayers who receive an increase in tax must go through a complicated, time-consuming audit reconsideration process to resolve their issue. This process, in which the IRS reconsiders the validity of a prior assessment, provides the taxpayer an opportunity to present information not considered in the original audit. Many audit reconsiderations result in the IRS abating the initial tax assessment.

The Treasury Inspector General for Tax Administration (TIGTA), in a report entitled *Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service*, attributed approximately 81,000 or 76 percent of all abatements to assessments made through ASFR or AUR programs.[39] TIGTA recommended that the IRS put in place a man-

[35] Treasury Inspector General for Tax Administration (TIGTA) Report–*Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* – #2001-40-053, March 2001, page ii.

[36] IRS Data Book 2001, Table 25, page 26.

[37] General Government Division, U.S. General Accounting Office, *Tax Administration – IRS Can Help Taxpayers Reduce the Need for Tax Abatement*, Report to Congressional Requesters, GAO-01-328, page 10.

[38] IRC § 6103 (d) (1). Disclosure of federal returns and return information to a state or local tax agency will be restricted to the agency's justified need for and use of such information for state tax administration.

[39] See fn 35, page iii.

agement information system (MIS) to identify volumes of audit reconsideration cases, abatements by type, account characteristics, and the reasons for abatements, but to date no such system has been implemented. This type of system could provide the impetus to identify trends and assist in developing corrective actions to reduce the volume of abatements and audit reconsideration cases.[40] Existing reports do not track the number of accounts affected by issue, only the total dollar amounts. As a result, the current reporting system is not helpful in accounting for the volume of taxpayers impacted by each specific issue.

Armed with detailed information, IRS could better analyze ways to improve voluntary compliance through education, outreach, improved services, and simpler forms; and improve resource allocation and training of IRS staff.[41]

In a recent sample of TAS cases, five out of the top six tax issues where AUR assesses additional tax result from taxpayer confusion about income reporting requirements.[42] There is little correlation between the errors identified in AUR and educational efforts. For example, taxpayers who receive payments from financial institutions, the Social Security Administration, and state unemployment agencies are often unaware of the tax implications at the time they receive the funds and fail to properly report the payments. Based on analysis of the Taxpayer Advocate Management Information System (TAMIS) database and AUR management reports,[43] the following are the most common issues:

1. Underreported Wages
2. Non-Employee Compensation
3. Unemployment Compensation
4. Social Security Benefits
5. Interest
6. IRA Premature Withdrawal Excise Tax

Example

Taxpayer A, who is under 59 1/2 years old, withdrew funds from an IRA account. She arranged for tax withholding on the withdrawal and reported the withholding on her income tax return. The financial institution did not inform Taxpayer A about the 10 percent IRA Premature Withdrawal Excise

[40] Treasury Inspector General for Tax Administration (TIGTA) Report–*Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service* – #2001-40-053, March 2001, page iii.

[41] U.S. General Accounting Office, *Tax Administrations, Information on Selected IRS Tax Enforcement and Collection Efforts*, Testimony before the Committee on Finance U.S. Senate, GAO-01-589T, page 8.

[42] The TAS sample consisted of Major Issue Code 430, Underreporter process–includes both open & closed cases. The sample size of 235 was based on a population size of 3,693. The sample was completed on July 12, 2002.

[43] Tax Year 2000, Underreporter Inventory Reports, Tax Years 1998 through 2000.

Tax. Taxpayer A was unaware of the additional early withdrawal tax and did not report it. After filing her return, Taxpayer A was then contacted by AUR when the IRS' document-matching program revealed the error. This could have been prevented if Taxpayer A had been informed of the tax consequences at the time of the withdrawal.

The IRS continues to experience problems with timely handling of taxpayer correspondence, corrected Forms W-2 and Form 1099 information, and processing Forms 1040X. The IRS processed 2.9 million corrected Forms W-2 in tax year 2001,[44] over 3.7 million amended returns (Form 1040X),[45] and in excess of one billion information returns from third-party payers such as banks and employers.[46] Research indicates that roughly 30 percent of abatement requests received in the TAS sample result from Form 1040X, W-2C, or Form 1099C being sent to the IRS but not posted timely or not properly associated with the taxpayer's account.[47]

Example

Taxpayer B filed his original return in February, then received an additional W-2 and filed a Form 1040X in July, reflecting additional income and paying the additional tax. In August, Automated Underreporter (AUR) issued a CP 2000, proposing an adjustment to Taxpayer B's account. The IRS had received the original Form 1040X in July, but did not post it to the taxpayer's account. Taxpayer B was required to forward an additional copy of the Form 1040X to the AUR tax examiner to resolve the issue. Although Taxpayer B did not include all of his income on this original return and owed additional tax, Taxpayer B did correct the issue and file an amended return. The timing of IRS' processing of the corrected document caused additional burden on this taxpayer.

In March, Taxpayer C received a Form W-2C from her employer showing an increase in withholding. Taxpayer C filed her return in April 2000 showing the increase. In January 2001, AUR disallowed this amount from the original tax return. The IRS did not process the tape from the employer showing the W-2C corrections for the company's employees until late January. A copy of the W-2C from the taxpayer resolved the issue. However, the timing of IRS' processing these corrected documents caused a burden on taxpayers.

[44] Report 413-06-41, CAWR W-2 Control Report, Tax Year 2001.

[45] IMF Amended/Duplicate Returns–Briefing Paper, Jacksonville Office of Research, March 2002.

[46] General Government Division, U.S. General Accounting Office, Tax Administrations, IRS' Use of Nonaudit Contacts, Report to Congressional Requesters, GAO/GGD-00-7, March 2000, page 19.

[47] TAS Sample, July 12, 2002. See fn 12.

IRS procedures instruct AUR employees to thoroughly screen the original return to ensure that the underreported issue is not reported on another line of the tax return before issuing the CP 2000.[48] Additionally, the taxpayer might have reported the income on a subsequent or prior year return. Without a comprehensive review of the taxpayer's entire filing record, a taxpayer may be unnecessary burdened in the process.

Example

> Taxpayer D's employer (third party) reported a $7,000 lump-sum payment on a Form W-2 in 1999, even though the taxpayer did not receive the payment until January 2000. Taxpayer D reported the lump-sum payment on his 2000 return. The IRS issued a CP 2000 since the taxpayer did not report the lump-sum payment in 1999. AUR did not review Taxpayer D's subsequent year tax return to determine if he reported the income in another year, which would have changed the nature of the inquiry to the taxpayer.

The IRS does notify other taxing authorities of increased tax liabilities, but is not notifying them of reductions in tax liability and income.[49] The exchange of confidential tax information between the IRS and the various states is intended to increase tax revenues and taxpayer compliance, and reduce duplicate resource expenditures.[50] Implementing agreements are developed and negotiated with each state taxing agency wishing to receive federal returns and return information.[51] Each agreement provides for the mutual exchange of tax data between a specific local tax agency and the IRS. Depending on these separate agreements, the IRS provides information to the local authorities when a change to the taxpayer's account increases tax. However, if the IRS later abates the increase, it is not required to notify the appropriate local taxing agency of the change. Consequently, when the IRS abates tax, taxpayers must obtain for the local authorities acceptable proof from the IRS that the liability has been lowered.

Example

> Taxpayer E resolved an AUR case that was caused by his employer erroneously issuing multiple Forms W-2. Six months later, Taxpayer E was contacted by his state's Department of Revenue about the same issue. Taxpayer E was required to substantiate the abatement for the state tax agency because the IRS did not provide the abatement information to the state.

[48] Internal Revenue Manual 4.19.3, Automated Underreporter.

[49] IRC § 6103(d).

[50] IRM 11.3.32, Disclosure to States for Tax Administration Purposes.

[51] Policy Statement P-1-35 dated January 1, 1979.

IRS COMMENTS

The Information Reporting Program is a major program used by the IRS to ensure accurate income reporting and appropriate return filing. As such, the IRS continually looks for opportunities to improve program efficiency and reduce any associated taxpayer burden.

The IRS recognizes the taxpayer burden and operational costs associated with assessing tax that must be subsequently abated. While reducing the number of abatements related to compliance programs is always desirable, to understand the scope of this issue as it relates to Information Reporting Program, it should be noted that the 81,000 abatements associated with the Automated Underreporter (AUR) Program and the Automated Substitute for Return (ASFR), as reported by the National Taxpayer Advocate, resulted from more than 2.5 million taxpayer contacts and represent approximately three percent of all program contacts. It should also be noted that those abatements related to the ASFR program are not surprising, since when the Service is forced to assess tax using substitute-for-return procedures, the assessment is based on a single/married-filing-separate filing status (as required by law) even though the taxpayer may ultimately be entitled to a more advantageous filing status and/or greater deduction amounts. To further reduce the number of abatements, the IRS will continue to evaluate all program information (including the expanded information recommended by TIGTA when it is available) to identify systemic issues that may contribute to the number of abatements related to the Information Reporting Program.

Providing taxpayers with the education and information required to accurately prepare their tax returns is one of the primary missions of the Internal Revenue Service. The National Taxpayer Advocate's report indicates that taxpayers do not fully understand their income reporting requirements for five of the six major tax issues resulting in AUR assessments. The sample reviewed by the National Taxpayer Advocate estimates that approximately six percent of the AUR cases seemed to be caused by the taxpayer's confusion about income reporting requirements. To evaluate the size of this problem, it is important to note that for the last AUR program year more than one billion information returns were filed and matched to income reported on tax returns and as a result 1.8 million taxpayers were identified and contacted to resolve questions about correct income reporting. The National Taxpayer Advocate sample would indicate that approximately 108,000 of the taxpayers contacted might not have fully understood their income reporting requirements. While the IRS will continue to improve taxpayer education and outreach (including information on reporting requirements) wherever possible, the IRS must always balance available resources with the magnitude of the problem when considering new initiatives.

As previously noted, more than one billion information returns were processed and matched in fiscal year 2002. In addition, over six million corrected and/or amended information and income tax returns were processed. AUR program information is updated weekly to ensure that corrected and amended returns are recorded and considered as soon as they are included in the taxpayer's electronic record. IRS acknowledges that there may be instances where the timing of processing corrected and amended returns as it compares to the timing for updating the AUR program information may result in a taxpayer contact that might otherwise be unnecessary. However, it does not appear that this problem occurs either routinely or frequently (the data in the National Taxpayer Advocate Report indicates that 30 percent or 24,300 of the total abatement requests received related to the Information Reporting Program are the result of processing delays associated with corrected and/or amended returns).

The IRS agrees that providing taxpayers with telephone access to resolve AUR cases needs improvement. The National Taxpayer Advocate's report indicates that taxpayers continue to experience difficulty in contacting the IRS employees assigned to their cases. The IRS completed the implementation of toll free numbers for taxpayers to contact the IRS about AUR notices during fiscal year 2001. Since fiscal year 2001, the number of calls to the AUR toll free number has doubled while the number of calls answered has remained constant. This increased workload without comparable resource increases challenges the ability of the Service to provide an acceptable level of telephone access for taxpayers contacted in the AUR program. Improving telephone access for the AUR program continues to be a top priority for Compliance leadership. In an effort to improve the efficiency of the AUR telephone system, the IRS has implemented automated messages on the toll free lines to provide improved access for taxpayers with general questions that can be satisfactorily answered without talking to a tax examiner/assistor. While the IRS believes that additional resources are needed during peak program periods to effectively handle taxpayer calls, in an effort to maximize the use of existing resources, an Inventory Management Tool was implemented in fiscal year 2002 to enable AUR management to more consistently match available resources with projected telephone demand.

The National Taxpayer Advocate report indicates "AUR employees fail to screen the original return to ensure that the underreported item is not reported on some line on the tax return other than the correct line before issuing the CP 2000. Further, they fail to check prior or subsequent filed returns to determine if the unreported item was reported there." In general, the IRS does not agree with this observation. While no screening process is perfect, it is incorrect to say that cases are not screened to determine if the income in question is reported anywhere on the return before contacting the taxpayer. In fact, the

IRS clearly invests significant resources in both systemic and manual screening of AUR cases in an effort to resolve discrepancies without taxpayer contacts wherever possible. In fiscal year 2002, more than 15 million returns were systemically screened for mismatches and after this screening, three million of these cases were then delivered to the 6 campuses handling AUR cases for manual screening by IRS personnel. This second screening is designed to ensure that the unreported amount cannot be found anywhere on the return before contact is made with the taxpayer. During this manual screening process almost 1.3 million discrepancies were resolved and notices were then sent to the remaining 1.7 million taxpayers. Approximately 24 percent of the taxpayers contacted were able to provide information to resolve the discrepancies while approximately 50 percent of those contacted agreed with the IRS that the amount had not been properly reported, and the remaining 26 percent either did not agree with the IRS determination or failed to respond to the IRS notice.

To measure the success of the AUR screening and notice process, the IRS has a quality review system at each campus and for fiscal year 2002 an accuracy level of 94.5 percent was reported. To ensure effective screening, training is routinely provided to all AUR personnel on screening activities and techniques and additional training may be done if the quality review data indicates problems with screening at a specific campus.

The other National Taxpayer Advocate concern related to screening deals with the lack of a requirement for tax examiners to check prior and subsequent returns to determine if the unreported amount may have been reported on these returns. The IRS agrees that this is not part of the current screening process due to the resource and time issues associated with this practice using current systems. However, to the extent that a taxpayer responds to the initial notice and indicates that the income was reported on a prior or subsequent year return, the tax examiner would give full consideration to this information in resolving the case.

IRS INITIATIVES TO RESOLVE PROBLEM

- Management will continue working to complete the programming required to provide the data extract recommended by TIGTA that will capture the vital statistics needed to evaluate the causes of abatements and develop corrective strategies. This system is scheduled to be operational in December 2002.
- The IRS will continue to work through our taxpayer education and outreach operations to identify new and improved strategies for educating taxpayers about their income reporting requirements.

- A number of internal studies to improve telephone access in the AUR program have been initiated. These studies are currently exploring (1) the identification of alternative means for meeting the taxpayers need to talk with IRS personnel, (2) the reasons for taxpayer calls, and (3) the patterns and reasons for call abandonment and callbacks.

In response to the National Taxpayer Advocate's concern about the AUR screening process, the IRS will do additional analysis by selecting a sample of the more than 400,000 cases that were resolved by contacting the taxpayer to determine if these cases should have been resolved in the screening process. Based on the outcome of this analysis, corrective actions will be developed as needed.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS on its initiatives to reduce the burden on taxpayers relative to this issue. The Taxpayer Advocate Service (TAS) will continue to support the IRS in developing clearer and more easily understandable notices by providing the IRS with feedback from a taxpayer's perspective.

Although the percentage of Automated Underreporter (AUR) abatement compared to assessments may not be a high number based on the overall inventory, this issue continues to be a major source of taxpayer contacts with TAS. TAS will support the IRS' efforts to develop a management information system that will capture all AUR assessments and abatements, including the number of and specific reason for the abatements. TAS has recently partnered with the Office of Research and obtained abatement data related to AUR cases by type for three prior years. TAS will share the results of this data with AUR to assist its educational efforts for taxpayers.

To help reduce the problem of unassociated amended or corrected documents, we recommend that the IRS implement procedures that require amended returns or corrected Forms W-2 and 1099 to be entered into IRS systems and databases as soon as they are received. The IRS would then immediately transfer this data electronically to the AUR system. The IRS could use this data as a trigger to hold the issuance of the CP-2000 until the amended return or form is fully processed. To assist this effort we would suggest that the IRS implement electronic filing capabilities for Form 1040X for taxpayers who file their Form 1040 electronically.

We recognize the challenges that the IRS faces in providing an appropriate level of telephone access to taxpayers. However, we remain concerned about this issue. By collecting and analyzing data that would identify the various root causes of the problems taxpayers face in contacting the IRS, the IRS would be able to develop long term solutions. From calls received in TAS, we believe that one of the major reasons taxpayers call AUR is because the AUR notice (CP 2000) is seven to 10 pages long; they simply cannot decipher the notice. The IRS has recognized that the current AUR notice (CP

2000) is confusing and difficult to understand, and has instituted a redesign effort. The IRS is using taxpayer focus groups and external contractors to assist in this project. We applaud these efforts. However, the IRS will not completely implement its current redesign until fiscal year 2004.

We are extremely pleased to see IRS' planned initiative to review more than 400,000 cases that were resolved by contacting the taxpayer to determine if these cases should have been resolved in the screening process. We look forward to reviewing the results. This is an excellent example of how IRS can use historical data to identify procedural deficiencies.

In its response, the IRS did not address the issue of the exchange of tax information with city or state tax authorities. It is imperative that the IRS enter into standard implementing agreements with all state and city tax authorities, especially because of the consolidation of programs and removal of the old IRS geographic boundaries. This would ensure that the IRS shares assessment and abatement information in a consistent manner with all participating agencies. The current process increases taxpayer burden and reduces the effectiveness of tax administration at the external tax agencies.

PROBLEM TOPIC #5 — PROCESSING CLAIMS FOR REFUND

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

IRS campuses (formerly Service Centers) cannot locate refund claims that their systems indicate the agency has received. This forces taxpayers to resubmit the claims and wait longer for refunds, while also exacerbating the campuses' inventory problems.

Further, the IRS also exceeds its own timeframe by taking longer than eight weeks, and sometimes more than 12 weeks, to process claims for refund. Refund processing is further complicated by the fact that IRS campuses use different procedures to process claims. Finally, there are no guidelines for IRS employees that allow taxpayers to provide proof of mailing when a claim is lost or return is amended before an appeal is made.[52]

ANALYSIS OF PROBLEM

In fiscal year 2001, taxpayers filed 3,750,963 Forms 1040X, Amended U.S. Individual Income Tax Return, representing a 16 percent increase over FY 2000.[53] A study conducted in FY 2001 by IRS Research and the Office of Program Evaluation and Risk Analysis (OPERA) revealed the increase in amended tax returns was primarily due to taxpayers filing original returns electronically, then later claiming earned income credits on amended returns.[54] As stated in the Form 1040X instructions, the normal timeframe for processing a claim is eight to twelve weeks.[55] Taxpayers contact TAS when it takes longer than that.

Campuses process refund claims in two ways. One method establishes a tracking control, but requires several labor-intensive steps that extend the processing time.[56] This could relieve burden on taxpayers by not requiring them to reconstruct or resubmit a copy of the originally filed claim or amended return. However, it can also further delay the refund beyond the 12-week timeframe. The other method of processing provides faster refunds, but does not establish tracking measures and is thus more susceptible to lost claims.

[52] IRC § 7502 and Internal Revenue Manuals 20 and 25 cover taxpayer burden for timely mailing. The Internal Revenue Manuals (IRM) 21 and 3.11 used by Account Management and Submission Processing employees do not address burden of proof for timely mailing.

[53] W&I Briefing Paper drafted by the Jacksonville Research Office dated March 2002 from Electronic Tax Administration (ETA).

[54] W&I Briefing Paper drafted by the Jacksonville Research Office dated March 2002 from ETA.

[55] Form 1040X, Amended U.S. Individual Income Tax Return Instructions and IRM 21 (45-Day Interest Free Period).

[56] IRM 3.11.6.1, Submission Processing Returns and Document Analysis. Tracking control refers to Integrated Submission Remittance Processing (ISRP) and Integrated Data Retrieval System (IDRS).

When this happens, the burden falls on the taxpayer to reconstruct or resubmit a copy of the original claim or amended return. [57]

Some claims may be disallowed because the time to claim the refund has lapsed.[58] Taxpayers that exercise their right to appeal are requested to provide proof of mailing. There are no IRS guidelines requiring the taxpayer to provide proof of mailing for a lost claim or amended return prior to filing an appeal.[59] If there is any indication that the IRS received an amended return and cannot locate the original, the taxpayer is asked for a new copy. The IRS then uses the received date, rather than the mailed date, of the original filed claim to process the new copy.[60]

The Taxpayer Advocate Service (TAS) performed an in-depth review of a random sample of 271 cases from the TAS inventory. [61] They consisted of 90 percent individual and 10 percent business returns.

TABLE 1.5.1
TAS REFUND CLAIM CASES

Individual Tax Return Related Forms Filed (90%)		
Form	**Number Reviewed**	**Percent of Total**
1040X, Amended U.S. Individual Income Tax Return	155	57%
8379, Injured Spouse Claim And Allocation	71	26%
Various other individual tax forms	19	7%
Business Tax Return Related Forms Filed (10%)		
Various business tax forms	26	10%

[57] NT Electronic Online/Output Network System Report from Oct. 1, 2000 to Sept. 30, 2001. The Deputy National Taxpayer Advocate is chair of the TAS/IRS cross-functional team working on establishing standard procedures across IRS campuses.

[58] TAS Quality Sampling Report of major issue code (MI) 330 cases (Random sample of 271 cases reviewed, three cases were applicable) from March 2000 to March 2002.

[59] IRC § 7502 and Internal Revenue Manuals 20 and 25 cover taxpayer burden for timely mailing. The Internal Revenue Manuals 21 and 3.11 used by Account Management and Submission Processing employees do not address burden of proof for timely mailing.

[60] The indicator for an amended return shows as transaction code (TC) 971/977 on the Integrated Data Retrieval System (IDRS); Internal Revenue Manual 21.

[61] TAS Quality Sampling Report of MI 330 cases (Random sample of 271 cases reviewed).

As shown in Table 1.5.1, the majority of the claims fell into two major categories.

- Fifty-seven percent of the claims filed for refund were on Form 1040X. Sixty-seven percent of these cases required handling in the IRS campuses' Accounts Management Department. These cases were assigned to the department because an incorrect adjustment was input or they met other Accounts Management criteria. The type of tax adjustment requiring the skills of an Accounts Management employee and the tax changes requested by the taxpayers filing these amended returns varied; however, when 41 percent of these amended returns came to TAS, they were open in the Accounts Management inventory waiting to be assigned and processed by an individual employee.[62]
- Twenty-six percent of the claims filed for refund were on Form 8379, Injured Spouse Claim and Allocation. The Taxpayer Advocate Service reviewed 71 Form 8379 cases. The processing time for the Form 8379 should be eight weeks.[63] Taxpayers contacted TAS because the injured spouses had not received the refund and it had been longer than the eight-week timeframe.

The taxpayer has the option to file Form 8379 electronically with his or her Form 1040, Individual U.S. Income Tax Return, or to prepare a paper document and mail it with his or her Form 1040. The processing of Form 8379 is not an automated system and therefore must be manually verified and computed. These procedures may add an additional eight weeks to the Form 1040 processing.

IRS COMMENTS

While IRS' objective is to certainly have an error free refund claim process, we do not concur that this is one of the most serious problems facing the taxpayer. Forms 1040X are screened and routed to various functions at our campuses. Claims can be routed through Integrated Submission and Remittance Processing (ISRP) or the Integrated Data Retrieval System (IDRS). Since input through ISRP delays the process, campuses have been encouraged to use IDRS. This will be mandated in the IRM once campuses have adequate IDRS terminals. Although claims may be lost using either of these methods, it is rare. The IRS would need more information concerning the Taxpayer Advocate's comments on "lost claims" reflected in this report.

[62] Internal Revenue Manuals 3.11.6 and 21.5; Submission Processing and Accounts Management work amended returns.

[63] Form 8379, Injured Spouse Claim and Allocation.

IRS INITIATIVES TO RESOLVE PROBLEM

IRS has focused attention on resolving more claims for refund within the Submission Processing Center while increasing consistency and improving timeliness in processing of these cases. Submission Processing Tax Examiners were trained to resolve additional issues found on these claims. In August, a joint conference was held to discuss timeliness, reporting and tracking issues, quality review, and training and workflow. Consistent monitoring of the program will reflect a more accurate volume and disposition and help reduce the timeframe for issuing refunds to taxpayers.

Electronic Tax Administration is doing a review to determine the functionality of receiving Form 1040Xs electronically. The Form 8379, Injured Spouse Claim, is now accepted electronically when filing online, which improves service to taxpayers. A new Correspondence Imaging System (CIS) is being piloted in Austin in 2003, which will also improve the timeliness of claims processing.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate (NTA) commends the IRS for the significant number of tax returns processed, taxpayer inquiries answered, and other account problems handled every tax year. TAS receipts are minimal by comparison – in fiscal year (FY) 2002, TAS received approximately 227,000 cases.[64] *The main focus in reviewing the TAS inventory is to identify key areas of TAS casework and describe, beyond the numbers, what initiatives we are undertaking with the Operating Divisions and Functional units to reduce, if not eliminate, these cases. Of the FY 2002 receipts in our TAMIS data base, "claims for refund" cases led all other categories.*[65]

The National Taxpayer Advocate agrees with the IRS that IDRS is the most expeditious method of issuing taxpayer refunds. IDRS lacks only a systematic clerical filing and tracking mechanism among the campuses. If the IRS adopts uniform tracking and filing systems along with the requirement to input the transaction code (TC 971) showing receipt of the claim and the adjustment for refund to IDRS, then the IDRS method would definitely become the most efficient method of providing faster refunds and tracking claims.[66] *When claims are handled manually from department to department, they are always subject to being misplaced. Taxpayers contacted TAS because the IRS took longer than eight weeks to process their refunds. Thirty-nine percent of these amended returns received in TAS met the Accounts Management Function criteria for "lost" cases.*[67] *The received dates of the claims were determined on the face value of the taxpayer's statement to TAS that the claim was*

[64] TAMIS (Taxpayer Advocate Management Information System) data, case receipts for fiscal year 2002.

[65] *Id.*

[66] Internal Revenue Manuals 3.11.6.1.5 (TC 971 Action Codes), 3.11.5.1.6 (IDRS Input, ISRP Input, and G Coding), and 3.11.6.2 (Priority Routing and Processing) do not cover the clerical functions such as filing, batching, and routing claims to IRS functions. Each campus uses local procedures.

[67] TAS quality sampling of MI 330 cases (random sample of 271). These claims met the criterion for Accounts Management Function (AFC) cases in the IRM 3.11.6.2.1, Priority Routing.

mailed to the IRS by a specified date. IDRS showed no open control in a functional area or a Transaction Code (TC) that indicated the claims were received.

The National Taxpayer Advocate also applauds the Wage and Investment Business Division for rolling out the Correspondence Imaging System (CIS) in Austin, Texas in 2003. The CIS will solve the lost claim problem, the inconsistency of batching and filing among campuses, and the other problems associated with paper inventories, such as extensive manual handling and controlling. The CIS scans correspondence and the Forms 1040X, saves the documents, and will be available at all times. Most importantly, the combination of using the IDRS method and CIS would improve the refund processing time and save money in storage and shipping.

Currently, the taxpayer provides proof of mailing after the claim for refund is formally disallowed. The National Taxpayer Advocate recommends that IRS Operations place more emphasis on the importance of providing proof of mailing prior to filing an appeal. The proof of mailing ensures taxpayers receive proper interest from the date of the original filed claim, discourages the IRS from disallowing the claim, and ultimately, eliminates the need for the taxpayer to file an appeal to recoup his refund.

At this time, the only option for filing the Form 1040X is mailing the paper document to the IRS. The Electronic Tax Administration has studied the feasibility of electronic filing. However, the ETA found that implementation of this proposal is being hampered by the IRS requirement for the taxpayer to explain in writing the reasons for the tax changes, on the second page of the claim.[68] *The National Taxpayer Advocate recommends that numerical electronic codes substitute for the written explanation now required in Part II of the Form 1040X.*

Providing the electronic filing option for Form 1040X would increase the likelihood that the IRS will receive the claim. It would also reduce mathematical errors, allow computers to check the amended figures against the original figures on the system, and deliver faster refunds to taxpayers.

Electronic filing of Form 8379, Injured Spouse Claim and Allocation, speeds up receipt of the claim but still requires an IRS employee to manually compute the refund online. The manual computation adds an additional four to eight weeks to the Form 1040 processing timeframe. The National Taxpayer Advocate recommends that the computation of Form 8379 be automated. The entire process would then be completed in the normal Form 1040 processing timeframe.

A Systemic Advocacy project team has completed a proposal to completely automate the manual computation for both the electronic and paper filed injured spouse claims. This eliminates the need for manual computations, allowing the taxpayer a more expeditious refund. The National Taxpayer Advocate welcomes the opportunity to partner with the IRS in implementing the above proposal.

[68] W&I Briefing Paper drafted by the Jacksonville Research Office, dated March 2002, from ETA.

PROBLEM TOPIC #6 EITC ELIGIBILITY DETERMINATIONS CAN BE MADE LESS BURDENSOME

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Code of Federal Regulations authorizes the IRS to request substantiation of items claimed on a tax return.[69] For the child-based Earned Income Tax Credit (EITC), a taxpayer must be prepared to substantiate any or all of eleven of fifteen eligibility criteria.[70] These are listed in IRS Publication 17.[71] The tax return or return information must satisfy the following requirements:

1) The taxpayer, his or her spouse, if married, and children, if applicable, must have a valid identification number.[72]
2) If married (under IRC §7703) the taxpayer must file a joint return.[73]
3) The taxpayer must be a U.S. citizen or have resident alien status, or be a nonresident alien married to a U.S. citizen or a resident alien, and elect to be treated as a resident.[74]
4) The taxpayer must have earned income.[75]
5) The taxpayer must satisfy income thresholds.[76]
6) The taxpayer must have limited investment income.[77]
7) The taxpayer must meet specific requirements if two or more taxpayers can claim the qualifying child.[78]
8) The taxpayer cannot be the qualifying child of another taxpayer.[79]

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[69] 26 C.F.R § 1.6001-1 Records, Current through P.L.286 approved 11/06/2002.

[70] Four additional rules apply to "income only" EITC.

[71] IRS Publication *Your Federal Income Tax For Individuals;* TAX GUIDE 2001; pages 244-249.

[72] IRC §32(c)(1)(F); § 32(c)(3)(D).

[73] IRC § 32(d).

[74] IRC § 32(c)(1)(E). The term "eligible individual" shall not include any individual who is a non resident alien...unless such individual is treated...as a resident...by reason of an election under subsection (g) or (h) of section 6013.

[75] IRC § 32(c)(2)(A).

[76] IRC § 32(a)(2).

[77] IRC § 32(i).

[78] IRC § 32(c)(1)(C).

[79] IRC § 32(c)(1)(B).

9) The qualifying child must meet a relationship test.[80]

10) The qualifying child must meet a residency test.[81]

11) The qualifying child must meet age requirements.[82]

The complexities, costs and intrusiveness associated with obtaining third party documentation impose an economic and sometimes emotional burden on low income taxpayers asked to substantiate EITC eligibility, dependency exemptions, head of household filing status, the child tax credit or the child and dependent care credit.

ANALYSIS OF PROBLEM

Intrusiveness, complexity and inconsistency in administering the tax laws have been identified as major causes of difficulties in substantiating eligibility for the EITC and other family status tax provisions. The problems can be summarized as follows:

- Documentation requirements impose a burden on low income taxpayers.
- There is a lack of consistency by the IRS in accepting verification of documents and other information.
- Communication gaps exist between the IRS and low income taxpayers during EITC audits.

Documentation Requirements Impose a Burden on Low Income Taxpayers

Documentation required to prove residency and relationship in qualifying for the EITC add both an administrative and financial burden for low income taxpayers. At times, it can also take an emotional toll.

Internal Revenue Code section 32 states that to claim a child for EITC purposes, the child must be related to the taxpayer[83] or be an eligible foster child placed with the taxpayer by an authorized placement agency.[84] The child must also live with the taxpayer in the United States for more than half of the tax year.[85]

"Horror" stories sometimes arise when taxpayers try to secure documentation. Though not the norm, they do illustrate the intrusive and, sometimes inequitable nature of the

[80] IRC § 32(c)(3)(B).

[81] IRC § 32(c)(3)(A)(ii).

[82] IRC § 32(c)(3)(C).

[83] IRC § 32 (c)(3)(B) Relationship test. An individual bears a relationship to the taxpayer if such individual is a son, daughter, stepson, or stepdaughter, or a descendant of any such individual, a brother, sister, stepbrother, or stepsister, or a descendant of any such individual, who the taxpayer cares for as the taxpayers own child.

[84] IRC § 32(c)(3)(iii) Eligible foster child. The term eligible foster child means an individual who is placed with the taxpayer by an authorized placement agency, and the taxpayer cares for as the taxpayer's own child.

[85] IRC § (c)(3)(A)(ii) The term "qualifying child" means, with respect to any taxpayer an individual who has the same principal place of abode as the taxpayer for more than one-half of such taxable year.

process, and demonstrate the necessity of revising and simplifying guidelines for substantiating eligibility. Examples follow:

- The IRS deemed a taxpayer not qualified for EITC because an unrelated taxpayer living in a different apartment in the same complex had a higher adjusted gross income.
- A taxpayer was not permitted to use a rental agreement to substantiate his residence and that of his children because the landlord did not include the rent received as income for the year in question.

More than six months residency is required to claim a child for EITC purposes, but a school transcript may show the school term extending from August of one year through May of the year in question. Therefore, because only five months of residency was established in the current year, EITC is disallowed or taxpayers are asked to secure a second transcript.[86]

Some documentation requested need not be obtained directly from taxpayers, as eligibility can often be determined from internal (IRS) sources or other government agencies. For example, IRS has access to Social Security Administration (SSA) information that includes:

Taxpayer name

Date and place of birth

Other names used

Citizenship information

Legal Alien- authorized to work

Legal alien - not authorized to work

Disability status

Date of death

Names of biological parents including mother's maiden name.[87]

Recognizing that this information is available, the IRS will, beginning in the 2003 filing season, stop asking taxpayers to furnish birth certificates of their children, including adopted children, to prove relationship. However, examiners will still request birth certificates to verify biological grandparent and other familial relationships.

[86] The 'disallowance of school records' issue was reported in the 2001 National Taxpayer Advocate Report to Congress. However, Local Taxpayer Advocates raised it again in response to a National Taxpayer Advocate request for Most Serious Problems facing taxpayers during fiscal year 2002.

[87] IRM 2.3.33.2 Command Code ACTRA. Exhibit 2.3.33-16 Command Code ACTRA –NUMIDENT Transcript with Social Security Administration (SSA) data.

Lack Of Consistency In Accepting Verification of Documents and Other Information.
Lack of consistency in requiring proof of EITC eligibility continues to plague taxpayers, tax return preparers, and the IRS during the EITC audit process. At times and in some locations, an oral statement from third party is acceptable. In others, the taxpayer must furnish a written statement from the service provider on letterhead stationery. In some instances, examiners ask that statements of third parties be notarized. Examiners may insist on receiving all documents in a list of items while other examiners may accept one item in verifying residency of the qualifying child.

Confusion resulting from the differing definitions of a "qualifying child" for EITC, dependency exemption and head-of-household filing status purposes contribute to taxpayer lack of understanding and inconsistent treatment. At times during EITC audits, taxpayers are required to document eligibility to claim head of household filing status and meet the test for claiming dependent exemptions when neither is required to claim the EITC. Substantiation for head of household filing status requires receipts to satisfy the "maintenance of the household" test, while dependency exemption verification requires receipts to prove "support" of the child.[88] The documentation required to establish head of household eligibility is not the same as is needed to claim the dependency exemption.[89]

Communication Gaps Exist Between The IRS And Low Income Taxpayers During EITC Audits

Low income taxpayers may not understand the critical nature of verifying eligibility for the Earned Income Tax Credit, and the IRS is not sufficiently sensitive to the difficulties that these taxpayers encounter in acquiring that verification. Feedback from Local Taxpayer Advocates (LTAs) and Low Income Taxpayer Clinics provides insight into the unique problems facing low income taxpayers. The LTAs and the clinics consistently point out that the kind of documentation that the IRS requests does not adequately consider the reality of how the low income population lives. For example:

- The residency rule requires taxpayers to verify that the child lived with them for at least six months. This is particularly difficult for taxpayers residing with children younger than five years old, who do not attend school.
- A taxpayer may not be able to get the residency information because the family moves several times in the year, the children are cared for by family members, or the family does not have a regular doctor.
- A taxpayer may not be able to substantiate head of household filing status and dependency exemption eligibility because he or she has no bank account, must

[88] IRC §2(b)(1) (A); §152(a).

[89] IRS Publication 17: *Your Federal Income Tax For Individuals*, TAX GUIDE 2001 pages 24 and 29.

deal in cash or money orders, does not keep receipts or does not understand what is required. It is unlikely a landlord has listed children's names on the lease, unless the lease is issued under a government housing program.

- In large cities such as New York, where several hundred thousand EITC claimants reside, the working poor live in "rented rooms" or partitioned space within apartments leased to other parties. This often means individuals do not have written leases to help establish head of household status or residency requirements for EITC, nor do they have adequate receipt records since they pay rent in cash or money orders. When dependent claims are disallowed because the head of household filing status has been disallowed (e.g. where another person living at the same address claimed head of household filing status), the taxpayers are left with the difficult task of furnishing the extensive documentation necessary to prove eligibility for dependency since they must disprove that anyone else in the "household" supports the children.
- Meeting the "residency" requirements for EITC presents a major challenge for many low income taxpayers. Multiple families may use the same address to claim EITC because it is the only valid mailing address in the area or because families may share apartments to conserve cash. Taxpayers may use a relative or ex-spouse's address on school records for their children to keep them from attending poorly performing school or ones with widespread gang violence. Taxpayers sometimes receive free housing and cannot easily validate residency. In each of these instances, the legitimate EITC claim may be disallowed.
- Similar issues confront families whose roots are from other cultures. Native Americans live near or on reservations that have no street names or addresses. Alaskan community elders care for children in their villages who are often not blood relatives. Immigrants from several African countries and the Hmong from Southeast Asia do not marry and divorce through the legal government system. Their marriages and divorces are agreements between their families. The IRS continues to request unrealistic, burdensome documentation requests (grocery or housing receipts when their housing is free) and does not uniformly accept documentation from tribal councils.

Clearly, the IRS needs a verification (examination) process to validate eligibility for the EITC and forms of documentation should be required, as appropriate. Nonetheless, the experience of Local Taxpayer Advocates and the Low Income Taxpayer Clinics points out the vital need to understand and meet the needs of the increasingly diverse low income taxpayer community, and for the IRS to adapt documentation requirements that assist eligible taxpayers in validating EITC claims.

IRS COMMENTS

We recognize that existing documentation requirements can, and often do, pose significant challenges to taxpayers. The IRS engages in an ongoing effort to educate taxpayers on the documentation requirements relating to EITC eligibility. When a taxpayer claims EITC and the return is selected for examination, it is necessary to ask for documentation to support eligibility. The purpose of the examination is to ensure that the EITC eligibility requirements are met. Both Congress and the Treasury Inspector General for Tax Administration (TIGTA) share the concern that duplicate dependent and qualifying child overclaims are resulting in a substantial loss of tax revenue each year. It is estimated that unintentional and fraudulent EITC non-compliance has increased to an estimated $9.3 billion a year and conducting examinations not only ensures the accuracy of the individual returns involved but it helps the Service better understand the nature of the issues involved in EITC non-compliance (in fiscal year 2002 less than 400,000 of the approximate 19 million taxpayers claiming EITC were examined).

A major source of the difficulty that many taxpayers have with EITC documentation requirements is the complexity of the tax law in this area. Since the law is complex, document requests to support EITC eligibility must be based on the facts and circumstances of each case and therefore may vary between taxpayers. If standard documentation does not support the taxpayer's claim, additional or alternative documentation may be requested. Adding to the difficulty with documentation are the differing legislative and statutory definitions for qualifying child for purposes of EITC, dependency exemption and head-of-household filing status.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS continues to take steps to clarify and streamline documentation requirements to substantiate EITC. Actions include:

- The design and development of a decision support tool to improve the consistency and quality of EITC eligibility determinations. The On-Line Tax Advisor (OTA) provides direct access to the IRM, procedural guides, publications and examples of acceptable documentation.
- The establishment of a documentation team to review the existing documentation requirements, to recommend alternative forms of documentation that could be provided by non-traditional taxpayers, and to issue new guidelines on acceptable documentation. This team is comprised of members from the Taxpayer Advocate Service, Chief Counsel, Wage & Investment Compliance, Small Business/Self-

Employed Compliance and Appeals. The team will make preliminary recommendations by September 2003.

- Providing examiners with access to additional data available from other government sources to reduce the documentation taxpayers need to provide. For fiscal year 2003 most taxpayers will not have to provide a Social Security card or a birth certificate, since this documentation will generally be available to the Internal Revenue Service by accessing new databases.
- New outreach efforts to non-traditional communities. For example, a communication problem was identified with Native Americans. Partnering with the TE/GE Indian Tribal Government Function and a preparer, a new specialized training module (Native Americans and Earned Income Credit) is being developed that will cover acceptable alternative documentation specific to Native Americans.
- Continued participation in the annual Tax Forums to provide practitioners with information about current issues and tax law changes. During fiscal year 2002 one session was specifically designed for tax issues related to the Hispanic Community, including EITC.
- Additional letters, forms, and publications related to EITC, including documentation requirements, are currently being converted to Spanish to provide improved tools for outreach and education.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate applauds the IRS for its development and implementation of the electronic Online Tax Advisor (OTA) to assist examination employees in evaluating taxpayer information and providing consistent treatment during routine EITC audits nationwide. TAS is disappointed to learn, however, that a more robust plan to create wider IRS employee and tax practitioner access has been delayed by funding issues. We believe OTA can result in better customer service and we support the IRS in obtaining funding to fully implement this initiative.

We are mindful, as well, of the flexible approach to be taken when conducting EITC audits, particularly when evaluating documentation to verify EITC eligibility. We encourage the IRS to recognize the non-traditional living arrangements often present in the low income population and work with taxpayers to find common ground when arriving at a correct audit result. It is unlikely, too, that the varied living arrangements of the target population can be programmed into an electronic assistant to produce a fair and accurate determination of eligibility. Therefore, the IRS should seek to train employees to take a common sense approach when applying the intent of the law and to make eligibility decisions accordingly. Whether in the pre-filing environment, during return processing or in post fil-

ing compliance, IRS employees must be sensitive to issues concerning low income taxpayers, such as special language and cultural differences that may impact taxpayer communication and access to customer service.

We recognize that the IRS makes efforts to accept alternative documentation when the initial response does not completely support the taxpayer's claim. However, the IRS should, during contacts, also focus on educating low income taxpayers and their representatives. Taxpayers often obtain completely different (favorable) results from the original IRS determination when they receive assistance from TAS in EITC audit reconsiderations, EITC math error notices, and Revenue Protection Strategy examinations.[90] *TAS intervention often involves helping the taxpayer understand what documentation is needed and then working with the taxpayer to find alternative ways of substantiating an EITC claim. TAS establishes reasonable timeframes for taxpayers to produce documentation, based on the taxpayer's specific ability and circumstances. TAS follows up with taxpayers when they miss the agreed upon timeframes. Experience has shown that many eligible taxpayers may not understand what the process requires of them in terms of "legal sufficiency" or how to find assistance. This leads to unintentional non-compliance.*

An initiative aimed at addressing EITC documentation, with TAS as well as IRS servicewide participation, is an important new development in the effort to reduce taxpayer burden and clarify documentation requirements. We support the team's attempts to develop pro-forma third party verification for taxpayer use in meeting EITC, dependency and filing status tests. This proactive approach to documentation can alleviate, for example, the confusion over school term (five-month) attendance records in establishing residency of a qualifying child.

The IRS has set up several task forces and working groups, with participation by TAS and IRS Operations, in a concerted effort to improve administration of the complex EITC laws. It is just such collaborative efforts that yielded an implemented taxpayer burden reduction plan for 2003 – a method of securing birth certificate and social security information internally rather than seeking copies of this information from the taxpayer.

[90] For the fiscal year ending September 30, 2002, TAS closed 26,639 Wage and investment cases involving Revenue Protection Strategy cases, 2,184 cases involving math error EITC issues, and 5,532 audit reconsideration cases. TAS assistance resulted in a respective change rate of 50 percent, 60 percent, and 51 percent.

PROBLEM TOPIC #7 PROCEDURES FOR EXAMINING EITC CLAIMS CAUSE HARDSHIP AND INFRINGE ON APPEAL RIGHTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple - Commissioner, Wage and Investment Division

Joe Kehoe - Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The IRS process of examining or auditing Earned Income Tax Credit claims was identified as a significant problem for taxpayers in the National Taxpayer Advocate's FY 2001 Annual Report to Congress.[91] Despite IRS attempts to make the process less burdensome, problems persisted into 2002. Procedures established at IRS campuses (formerly service centers) for examining EITC returns create a particular set of problems for low income taxpayers. Specifically:

- IRS Revenue Protection Strategy (RPS):
  - To prevent questionable refunds, the taxpayer's entire refund is held until the examination is complete, including any refund associated with overpaid tax withholding credits. The examination process is a lengthy one and can create a hardship for qualified and needy EITC claimants.[92] Consequently, taxpayers justifiably seek expedited treatment of their refund claims or believe they are entitled to an immediate release of the undisputed portion of their tax refund to defray basic living expenses.
- Letter 566B and the Batch Processing of EITC audits:
  - The initial notice, Letter 566B, requesting documentation to support the EITC claim and containing the report of examination changes, includes notification of the right to appeal. Combining these two aspects of the process in one letter (the so-called "Combo" letter) means that the timeframe for the taxpayer to gather verification before receiving a statutory notice of deficiency is significantly compressed. The taxpayer may be confused as to whom to respond and thus lose the opportunity for an Appeals hearing.
  - If a taxpayer does not respond to the request for substantiation, the batch processing audit system automatically sends out a deficiency notice. A notice will also be sent if a taxpayer replies but the IRS does not associate or consider the response in the timeframe allotted.[93]

[91] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, publication 2104 (Revision 12-2001) pages 26-29.

[92] The average cycle time for EITC audits for FY 2001 (cumulative through July 2002) was 265 days. IRS Wage & Investment, Tax Reporting Compliance, "Exam Measure, July '02", Executive Advisory Council meeting September 2002.

[93] Through July of fiscal year 2001, the IRS reported closing 32,755 EITC cases that were more than one year old retaining an inventory of 24,797 open EITC cases in excess of one year. Wage and Investment, Tax Reporting Compliance, "Exam Measures July 02," Executive Advisory Council Meeting, September 2002.

- Appeal Rights:
  - Correspondence concerning appeal rights for the EITC taxpayer is unclear or non-existent. IRS correspondence consists of a computer-generated letter (75 or 75A) informing the taxpayer of a possible examination. If selected for examination, taxpayers are then sent a Letter 566B, which informs taxpayers of their appeal rights. The accompanying Publication 3498 provides guidance on how to appeal. Neither the letter nor the publication adequately covers the specific steps necessary to request an appeal, nor do they clearly state that the time frame for requesting an appeal has begun.
- Notice of Deficiency Procedures:
  - The Internal Revenue Manual (IRM) limits examiners' administrative ability to help taxpayers reach the proper decision on an eligibility determination once the notice of deficiency is issued.[94] Taxpayers whose substantiation may contain a minor defect are frustrated by the need to file a petition with the Tax Court; or worse, they are forced to abandon a valid claim as an outcome of the process.

ANALYSIS OF PROBLEM

Revenue Protection Strategy (RPS)

The EITC is a refundable tax credit, which means qualifying taxpayers may receive a refund greater than the amount of tax paid into the system during the tax year. However, it is difficult to collect the EITC paid to a taxpayer who is not entitled to the credit. To guarantee that the government does not jeopardize this revenue, the Campus Examination unit in 1997 began working the Revenue Protection Strategy (RPS).[95] This program holds part or all of the refund from a taxpayer's current year Form 1040.[96] There are eight main examination streams in the RPS: Earned Income Tax Credit, Exemptions, Filing Status, Schedule C Gross Receipts, Child Tax Credit, Child Care Credit, Education Credit and Adoption Credit.

The IRS holds the entire refund (Earned Income Tax Credit as well as the withholding) when a return is selected for examination under RPS. The ensuing examination process is lengthy. The average cycle time for an EITC examination in fiscal year 2001 (cumulative through July 2002) was 265 days.[97] An analysis of EITC examination cases from tax year 1998 disclosed that 66 percent of the taxpayers ultimately received refunds, which aver-

[94] Internal Revenue Manual (IRM) 4.19.1.8(3) and 4.19.1.5.1.3.6. (Rev. 10-01-2002).

[95] IRM 4.19.1.5.1, Service Center Examination Operations.

[96] IRM 25.12.1.5, Delinquent Return Refund Hold Program, Revenue Protection Strategy (Rev. 01-01-2002).

[97] IRS Wage & Investment, Tax Reporting Compliance, "Exam Measures July 02", Executive Advisory Council Meeting, September 2002.

aged $1,420.[98] Holding entire refunds for this length of time inevitably creates hardships for low income taxpayers.

"Batch Processing" System

Campus Examination EITC cases are processed through the IRS Report Generating Software System (RGS), which creates numerous reports to assist tax examiners and managers in monitoring individual tax examiner inventories.[99] Beginning in processing year 2001, in order to maximize resources, a new batch processing system was added to existing software. The process computes tax and automatically generates Letters 566B (the "Combo" letter) with attachments and statutory notices of deficiency at predetermined timeframes.[100] If the taxpayer does not respond to the correspondence, or the IRS does not associate the taxpayer's response with the case soon enough, the examination will systematically move through the audit process to closing.[101] The untimely handling of responses has resulted in premature notices of deficiency. During fiscal year 2001, the Taxpayer Advocate Service received over 40,000 taxpayer requests for assistance on EITC RPS cases examined by Campus Exam, many of which arose from unexplained notices of deficiency.[102]

"Combo" Letter

Before processing year 1998 for EITC examinations, and in some other correspondence examination procedures, an initial contact letter (Letter 556) informed the taxpayer of an examination and requested information to verify items in question. A subsequent letter (Letter 525, referred to as a "30 day" letter), together with an Examination Report (Form 4549), was prepared to reflect the proposed changes and the difference in the proposed refund. Another request for information was included in the event the taxpayer disagreed with the assessment. The process allowed the taxpayer approximately 60 days to compile and provide the necessary information. If the taxpayer sent incomplete documentation, the IRS sent another letter (Letter 692) requesting additional verification within 15 days.[103]

Beginning with processing year 1998, in an effort to reduce the length of examinations of EITC, and certain other correspondence examination issues, the IRS combined the initial

[98] Tax year 1998, Compliance Research Information System (CRIS), Model IFM 2002.

[99] IRM 4.19.1.4.10 (5).

[100] Letter 566B attachments include Form 4549 (Exam Report), Form 886 (list of acceptable documentation), and Publication 3498 (The Examination Process).

[101] IRM 4.19.1.4.10, Service Center Examination Operations.

[102] This volume includes cases caused because the taxpayer is suffering an economic hardship. However, economic hardship cases traditionally represent less than 15 percent of TAS case receipts. The remaining 85 percent are due to delays and system failures (systemic hardship). TAS Inventory Study, Fiscal Year 2001 Reciepts, April 17, 2002, pages 40-41.

[103] IRM 4.19.1.5.1.2, Figure 4.19.1-1.

contact letter and the official Examination Report into one mailing (the "Combo" letter) with a 30-day response time. If the taxpayer does not respond within that time, a statutory notice of deficiency is automatically issued. The only reference to an appeal in the "Combo" letter is the following language: *"After we review what you've sent us, we will contact you with the results. If you* ***still*** *disagree with our findings, you have the right to file an administrative appeal as explained in the enclosed Publication 3498, The Examination Process."* This means that the taxpayer must, within 30 days:

- Gather and mail/fax supporting documentation to Campus Examination;
- Await a denial of EITC eligibility by Campus Examination; and
- Request an appeals conference.

Prior to sending the notice of deficiency, the IRS sends a letter (Letter 692) requesting verification within 15 days if the submitted information is incomplete.[104]

Taxpayers examined in the EITC process receive disparate treatment from the IRS in terms of opportunities and time to substantiate the items at issue and opportunities to request appeals hearings.

Correspondence Concerning Appeal Rights Is Unclear or Non-existent

Public Law 105-206 (Internal Revenue Service Restructuring and Reform Act of 1998) explains the appeals and collection process. It states:

> "The Secretary of the Treasury or the Secretary's Delegate shall… include with any first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals an explanation of the entire process from examination through collection with respect to such proposed deficiency, including the assistance available to the taxpayer from the National Taxpayer Advocate at various points in the process."[105]

The Code of Federal Regulations outlines how the IRS will implement the law. It includes the following provision: "An oral request is sufficient to obtain Appeals consideration in all office interview or correspondence exam cases."[106]

The procedures and correspondence used in Exam do not give the taxpayer an adequate opportunity to request an appeal. The following documents contribute to the lack of information of appeal rights.

[104] IRM 4.19.1.5.1.2, Figure 4.19.1-2.

[105] Internal Revenue Service Restructuring and Reform Act of 1998; Pub. L. No. 105-206, Title III, Subtitle F, §3504, 112 Stat.771. Explanation of Appeal and Collection Process.

[106] CFR § 601.106(1)(a)(iii)(a), The taxpayer must request Appeals consideration.

The "Combo" letter states, "After we review what you have sent us, we will contact you with the results. If you still disagree with our findings, you have the right to file an administrative appeal as explained in the enclosed Publication 3498, The Examination Process." However, the Publication 3498 states, "…The Tax examiner will explain your appeal rights" … "You will receive a letter (known as a 30 day letter) notifying you of your right to appeal the proposed changes within 30 days." [107] (Note: For EITC examinations, the taxpayer has already received the 30-day letter as part of the "Combo" Letter (566B).) The publication also mentions, "If you want to have a conference with an appeals officer, follow the instructions in the letter you received."[108]

The instructions contained in the document do not appear to fulfill the mandated explanation of the appeals process in IRC § 6212. The EITC examination process does not accomplish the intent of the law, to ensure the taxpayer is made aware of his or her appeal rights. The consolidation of batch processing and the use of the "Combo" letter have, in this respect, failed to provide adequate notice of a taxpayer's right to appeal.

Taxpayer appeal rights are not fully described in the instructions for examiners handling the Campus Examination toll-free phone lines. The IRS developed an on-line Examination Toll-Free Telephone Procedural Guide (also known as Script), which provides examiners with probes and responses to resolve taxpayer audit issues. This guide contains no information to assist taxpayers with appeals procedure questions.

When a statutory notice of deficiency is sent, the taxpayer has 90 days to petition the United States Tax Court to re-determine the amount of tax before assessment. The taxpayer may still request an administrative appeal,[109] but the notice does not clearly describe that right. If a taxpayer is granted Appeals consideration, he or she may mistakenly believe it is not necessary to file a petition with the Tax Court. The average administrative appeal took 293 days in tax year 2000, far beyond the allotted 90 days to petition the Tax Court.[110]

Notice of Deficiency

The current IRS Campus Examination guidelines do not allow examiners to seek additional supporting documents from taxpayers once a statutory notice of deficiency is issued. The examiner may explain why a given response was insufficient, but may not

[107] Publication 3498 Department of the Treasury Internal Revenue Service (Rev 7-2002) Catalog number 73074S: page 6.

[108] Id. page 8.

[109] C.F.R. § 601.106 (b) Appeals Function.

[110] Treasury Inspector General for Tax Administration, *Taxpayers Should be Informed of the Benefits of the Fast Track Mediation System*, March 2002 # 2002-10-070.

offer suggestions or otherwise assist the taxpayer, even when the taxpayer's documentation clearly contains a minor defect.[111] There is no statutory prohibition governing this practice, but rather a belief that to commence a dialogue with the taxpayer would detract from the understanding about the 90-day running period to petition the Tax Court. Given the very limited timeframes for taxpayers to respond during EITC audits and the need for assistance inherent in this population of taxpayers, critical opportunities to arrive at a proper examination result may be lost during this period. Further, if necessary, IRC § 6212(d) allows for the rescission of a notice of deficiency,[112] while IRC § 6212(c) allows for the issuance of a second notice of deficiency unless the taxpayer has already petitioned the Tax Court.[113] Current IRM procedures place unnecessary limitations on taxpayers and IRS examiners' ability to resolve EITC eligibility issues through proactive and creative means throughout the examination process.

IRS COMMENTS

The IRS continues to take actions to make the EITC examination process less burdensome for taxpayers. However, taxpayers continue to have concerns, generally because this process involves freezing their refunds until the determination of their EITC eligibility is completed.

Recognizing that taxpayer participation reduces the length of time needed to complete an EITC examination, which in turn reduces taxpayer burden and expedites release of allowable refunds, IRS has made several unsuccessful attempts to determine why taxpayers do not respond during the examination process. During the last two fiscal years 31 - 35 percent of taxpayers contacted did not respond to EITC examination notices and this remains both a significant factor contributing to the length of time needed to complete examinations and a burden for taxpayers expecting refunds.

However, for the taxpayers (approximately 65 percent) who do respond to examination notices, the IRS is continually searching for techniques to expedite the completion of cases. One such technique was the development of the Batch Processing System, which allows for a faster response to taxpayers' correspondence and telephone inquiries and thus reduces the length of time needed to complete the examination and release allowable refunds.

[111] IRM 4.19.1.4.8 (3) "Do not include copy of the Letter 566B or form 886H in Statutory Notice issuance. Although documentation can be reviewed if submitted by the taxpayer, it CANNOT be requested from the taxpayer after the Statutory Notice is issued." In addition IRM 4.19.1.5.1.3.6 states "Do not solicit additional information from the TP when the case is in 90 day status."

[112] IRC § 6212(d) Authority to rescind notice of deficiency with taxpayer's consent.

[113] IRC § 6212(c). Further deficiency restricted. (1) General rule. If the Secretary has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the secretary shall have no right to determine any additional deficiency of income tax for the same taxable year.

As the Taxpayer Advocate Service mentions, another attempt to reduce the time needed to complete an EITC examination was the introduction of the "Combo" letter. This letter combines the issuance of an initial contact letter and the preliminary Examination Report (30-day letter) into one notice (similar to the process used for Underreporter cases). Taxpayers are asked to respond to the proposed tax change within 30 days by providing additional documentation, indicating agreement or requesting an appeal. An analysis of examination correspondence in the EITC program reveals that the average response time to the "Combo letter" is 25 days, so for those taxpayers responding, this timeframe is generally adequate. When using the "Combo Letter", the Service takes no further action on cases until mail is associated or an additional 30 days after the initial 30 days offered in the "Combo Letter" has expired in an effort to ensure that cases are not moved to the next stage of the process (issuance of a statutory notice of deficiency) prematurely. Therefore, taxpayers receiving the "Combo Letter" are given at least sixty days to respond or request an Appeals Hearing.

The IRS always strives to ensure that all procedures, correspondence, and publications used in examination processes provide taxpayers with a complete understanding of their appeal rights as well as the procedures to request an appeal. During EITC examinations, taxpayers are provided comprehensive information about their appeal rights on page 8 of the Publication 3498 (Rev. 7/2002) entitled "The Examination Process." This publication is provided with the initial correspondence ("Combo letter"). In addition, the "Combo" letter itself is subject to ongoing simplification and improvement initiatives to enhance taxpayer understanding of the examination process. During FY 2002, the "Combo" letter was revised based on feedback from the Taxpayer Advocate Service and practitioner groups and this revised letter will be implemented in January 2003.

To further reduce taxpayer burden, toll-free telephone units have been established to provide taxpayers with another avenue for making general inquires about the EITC examination process. Initial calls regarding the examination are answered in centralized units staffed by telephone assistors. When taxpayers participate in the examination by providing requested documentation, the case is assigned to a specific tax examiner. All subsequent correspondence will have that examiner's telephone extension as a point of contact and all subsequent contacts and inquires, including all questions regarding appeal rights, can be directed to the tax examiner assigned the case, who is knowledgeable about appeal rights and can assist the taxpayer in understanding the procedures to exercise these rights. Taxpayers are always encouraged to participate in the examination process and work with tax examiners to resolve their cases at the lowest level.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS will take the following additional actions to help reduce the taxpayer hardship incurred during an EITC examination:

- As of January 2003, a correspondence received date will be input into the Audit Information Management System (AIMS), which will freeze the taxpayer's account to prevent the premature issuance of a statutory notice of deficiency.
- As mentioned in the previous National Taxpayer Advocate's Report, the IRS continues to study the feasibility of a partial refund freeze rather than a full refund freeze. Following the review of additional data, recommendations on this issue are expected by June 2003.
- Effectively immediately, tax examiners can request additional information, offer suggestions and otherwise assist the taxpayers to resolve their case after the issuance of a statutory notice of deficiency. This new procedure is based on a revised opinion from Counsel and will be incorporated in the appropriate Internal Revenue Manuals.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate remains concerned about the burden placed on low income taxpayers when their entire refunds are held pending conclusion of EITC audits. The issue was raised in discussion of last year's Most Serious Problems Encountered by Taxpayers (Topic #6, Refund Inquires). The IRS agreed to study the issue. A TAS analysis shared with IRS Operations indicates that, on average, taxpayers are entitled to a several hundred-dollar refund of the undisputed amount (primarily tax withholding), which should not be subject to pre-refund examination. The National Taxpayer Advocate strongly recommends that the IRS task force propose the release of the undisputed portion of the taxpayer refund during return processing and direct its efforts to immediate implementation.

The use of batch processing in EITC cases does not address the very real concerns associated with the significant percentage of taxpayers who do not respond during an audit. We are pleased that IRS agrees that more analysis is needed to address this issue and has agreed to conduct a priority research study to address this concern. A non-responding claimant is not necessarily an ineligible claimant. A variety of reasons have been put forth as to why taxpayers do not respond in EITC examinations, including language and literacy barriers, non-receipt of notices, lack of time or resources to gather documentation, lack of telephone access, lack of representation, feelings of intimidation, and fear of government intrusion as well as ineligibility.

The National Taxpayer Advocate believes that the IRS should devote additional resources to taxpayer outreach concerning this critical issue. During FY 1998-FY 2002, the EITC Program Office devoted a maximum of four percent funding to pre-refund initiatives, while on average 68 percent went to post-filing initiatives including Criminal Investigation, Collection, and Exam.[114] *A further indication that more could be done to increase taxpayer participation in EITC was reported in a December 2001 General Accounting Office report, which estimated that one in four taxpayers eligible for the EITC failed to claim it.*[115]

TAS remains concerned about the potential abridgement of appeal rights in EITC cases. While TAS recognizes the administrative efficiency embedded in the "Combo" letter (556B), this procedure treats low income taxpayers differently from other taxpayers who are being audited. The IRS has revised Letter 566B. However, the draft of new Letter 566BZ has language almost identical to that of Letter 566B concerning the taxpayer's right to appeal the audit report that accompanied the letter. The National Taxpayer Advocate believes that the appeal rights as mandated in RRA 98 § 3465 are not adequately described in this letter, given the target population. This letter does ***not*** *constitute notice of appeal rights to its intended recipients. The publication informs the taxpayer of appeal rights as mandated in the law, but inadequately explains the procedure to this unsophisticated, often unrepresented population. The efficiencies of the "Combo" letters do not offset the fact that low income taxpayers are not receiving separate, clear notice of their appeal rights. The use of the "Combo" letter should be discontinued, and Publication 3498 should be rewritten to more clearly describe the appeals process.*

The long-established policy of prohibiting the tax examiners from requesting information after the issuance of the Notice of Deficiency meant a lost opportunity for IRS to take steps to resolve audit issues. This policy especially affected EITC claimants whose examination process is so telescoped. The recent action by the IRS, prompted by a collaborate effort of TAS and IRS, resulted in the discontinuation of this practice. With Chief Counsel approval the IRS issued a National Alert on November 25, 2002[116] *to tax examiners to continue to work with the taxpayer to resolve the tax matter after the issuance of the Notice of Deficiency, provided the taxpayer is notified that the time for filing a petition continues to run. TAS believes this policy change will enable taxpayers and the IRS to communicate more effectively, reduce taxpayer burden and correctly resolve more EITC audits.*

[114] *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 1998-FY 2002:* Appendix A, Department of the Treasury, Internal Revenue Service, February 28, 2002.

[115] U.S. General Accounting Office, *Earned Income Tax Credit Participation*, GAO –02-290R December 14, 2001.

[116] IRM Procedural Update; Number W 03090; "Taxpayer Replies to 90 Day Letter".

PROBLEM

TOPIC #8 LACK OF RESPONSE DURING EITC EXAMS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage and Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The lack of personal contact with an IRS examiner during an EITC examination imposes an unnecessary burden on EITC filers and leaves some taxpayers unsure of the status of their cases. Taxpayers continue to report frustration in getting through by telephone to the IRS specialists listed on the notices they receive, and employees fail to return calls from taxpayers, their representatives and Taxpayer Advocate Service (TAS) case advocates.[117] Remote Examination employees do not use the telephone as a primary means of communication with customers, even when a phone call could answer audit status questions and resolve cases instead of letting them progress to a statutory notice of deficiency.

ANALYSIS OF PROBLEM

Before 1998, the IRS campuses' (formerly service centers) Remote Examination functions were called "Correspondence Audit." In May 1998, as part of its efforts to improve customer service, the IRS moved to establish a toll-free telephone system in Remote Examination. This system was implemented nationwide in November 2000. Taxpayers selected for examination are given a toll free number to call if they have questions about the documentation requested by mail to support items claimed on their returns, or about the status of their cases.

It has been a challenge for Campus Remote Exam employees to use the telephone effectively in examinations. The toll-free operation has required changes in examination processes and the examiners' approach. Correspondence had long been the preferred and often the only means of communication.[118] The toll-free phone number is now listed on all letters, beginning with the initial contact letter, which notifies the taxpayer of the pending exam.[119] All EITC filers selected for audit by Remote Examination are provided a toll free number to call about the documentation requested or the status of their case.[120] However, taxpayers, low income taxpayer clinic representatives and IRS employees have indicated that this number is answered by voice mail. One clinic reported that it has never received a response to any message left on the voice mail.[121]

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[117] IRS Customer Satisfaction Survey, Service Center Examination, March 2001.

[118] IRS Commissioner, Wage and Investment Division, Memorandum for Treasury Inspector General for Tax Administration, Response to Audit Report #200140041, Implementation of the Remote Examination Toll-Free Telephone Program is Ongoing, December 7, 2001.

[119] Letter 566-B (SC/CG) (Rev. 11-2000).

[120] Id.

[121] Legal Aid Society of Minneapolis, Comments to a Local Taxpayer Advocate, June 2002.

Additionally, a recent revision to the Internal Revenue Manual (IRM) requires examiners to attempt telephone calls three times before sending a letter requesting additional information.[122] However, examinations are still completed without such contact, and some cases that could have been resolved by telephone instead progress to the issuance of a statutory notice of deficiency. At that point, the taxpayer has 90 days to file a petition in the United States Tax Court.

This lack of communication leads to unnecessary frustration on the part of taxpayers and adds a significant expense to taxpayers who are least able to afford it. One Low Income Taxpayer Clinic reported to the National Taxpayer Advocate that 80 percent of the EITC taxpayers it represented before the Tax Court had their deficiencies reduced or abated.[123] A recent review of EITC-related docketed appeals cases bears out the clinic's experience.[124]

Some taxpayers' documentation is submitted several times and is never associated with the audit file. Many cases are closed and the EITC denied without the taxpayer ever knowing whether the IRS received or considered the documentation. In audit reconsideration cases, taxpayers and practitioners have presented certified mail receipts to the Taxpayer Advocate Service to substantiate that information was sent to the IRS timely yet not acted upon.

IRS COMMENTS

While the remote/correspondence exam process is not premised on telephone contact during examination, the IRS is concerned with the current level of access when taxpayers do try to reach us by telephone related to their EITC examinations.

In an effort to improve customer service to taxpayers, the IRS established a toll-free telephone system in remote Examination operations on the campuses during fiscal year 2000. Initial contact letters sent to taxpayers provide toll-free numbers for the taxpayers to call with general inquiries. These calls are answered in centralized phone units, which are staffed by telephone assistors. While waiting to reach a live assistor, the taxpayers can listen to pre-recorded messages that may answer their question or wait to speak to the assistor. However, in fiscal year 2002 the number of calls received at these phone units increased at a pace that could not be matched with available resources, making it very difficult for IRS to be responsive to taxpayers at the desired level.

[122] Internal Revenue Manual (IRM), Service Center Examinations Operations, § 4.19.1.4.6.

[123] Georgia State University, College of Law Tax Clinic reported that of the 25 taxpayers that they represented in cases before the United States Tax Court during the May 2002 trial calendar, 15 had their entire proposed deficiency abated and five taxpayers had the deficiency substantially abated.

[124] The August 2002 Appeals Office review, completed at the request of the Taxpayer Advocate Service, shows that in a sample of 125 docketed EITC cases, 85.6 percent received government concession. Of those, 58.4 percent received full concession, and 27.2 percent received partial concession.

Taxpayers may experience telephone access issues not only when contacting the centralized phone units discussed above but also when taxpayers are trying to reach the tax examiner assigned to their case. When taxpayers provide a response to the initial inquiry requiring further interaction, taxpayers are given the telephone number of the tax examiner handling their case; however, based on workload levels, taxpayers may not always be able to easily reach that tax examiner.

The IRS believes that additional resources are needed to effectively handle the volume of calls regarding EITC examinations. However, in an effort to maximize the efficiency of current telephone operations, new initiatives such as the implementation of an Inventory Management Tool, which enables management to more consistently match available resources with projected telephone demand will continue.

IRS INITIATIVES TO RESOLVE PROBLEM

Improving taxpayers' access during the remote examination process became one of our top priorities in fiscal year 2002 and the following actions are being taken to support this goal:

- A new IRM section, (IRM 4.19.18(4)), requiring tax examiners to respond to all taxpayer calls within three business days will be implemented in November 2002,
- Fax machines have been placed in all remote examination units so taxpayers can forward documentation directly to the tax examiner assigned to their case which may reduce the need to contact the tax examiner by telephone to provide further clarification.
- An Inventory Management Tool has been implemented that enables managers to better forecast the resource demands associated with projected telephone demands. Use of this tool should improve taxpayers' ability to reach an examiner by telephone.
- A new Correspondence Examination Automation Support (CEAS) system is currently being developed. In fiscal year 2003, CEAS will provide telephone assistors in the centralized units with universal access to case information and providing this information may reduce the number of taxpayer callbacks and requests for information needed.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate appreciates IRS efforts to improve customer service by establishing a toll-free telephone system in Remote Examination and committing to increase funding for improvements in telephone service in FY 2003. We can appreciate the difficulty the IRS faces in handling the substantial increase in demand for Remote Examination toll-free service, as well as the IRS' concern about the impact on taxpayer level of access.

TAS agrees that the deployment of toll-free telephone assistors, rather than auditors, to answer general inquiries from initial contact letters is a better use of Campus Remote Examination resources. Equipped with the W&I Examination Toll-Free Telephone Procedural Guide, assistors can readily respond to most taxpayer inquiries. However, the responses outlined in the guide are generic. A taxpayer with specific questions about his or her case will not have these questions referred to an examiner unless a specific examiner is working the case and the taxpayer asks for that examiner's telephone extension.[125]

The case is not assigned to an examiner until the taxpayer sends in correspondence and the correspondence is associated with the case. We suggest that the IRS take telephone numbers from taxpayers at any point in the process when they wish to be contacted by the examiner. This will to help facilitate communication during the examination process.

We are concerned that Remote Examination sites comply with the mandate of the IRS Restructuring and Reform Act of 1998 (RRA98) relating to assignment of audits. The use of telephone assistors to handle taxpayer telephone calls does not fulfill the assurance given by W&I to the Treasury Inspector General for Tax Administration (TIGTA) to provide taxpayers with a single point of contact throughout the examination process. We concur with the TIGTA suggestion that reviewing telephone activity reports in conjunction with local Quality Review staff assessments may help ensure compliance with RRA98.[126]

We strongly support the IRS' continued emphasis on the requirement to call the taxpayer before sending a letter requesting additional information. [127] *Furthermore, the Taxpayer Advocate Service has elevated the recommendation that more emphasis be placed on contacting third parties to validate EITC*

[125] IRS, *W & I Examination Toll-Free Telephone Procedural Guide*. "Note: No calls are to be transferred to a tax examiner, unless a taxpayer who has inadvertently been routed through to the phone units asks to be transferred to a specific extension."

[126] IRS Commissioner, Wage & Investment Division, Memorandum for Treasury Inspector General for Tax Administration; Response to Audit Report #2002-40-034 Recommendation 1, "The Commission W & I Division, should ensure that Remote Examination sites comply with RRA 98 mandates relating to the assignment of Audits and the inclusion of specific information on IRS audit correspondence." Implementation of the Remote Exam Toll-Free Telephone Program is Ongoing, December 7, 2001.

[127] IRS Commissioner, Wage & Investment Division, Memorandum for Treasury Inspector General for Tax Administration; Response to Audit Report #2002-40-034 Recommendation 2, " The Commissioner, W & I Division, should ensure that auditors attempt telephone contact with the taxpayers who provide the IRS with a telephone number when additional information is needed." *Implementation of the Remote Exam Toll-Free Telephone Program is Ongoing* (December 7, 2001).

claims. In most instances, examination employees opt not to contact third parties because of the administrative procedures required in these contacts. RRA98 Section 3417 enacted IRC §7602(c)(1), which prohibits IRS employees from contacting persons other than the taxpayer to obtain information relating to a determination of tax without prior notification to the taxpayer and without following certain other administrative requirements.[128] *The Taxpayer Advocate Service looks forward to IRS support for increased use of third party contacts in eligibility determinations.*

We are pleased with ongoing initiatives to improve taxpayer access to Remote Examination. The proactive policy of requiring examiners to respond to all calls within three business days is significant. Placing facsimile machines in all units to receive documentation directly from taxpayers should greatly reduce instances of unassociated taxpayer documentation. We look forward to further improvements that the Inventory Management Tool and Correspondence Examination Automation Support will engender. The Taxpayer Advocate Service will continue to follow these initiatives in FY 2003.

[128] In addition to notifying taxpayers that they will be contacting a third party, Service employees must maintain records of third parties contacted and send the taxpayer a list of those third parties both periodically and at the taxpayer's request.

PROBLEM TOPIC #9 IRS OVERSIGHT OF EITC RETURN PREPARERS CAN BE IMPROVED

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joe Kehoe – Commissioner, Small Business/Self-Employed Division
David B. Palmer – Chief, Criminal Investigation

DEFINITION OF PROBLEM

The laws and regulations governing family status in the Internal Revenue Code are numerous and complex. As a result, taxpayers must often seek the service of paid tax preparers to claim credits and benefits on returns. Low income taxpayers are particularly susceptible to this need. They rely extensively on paid preparers to assist in navigating the intricacies of the Earned Income Tax Credit (EITC).[129] Paradoxically, the very practitioners that taxpayers depend on for help account for one third of EITC related mathematical errors on tax returns.[130] Further, of the approximately 161,000 returns selected for EITC examination in 2002, through mid-October nearly 67 percent (108,000) were preparer-filed returns.[131] Tax returns selected for examination represent returns that the IRS believes have a high probability of error.

EITC filing errors caused by tax law complexity may be unintentional, or result from inadvertent misinformation supplied by taxpayers. The lucrative nature of the tax preparation business and the vulnerability of needy EITC claimants leave the field open for casual, if not unscrupulous preparers.[132]

IRS statistics show that for tax year 1999, paid preparer returns accounted for 33 percent of math errors related to EITC. While it is unknown whether the tax preparer or the taxpayer provided the incorrect information, this error rate clearly demonstrates there are a number of problems associated with professionally prepared returns.

[129] For tax year 2000, 46 percent of W&I low income filers and 65 percent of EITC claimants used a paid preparer. (IRS Wage and Investment, "Tax Year 2000 Return Information (Nationwide)."

[130] For tax year 1999, self-prepared returns generated 616,929 math errors, paid preparers other than H & R Block offices generated 302,642 and H & R Block returns generated 10,675 math errors. The IRS, Volunteer Income Tax Assistor and Tax Counseling for the Elderly preparer groups assisted with returns that generated 9,993 of the over 900,000 math errors identified on TY 1999 returns. Tax year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

[131] IRS Wage and Investment Office of Research, "Measuring Effectiveness of EITC Dependent Database – PY 2002 (Project #3-02-12-3-004/CR-33A)", Interim Report #2 (November 2002).

[132] Forty percent of taxpayers who get Refund Anticipation Loans (short term loans by commercial tax preparers and the banks that provide the loans secured by the taxpayers' tax refund) are EITC recipients. Tax refund loan costs siphon off an estimated $324 million in loan fees and cost an additional $670 million in tax preparation, electronic filing fees, and check cashing fees every year from the Earned Income Tax Credit. Consumer Federation of America and the National Consumer Law Center Inc., *"Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed From The Working Poor and The U. S. Treasury,"* January 31, 2002, available at www.consumerlaw.org - Special Reports, October 2002.

ANALYSIS OF PROBLEM

During processing year 2000, paid preparers filed 44 percent of paper returns and 82 percent of electronic returns claiming EITC.[133] Each year, the Internal Revenue Service reports the top ten mathematical and clerical errors on returns submitted by paid preparers. Earned Income Tax Credit related errors appeared among the top errors on Forms 1040, 1040A and 1040EZ paper returns in processing year 2002 (through July 26, 2002), the primary error being the "Earned income credit was figured or entered incorrectly."[134] In addition, the IRS selects returns for examination based on the high probability of those returns containing unallowable or misreported items. A recent interim report compiled by the IRS Office of Research determined that during processing year 2002, 66.9 percent of the returns selected for EITC examination, based on pre-determined probability rules, were completed by paid preparers.[135]

Simplifying the complex family status provisions of the Code could reduce errors, as proposed by the National Taxpayer Advocate in her fiscal year 2001 Annual Report to Congress.[136] However, given the error rates of EITC returns prepared by paid preparers, more immediate measures are needed.

Four types of individuals prepare returns professionally:

- Attorneys – An attorney is licensed and regulated by state agencies and is generally required to maintain his or her knowledge base through continuing education. Attorneys often prepare taxes for clients in connection with other legal matters, for example, business and estate planning. Attorneys are authorized to represent taxpayers in practice before the IRS.
- Certified Public Accountants (CPAs) - A CPA is licensed by a state agency and is required to maintain his or her knowledge base through continuing education. CPAs can often provide useful financial planning advice in addition to tax preparation. CPAs are authorized to represent taxpayers in practice before the IRS.
- Enrolled Agents (EAs) - Enrolled agents are certified by the IRS; many are former employees of the agency. They are also authorized to represent taxpayers in prac-

[133] Paid preparers filed 12.1 million of the 18.5 million EITC returns processed during 2000. IRS Wage and Investment Division, "TY 2000 Return Information (Nationwide)."

[134] Internal Revenue Service, The Digital Daily – Tax Professionals, *Top Errors for Paid Preparers on Paper Return Submissions* (Through July 26, 2002), available at www.irs.gov.

[135] The IRS Dependent Database process adds external data from the Department of Health and Human Services and Social Security Administration to internal and applies a comprehensive set of rules to score returns for audit selection. IRS Wage and Investment Office of Research, *Measuring Effectiveness of EITC Dependent Database* – PY 2002 (Project #3-02-12-3-004/CR-33A), Interim Report #2 (November 2002).

[136] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001), Pages 76-127.

tice before the IRS. Enrolled agents also have to maintain continuing education requirements.[137]

- Unenrolled Return Preparers- This category consists of many different types of preparers, from financial planners and retired accountants to part-time preparers operating out of check-cashing businesses. An unenrolled return preparer is not authorized to represent taxpayers before the IRS, except with regard to an examination of a return prepared by that preparer. They have no federal licensing or education requirements.

"Tax preparers may range from certified experts with credentials who are knowledgeable in new tax changes through continued education to an unlicensed, unqualified person with a pencil and a calculator trying to make a little extra money to pay off holiday debts."[138]

It is this last group of tax preparers that causes concern to tax administrators and low income advocates alike. If an EITC refund is denied because of a preparer's error, the low income taxpayer faces substantial hardship. Until the IRS is able to regulate this group of preparers, other means of preventing errors on EITC returns must be explored, either by educating practitioners directly or through increased partnering with outside organizations that provide return preparation training.

Some tax preparers intentionally disregard the tax laws, or fail to solicit the correct information from the taxpayer, to obtain erroneous refunds and larger service fees. While there are many reputable tax professionals that assist their clients with return preparation, there are also those who provide less than accurate information, causing clients' refunds to be "frozen" and their claims disallowed.

The IRS reported that during the past three fiscal years, the Return Preparer Program initiated 96 criminal investigations involving return preparer schemes relating to fraudulent EITC claims. These investigations identified a minimum of 6,854 questionable returns claiming over $18 million dollars in unsubstantiated EITC. The IRS Questionable Refund Program netted 176 investigations involving over 7,000 questionable returns claiming over $17 million dollars in fraudulent EITC.[139] These efforts are commendable and we encourage the IRS to continue on this course.

[137] In order to qualify for enrollment to practice before the Internal Revenue Service, an individual must demonstrate competence in tax matters by written examination in addition to other requirements. Effective after March 31, 2004, an individual must certify on an application for renewal of enrollment that he/she has satisfied specified continuing professional education requirements. For example, a minimum of 16 hours of continuing education credit must be completed during each calendar year in the enrollment term. Source: Department of the Treasury, Treasury Department Circular No. 230, "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service – Title 31 Code of Federal Regulations, Subtitle A, Part 10, Subpart A–*Rules Governing Authority to Practice* (July 26, 2002).

[138] *Learn About Taxes: Choosing the Right Tax Preparer*, available at http://www.taxgaga.com, October 21, 2002.

[139] Department of the Treasury, Internal Revenue Service, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 1998 – FY 2002* (February 28, 2002).

To facilitate accurate EITC claims, Congress enacted Internal Revenue Code section 6695(g).[140] This provision authorizes the IRS to impose a penalty on preparers for failing to exercise due diligence in determining clients' eligibility for the EITC and the amount of the credit. Any person who prepares a return or claim for refund for compensation or employs other persons to prepare returns or claims is considered an income tax return preparer.[141] The preparer must complete Form 8867, Paid Preparer's Earned Income Credit Checklist, or otherwise record the answers to the questions it contains, and retain the form (or substitute) and the appropriate worksheets in his or her records for three years. Failure to meet the due diligence requirements could result in a $100 penalty for each failure under IRC § 6695(g). This penalty could deter fraudulent EITC returns; however, only 101 penalties were assessed during fiscal year 2001.[142] The IRS can place more emphasis on enforcing the requirements of IRC § 6695(g).

While the taxpayer is ultimately responsible for the information on his or her return, the tax preparer is also responsible for showing diligence in preparing the return.[143] The IRS must take the lead in assuring that paid preparers are adequately trained and updated on tax law changes and that unscrupulous preparers are not allowed to continue their unethical, illegal practices. To meet this challenge, the IRS must seek to educate the preparer community by, for example, conducting ongoing outreach. It must guard against the fraudulent claims of those taxpayers and return preparers who seek to use the system for personal gain. Establishing standards and procedures for registering and certifying tax preparers under IRS guidelines may be one way to reduce fraudulent claims and produce a higher percentage of error free tax returns.

IRS COMMENTS

The IRS agrees that IRS oversight of EITC return preparers can be improved. We also believe that this issue is equally important for non-EITC returns and return preparation.

To meet the challenge of providing improved oversight, the IRS must continue a balanced strategy of providing education to the preparer community through ongoing outreach and guarding against the fraudulent claims of those return preparers who seek to use the system for personal gain through preparer investigations and sanctions. We also believe that

[140] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Section 1085(a)(2).

[141] Internal Revenue Manual 4.19.1, Service Center (Campus) Examination Operations, *Return Preparer Penalties*, Page 13 (Rev. October 1, 2001).

[142] Commissioner, Wage and Investment Division, Earned Income Tax Credit Program Office, *IRS Tracking – Earned Income Tax Credit Appropriation, Fourth Quarter – FY 2001*.

[143] Treasury Department Circular No. 230 (Rev. 7-94) *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service*, §10.22 Diligence as to accuracy.

establishing standards and procedures for registering and certifying all tax preparers under IRS guidelines would provide a new and effective tool by reducing fraudulent claims, producing a higher percentage of error free tax returns, and advancing the cause of providing better tax services to the public.

While the taxpayer is ultimately responsible for the information on his or her return, tax preparers are also responsible for showing diligence in preparing returns and it is clear the IRS has an oversight role in the exercise of this diligence.

IRS INITIATIVES TO RESOLVE PROBLEM

To the extent resources allow, the IRS will increase enforcement actions against those return preparers who are identified as consistently submitting erroneous and/or fraudulent returns.

The IRS intends to issue an advance notice of proposed rulemaking shortly that will request public comments regarding a proposal that would require registration and certification for all tax preparers.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Taxpayer Advocate Service believes that tax return preparers who operate in low income communities and handle EITC returns require a heightened level of monitoring and regulation. Generally, non-EITC refunds are made up of income tax withholding paid through income withholding, whereas the EITC refund is a refundable credit paid with public funds. In 2001, the federal EITC provided over $30 billion to 18.5 million low-income taxpayers. Low income taxpayers provide a source of significant revenue for legitimate and unscrupulous preparers alike. Many members of the low income community must compensate for a lack of education, language barriers, fear or intimidation, and have little in the way of bank accounts or cash on hand to pay for tax preparation. Studies estimate that $994 million in EITC refunds were recycled to tax preparers and related businesses in the form of preparation, filing, loan and check cashing fees.[144] The IRS must undertake a significant consumer education campaign so that low income taxpayers are able to make informed choices between tax preparers and tax preparation products.

The IRS' efforts to increase outreach to the practitioner community through field visits and other contacts are commendable and the National Taxpayer Advocate supports increased activity in this area. The IRS recognizes the need to increase enforcement of current due diligence requirements by imposing monetary penalties on preparers that make multiple false claims for EITC and seeking criminal sanctions when appropriate.

[144] Consumer Federation of America and the National Consumer Law Center Inc., *"Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed From The Working Poor and The U. S. Treasury,"* January 31, 2002 at www.consumerlaw.org - Special Reports (October 2002).

The results of a recent Gallup survey indicate that the outreach visits could be refocused, however. The survey analysis concluded that, "The lower the education level of the tax preparer, the more useful he or she found the IRS EITC visit to be."[145] *Undeniably, the ever-increasing use of paid tax preparers for EITC filers means the IRS needs to become ever more involved in the education and oversight of tax preparers.*

The National Taxpayer Advocate commends the IRS for seeking public comments on a proposal that would establish standards and procedures to regulate and certify tax return preparers. The National Taxpayer Advocate is proposing a legislative certification scheme to address this problem. (See "Regulation of Federal Return Preparers" elsewhere in this report.) Several states have passed legislation to govern preparers of income tax returns, both state and federal. For example, California requires a $5,000 bond be maintained by all tax preparers (definition also defined in the code section) which "shall be payable to, the people of the State of California and shall be for the benefit of any person or persons damaged by any fraud, dishonesty, misstatement, misrepresentation, deceit, or any unlawful acts or omissions by the tax preparer, or the tax preparers employed or associated with it to provide tax preparation services."[146]

Additionally, the current EITC compliance appropriation was scheduled to expire September 30, 2002. For the IRS to continue its EITC-related strategies, Congress must appropriate necessary funds. The National Taxpayer Advocate supports a continuation of funding for these efforts, which are estimated to have saved the government five billion dollars with an appropriation of $716 million over the past five years.

[145] The Gallup Organization, *EITC Preparer Outreach Program Customer Satisfaction Questionnaire*, (March 6, 2000), Page 3.

[146] California Business & Professions Code Section 22250-22259, at http://www.ctec.org/html/legislative_authority.html

PROBLEM TOPIC #10 THE LENGTH OF EITC AUDITS CONTRIBUTES TO TAXPAYER CONCERNS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage and Investment Division
Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Earned Income Tax Credit (EITC) correspondence audit process requires taxpayers to substantiate their eligibility for the credit they claim. As part of the process, the IRS must select, notify and further correspond with taxpayers, reviewing and analyzing the verification they provide. The various steps add time to the audit.[147] Of critical importance to low income taxpayers is that most EITC audits are conducted in a pre-refund environment, which involves holding the taxpayer's refund, including any income tax withholding, until the audit is finished. As a result, delays in the EITC audit process can have significant economic consequences to taxpayers. The more expeditious the process, the more quickly taxpayers can receive their refunds when warranted.[148]

The lack of available resources to handle the cases under audit consideration contributes to delays. For example, if their returns are not selected for audit after they are notified of a frozen refund, taxpayers are told the IRS will issue a letter in eight weeks to inform them of the refund status.[149] Historically, an average of only 43 percent of such refunds are issued within the stated timeframe.[150] Furthermore, as of July 2002, there were still more than 25,000 pieces of over-age correspondence waiting to be reviewed.[151]

The IRS must protect the government's revenue while ensuring that taxpayers who are eligible and entitled to refunds receive them timely. Resource limitations are preventing the IRS from meeting this goal.

[147] The average time to complete an EITC audit was 265 days in fiscal year 2001. Source: "Exam Measures" July 2002. IRS Wage & Investment Report, September 2002.

[148] An analysis of 1998 audited EITC cases showed that 66 percent ultimately received a refund. The average amount of the refund was $1,420. Source: Tax Year 1998, Compliance Research Information System (CRIS), Model IFM 2002.

[149] IRS Letter 75 or 75A is issued to notify the taxpayer that his/her refund is being held and the timeframe for the next contact.

[150] U.S. General Accounting Office, *Earned Income Credit Opportunities To Make Recertification Program Less Confusing and More Consistent*, GAO-02-449 (Washington, D.C.: Apr. 25, 2002), page 36.

[151] Total over-age mail (status 57) means returns identified on the status workload review list as having correspondence over 60 days old; taxpayer has responded but case has not been worked. Source: "Exam Measures" July 02.xls. IRS W& I Director, Examination Strategy and Selection Report, September 2002.

ANALYSIS OF PROBLEM

The issue of lengthy EITC examinations was identified as one of the most serious problems facing taxpayers in the 2001 National Taxpayer Advocate Annual Report to Congress.[152]

Procedures

EITC cases fall under the Revenue Protection Strategy (RPS), which freezes the taxpayer's entire refund pending completion of the audit. The examination begins when cases are selected from the Electronic Fraud Detection System (EFDS) files, the dependent database (DDb), research extracts, or prior audit activity.

Prior to 1997, correspondence audits involving EITC began with an initial contact letter informing the taxpayer of an impending audit and requesting documentation to prove the item(s) claimed.[153] A follow-up letter was sent with an examination report and another request for information.[154] If the taxpayer did not respond, the case remained open for 232 days.[155] The audit timeframe could be shortened or lengthened according to the type of verification documents sent by the taxpayer.

To address concerns about the lengthy audit process, the IRS revised its procedures. The correspondence audits now combine the initial and follow-up letters into one, referred to as a "Combo" letter. A letter informing the taxpayer of a delay in tax refund and possible examination precedes this "Combo" letter.[156] The letter states, "IRS may audit your tax return for reasons relating to filing status, earned income credit or dependent(s). We will send you a letter within 30 days if we are going to examine your return before we issue your refund…if we are not going to examine your return, you will receive notification from us within eight weeks. We apologize for any inconvenience." The taxpayer is not asked to respond during this first 30 days because IRS has not yet decided whether to examine the tax return.

If the IRS decides to examine the tax return, the "Combo" letter is sent requesting documentation to verify eligibility for the EITC.[157] It includes a report of changes for taxpayer signature. If the taxpayer does not respond, a Statutory Notice of Deficiency is sent. The

[152] National Taxpayer Advocate, *FY 2001 Annual Report to Congress;* Publication 2140, (revised 12-2001), page 26.

[153] Letter 566.

[154] Letter 525.

[155] IRM 4.19.1, Figure 4.19.1-3, Correspondence Exam Non-EITC Timeline on Refund Returns.

[156] Letter 75 or Letter 75A, which relates to Recertification.

[157] Letter 566B, which combines the request for supporting documentation with the explanation of the proposed adjustment and appeal rights.

Statutory Notice of Deficiency explains timeframes and guidance concerning petitioning the United States Tax Court if the taxpayer does not agree with the proposed assessment.[158]

Plans and Resources

Although correspondence audit timeframes have been reduced, the audit process remains a lengthy one. Based on a July 2002 statistical report, the average time to complete an EITC audit during fiscal year 2001 was 265 days. Furthermore, 33,000 cases remained open more than one year.[159]

The correspondence audit plan incorporates cases which are selected for examination based on prior audit activity. They include the "Pickup" cases (current year returns examined for the same issue as the prior year audit), EITC claims (1040X), audit reconsiderations and recertification cases. Although 26 percent of the plan in FY 2001 was set aside for these cases, they actually consumed 41 percent of planned cases started, thus affecting the ability to complete current workload.[160]

Low Income Taxpayer Clinics and Local Taxpayer Advocates report that the timeframes promised in the delay of refund letters sent to EITC claimants have not been met. As an example, a Low Income Taxpayer Clinic reported that a taxpayer received a "delay of refund" letter dated March 4, 2002, informing him that his refund was being held for 30 days pending a possible audit. The next contact was a "Combo" letter requesting documentation to substantiate the EITC claim. The letter was dated May 17, 2002, well beyond the 30-day timeframe.

Taxpayer Advocate Service cases include those requests for assistance from taxpayers because the IRS has not responded to the taxpayer within 30 days or by the promised date.[161] In FY 2002, EITC TAS cases numbered 40,411. Of those, 60 percent or 24,287 resulted from operational delays.[162] This is another indication that timeframes for EITC audits are problematic.

[158] IRC § 6213 (a) Time for filing petition and restriction on assessment. Within 90 days, or 150 if the notice is addressed to a person outside the United States, after the notice of deficiency, authorized in IRC § 6212 is mailed… the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency.

[159] Exam Measures" July02.xls. IRS Wage & Investment Director, Examination Strategy and Selection, EITC Advisory Council Meeting, September 2002.

[160] EITC New Starts: Plan vs Actual: Source Doc: Weekly SC Reporting DTD, as of August 4, 2001.

[161] IRC 7811§(a)(2)(B); (IRM 13.1.7.2 Taxpayer Advocate Case Criteria; Criteria #5 and #6.

[162] Commissioner's Monthly Reports, Receipts FY 2002: TAS Office of Program Planning and Quality. EITC issues account for 18 percent of all TAS receipts. EITC receipts include major issue codes 470 (math error EITC issues), 471 (EITC/RPS Exam Projects), 472 (EITC Invalid SSN), 474 (EITC Criminal Investigation). Also included are 52 percent of major issue code 610 (Open Audits) and 38 percent of code 620 (Audit Reconsiderations). Does not include an unspecified number of EITC refund inquiry cases.

IRS COMMENTS

The IRS is devoting significant resources to increasing taxpayer awareness of EITC requirements, improving selection accuracy for EITC examinations and simplifying the return examination process. One of the primary purposes of the increased emphasis in these areas is to increase taxpayer participation in the examination process.

Taxpayer participation plays a key role in the length of EITC audits. During fiscal year 2002, the time required to complete an EITC examination when the taxpayer did respond was approximately 167 days for no change cases and 96 days for agreed cases. While we continually strive to reduce this timeframe, in contrast, for those cases where the taxpayers did not respond (these cases frequently later re-enter the examination process as audit reconsiderations), the time required to complete the examination increased to approximately 272 days. It is clear that taxpayer cooperation not only improves the accuracy of case resolution, but also shortens the timeframe of the examination process.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS continues to strive for improved efficiency in the EITC examination process, as well as increased taxpayer participation and an overall reduction in taxpayer burden. One automation initiative recently developed to improve system efficiency is the Batch Processing System, which allows for a more expeditious response to taxpayers who do participate in the examination process.

The simplification of examination notices, increased taxpayer participation in examinations, and process improvements has resulted in a reduction of the number of EITC cases that take more than 365 days to close. During fiscal year 2002, the number of EITC cases in inventory for more than 365 days was reduced by 27 percent.

Additional actions to reduce the length of EITC examinations include the following:

- Simplifying the Form 886H so that the information provided to the taxpayer directly relates to their individual issue. This change is aimed at improving the taxpayer response rate to the initial inquiry, because taxpayers will not be so overwhelmed by the amount and complexity of the information provided on the form (much of which is not applicable to their situation). The revised Form 886H will be implemented in January 2003.
- Continuing to refine and clarify all forms, notices and letters, to facilitate taxpayer participation in the examination process, which will reduce the length of EITC examinations.

TAXPAYER ADVOCATE SERVICE COMMENTS

TAS acknowledges the actions taken to reduce the timeframes for EITC audits. The 27 percent decrease in cases more than 365 days old is very significant and reflects the IRS' attention in this area. Although the IRS response does not indicate the reason, improvements in batch processing may have had an impact on inventory.

While batch processing allows for more expeditious treatment where a taxpayer does respond, it does not address the problem of high volumes in "no response" cases. Conducting research to better understand and address the reasons for a high "no response" rate in EITC audit process is a clear imperative for increasing taxpayer participation and improving audit results.

Use of the "Combo" letter leaves a smaller window of opportunity for the taxpayer to respond timely in writing, or for the IRS to associate taxpayer correspondence with the case before the computer-generated notice of deficiency is sent. The Audit Information Management System, effective January 2003, will alleviate some of the problem by preventing premature issuance of a statutory notice of deficiency. A further problem for taxpayers is that a phone call to the IRS in response to an audit notice does not interrupt the batch processing system cycle, and taxpayers are still required to provide written documentation.

Although the IRS comments do not indicate the method, we assume that the reference to simplifying the return selection process is based on the use of the Dependent Database in the selection process of EITC returns.[163] The Wage & Investment Division Fiscal Year 2003 Performance Plan indicates that the total number of Correspondence Examination audits for FY 2002 decreased by 12 percent to 575,000, of which more than 80 percent are EITC.[164] "The decrease reflects the efforts of the IRS to improve targeting of unproductive EITC examinations through full implementation of the Dependent Database and new procedures that allow taxpayers to self-correct errors in lieu of traditional examinations."[165] The identification of high–risk cases early in the process is critical to meeting customers' needs and increasing their satisfaction with the time required for resolution of their issues. In addition, we note in IRS plans that additional time will become available to front line employees through overhead reduction and a decreased demand for assistance during the filing season.[166]

[163] The Dependent Database, which the IRS uses for electronic selection of EITC cases for examination, is based on a combination of state data and other internal and external sources that can be used as evidence of support and residency of children.

[164] IRS Wage & Investment, Strategy and Finance; Performance Improvement, Strategy Planning and Budget Cycle, Phase 4, FY 2003 IRS Annual Performance Plan. Page PA-63.

[165] Id.

[166] W & I Strategy and Finance, Performance Improvement, Strategy Planning and Budget Cycle; "FY 2003 IRS Annual Performance Plan" page PA-44.

The Taxpayer Advocate Service agrees that investment in electronic risk-based selection, such as the Dependent Database, and electronic processing of tax returns, will alleviate some of the strain on resources in Correspondence Exam.[167] *However, we also believe that the reliance on the Dependent Database is premature. The Federal Case Registry Study is currently evaluating data used in the Dependent Database.*[168] *If the results of the Federal Case Registry Study show that the states' data is not reliable, the IRS should devise a backup plan that will reduce the timeframe for holding refunds.*

Taxpayer refunds, including any undisputed portions of the refunds, are held pending the outcome of the audits. This policy can have serious economic consequences for taxpayers and has surfaced as a problem in a related section of this report ("Procedures for Examining EITC Claims Cause Hardship," Most Serious Problems #7). Many refunds held are released at least in part (and with interest) at the conclusion of the audit. A recent analysis of EITC returns audited for 1998 indicated that 66 percent of the taxpayers ultimately received refunds.[169] *The IRS is considering partial refund release during processing. The National Taxpayer Advocate strongly supports such an approach and looks forward to immediate implementation.*

[167] "EITC Program Effectiveness and Program Management FY1998-2002," page 8. System enhancements will also identify taxpayers who would benefit from alternative treatments, such as soft notices.

[168] The Federal Case Registry (FCR) Study was developed to evaluate the accuracy and timeliness of data contained in FCR database prior to use of the Dependent Database in the Math Error Processing, mandated for Tax Year 2004. The FCR is maintained by the Department of Health and Human Services to which states are required to electronically submit data regarding all child support cases handled by the state Title IV-D child support agencies and all non-Title-D support orders established or modified after October 1, 1998. The Dependent Database, which the IRS uses for electronic selection of EITC cases for examination audit, contains FCR data combined with other internal and external sources that can be used as evidence of support and residency of children.

[169] Tax year 1998, Compliance Research Information System (CRIS), Model IFM 2002.

PROBLEM TOPIC #11 EITC RECERTIFICATION COMPOUNDS TAXPAYER BURDEN

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Taxpayers experience a multitude of problems when they try to recertify their eligibility for the EITC in years after the credit has been disallowed. These problems include:

- EITC disallowance letters do not give taxpayers an explanation of the documentation necessary to establish EITC eligibility in subsequent years.
- A blank Form 8862, Information to Claim Earned Income Credit After Disallowance, is not provided at the end of the process; rather, the taxpayer must seek out the form independently.
- The timing of recertification audits negatively impacts the EITC claims made by the taxpayers for subsequent years.
- Taxpayers mistakenly receive EITC math error disallowance notices and requests to file the Form 8862 in a subsequent year, because the IRS does not remove recertification indicators from taxpayers' accounts when warranted.
- The Form 8862 does not advise the taxpayers that the recertification process will delay any refund.
- The information that taxpayers are required to provide on the Form 8862 is not used in the examination recertification process.
- The IRS is not meeting contact timeframes promised in IRS letters.

ANALYSIS OF PROBLEM

Internal Revenue Code section 32(k) authorizes the IRS to disallow a taxpayer's EITC for any tax year after 1996 if the taxpayer is ineligible for any reason other than a mathematical or clerical error. Taxpayers must "recertify" that they are eligible for the credit the next time they claim EITC by attaching to that return a completed Form 8862, Information to Claim Earned Income Credit After Disallowance. When the IRS receives a recertification request with the tax return, it automatically selects that return for examination.

Problems identified in the 'recertification' process and reported in the FY 2001 Annual Report to Congress are still occurring.[170] The General Accounting Office recently reported

[170] National Taxpayer Advocate's, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001) pages 36-38.

that, "Although IRS made some changes to its correspondence, improved its examiner training, and expanded taxpayer outreach, certain aspects of the Recertification process continue to cause problems for taxpayers."[171]

When the IRS disallows all or part of the EITC claimed, it sends a letter advising the taxpayer that he or she must recertify eligibility for EITC on the next return claiming the credit by completing and attaching Form 8862, Information to Claim Earned Income After Disallowance.[172] The letter also states the IRS may ask for additional documentation. However, the letter does not say what documentation is needed to support residency, relationship, filing status, and other eligibility requirements.[173]

For tax year 1999, the IRS disallowed the EITC or otherwise rejected the return on more than 61,000 paper returns[174] and nearly 75,000 electronically filed ones[175] because taxpayers failed to attach the required Form 8862. An escalating number of the more than 88,000 tax year 2001 EITC claims on paper returns were disallowed because Form 8862 was missing.[176] The IRS explained that it does not enclose Form 8862 with the prior year EITC disallowance letter because of "the time lapse between having the EITC disallowed in one year and the filing of the subsequent year's return claiming EITC again."[177] The IRS believes that to do so would invite the taxpayer to incorrectly attach the form to a claim for the disallowed year, or to file it separately before the subsequent year filing. However, in light of the significant number of Forms 8862 omitted from filed returns, it appears problems persist.

The timing of recertification audits remains an issue. Low Income Taxpayer Clinics report a problem frequently occurs when (1) the taxpayer is denied EITC in the first year; (2) files a return the second year accompanied by Form 8862; and (3) the IRS does not complete its audit allowing the second year claim before the due date of the third year. Thus, the IRS will automatically deny the later year claim as a math error, for failure to include a Form 8862 on the third year return, even when the IRS ultimately determines the taxpayer is entitled to the EITC in year two and releases the recertification indicator for that

[171] General Accounting Office, *Earned Income Credit – Opportunities To Make Recertification Program Less Confusing and More Consistent*, GAO-02-449, April 2002.

[172] IRS Computer Paragraph Notice 79 (formerly Letter 3094).

[173] In most instances, the disallowance letter for the prior year is sent at a time when the taxpayer can begin accumulating the proof needed to claim the EITC for the subsequent year. Most EITC audits are closed by the end of the year in which a timely return is filed. If the disallowance letter included examples of the types of supporting documentation needed to recertify, taxpayers would have several additional months to secure that information before filing.

[174] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

[175] IRS ELF1545 report dated 4/18/2000.

[176] IRS Wage & Investment, IMF Error Code Report (P/R/F/: 480-62-11) through September 2002.

[177] National Taxpayer Advocate, FY 2001 Annual Report to Congress, page 37.

year. However, if the taxpayer does submit Form 8862, the third year return will be subject to audit and a delayed refund. The lengthy audit cycle creates an endless loop for EITC-eligible taxpayers, and delays refunds for years.

During the 1999 tax year (through September), the IRS failed to remove 11,400 recertification indicators on the records of 19,200 taxpayers for whom EITC was allowed.[178] Local Taxpayer Advocates report this problem persists, particularly when the EITC is fully allowed as the result of the Audit Reconsideration process.[179] The IRS recently issued an Internal Revenue Manual update to clarify that examiners should release the indicator on cases where the EITC is fully allowed even though the filing status and/or dependent exemptions are disallowed.[180] Failure to remove the indicator means future claims for the EITC may be erroneously denied and at the very least results in delayed refunds and taxpayer burden.

Taxpayers are not advised that filing Form 8862, Information to Claim Earned Income Credit After Disallowance, will likely delay their refund, nor for how long. The latest version of the instructions does include the cautionary note, "In addition to filing Form 8862 and, if required, Schedule EIC, you may be asked to provide other information before any refund resulting from the EIC claimed on your return is issued."[181] However, this statement does not go far enough in explaining the likelihood of the delay. For fiscal year 2001, the average cycle time for an EITC audit was 265 days (cumulative through July).[182] The length of the process and lack of information about timeframes result in unnecessary taxpayer contacts with the Taxpayer Advocate Service. Local Taxpayer Advocates report that many taxpayers believe that completing Form 8862 will grant the claim immediately.

Though there is significant burden to the taxpayer in completing Form 8862, the IRS does not routinely review or utilize the form in conducting the examination. [183] The IRS

[178] Treasury Inspector General for Tax Administration, *Improvements Are Needed in the Earned Income Credit Recertification Program*, Reference Number: 2001-40-030, December 2000.

[179] Audit reconsideration is an IRS procedure designed to help taxpayers when they disagree with the results of an IRS audit. The taxpayer must not have signed an agreement, should have information that the IRS did not previously consider which might change the determination, and the taxpayer provides a copy of the audit report. (IRS Publication 3598, *What You Should Know About The Audit Reconsideration Process* (Rev. July 2000).

[180] IRM Procedural Update, W 02642, September 26, 2002.

[181] Instructions for Form 8862, Information To Claim Earned Income Credit After Disallowance (Rev. November 2000).

[182] IRS Wage & Investment, Director, Examination Strategy and Selection, EITC Advisory Council Meeting, September 2002.

[183] Form 8862 includes two pages of instructions and two pages of questions for the taxpayer to answer regarding each EITC qualifying child. The IRS estimates that it takes an average of approximately 2 hours 19 minutes to keep records, learn about the law or the form, prepare, copy, assemble and send the Form 8862 to the IRS. (Instructions for Form 8862, Information to Claim Earned Income Credit After Disallowance, Paperwork Reduction Act Notice, Rev. November 2000).

does not transcribe or otherwise use the information provided on the form.[184] When attached to the tax return, the form serves merely as a flag in the system to initiate the recertification process. When the return is flagged, the taxpayer's entire refund is frozen while the examiner reviews the return information (not the Form 8862) to determine whether to perform a full audit. If the review indicates an EITC audit is appropriate, letters are sent requesting documentation to substantiate eligibility for the credit. In a 1999 report, the U.S. General Accounting Office (GAO) recommended that the IRS cease using Form 8862 if it is not needed for recertification purposes.[185] In a follow-up report, GAO stated "IRS did not eliminate the form because it said it relies on the form to 'identify the type of action to be taken for taxpayers required to recertify.'"[186] In practice, however, it does not benefit taxpayers to answer two pages of questions on the form including the child's relationship to the taxpayer, the addresses where the taxpayer lived with the child, and the name of the school or day care provider.

Once a refund is withheld, the IRS is not adhering to timeframes that it gives taxpayers on the initial notice of a possible audit (CP 75A). This initial letter states that taxpayers will be notified within 30 days if their return will be examined or, if not examined, given the status of their refunds within eight weeks. Taxpayers and practitioners have reported the second letter is delayed or often never received.[187] These taxpayers believe they deserve timely and informed treatment concerning their claims.

IRS COMMENTS

We agree that taxpayers experience problems when they attempt to recertify eligibility for EITC. These problems are often directly related to the lack of taxpayer awareness of the EITC requirements in general and more specifically, the requirements to recertify eligibility for the credit after it has been disallowed.

The lack of taxpayer participation in the examination process also contributes to recertification problems. When taxpayers do not participate, the examination process is prolonged and there is an increased likelihood that another return will be filed and selected for examination prior to the completion of the examination of the first return.

In addition, the Service will continue to identify improvements to the recertification process that will reduce the current issues some taxpayers encounter.

[184] The form does not require the taxpayer to list the name or social security number of the EITC qualifying child, for example.

[185] U.S. General Accounting Office, *Tax Administration: IRS' 1999 Tax Filing Season*, GAO/GGD-00-37 (Washington, D.C.: December 15, 1999).

[186] U.S. General Accounting Office, *Earned Income Credit – Opportunities to Make Recertification Program Less Confusing and More Consistent*, GAO-02-449 (Washington, D.C.: April 2002).

[187] The second notification is a combination letter advising the taxpayer that he or she has been selected for audit and includes a computation of the proposed changes (generally Letter 566 series).

IRS INITIATIVES TO RESOLVE PROBLEM

The National Taxpayer Advocate's 2001 Report to Congress acknowledges that IRS has made some changes to its correspondence, improved its examiner training and expanded taxpayer outreach. The IRS is taking the following additional steps to improve the recertification process by:

- Initiating a research study to evaluate the recertification process including the effectiveness of Form 8862, Information to Claim Earned Income Credit After Disallowance. Revisions to the form that will improve communication, reduce taxpayer burden and aid the recertification/examination processes will be a primary focus. Initial recommendations from this study should be completed by June 2003.
- Revising the EITC disallowance letter based on the recommendations of the Taxpayer Advocate EITC Task Force. This revised letter (released in September 2002) now includes information concerning the possibility of future examinations, and the related documentation requirements. In addition, the revised letter provides a website and telephone number to assist taxpayers in obtaining Form 8862.
- Creating monthly reports for all campuses that identify any cases with recertification indicators that should have been removed. These reports will be used by campus personnel as a tool to ensure that indicators are removed from the taxpayer accounts in a more timely fashion. Actions have also been initiated to have the recertification indicators systemically removed. This program change is scheduled for implementation in FY 2004.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS on its establishment of the task force to review the recertification process and the Form 8862 in partnership with Wage and Investment, Office of Research. Notably, the Taxpayer Advocate Service has also been invited to participate in this process that we expect will generate solutions to reduce taxpayer burden while ensuring adherence to the tax laws.

The IRS acknowledges that many recertification problems are caused by the taxpayers' difficulty in understanding EITC rules and in documenting eligibility. We encourage the IRS to take every opportunity to fill the void in taxpayers' understanding through education, outreach, and individual taxpayer contact. We are pleased to note the IRS has revised the EITC disallowance notification (CP79/79A) to include the EITC eligibility documentation requirements among other useful changes. This change will give taxpayers much-needed additional time to provide required items. We look forward to reviewing the final version.

An additional opportunity for guidance may have been overlooked. The IRS Publication 596, Earned Income Credit, and the EITC instructions should contain a section entitled "What You May Have to Furnish the IRS if Your EITC Eligibility is Questioned."

Failure to attach Form 8862, Information to Claim Earned Income Tax Credit After Disallowance, is the fifth largest of the approximately 24 categories of EITC math errors caused by taxpayers.[188] While the IRS is unclear about the occurrence, in recognizing the problem the IRS decided to place a contact website and telephone number on the disallowance notice to facilitate the taxpayer's obtaining the blank Form 8862. This is a step in the right direction. We are puzzled, however, as to why the form is not included in Form 1040 series tax packages for the particular taxpayers who are required to recertify, using the recertification indicator as a trigger. Though including the form in the tax package would be the practical solution, an alternative recommendation would be to target a mailing of the form to the appropriate taxpayers.

In December of each year, the IRS should consider generating to all taxpayers whose accounts have recertification indicator "1" a letter explaining the recertification process, including their right to appeal, and enclosing the blank Form 8862. The mailing should advise the taxpayer of the circumstances in which to attach the completed Form 8862 to the subsequent year tax return.

We are pleased that the IRS has revised instructions to Form 8862 in its November 2002 edition to advise "…The process of establishing your eligibility to take the ETIC will delay your refund." This statement should lessen taxpayer frustration resulting from recertification processing delays.

Taxpayers required to recertify because of a disallowed child in the prior year often stop claiming the disallowed child in the current year and claim only the income- based EITC.[189] Under current procedures (Processing Year 2002), the EITC refund is automatically held under the recertification procedures and is subsequently released manually by an examiner. A 2001 TIGTA (Treasury Inspector General for Tax Administration) recommendation, subsequently approved by the IRS, requires recertification only if the taxpayer claims EITC in the current year based on the same reason it was denied in the prior year.[190] IRS should implement programming to systemically identify these claims and without delay issue the refunds under these circumstances.

The National Taxpayer Advocate also recommends the following changes to the Recertification Program procedures that may serve to enhance the program's effectiveness and reduce taxpayer burden:

- *The IRS should consider allowing the Service Center Error Resolution Function to correspond for missing Forms 8862 rather than to immediately disallow the EITC using the math error procedures.*

[188] Tax Year 1999, Compliance Research Information System (CRIS), IFM 2000.

[189] IRC § 32(c)(1)(A)(ii).

[190] Treas. Reg. § 1.32-3.

- *The IRS should require tax examiners to simultaneously address all open tax returns claiming EITC to prevent taxpayers having to submit some of the same information numerous times to different employees and to prevent various determinations being made.*
- *Removal of any expired or erroneous recertification indicator from a taxpayer's account is critical to normal processing since failure to do so unnecessarily delays the refund. It is commendable that programming to alleviate the problem of erroneous indicators is scheduled for 2004. However, in the interim, we encourage the IRS to emphasize the importance of manually removing the indicators with IRS campuses based on monthly reports.*

PROBLEM TOPIC #12 LANGUAGE & CULTURAL BARRIERS IMPACT TAXPAYER COMPLIANCE

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division
Judy Tomaso – Office of Tax Administration Coordination
John M. Robinson – Office of Equal Opportunity Employment & Diversity
Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The demographics of multilingual or English-as-a-Second-Language (ESL) taxpayers present unique challenges for tax administrators.[191] New arrivals to the United States often live below the poverty level and possess little understanding of the U.S. tax system and its cultural doctrine of voluntary compliance. Preparing tax returns, claiming the Earned Income Tax Credit (EITC), communicating with the IRS, responding to IRS letters or notices, and understanding taxpayer rights are particularly vexing. ESL taxpayers have a unique incentive to seek tax preparation assistance. They rely on preparers at a higher rate because of the complexity of federal tax laws, literacy problems, IRS compliance initiatives, and fear of the IRS.[192]

English-as-a-Second-Language taxpayers acutely need services in post-filing tax controversies.[193] In the return examination process, for example, cultural or behavioral differences present unique challenges for the auditor and taxpayer. The IRS may not always be sensitive to the particular characteristics of a taxpayer's situation, which might require the auditor to do some additional probing. To complicate matters further, ESL taxpayers receive IRS notices that are not written in their native language.

ANALYSIS OF PROBLEM

Early results from the 2000 U.S. Census noted a significant growth in the non- English speaking or multilingual population over the past decade. In particular, the Census highlighted the increase in Hispanic/Latino sector, now the fastest growing U.S. minority. Their numbers increased by 58 percent during the 1990s, from 22.4 million to 35.3 million. Hispanics now represent the largest ethnic/racial group in the U.S. (12.5 percent).[194] The Census also revealed that in a number of metropolitan areas, the majority of the pop-

[191] ESL taxpayers are sometimes referred to as Limited English Proficiency or (LEP) taxpayers.

[192] Michael O'Connor, *Tax Preparation Services for Lower-Income Filers: A Glass Half Full, or Half Empty?* 2001 Tax Notes Today, 5-106.

[193] Leslie Book, *Tax Clinics: Past the Tipping Point and to the Turning Point*, 2001 Tax Notes Today 161-75, August 2001.

[194] The Brookings Institution, Center on Urban & Metropolitan Policy and The Pew Hispanic Center, *Latino Growth in Metropolitan American: Changing Patterns, New Locations*, July 2002.

ulation is multilingual and speaks a language other than English.[195] Take, for example, the results from the following fast-growing population centers:

TABLE 1.12.1
PERCENT SPEAKING A LANGUAGE OTHER THAN ENGLISH

Santa Anna CA (Orange County)	83.6
Miami Fl	75.9
El Paso TX	73.2

TABLE 1.12.2
PERCENT SPEAKING SPANISH AT HOME:

Santa Anna CA (Orange County)	74.0
El Paso TX	69.5
Miami Fl	66.0

The problems impacting ESL taxpayers can generally be categorized into two broad areas: language barriers rooted primarily in limited English language proficiency; and cultural barriers that are unfamiliar to tax administrators or unrecognized by the tax system.

For example, unenrolled tax preparers flourish in many ethnic communities. Often these businesses operate only during filing season and close their doors on April 16, thereby being unavailable to help their customers cope with follow-up notices from the IRS. Low income taxpayer clinics have reported that even if these offices are still in business, many are unwilling to assist with subsequent notices.

Most IRS literature (tax forms, instructions, notices, etc.) is not printed in languages other than English.[196] For example, a Spanish version of Form 1040 is not available.[197] The IRS is engaged in initiatives designed to address the needs of taxpayers with limited English proficiency.

The IRS does not issue a Spanish version of letters to taxpayers whose EITC claims are being examined (e.g. Letter 566-B or statutory notice of deficiency). Currently, examiners use locally translated letters. (Several EITC publications are, however, printed and available in Spanish.) IRS notices and letters in English are difficult or sometimes impossible for taxpayers with limited English proficiency to comprehend. As a result, many do not

[195] U. S. Census Bureau, *Census 2000 Supplemental Survey*, available at http://www.census.gov (November 6, 2002).

[196] A limited number of IRS tax documents have Spanish versions, none of which are printed in languages other than English and Spanish. IRS Digital Daily, Forms and Publications, available at http://www.irs.gov/individuals/index.html.

[197] Tax Administration Council Minutes, June 17, 2002.

respond to letters or notices, and are thus unaware of and suffer the consequences of not responding.

The IRS also has no Spanish letters for taxpayers whose returns are subject to the Underreporter Program, so ESL taxpayers are further handicapped in communication with the IRS. ESL taxpayers also have specialized needs in the process of filing Form W-7, and in obtaining Individual Taxpayer Identification Numbers (ITINs).[198] The IRS requires all foreign and domestic taxpayers to provide either a Social Security Number (SSN) or an ITIN when filing returns. While IRS personnel are generally aware that ITINs are not valid for claiming the EITC, there is no requirement to inform immigrants who are later issued a SSN that they can amend a return filed under an ITIN and claim the EITC for any open tax year.

IRS has no way to determine the language spoken by taxpayers to facilitate communication when they enter the tax system.

IRS COMMENTS

Language barriers represent a problem for all federal agencies and the IRS has recognized for many years that language can be a major barrier for Limited English Proficient (LEP) taxpayers - referred to as "multilingual" by the Taxpayer Advocate - in fully exercising their tax rights and responsibilities. Even before the President signed Executive Order 13166 in August 2000 requiring all federal agencies to "improve access to services for persons with Limited English Proficiency," the IRS was providing a growing number of products and services to address the needs of LEP taxpayers.

These efforts became even more focused in 1998 with the enactment of the Restructuring and Reform Act of 1998 (RRA98). Two Sections of the Act spoke directly to language issues: Section 3705(c) required the establishment of Spanish telephone help-lines and Section 1203 (b)(3) established the External Civil Rights Unit (ECRU) which was tasked with addressing allegations filed by taxpayers who alleged violation of the Title VI of the Civil Rights Act of 1964.

The IRS followed in 1999 with an official Policy Statement (P-6-41) on multilingual services, in 2000 with the start up of the Spanish telephone helpline, and in 2001 with the establishment of the Multilingual (MLI) Project Office to oversee a five-year Servicewide Multilingual Strategy. This Office was charged by the Commissioner to ensure that the goals of IRS Policy Statement were attained: "*The IRS commits to provide top quality service to*

[198] The ITIN is used by alien individuals who are required to furnish a United States Taxpayer Identification Number to the IRS but who do not have, and are not eligible to obtain, a social security number. Form W7, Application for IRS Individual Taxpayer Identification Numbers, is used to apply for an ITIN. An ITIN is intended for tax use only. (IRC § 6109; Regs. sec. 301.6109-(d)).

each taxpayer, including those who lack a full command of the English language. The needs of these taxpayers will be included in the agency strategic and tactical plans consistent with available resources. Our workforce will have the essential tools necessary to interact appropriately with our diverse taxpayer base."

In addition to the Taxpayer Advocate's analysis of the problem, we are focusing on the larger demographic picture of which LEP taxpayers are a part. Data from the 2000 Census shows that over 10.4 million U.S. residents are LEP, denoting that they speak a language other than English and speak English either not well or not at all. This represents 3.8 percent of the total U.S. population. Spanish speakers represent 71 percent of that segment which equates to 3.2 million of the total LEP population. The remaining 29 percent of the LEP population is comprised of over 100 other languages or language groups.

Although the IRS is aware that projections for 2005 indicate these numbers will increase, the Service has an obligation to use its increasingly constrained resources where they will serve the maximum number of taxpayers. To date the emphasis for other-than-English has been placed on the Spanish language, as an attempt to address all languages would be cost prohibitive. The focus of the Multilingual Strategy has been to balance our sincere desire to serve all taxpayers with a realistic assessment of where resources will best be used. The following section focuses on the current MLI initiatives to identify where those resources best serve the taxpayer with limited English proficiency.

IRS INITIATIVES TO RESOLVE PROBLEM

In November 2000, MLI teams, consisting of IRS personnel, the National Treasury Employees Union (NTEU) and the Hispanic Internal Revenue Employees (HIRE) organizational representatives, were established to develop recommendations for improvement and expansion of IRS products and services for LEP taxpayers. The Taxpayer Advocate Service was invited to join these teams. The teams, initially focusing on the needs of the Spanish-speaking taxpayer, developed thirty-two recommendations in seven areas:

- Telephone Services
- Notices, Forms, Letters, Publications
- Monitoring and Tracking of Spanish-Language Correspondence
- Processes for Assessing Bilingual Services
- Training/Tools for Employees
- Internal and External Communications
- Outreach and Taxpayer Education.

The scope of these efforts is comprehensive but we will focus our response on the specific issues that the National Taxpayer Advocate has raised regarding service to taxpayers with Limited English Proficiency.

The National Taxpayer Advocate's analysis that "a limited number of IRS tax documents have Spanish versions (and) none are printed (in) other languages" significantly understates the number of IRS products. There are over 246 official IRS forms, letters, notices and publications available in Spanish and a growing, unofficial number of documents in other languages such as Chinese, Russian and Vietnamese. Employees who are fluent and have voluntarily produced translations provide these. As part of the MLI effort, in January 2003 the IRS will identify the next five languages for "official" translation of products and services.

Although the documents that the National Taxpayer Advocate mentions in her report are certainly important, for the moment the IRS is focusing on the input that is coming directly from Spanish-speaking taxpayers and their organizational representatives. To ensure that we are translating the documents deemed important by that community, this year the IRS worked with representatives of the Taxpayer Advocate Service to contact over 140 Low Income Taxpayer Clinics and Tax Clinics for the Elderly, three out of the four Citizen Advocacy Panels, the Congressional Hispanic Caucus, the Association of Latino Professionals in Finance and Accounting, the League of Latin American Citizens and the Internal Revenue Service Advisory Council. The short list of documents that came from that research of our external stakeholders is now being matched up with the research on customer needs that is going on throughout the Service. That research includes the recent Hispanic Communication Initiative, customer service studies by the front-line IRS service providers and several recently established systems to track and measure demand for Spanish language products and services. Thus it is also incorrect that the "IRS has no process in place to determine the language spoken by taxpayers" as noted by the National Taxpayer Advocate.

The IRS has already identified the issue of Form W-7 and ITINs noted by the National Taxpayer Advocate and has revised and simplified the Spanish version of the W-7 for Filing Season 2003 and has improved the ITIN program training. Posters in Spanish that explain taxpayer's Civil Rights and the complaint process are being distributed to geographic areas in which there is a substantial Spanish-speaking customer base. In February 2003, the IRS will begin testing the addition of a line in Spanish on Examination and Automated Underreporter communications that would provide Spanish-speaking taxpayers a phone number to request the communication in Spanish.

To supplement the needs of taxpayers where we do not currently have translated documents, over-the-phone (OPI) translation services are now offered in all 406 taxpayer assistance centers. OPI is an easy to use, cost-effective service that allows IRS employees to communicate with limited or non-English speaking taxpayers through the use of an interpreter. The service is accessed from any telephone, enabling a three-way telephone conversation with the IRS employee, taxpayer and an interpreter. The only equipment needed is a telephone with a second handset or a speakerphone. OPI services over 140 languages and regardless of the language, a translator is always available.

There are now 24 kiosks around the nation with Spanish language information. Additionally, the IRS has expanded its Spanish help-lines, implemented Spanish language training and Spanish tools for those employees on the Spanish phone lines, established a cadre of Spanish-speaking trainers to deliver training to the phone assistors and expanded the Tele-Tax system to include Spanish language scripts.

The issue of unscrupulous practitioners operating in communities with limited English proficiency is one that also concerns the IRS. We believe that this issue, while it may be more pronounced in a community with large numbers of people with limited English proficiency, is part of the larger issue of the oversight of paid preparers which is addressed in this report (Section on "IRS Oversight of EITC Return Preparers Can Be Improved.") As noted in that section, paid preparers are not subject to the standards of Circular 230, "The Rules That Govern Practice before the IRS." Putting the Paid Tax Preparers on equal footing with Certified Public Accountants, Attorneys and Enrolled Agents in terms of Circular 230 will advance the cause of providing better tax services to both the English-speaking taxpayer as well as the taxpayer with limited English proficiency.

TAXPAYER ADVOCATE SERVICE COMMENTS

The efforts to increase outreach to the English-As-a-Second-Language (ESL) population are evident in the new Wage and Investment Division with responsibility for oversight and administration of the IRS Multilingual Initiative (MLI). Multilingual initiatives, with participation across all IRS operating divisions and functions, provide expanded customer service and public outreach programs to assist Spanish-speaking and other Limited English-Proficient taxpayers in meeting their tax obligations.

Despite these impressive efforts, TAS remains concerned that ESL taxpayers do not understand IRS notices or letters, or the consequences of failing to respond to them. We do not believe that the IRS has addressed our concern that there is no process in place to determine the language spoken by taxpayers at the ***outset*** *of their interaction with the tax system rather than further into the examination or collection stream. Tracking and measuring "demand for Spanish language products and services" is not the*

same thing as identifying, up front, a particular taxpayer's need for communications in Spanish from the beginning of his or her interactions with the IRS. Development of a check box on the tax return to identify the preferred language for taxpayer contact could facilitate communication. If transcribed and posted to the taxpayer's account during processing, this "preferred language indicator" would cause subsequent letters and notices to be printed in Spanish initially, and in other languages as the technology expands. The indicator could also prompt IRS notices to print the applicable IRS contact telephone number best suited to help the taxpayers in Spanish, or other desired language.

The strategy currently under development, aimed at assisting ESL taxpayers, understanding population behavior, identifying and handling unique taxpayer treatments and improving taxpayer participation, is commendable. Enhanced diversity or sensitivity training can help employees understand cultural differences and comprehend why, for example, a taxpayer may not be able to provide the requested documentation, and help this taxpayer provide alternates.

However, the IRS should explore not just the demographics of this population (or populations, given the diversity of the multi-lingual community). Many programs – federal, state, for-profit, and non-profit – have developed attitudinal, cultural, and psychographic profiles of various immigrant communities in the United States. The IRS should utilize this readily available information when designing audit programs, initiating collection contacts, and developing outreach strategies to the ESL community. Rather than "translating" current IRS strategies and imposing them on the ESL population, a more productive approach would entail designing a strategy that fits the characteristics of the target population.

Although we are pleased by the IRS' progress in translating forms and publications into Spanish, and its efforts to work with the Spanish speaking community and its advocates, it is simply unacceptable that the statutory notice of deficiency is unavailable in Spanish. The significance of this notice for taxpayer rights and due process cannot be understated. The Notice of Deficiency as defined under IRC § 6212 provides the taxpayer with a 90 day window within which to petition the United States Tax Court to protest a deficiency in tax ***before*** *it is assessed and* ***before*** *it is paid.*[199] *Regardless of whether Spanish speaking taxpayers or their representatives identify this notice as important, the IRS, on its own initiative and because of its understanding of the importance of this notice should immediately undertake the translation of the Notice of Deficiency into Spanish. The National Taxpayer Advocate will monitor this closely.*

[199] IRC § 6213(a), Restrictions applicable to deficiencies; petition to Tax Court.

PROBLEM TOPIC #13 FREE U.S. INDIVIDUAL INCOME TAX RETURN PREPARATION

IRS RESPONSIBLE OFFICIALS:

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM:

Low income taxpayers face numerous hurdles in obtaining free tax preparation and electronic filing.

- The Internal Revenue Service limits the resources available for free tax preparation in Taxpayer Assistance Centers (TACs), despite a demonstrated need by low income taxpayers.
- Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs do not always provide electronic filing.
- Low income taxpayers without electronic access or filing capabilities will not be able to benefit from the EZ-Tax Filing Initiative.

ANALYSIS OF PROBLEM:

Taxpayer Assistance Centers:

The IRS instituted uniform guidelines for Form 1040 return preparation in the IRS Taxpayer Assistance Centers ("Walk-in Offices") in fiscal year 2001. In prior years, local IRS executives determined which offices would provide return preparation services. This approach resulted in inconsistent service throughout the country.

In January 2001, the IRS issued nationwide standards for return preparation. The criteria for fiscal years 2001 and 2002 are shown in table 1.13.1

PROBLEMS

TABLE 1.13.1
TAX RETURN CRITERIA IN TAXPAYER ASSISTANCE CENTERS TAC FOR FY 2001 AND 2002

TAC CRITERIA	FISCAL YEAR 2001[200]	FISCAL YEAR 2002[201]
Current Filing Tax Year	2000 U.S. Individual Income Tax Return	2001 U.S. Individual Income Tax Return
Income Limits	Less than or equal to $41,000 Adjusted Gross Income	Less than or equal to $33,000 Adjusted Gross Income
Forms	• Form 1040, U. S. Individual Income Tax Return • Form 1040A, U.S. Individual Income Tax Return • Form 1040-EZ, Income Tax Return for Single and Joint Filers with No Dependents	• Form 1040, U. S. Individual Income Tax Return • Form 1040A, U.S. Individual Income Tax Return • Form 1040-EZ, Income Tax Return for Single and Joint Filers with No Dependents
Schedules	• Schedule A, Itemized Deductions • Schedule EIC, Earned Income Credit • Schedule R, Credit for the Elderly or the Disabled • Schedule B, Interest Only	• Schedule A, Itemized Deductions • Schedule EIC, Earned Income Credit • Schedule R, Credit for the Elderly or the Disabled • Schedule C-EZ, and Schedule SE Self-Employment Tax (in conjunction with C-EZ only). • Schedule B, Interest Only
Other Forms	Form 2290, Heavy Vehicle Use Tax Return	• Form 2290, Heavy Vehicle Use Tax Return • Form 2441, Child and Dependent Care Expenses • Form 8812, Additional Child Tax Credit • Form 8839, Qualified Adoption Credits • Form 8863, Education Credits
Excluded	• Schedule C - Profit or Loss From Business • Schedule D – Capital Gains and Losses • Schedule E – Supplemental Income and Loss or • Schedule F – Profit or Loss From Farming • Form 2106, Employee Business Expenses • Schedule B, Dividend Only	• Schedule C - Profit or Loss From Business • Schedule D – Capital Gains and Losses • Schedule E – Supplemental Income and Loss or • Schedule F – Profit or Loss From Farming • Form 2106, Employee Business Expenses • Schedule B, Dividend Only

[200] Field Assistance Operational Procedures for Fiscal Year 2001.

[201] Field Assistance Operational Procedures for Fiscal Year 2002.

The Taxpayer Assistance Centers (TACs) provide return preparation on a first-come, first-served basis, but resources limit the number of customers the centers can handle. Each office stops assisting taxpayers when the maximum capacity for any given day is reached, which means taxpayers must often come back several times to obtain services.[202]

In addition to tax return preparation for qualifying individuals, TAC provides the following services:

- Account inquiries and adjustments
- Payments/payment arrangements
- Tax law assistance
- Procedural inquiries
- Securing Individual Taxpayer Identification Numbers
- Multilingual assistance
- Securing copies of tax returns and transcripts
- Copies of tax forms
- Alien clearance

Taxpayers filed more than 124 million individual returns during calendar year 2000 and 126 million during calendar year 2001.[203] Table II compares the volume and percentage of returns prepared by different types of preparer. For both years, approximately 31 percent of the returns filed – representing 38 million taxpayers – were at income levels that qualified for the Earned Income Tax Credit.

TABLE 1.13.2
TAX RETURNS BROKEN DOWN BY TYPE OF PREPARER, 2000 & 2001

PREPARER TYPE	CALENDAR YEAR 2000[204] TAX RETURN PERIOD 1999		CALENDAR YEAR 2001[205] TAX RETURN PERIOD 2000	
	VOLUME	PERCENTAGE	VOLUME	PERCENTAGE
Paid Preparer	67,899,473	54.5	67,829,748	53.5
Self	55,199,230	44.3	57,469,999	45.4
TAC	292,887	.2	325,659	.3
VITA	648,526	.5	596,539	.5
TCE	479,012	.4	518,094	.4
Total	**124,519,128**	**100**	**126,767,039**	**100**

202 IRS Field Assistance Operational Procedures for fiscal year 2002.

203 Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2000, and Tax Year 2000 Compliance Research Information System (CRIS), Model IFM 2001.

204 Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2000.

205 Tax Year 2000, Compliance Research Information System (CRIS), Model IFM 2001.

IRS Operations' Strategic Plan for fiscal year 2003 indicates a planned reduction of 25 percent in tax return preparation.[206] The number of returns prepared for calendar year 2002 was not available. However, based on data for calendar years 2000 and 2001, the average number of returns prepared by TACs was about 309,000. A 25 percent reduction would result in over 77,000 low income taxpayers not receiving assistance.

The Director of Field Assistance stated that the IRS justification to reduce resources is based on the fact that 25 percent of available resources are used to serve the 10 percent of taxpayers who request assistance with tax return preparation.[207]

There is currently no method of tracking the total volume of taxpayers not assisted or turned away due to lack of resources.[208]

VITA and TEC Programs

The Stakeholder Partnership, Education & Communication (SPEC) organization in the Wage & Investment Division trains volunteers to help prepare basic returns for taxpayers with low or limited incomes, individuals with disabilities, English as a second language (ESL) and elderly taxpayers through the Volunteer Income Tax Assistance (VITA) program. The volunteers work at neighborhood centers, libraries, schools, churches, shopping malls and other locations. Some of these locations offer limited electronic filing at no charge.

SPEC also administers Tax Counseling for the Elderly (TCE), a grant program to organizations that offer free tax help to people aged 60 or older. Volunteers visit retirement homes, neighborhood sites, or the houses of the homebound in addition to preparing returns in public locations. Some of these organizations offer free electronic filing.[209]

With the reduction of return preparation at TACs, IRS expects various VITA/TCE sites to supplement the services previously provided by the TAC offices. A recent study by the Treasury Inspector General for Tax Administration (TIGTA) indicated that SPEC has several barriers to overcome before achieving this goal.[210] These barriers include:

[206] Fact Sheet, *Return Preparation in IRS Taxpayer Assistance Centers*, rev. 10/2/02.

[207] Per interview conducted with Director of Field Assistance on July 11, 2002.

[208] Per Field Assistance Operational Procedures for fiscal year 2002, Appendix A, the taxpayers cannot call to make an appointment and must travel to the TAC to obtain an appointment. The appointment may not be on that day, which would require the taxpayer to make a second trip to the office for return preparation. The taxpayer must provide the social security card (not just number) for all individuals filing and dependents. If a joint return is being filed, both husband and wife must come to the office together. If the taxpayer does not know these requirements in advance, he or she must make a return trip to the TAC.

[209] To qualify for the TCE cooperative agreement an organization must be a non-profit (IRC section 501) organization and experienced in coordinating volunteer programs, preferably with some experience in income tax preparation. http://www.egrants.irs.gov/index.htm.

[210] Treasury Inspector General for Tax Administration, *The Internal Revenue Service Needs to Improve the Pre-Filing Tax Services Provided to Taxpayers*, Reference Number: 2002-40-174, September 2002.

- Reduction of approximately 1,000 volunteer sites.
- Staffing shortages.
- Inadequate computer equipment for VITA.
- Shortage of technical assistance.[211]

The free services provided by TACs, VITA and TCE prepared a total of 1.1 percent of all returns filed for tax years 1999 and 2000. The following tables demonstrate the volume of filers meeting the income eligibility criteria for EITC based on income levels, dependents, and method of filing.

The data in Tables 1.13.3 and 1.13.4 shows the ratios of the three primary free services offered to taxpayers (IRS/TAC, VITA and TCE). Of those, the TACs helped prepare returns for only two-tenths of one percent of the total returns filed.

TABLE 1.13.3
TAX YEAR 1999 RETURNS FILED BY INCOME LEVEL AND SERVICES USED[212]

	1999 INCOME ELIGIBILITY LIMIT OF $10,200 WITH NO DEPENDENTS (PERCENT)[213]	1999 INCOME ELIGIBILITY LIMIT OF $26,928 WITH ONE DEPENDENT (PERCENT)[214]	1999 INCOME ELIGIBILITY LIMIT OF $30,580 WITH TWO OR MORE DEPENDENTS (PERCENT)[215]	1999 TOTAL RETURNS FILED FOR ALL LEVELS OF INCOME (PERCENT)
Paid Prepared	41.3	65.1	69.2	54.5
Self-Prepared	57.2	33.3	29.4	44.3
TAC Prepared	0.4	0.5	0.4	0.2
VITA Prepared	0.6	0.8	0.9	0.5
TCE Prepared	0.5	0.3	0.1	0.4
Total	100.0	100.0	100.0	100.0

[211] "Technical assistance includes delivery and setup of computers at volunteer sites, installation and updates of the necessary software needed to e-file tax returns, and troubleshooting and fixing problems with the computers." *The Internal Revenue Service Needs to Improve the Pre-Filing Tax Services Provided to Taxpayers*, Reference Number: 2002-40-174, TIGTA, dated September 2002, page 12.

[212] The total data figures were stratified to provide the potential number of individuals that meet the income and/or exemption levels for earned income credit for the 1999 U.S. Federal Income Tax Return. The actual number of individuals that qualified for earned income credit will vary. Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2000.

[213] $10,200 is the 1999 income eligibility limit for the childless taxpayer claiming EITC. Field Assistance Operational Procedures for Fiscal Year 1999.

[214] $26,928 is the 1999 income eligibility limit for taxpayers claiming EITC with one dependent. Field Assistance Operational Procedures for Fiscal Year 1999.

[215] $30,580 is the 1999 income eligibility limit for those claiming EITC with two or more dependents. Field Assistance Operational Procedures for Fiscal Year 1999.

TABLE 1.13.4
TAX YEAR 2000 RETURNS FILED BY INCOME LEVEL AND SERVICES USED [216]

	2000 INCOME ELIGIBILITY LIMIT OF $10,380 WITH NO DEPENDENTS (PERCENT)[217]	2000 INCOME ELIGIBILITY LIMIT OF $27,413 WITH ONE DEPENDENT (PERCENT)[218]	2000 INCOME ELIGIBILITY LIMIT OF $31,152 WITH TWO OR MORE DEPENDENTS (PERCENT)[219]	2000 TOTAL RETURNS FILED FOR ALL LEVELS OF INCOME (PERCENT)
Paid Prepared	57.4	34.2	29.9	45.4
Self-prepared	41.0	64.4	68.8	53.5
TAC Prepared	0.3	0.6	0.3	0.3
VITA Prepared	0.5	0.5	0.7	0.5
TCE Prepared	0.7	0.4	0.2	0.4
Total	100.0	100.0	100.0	100.0

E-Z Tax Filing:

The Secretary of the Treasury has announced that 78 million taxpayers will have access to free tax return preparation by the 2003 filing season.[220] This proposed agreement is supported by a group of private sector companies working together to offer free online filing services. The responses received about this proposal were posted in the Federal Register on August 4, 2002. They indicated approval from the segment of the population that is at ease with technology and knowledgeable about tax laws. However, this initiative would not reach low-income taxpayers who lack access to or knowledge of this technology. These taxpayers are also less familiar with the law, and consequently require the services of a tax professional or IRS (TAC, VITA or TCE) to ensure that they receive all available credits and deductions.[221] A 1999 IRS study on the traffic at IRS "walk-in" sites concluded that only 31 percent of taxpayers seeking return preparation services had internet access.[222]

[216] The total data figures were stratified to provide the potential number of individuals that meet the income and/or exemption levels for earned income credit for the 2000 U.S. Federal Income Tax Return. The actual number of individuals that qualified for earned income credit will vary. Tax Year 2000, Compliance Research Information System (CRIS), Model IFM 2001.

[217] $10,380 is the 2000 income eligibility limit for the childless taxpayer claiming EITC. Field Assistance Operational Procedures for Fiscal Year 2000.

[218] $27,413 is the 2000 income eligibility limit for the childless taxpayer claiming EITC. Field Assistance Operational Procedures for Fiscal Year 2000.

[219] $31,152 is the 2000 income eligibility limit for the childless taxpayer claiming EITC. Field Assistance Operational Procedures for Fiscal Year 2000.

[220] *Federal Register Notice on Free Internet Filing, Federal Register*, Volume 67, No 153, August 8, 2002, (FR Doc 02-19835 Filed 8-5-02)

[221] *Responses to Federal Register Notice on Free Internet Filing Agreement (i.e., EZ Tax Filing Initiative)*, Internal Revenue Service, Electronic Tax Administration, September 17, 2002.

[222] North Florida, Brooklyn, Central California, Houston, and North Central District Offices Research and Analysis (DORA), *Walk-In Taxpayer Demographic and Attitudinal Profile*, April 2000.

IRS COMMENTS

We concur that access to free income tax return preparation is a serious issue facing taxpayers. Our Stakeholder Partnership, Education & Communication (SPEC) organization has been and will continue to be proactive in identifying locations where the maximum number of eligible taxpayers *(taxpayers with low or limited incomes, taxpayers for whom English is their second language, elderly taxpayers, and individuals with disabilities)* can have access to free tax return preparation services.

In the Field Assistance (FA) organization, providing face-to-face assistance to customers with notice and account problems is a primary function; however, to the extent resources permit, needs-based return preparation service is provided. The development of a needs-based income criteria for free return preparation was done to help focus limited resources on that taxpayer segment most in need of these services. The income criterion for free preparation corresponds to the income level for Earned Income Tax Credit (EITC) eligibility or $35,000 (for Fiscal Year 2003). In addition to the income criteria there are also form and schedule limitations for free preparation. It should be noted that although return preparation represents 11 percent of the services provided in Taxpayer Assistance Centers (TACs), it has historically required 25 percent of the total resources. Return preparation has been a cross divisional effort with a significant portion of the resources needed coming from Small Business and Self-Employed (SB/SE) Division which diverted personnel from critical Compliance functions whose primary mission is to audit returns and collect delinquent accounts. Establishing criteria to qualify for return preparation allows us to continue providing free income tax return preparation to those most in need, while not impacting other priorities.

IRS INITIATIVES TO RESOLVE PROBLEM

- During the past two years, IRS has worked diligently to co-locate VITA sites in close proximity to TACs. During the 2002 filing season, we operated 179 co-located Volunteer Income Tax Assistance (VITA) sites allowing more flexibility to low-income taxpayers (for example, if the waiting lines are long at the TAC, they have the option of walking to the VITA site). This redirection of traffic permits Field Assistance to utilize their limited resources to resolve account problems, while still giving low-income taxpayers the options for free tax return preparation.
- In the past, VITA sites were established without any clear business rationale other than an organization such as a church, a community center, a library, or a shopping mall offering free space to establish a VITA site. IRS supported VITA through a direct business model. In effect, IRS recruited volunteers, trained volunteers,

managed the site, provided computers and e-filing software, and served as the primary technical resource for the volunteers. However, based on their resource needs, many VITA sites required substantial support from Compliance personnel. In addition, the expectations for many of these VITA sites did not materialize with some preparing less than 50 returns during a filing season, even though the IRS was investing critical resources in both staffing and equipment to support the site.

For the last few years, we have attempted to migrate from the direct business model to a leveraged business model. We now concentrate on establishing partnerships with external partners to provide education and free tax return preparation. These external partners include local governments such as mayors' offices, nonprofit organizations such as United Way and the Annie Casey Foundation, Low Income Tax Clinics, private for-profit business organizations, and other community coalitions that are interested in raising the standard of living for low income citizens. These partnerships focus on education, tax assistance, and asset building strategies. They strive to ensure that low income citizens have access to free tax return preparation and have adequate information to take advantage of:

1) refundable tax credits such as EITC and child tax credits and,
2) asset building strategies such as Individual Development Accounts (IDAs) and checking/savings accounts.

Through these external partnerships, we are focusing the limited IRS resources on providing information-based support, and encouraging the community partners to provide resources such as volunteers, space, computer equipment, etc. This strategy allows the IRS to expand access to low income taxpayers and provide greater free tax return preparation than was possible under the direct business model. Within the next two to three years, this partner-focused business model should provide multiple options to shift tax return preparation away from TACs to the VITA program. Using this approach, community partner coalitions will provide much more comprehensive and sustainable programs to low income taxpayers than IRS resources could support alone.

- The income and schedule criteria used to qualify for free return preparation are clearly aimed at providing services to low income customers. At this time the data is not available to quantify the number of low income taxpayers who received free preparation or who were unable to receive needed free preparation services. In response to the need to gather this type of data, a research study is planned for fiscal year 2003. This study will allow us to determine the type of customers who use our preparation services and the reasons for needing these services. This type of

data will aid us in better defining customer needs and in planning both TAC services and alternative services such as those offered at VITA/TCE sites, the IRS Website, Low Income Taxpayer Clinics and local and national practitioner referral services.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the leadership in Wage and Investment for their desire to improve Stakeholder Partnership, Education & Communication (SPEC). SPEC has been given a new direction in assisting disadvantaged individuals with their tax obligations, especially the low income taxpayers. This effort is on the right track, and as the IRS stated, in two to three years low income taxpayers will have many more viable options to receive free tax preparation

However, we remain concerned about the immediate service cuts in Taxpayer Assistance Centers (TACs). In offices such as Hartford, Connecticut and Seattle, Washington, the number of taxpayers requesting assistance was so extensive that many had to be turned away. Based on the inability of SPEC to absorb the overflow from TAC, we do not recommend that Operations reduce services provided in all TAC offices at this time. We encourage the leadership to reevaluate this and to retain services at those TACs where it has clearly been demonstrated that SPEC and VITA cannot yet adequately meet the demand.

Even with the services available, just over one percent of all taxpayers were able to avail themselves of free services for their 1999 and 2000 returns, and the majority of those services came from VITA and TCE. It is clear that TACs alone will not make up this gap in services. The National Taxpayer Advocate recommends that Congress authorize and appropriate funding for a grant program, modeled after the Low Income Taxpayer Clinic program, for community-based coalitions to provide low income taxpayers not only with free tax preparation but also with education about and opportunities to bank and save their tax refunds. (See discussion in Preface, herein.)

PROBLEM TOPIC #14 ACCESS TO ACS (AUTOMATED COLLECTION SYSTEM)

IRS RESPONSIBLE OFFICIALS

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

John Dalrymple – Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS Automated Collection System (ACS) is generally the second step in the IRS compliance process. Accounts are assigned to ACS when the IRS does not receive a response to initial balance due or delinquent return notices. If unable to contact or come to an agreement with the taxpayer, ACS may use enforced collection actions such as filing federal tax liens or levying sources of income.

Given the possibility of such actions, it is critical that taxpayers be able to contact ACS. In FY 2002, approximately 1.7 million of the 4.2 million calls to ACS did not reach an IRS employee.[223]

ANALYSIS OF PROBLEM

Automated Collection System case processing requires employees to make telephone calls, send notices and take enforcement actions. Program imbalances occur when too few employees are available to answer the incoming calls generated by processing cases. In FY 2001, taxpayers reached an ACS employee 80 percent of the time. However, in FY 2002 this rate, known as the Customer Service Representative (CSR) Level of Service, fell to 68 percent.[224]

This 15 percent decrease occurred because ACS employees were not able to handle the calls generated by an increased workload. Total ACS phone calls received in FY 2002 increased by 743,000.[225] This growth could not be anticipated, causing the decrease in level of service. The "business measures" reports for the next fiscal year do not estimate the number of phone calls expected. Instead they reflect the number of cases the operation expects to close.

Closure goals have been set for FY 2003 at 1.4 million, a 27 percent increase from FY 2002 performance.[226] See table 1.14.1 below. Although the CSR Level of Service goal has been reduced to an average of 76.50 percent from the FY 2001 performance level of 80.42

[223] Weekly Enterprise Snapshot Report, Week Ending 9/30/2002: FY 2002 Net attempts = 4,197,671. FY 2002 Calls answered = 2,541,745

[224] Snapshot Report: ACS CSR Level of Service = 68.19 percent for FY 2002. 80.42 percent for FY 2001.

[225] Snapshot Report: FY 2002 Net Attempts (4,197,671) - FY 2001 Net attempts (3,454,595).

[226] Data provided by operating divisions. Figure represents the sum of closures for both SB/SE and W&I operating divisions.

percent, the total Full Time Equivalents (FTEs) would decrease by two percent.[227] These goals would require remarkable program efficiency.

TABLE 1.14.1
ACS CLOSURES & SERVICE

FISCAL YEAR	2001 (ACTUAL)	2002 (ACTUAL)	2003 (PROJECTED)
ACS Closures	1.3 million	1.1 million	1.4 million
ACS FTE	2,633	2,706	2,655
CSR Level of Service	80.42%	68.19%	76.50%

*FTE: Full Time Equivalent (Staffing measure)[228]

In FY 2002, almost one third of taxpayer efforts to reach the ACS call site were unsuccessful. [229] Increasing production goals while maintaining a reduced level of service could impose a greater burden on taxpayers who must repeatedly call ACS to get their problems resolved. If they are unable to get through, they face dire and possibly needless consequences.

IRS COMMENTS

We agree that taxpayer access to ACS employees to resolve delinquent accounts is a very important issue and we continue to focus on both process and systemic improvements to provide better access and service. However, we disagree with the assumption that there is a direct correlation in a decline in Level of Service (LOS) with projected increases in case closures. Projected increases in case closures reflect the Service's expectation to achieve productivity gains through training and better prioritization of cases to be worked. We do not agree that an increased closure goal automatically precludes providing adequate taxpayer access.

Several factors impacted LOS in FY 2002. Introduction of new work to the ACS environment without a corresponding increase in resources made it very difficult to balance competing workload demands. In accordance with the 1997 enactment of the Federal Debt Collection Act, IRS implemented the Federal Payment Levy Program (FPLP) using the Treasury Offset Program developed by the Financial Management Service. To date 18 of 42 federal agencies are participating in FPLP. In FY 2002, this program resulted in the issuance of more than 600,000 additional notices that included the ACS phone number (more than 250,000 notices issued by the Social Security Administration alone). More fed-

[227] Data provided by operating divisions.

[228] Data provided by operating divisions. Snapshot Report: FY 2002 - CSR Level of Service for FY 2001 and FY 2002.

[229] Snapshot Report: ACS CSR Level of Service = 68.19 percent for FY 2002. 80.42 percent for FY 2001.

eral agencies are scheduled to issue notices as part of the FPLP program in FY 2003. In addition, the State Income Tax Levy Program (SITLP) expanded in FY 2002 by adding eight additional states. A total of 81,000 notices were issued that included the ACS phone number. Twenty new states plus the District of Columbia will be added to the SITLP program by the end of calendar year 2003. This increase in new workload (not IRS initiated) without a corresponding increase in resources is a major challenge to meeting taxpayer access needs.

Also in FY 2002, the IRS continued implementation of the Service Center Transition plan, a key component of the modernization effort. As part of this transition plan, the workload of four sites previously dedicated to ACS calls was changed to handle calls on the general taxpayer toll-free lines. As a result, new Customer Service Representatives (CSRs) had to be hired and trained in the remaining ACS locations to pick up the additional ACS traffic. While this restructuring effort did impact ACS productivity in the short term, in the long-term the agency will reap customer service benefits to both general toll-free operations and ACS operations.

Another factor affecting ACS access in FY 2002 was the full implementation of the Enterprise Call Routing (ECR) for non-business taxpayer inquiries and Tele-center Workforce Management System (TCWMS) technology. While ECR expanded the ability to route phone calls corporately to maximize available staffing, there was a significant learning curve for using TCWMS to forecast and schedule the workload. The complexity of the workload planning process for ACS is greatly complicated by the multi-faceted nature of the work. ACS is responsible for handling inbound calls, making outbound calls and working inventory.

ACS efficiency on an enterprise-wide basis also continues to be affected by non-ACS work. Calls made from taxpayers whose cases are in the collection queue as well as calls from taxpayers with cases in other functions are directed to ACS. A study conducted by the Collection Reengineering Team indicates that 25 percent of calls received in ACS are “non ACS” calls. This phenomenon makes it very difficult to accurately forecast call levels. Without an accurate forecasting of calls, it is difficult to ensure that adequate staffing is provided to handle incoming calls. ACS could achieve a higher level of service by transferring these taxpayers to other functions, but generally this would provide a lower level of customer service and therefore, ACS handles these calls.

Recent studies of ACS incoming calls and inventory levels have found that 42 percent of ACS callers call two or more times (22 percent call two times, nine percent call three times, five percent call four times, three percent call five times and three percent call more

than five times). It appears that this pattern of multiple calls is largely a result of ACS focusing the majority of its resources on taking incoming calls while delaying resolution of cases already in inventory. There are indications that by devoting more resources to resolving inventory by closing cases, the number of taxpayers calling multiple times can be reduced and the LOS can also be improved in the long-term. In an effort to reduce the number of multiple incoming calls, more resources will be used to work ACS inventory. The LOS target is being reduced to reflect the actual level of service that ACS has been able to achieve while also incorporating an improvement factor.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS recognizes the need to improve the ACS operations. Without additional resources, improvement is only possible by optimizing the use of technology and available resources. The following actions are being taken to identify opportunities for process/system improvement:

- The case flow in the telephone and inventory systems is being analyzed to develop improved ACS management processes. For example, a new workload planning tool will be developed to enhance the ability to forecast ACS call volume based on outgoing notice projections. This new planning tool, in conjunction with enhanced workforce management tools, should improve the ability to assign available staffing based on workload demand.
- New easy-to-use procedural guidelines and training are being developed to enhance customer interactions.
- An "inventory day" program is being instituted that will allow site personnel to address priority inventories. By addressing these inventories, fewer taxpayers will need to make incoming calls or need to make multiple calls to resolve their cases. Calls will be routed to other sites on "inventory days" to allow for this emphasis on inventory priorities.
- An adherence standard and a workforce management tool are being provided to ACS management. The adherence standard requires each call site to provide a specified number of CSRs to take incoming calls, while the workforce management tool (TCWMS) will provide each ACS manager with the ability to know exactly what resources are available to apply to either inventory or phone calls.
- Practitioner hotlines will continue to provide practitioners with another avenue of access to resolve taxpayer problems.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Automated Collection System has not been listed among the top 20 problems for taxpayers since the FY 1999 National Taxpayer Advocate Report to Congress. Many previous complaints were reduced by the implementation of RRA 98 requirements and other operational changes. For example, the IRS has increased its efforts to notify taxpayers of Collection Due Process provisions and to make filing or payment arrangements before resorting to enforced collection actions. The IRS also has safeguards to prevent levies from being issued without taxpayers being notified.

We are pleased to note that overall customer satisfaction ratings for ACS, though falling, still stand between the neutral and "completely satisfied" range. We acknowledge the steps the IRS has taken to make ACS more efficient and to better forecast staffing needs for phone centers. We accept that the transition to a more streamlined operating structure might temporarily detract from standard performance levels.

ACS has returned to the list of most serious issues facing taxpayers because the dramatic decrease in CSR Level of Service presents serious concerns for taxpayers who have been notified they may face a lien or levy if contact is not made. In a more stable work environment, enhanced productivity would likely translate into improved customer access, and the coming year would show substantial gains in the level of service. However, as demonstrated in the response above, the ACS workload is not stable.

The IRS identified several factors that contributed to the FY 2002 decline in the CSR Level of Service. One primary cause was an increased workload from Federal (FPLP) and state (SITLP) debt collection programs described by the IRS as "non-ACS" work. While ACS does not control the flow of notices from either source, all FPLP and SITLP notices bear the ACS telephone number. The IRS attempted to minimize the impact of this additional work by handling fewer ACS inventory cases in FY 2002 as indicated in Table 1.14.1. In spite of those efforts the CSR Level of Service still declined substantially. This demonstrates the potential for continued access problems if the workload and resulting telephone demand continue to grow without resources to support that growth.

For FY 2003, the IRS anticipates substantial increases in both internally controlled case activity and externally driven FPLP and SITLP collection activity. The number of attempted calls by taxpayers will undoubtedly climb. The question remains whether the existing ACS resources can possibly deliver such an aggressive work plan while also improving the CSR Level of Service.

We conclude that relying on a hoped for efficiency level is not sufficient to protect taxpayers from hardship. The IRS should implement several additional approaches. First, FPLP and SITLP programs should be provided with a separate toll-free number to help track the workload that is "not IRS initiated." This information can be used to demonstrate to Congress the need for additional resources to administer these programs. Second, ACS must have the ability to influence the timing and distri-

bution of FPLP and SITLP notices, which combine to generate 25 percent of telephone demand. Further, Congress and the administration should strongly consider allocating additional resources to support the demand of the FPLP and SITLP.

Total ACS staffing has decreased slightly over the past several years and was not adjusted for the additional requirements of FPLP and SITLP. Overall ACS staffing for FY 2002 stood at approximately 2700 employees or Full Time Equivalents (FTEs), with "new" employees hired only to replace losses from the consolidation of sites. Additional employees (FTEs) may be added in FY 2004 only if the Staffing Tax Administration for Balance and Equity (STABLE) initiative is fully funded.

The alternatives, in the absence of these changes, are either subjugation of ACS inventory work to the increased demands of the FPLP program and "non-ACS" telephone traffic or continued reduction of service to taxpayers. As the collection of taxes and other liabilities is given renewed priority, it is imperative that taxpayers facing collection action must have access to the IRS.

PROBLEM TOPIC #15

COLLECTION DUE PROCESS (CDP)

IRS RESPONSIBLE OFFICIAL

David Robison – Chief, IRS Appeals

DEFINITION OF PROBLEM

Taxpayers experience delays in receiving determinations on their Collection Due Process (CDP) cases.

ANALYSIS OF PROBLEM

The IRS Restructuring and Reform Act of 1998 provides taxpayers an opportunity for an independent review of a lien filed by the IRS or a proposed levy action.[230] This law established the Collection Due Process (CDP) hearing, which is held by an impartial officer from the Appeals unit of the IRS.[231] A CDP hearing is informal and can be conducted face-to-face, by telephone or by correspondence.[232]

The process begins when the IRS mails a certified notice to the taxpayer.[233] To schedule a hearing, the taxpayer returns a signed, written request within 30 days to preserve their right to a judiciary appeal of the decision.[234] If the request is not received timely, a hearing will be allowed but the right to a court appeal is lost. Further details of the process can be found in the Most Litigated Issues section of this report.

The receipt of CDP cases has steadily increased since the program began on January 19, 1999:[235]

TABLE 1.15.1
CDP RECEIPTS

12-MONTH PERIOD ENDING	CDP CASE RECEIPTS
9/30/2000	6,892
9/30/2001	19,119
9/30/2002	26,666

[230] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Section 3401.

[231] IRC §§ 6330(b)(1) and 6330(b)(3).

[232] Treas. Reg. § 301.6330-1(d)(2), Q&A-D7.

[233] IRC § 6320(a)(2)(C) and IRC § 6330(a)(2)(C). The notice regarding a lien filing is sent after the lien is filed; it is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action; it is required to be sent not less than 30 days before the day of the first levy.

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

[235] Diagnostics and Balanced Appeals Measures Report System for ACDS, IRS Appeals Due Process Workload & Cycle Time Report, FY 2002, Cumulative Through 9/30/02.

The IRS was not prepared for the influx of CDP cases. It has taken steps to address this problem by:

- Hiring more Settlement Officers;[236]
- Conducting collection training for employees of the Appeals division who have no collection experience;
- Implementing eight initiatives from Appeals' strategic plan for fiscal years 2002/2003 to reduce the processing time of CDP cases by 25 percent;[237]
- Implementing the Collection Due Process Tracking System; and
- Creating a new CDP screener position.[238]

Although the inventory is currently declining, increasing lien and levy activities could change that trend. The table below outlines the monthly CDP case inventory for the fiscal year ending September 30, 2002:[239]

TABLE 1.15.2
CDP CASE INVENTORIES

MONTH	CDP CASE INVENTORY	SUSPENDED CASES[240]
October 2001	19,087	2,036
November 2001	20,531	2,314
December 2001	19,840	2,474
January 2002	20,145	2,776
February 2002	19,965	3,319
March 2002	20,076	3,872
April 2002	19,942	4,317
May 2002	19,188	4,147
June 2002	18,654	4,024
July 2002	18,129	3,615
August 2002	17,474	3,624
September 2002	17,060	3,484

[236] According to Appeals management, as of October 1, 2002, Appeals has hired over 100 Settlement Officers, for 232 nationwide.

[237] Appeals Strategy/Program Plan – FY2002/2003, Major Strategies, p. 2. The initiatives are (1) implement CDP Task Force recommendations, (2) enhance CDP Intranet website, (3) begin CDP Program Review process, (4) develop CDP case management and best practices guide, (5) streamline CDP case write-up procedures, (6) continue comprehensive CDP training program, (7) continue to streamline procedures and evaluate effectiveness of procedures between Operating Units and Appeals, and (8) increase cross-functional cooperation through transfer of knowledge regarding workload trend *[sic]* and sharing of concerns.

[238] According to Appeals management, as of October 1, 2002, Appeals has hired 25 of 36 CDP screeners.

[239] Current CCI [Collection Currency Initiative] - September 2002 Receipts, Disposals, and Inventory (Oct. – Sept. Act.).

[240] Current CCI [Collection Currency Initiative] – September 2002 Receipts, Disposals, and Inventory (Oct. – Sept. Act.), and IRM 8.7.2.3.9(9), (10), (11), and (12). Suspended cases are those cases where Appeals has issued a determination letter. Appeals holds the case open to determine if the taxpayer has petitioned the court for judicial review. This can take up to 180 days. The CDP Case Inventory figures above include these suspended cases.

The IRS, practitioners, and commentators have identified several concerns that lead to misuse, delays, or confusion about the CDP process:

- One commentator has noted that:

  > The regulations provide that a taxpayer seeking judicial review of IRS determinations at the hearing can raise only issues considered at the CDP hearing. To preserve rights of review, taxpayers should ensure that all claims or issues that it wishes the AO [Appeals Officer] to consider are stated in writing, either on the Form 12153 requesting the hearing or in a subsequent writing. Form 12153 is incomplete in that it does not provide a checklist for the types of issues that Appeals could consider; rather, it provides a blank space for taxpayers to explain why she does not agree with the proposed collection action. For a taxpayer who is unaware of what issues the AO could consider at the CDP hearing, this could prevent the taxpayer from fully exercising her rights. The IRS should modify the form to allow a taxpayer to easily identify issues she wishes for Appeals to consider.[241]

- Taxpayers requesting a CDP hearing are often unclear about what issues they may raise. This confusion can result in delays and the loss of judicial review of important issues.
- Taxpayers submitting a CDP request from outside the United States do not have additional time to respond, although the IRS often grants extra time for those outside the country to file other documents or respond to inquiries where important procedural rights are involved:

TABLE 1.15.3
EXTRA TIME ALLOWED FOR FILING OTHER IRS DOCUMENTS

TITLE OF DOCUMENT	ADDITIONAL TIME ALLOWED
Notice of Deficiency	60 days[242]
Proposed Trust Fund Recovery Penalty Assessment Letter	30 days[243]
US Individual Income Tax Return	2 months[244]

[241] Leslie Book, *The New Collection Due Process Taxpayer Rights*, Tax Notes, Feb. 21, 2000, p. 1127.

[242] IRC § 6213(a).

[243] IRM 5.7.6.3(2).

[244] IRS Publication 17, *Your Federal Income Tax*, for use in preparing 2001 returns.

- An IRS research report issued in June 2001 revealed that 56.8 percent of businesses owing payroll taxes and seeking CDP hearings incurred additional delinquent payroll taxes after requesting the hearings.[245]
- The IRS is concerned about frivolous issue submissions and the misuse of CDP to delay collection action. Former Commissioner Charles Rossotti expressed this concern in testimony to Congress on May 14, 2002:

  Some individuals are using the hearing process to delay collection action by filing hearing requests that raise frivolous issues.…IRS Appeals has approximately 20,000 CDP cases in inventory. About four percent, or 800 cases, involve frivolous issues taxpayers…However, the numbers alone do not account for the inordinate amount of time it takes for such cases. Frivolous claims occupy a disproportionate share of time over claims from taxpayers having substantive issues. Frivolous issue taxpayers frequently file voluminous claims. Just reading these to ensure any valid issues presented are addressed is extremely time-consuming. A larger percentage of the frivolous issue taxpayers go to court where they raise the same frivolous issues. Also, some of these individuals file Sec. 1203 actions (mandatory employee termination violations) against IRS employees, which are very time-consuming, even when they are not sustained.[246]

  Proposed legislation would increase the penalty for frivolous submissions, as is explained in the Most Litigated Issues section of this report.

IRS COMMENTS

While Section 3401 of the Restructuring and Reform Act of 1998 (RRA98) created additional protection for taxpayers it also added major new responsibilities to the IRS. These additional duties placed significant demands on IRS' personnel resources and required Appeals to organizationally regear in a relatively short period of time in order to implement CDP.

As noted below, Appeals met the array of challenges and successfully implemented a sound CDP program. Over 100 new Settlement Officers were hired and trained along with 25 CDP screeners to work the unexpectedly large CDP inventories. These actions along with process improvements started to show results in the second half of FY 2002 as the numbers of case closures significantly increased while case aging decreased.

[245] *Collection Due Process: Pyramiding Trust Fund Liabilities*, IRS SB/SE Research, Brooklyn/Hartford/Philadelphia, June 2001.

[246] Progress Report on the IRS Restructuring and Reform Act of 1998, Hearings Before the Joint Economic Committee, 107th Congress, 2nd Sess, May 14, 2002 (statement of Commissioner of Internal Revenue Charles O. Rossotti).

IRS INITIATIVES TO RESOLVE PROBLEM

Delays in CDP Case Determinations

Combining process improvements with training efforts expended in fiscal year 2002 and the hiring of additional Appeals employees with collection experience, we believe that we have sufficient trained personnel to address the anticipated receipts within reasonable time frames. This is evidenced by the significant increase in the number of completed cases and reduced age of CDP inventory achieved during the second half of fiscal year 2002.

Form 12153 Is Confusing

Appeals believes that a checklist as suggested could actually limit, rather than enhance, the number and description of issues taxpayers may wish to raise. Moreover, taxpayers are free to raise additional issues in the hearing process, other than those listed on the Form 12153. In addition, Publication 1660, Collection Appeal Rights, which explains the taxpayer's appeal rights, is mailed with all CDP notices along with Form 12153. Finally, Appeals employees are trained and provided guidance requiring that they raise any issues that the taxpayer may have failed to raise that Appeals believes would serve as an acceptable payment alternative.

Timeframe for Filing CDP Requests

The statute does not provide the authority to alter or extend the time frame for filing a request for CDP hearing for any taxpayer. Other statutes either state a specific time frame including such extensions or allow the Secretary to prescribe procedures and timeframes as may be appropriate or reasonable. For example, IRC 6213(a) specifically provides 150 days to persons outside the U.S.A. to file a petition in response to a notice of deficiency, or 90 days for those residing in the U.S.A. IRC 6320 and 6330 specifically limit the time period to 30 days for all persons regardless of address. It is noted that when the timeframe for filing a CDP request is exceeded, the taxpayer is entitled to an equivalent hearing of the issues. The difference is that an equivalent hearing determination is not subject to judicial review.

56.8 Percent of Businesses Incurred Additional Payroll Liabilities

Appeals instituted a strict reporting requirement and monitoring system intended to ensure these cases are worked expeditiously. Appeals no longer holds these cases 180 days for default. Utilizing PACER, Public Access to Court Electronic Records, Appeals can now return cases to Compliance as early as 45 days after issuance of the determination letter where the taxpayer has not timely requested judicial review.

Frivolous Submissions

We concur that frivolous submissions require a disproportionate amount of time to work over those cases with substantive issues. The IRS strongly supports the legislative proposals currently being considered by Congress to effectively reduce these frivolous claims and still ensure that all taxpayers are provided with the rights intended under the statute.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend Appeals for taking steps to address the CDP problems facing taxpayers. We are pleased with the initiatives implemented by Appeals, particularly the hiring of additional Settlement Officers, and the creation of CDP Screener positions.

The Taxpayer Advocate Service plans to continue studying the Collection Due Process program and participate with the functions to improve the process as problems arise. TAS has established an advocacy team to identify trends and assist with process improvements to ensure the continued protection of taxpayer rights. This team will also study the effectiveness and impact of the newly created CDP tracking system. We will also look at the IRS functions involved in CDP cases in an attempt to identify process improvements at the earliest possible stage.

The National Taxpayer Advocate also recommends that the IRS undertake a research project to discover why CDP cases are not resolved at earlier stages of the collection process, prior to the issuance of the CDP notice. The IRS can also obtain important information about tax administration from those cases in which the taxpayer unsuccessfully raises questions about the validity of the underlying tax liability.

PROBLEM TOPIC #16 AWARENESS AND UNDERSTANDING OF FEDERAL TAX DEPOSIT REQUIREMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The rules for making federal tax deposits are complicated and cause errors that result in additional payments by businesses in the form of penalties. The rules also increase the cost of doing business at the IRS, due to the expense of making millions of adjustments and abatements to taxpayers' accounts.

ANALYSIS OF PROBLEM

Taxpayers must make deposits of federal employment taxes on time, in full, and in the correct manner to avoid a penalty for failure to deposit.[247] In addition, as the payroll of the taxpayer's business increases, the required deposit date or method changes.

The IRS assessed approximately 3.5 million Federal Tax Deposit (FTD) penalties for a total of $5 billion in 2001 and 4.2 million FTD penalties totalling $5.8 billion in 2000.[248] For many small businesses, receiving a penalty for even one quarter, and the subsequent amount of time it takes to straighten out and correct, can consume many resources. It also leaves taxpayers feeling confused, frustrated, and "set up." These errors drain IRS resources as well.

Coupon users generate 99 percent of FTD penalties. The IRS estimates taxpayers make FTD payments with coupons 81 percent of the time instead of using the Electronic Federal Tax Payment System (EFTPS).[249] In calendar year (CY) 2001, the IRS issued approximately 1.2 million notices to taxpayers or their representatives for failing to correctly identify the type of tax or tax period on the coupon. The format of the coupon contributes to these types of errors, and educational materials are lacking.

For fiscal year (FY) 2001, TAS resolved 5,761 cases involving problems with the payment of FTDs or requests for FTD penalty abatements. A review of 385 TAS cases uncovered two major problems: [250]

- Taxpayers did not receive notice of a change in their deposit schedule; or once notified did not have enough time to make the necessary adjustments.

[247] IRC § 6656.

[248] IRS 1995 to 2001 Data Book, Publication 55B.

[249] Small Business/Self Employed FTD Improvement Initiative Draft, at Part IV, page 6.

[250] The TAS sample consisted of Major Issue Code 510, Requests involving adjustment or abatement of an FTD penalty. The sample was pulled from a population of 3,693 cases involving Form 941.

- Taxpayers have difficulty computing the deposit frequency and completing Schedule B, Employer's Record of Federal Tax Liability.

Change in Deposit Schedule

During the fourth quarter of 2001, the IRS issued 396,859 notices informing taxpayers of a change in deposit requirements. These notices are generated over a three-week period and must be mailed no later than the first week of December.[251] Twenty-three percent of these taxpayers were liable for an FTD penalty in the first quarter of calendar year 2002. This could indicate that some taxpayers are not receiving the notices, are getting them too late to adjust their deposit schedules as instructed, or are disregarding or not comprehending the notices.

Legislation enacted in 1998 allows the IRS to grant relief for penalties under IRC § 6656 for untimely deposits, based on a change in deposit schedule. From January through July of 2002, the IRS sent 91,990 FTD penalty waiver notices informing the taxpayers of their deposit schedule errors. This waiver is issued after the tax return is filed and the IRS determines that the taxpayer is not following the correct deposit schedule. Because the taxpayer is not notified of the error until the middle of the following quarter (when he or she receives the waiver notice), additional penalties can accrue in intervening quarters. The waiver notices issued during January through July of 2002 increased by 19 percent over the same period in calendar year 2001.

Deposit Frequency and Form 941, Schedule B

Monthly schedule depositors who accumulate $100,000 or more on any day and semiweekly schedule depositors are required to complete and attach a Schedule B to their Form 941 in lieu of the monthly schedule of deposits. The IRS uses Schedule B to determine if taxpayers have timely deposited their withholding and tax liabilities.

Problems associated with Schedule B indicate that semiweekly depositors either did not file the form as required or completed it incorrectly. Semiweekly depositors also used the monthly schedule on the Form 941, Employer's Quarterly Federal Tax Return, to report their semiweekly tax liability. One of the reasons that semiweekly depositors may not be completing the Schedule B appropriately is the lack of guidance in the Publication 15, Circular E, Employer's Tax Guide. The IRS issued 183,765 notices to taxpayers that had missing, incomplete, or illegible Schedules B in (calendar year) 2001.

When a taxpayer establishes a new business, the IRS issues a notice assigning an employer identification number or EIN. If the taxpayer indicates that he or she will have employees, the IRS will include a FTD coupon with instructions and several Social Security

[251] The mailing of these notices is staggered through the months of October and November with the final mailing ending during the first week of December.

Administration publications with the notice. Publication 15 is mailed separately to new businesses.

The publications, notices and CD-ROMs that explain FTD requirements can be confusing, especially to taxpayers operating new businesses. The information in the publications is difficult to follow, causing the taxpayer to back up and reread previous sections. For example, Publication 15 states on page 17 that if the accumulated tax liability is less than $2,500, the taxpayer may pay with the return. However, page 18 states that if total taxes on Form 941 line 11 in the lookback period are $50,000 or less, the taxpayer is a monthly depositor. This leads a taxpayer to believe that they may be a monthly depositor when their accumulated tax liability is less than $2,500.

The IRS Small Business/Self Employed division web site provides information about FTDs.[252] However, the material on the site duplicates Publication 15. This does not offer taxpayers the educational material they need to better understand the FTD requirements. The IRS has produced a video on FTDs titled "The ABC's of Federal Tax Deposits." However, IRS does not market this video to taxpayers and uses it only in workshops.

IRS COMMENTS

The IRS recognizes that FTD requirements may seem complex to taxpayers and for the last few years we have increased our efforts to inform citizens of their options in making FTD payments. We will use the National Taxpayer Advocate's observations on the clarity of the materials to improve our publications and other outreach efforts. In the following sections, we outline specific measures that we are currently implementing to serve the FTD taxpayer.

Change in Deposit Schedule

Taxpayers are classified as Monthly or Semi-weekly based on a look back of prior tax periods. If the taxpayer's requirement changes, the IRS mails an information notice by the end of November, so taxpayers have the month of December to familiarize themselves with the new requirement prior to the beginning of the new tax year. A notice (CP136) is issued and includes deposit requirement information, similar to the information provided in Publication 15.

The IRS Publication 509 (Cat. No. 15013X) provides the deposit due dates for monthly depositors and a quarterly due date chart for semi-weekly depositors, as a tool for helping taxpayers meet their deposit requirements. The IRS publications and notices promote the use of the Electronic Federal Tax Payment System (EFTPS), as a means of timely deposit-

[252] Available at http://www.irs.gov.

ing taxes, with less chance of deposit misapplication. The IRS is considering revising the Form 8109, Federal Tax Deposit Coupon, as another means of helping taxpayers properly complete the required information.

Deposit Frequency and Form 941, Schedule B

The IRS realizes that the rules for making deposits may be considered complex by some taxpayers despite the fact that the current Federal Tax Deposit requirements for Federal Employment Tax have been in effect since January 1, 1993, with only two changes to the de *minimis* rule. In an effort to ease potential confusion, the IRS provides information to all business taxpayers on how to file as part of the form itself. Taxpayers also have the right to request an abatement or a decrease in penalty due to reasonable cause, and the penalty is automatically waived for first time incidents.

Normally IRS publications, such as Publication 15 and Circular E, "Employer's Tax Guide," do not give specific instructions for completing a schedule that may become part of a tax return. The instructions for completing Schedule B (Form 941), Employer's Record of Federal Tax Liability, are part of the schedule itself. The current Form 941 instructs the taxpayers to use and attach Schedule B if they are Semi-weekly depositors or Monthly depositors who accumulated $100,000 or more on any day during the tax period. At this time, the IRS is working on combining the Form 941 tax return and Schedule B, making it one complete tax return document. The proposed revision will eliminate Line 17, Monthly Summary of Federal Tax Liability (under the 2002 Form 941), and move that information to Lines A, B and C on Schedule B. Having only one Federal Tax Liability schedule should decrease the number of times the return is filed with an incorrect or missing Schedule B.

Regarding the example provided for this problem, the information on pages 17 and 18 of Publication 15 is correct. As stated on page 17, any employer whose accumulated tax for the quarter is less than $2,500 may pay the entire amount with the tax return. This is true for both Monthly and Semi-weekly depositors. However, that statement on page 17 has nothing to do with determining whether a particular taxpayer is a Monthly or a Semi-weekly depositor. That determination is based on the $50,000 total tax threshold for the four-quarter look back analysis, as explained pages 17 and 18 of Publication 15.

IRS INITIATIVES TO RESOLVE PROBLEMS

Change in Deposit Schedule

The IRS is creating a Masterfile analysis that will identify all accounts that received notification of deposit frequency change from Monthly to Semi-weekly. The analysis will check for deposits posting under Semi-weekly requirements. If no deposits are located during January for a new Semi-weekly depositor, an information notice will be generated to the taxpayer explaining that it appears he or she may be following the old Monthly deposit rules rather than the new Semi-weekly schedules. This early notification should decrease the number of Federal Tax Deposit penalty assessments in the first and second quarters. SB/SE expects to implement this early intervention notice in January 2004.

Deposit Frequency and Form 941, Schedule B

The IRS is piloting a program that offers a one-time FTD penalty refund for a business that voluntarily converts to EFTPS from Form 8109 FTD Coupons. After making timely EFTPS deposits for four consecutive quarters, the taxpayer will have their last FTD penalty abated and the credit used to pay the penalty will be refunded. Based on the results of the test, a national rollout of the project is proposed for January 2004.

In addition, we are also producing a new bilingual Employment Tax CD-ROM, which discusses all aspects of filing employment tax returns and making federal tax deposits. We expect this CD-ROM to be made available during 2003.

TAXPAYER ADVOCATE SERVICE COMMENTS

Although the IRS continues to expand its outreach and educational programs for businesses, taxpayers continue to receive Federal Tax Deposit penalties. The National Taxpayer Advocate recommends that the IRS hold focus groups or survey employers, practitioners and payroll agents for feedback about the current federal tax deposit requirements (including lookback period, deposit schedules, payment method.) to identify educational needs.

The IRS needs to revise publications, CD-ROM products and educational notices to include flow charts or matrices as tools to aid taxpayers, especially those establishing new businesses, in determining their deposit schedules. Although we recognize the technical accuracy of Publication 15, the written material needs to flow from one section to the next and instructions need to be clear and easily understood without causing the taxpayer to have to reread previous sections.

The IRS' Small Business/Self Employed Division web site offers taxpayers access to various CD-ROMs to assist in meeting tax requirements. We are pleased to hear that the IRS is producing a new bilingual CD-ROM to assist taxpayers with limited English proficiency, but until the current instruc-

tions are revised in all published materials, federal tax deposits will continue to be a problem. We recommend the IRS develop a CD-ROM and publication that exclusively target the federal tax deposit requirements. We also suggest that these products be marketed to all taxpayers and distributed to all new businesses with employees.

Semiweekly depositors are required to file Schedule B while monthly depositors complete line 17 (Monthly Summary of Federal Tax Liability) on the Form 941. Instructions in Publication 15 and other educational materials need to emphasize this requirement. We support the IRS' initiative to redesign the Form 941 and Schedule B and we are looking forward to seeing if the redesign decreases the amount of missing or incorrect schedules.

We are concerned about the number of taxpayers that continue to make their deposits under their old schedule in the second and third quarters. We are pleased to hear that IRS is planning to monitor accounts that previously received a CP136 notice to determine if they are making their deposits based on the new schedule and look forward to its implementation.

We applaud the IRS' efforts to increase the number of taxpayers currently using the EFTPS by offering a one-time FTD penalty refund. We are eager to see the results of the pilot program. However, since the majority of taxpayers make their deposits using the payment coupon, the National Taxpayer Advocate strongly suggests that the IRS revise the current payment coupon to minimize errors. One suggestion could be to move the position of the bubbles to the right of the text, which reflects the acceptable standard for bubble forms. Finally, the IRS needs to include instructions on how to properly complete a payment coupon in CD-ROMs and other educational materials.

PROBLEM
TOPIC #17

TOLL-FREE ACCURACY

IRS RESPONSIBLE OFFICIALS

Joe Kehoe – Commissioner, Small Business/Self-Employed Division
John Dalrymple – Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

IRS quality measures indicate that in fiscal year 2002, errors were made in approximately 20 percent of all calls to primary toll-free service lines.[253]

The IRS did not distinguish between the significance and severity of the various errors. For example:

- Was the answer incorrect?
- Did the employee fail to address a fact that might change the conclusion?
- Did the response exclude a reference source or form number, possibly requiring the customer to call again for that information?

The failure to report such distinctions diminishes the confidence of the taxpayer in the response received from toll-free lines. One accountant, quoted in the Wall Street Journal, said, "My advice is not to call the IRS if it's something important."[254]

ANALYSIS OF PROBLEM

The quality of IRS Toll-Free Telephone service was one of the Most Serious Problems in the National Taxpayer Advocate's FY 2001 Report to Congress.[255] For the period covered by that report, the IRS achieved a 75 percent accuracy rating for tax law responses and a 69 percent rating for taxpayers' account responses.

As noted in a recent General Accounting Office (GAO) report, the IRS has "achieved some improvements in telephone service."[256] Through the end of FY 2002, tax law quality ratings improved to 81.2 percent, and ratings for account inquiries increased to 74.2 percent.[257]

[253] Weighted Accuracy Report, Fiscal Year Rollup, (as of July 2002) W&I/SBSE "Enterprise" combined rates: Tax Law – 81.1 percent; Accounts 74.3 percent.

[254] Tom Herman's "Tax Report," *The Wall Street Journal*, Sept. 5, 2002.

[255] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001), page 18.

[256] General Accounting Office, IRS *Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, page 12; GAO-02-580T.

[257] Weighted Accuracy Report, Fiscal Year Roll-up, as of September 21, 2002.

TABLE 1.17.1
QUALITY DATA FOR FY 2001 AND FY 2002[258]

MEASURE	FY 2001	FY 2002
Tax Law Quality	74.7	81.2
Accounts Quality	69.1	74.1

Although the quality of responses has improved, accuracy will continue to be a serious problem with toll-free telephone service until taxpayers can consistently rely on IRS responses.

Part of the problem is the measurement used, which judges responses either right or completely wrong. A single mistake or omission during the call, no matter how critical to the overall response, will render the entire contact wrong. This sets a high standard for IRS employees but makes it impossible to know from the quality report the type of errors and omissions most frequently made, and where additional training is needed.

IRS COMMENTS

IRS continues to be committed to providing the best possible service to its customers. Improving accuracy was a major focus in planning for filing season 2002. IRS thoroughly analyzed its accuracy data to identify problems and develop action items. Initiatives included actions such as specialized training and certification during the early months of FY 2002, assigning call site managers "ownership" or accountability for specific tax law topics, and issuance of consistent review guidelines to all managers. The action items resulted in significant improvement in quality measures for FY 2002.

Although a "pass/fail" system was used to assess accuracy, IRS maintains a national database to identify top defects and detail information by telephone calls reviewed. Reports can be generated to determine the questions asked by customers and responses by customer service representatives (CSR), and why the questions were considered inaccurate.

IRS INITIATIVES TO RESOLVE PROBLEM

On October 1, 2002, IRS implemented an "embedded quality" (EQ) program that eliminates the "pass/fail" method for measuring quality and should rectify the problem of not distinguishing between "wrong" answers and procedural defects that do not affect the accuracy of the answer. New quality measures were defined from analysis of customer satisfaction data and feedback from employees and managers and are calculated based on

[258] Weighted Accuracy Report, November 2002.

defects per opportunity. The comprehensive measures include timeliness, professionalism, and accuracy with sub-components for customer accuracy, regulatory accuracy, and procedural accuracy. In addition, the new measurement system links employee performance to organizational results related to the quality of customer service. Data from the proof of concept and pilot testing were very positive and pinpointed problems and their severity.

This new measurement system will be used in our toll-free operations and other segments of the IRS during FY 2003 with plans to expand it during FY 2003 to other programs. During this transition, the IRS will maintain the old accuracy measures for FY 2003 in the functions not testing the new measurements. The results of the new system will be used as a baseline. Both the Treasury Inspector General for Tax Administration and the General Accounting Office are aware of this new approach, which we believe will be a significant step in achieving a permanent improvement in providing quality service to taxpayers.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS faces both real and perceived response reliability problems in the Toll-Free telephone service operations. We are pleased with the steps taken in FY 2002 and in planning for FY 2003 to address these problems.

As noted in the IRS comments, IRS quality review staff produced numerous system and program recommendations based on analysis of filing season errors. The challenge for the IRS will be to effectively implement the recommendations and track the impact of those efforts on 2003 filing season performance.

The Embedded Quality initiative has the potential to significantly bolster public confidence in IRS responses through an improved portrayal of program performance and a heightened engagement of each assistor in the quality process. Measuring employees on timeliness, professionalism, and accuracy – qualities that internal and external users identified as critical to customer satisfaction – will align IRS performance with taxpayer expectations. We are pleased to note the effort the IRS will expend in FY 2003 to capture data that will allow for comparison of current performance against prior years' measures.

We applaud the IRS for increasing the quality of service provided to taxpayers in FY 2002 and recognize that this success required substantial effort. For FY 2003, we anticipate continued "real" improvement and a clearer picture of the IRS as a source of reliable information and service. We will be monitoring these initiatives in FY 2003 and look forward to the time when toll-free accuracy is no longer on the National Taxpayer Advocate's list of Most Serious Problems.

PROBLEM TOPIC #18 TOLL FREE LEVEL OF SERVICE (ACCESS)

IRS RESPONSIBLE OFFICIALS

Joe Kehoe – Commissioner, Small Business/Self-Employed Division
John Dalrymple – Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS has not clearly explained to taxpayers its strategy for providing toll-free service and the use of automated service for some inquires. Taxpayers call expecting live assistance, but 22 percent of those who reached the IRS in FY 2002 received only automated help.[259] This conflict between expectations and the limited availability of live assistors results in poor customer satisfaction.

The IRS has not defined specific goals for achieving what it calls "world class" customer service.

ANALYSIS OF PROBLEM

Access to IRS toll-free service led the National Taxpayer Advocate's fiscal year 2001 list of the Most Serious Problems Encountered by Taxpayers.[260] "Access" describes the ability of callers to reach IRS assistance menus without a busy signal. The IRS has improved access. Former Commissioner Charles Rossotti stated in his *Progress Report From the Commissioner of the Internal Revenue Service* that "Nearly all callers now have almost immediate access to automated services, although some callers are forced to wait longer to receive assistor service."[261] The response of the operating divisions published in the FY 2001 National Taxpayer Advocate's Annual Report to Congress listed the access rate at 94 percent.[262]

The problem has now shifted to the handling of calls once the taxpayer reaches the IRS menu system. The FY2002 National Taxpayer Advocate's Annual Report to Congress focuses on the ability of callers to connect with a Customer Service Representative (CSR) as measured by the "CSR Level of Service."

In fiscal year 2002, the IRS achieved a CSR Level of Service of 70.24 percent.[263] The agency has taken many steps to maximize the likelihood that a caller can reach someone

[259] IRS Weekly Enterprise Snapshot Report, Enterprise Telephone Data, 9/30/2002.

[260] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001), page 8.

[261] Charles M. Rossotti, *Progress Report From the Commissioner of the Internal Revenue Service*, December 2001, page 14.

[262] See fn. 260.

[263] Weekly Enterprise Snapshot Report, Enterprise Telephone Data, 9/30/2002.

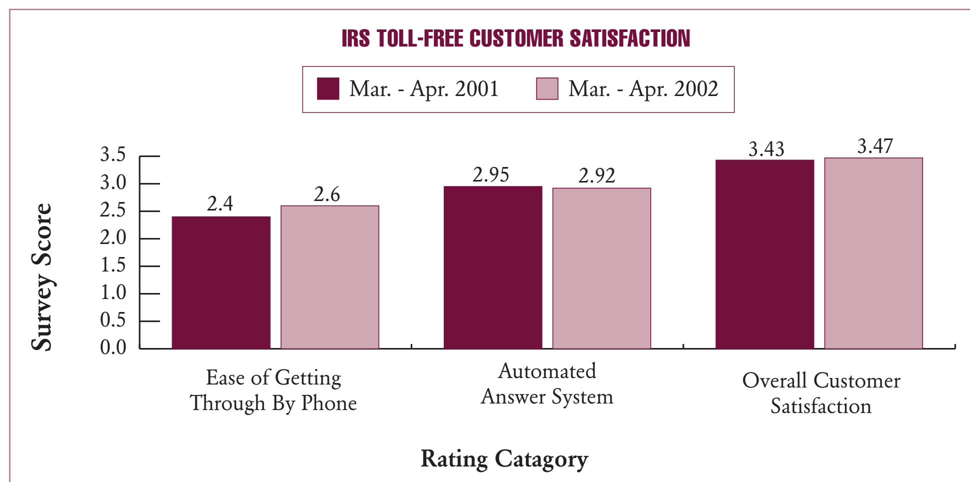
to help them with their inquiry.[264] Indeed, the level of service increased by 14 percent from FY 2001 to FY 2002, yet customers still report discontent with automated systems and menus.[265]

TABLE 1.18.1
TOLL-FREE ACCESS & SERVICE

MEASURE	FY 2001	FY 2002
Level of Access	94%	NA[266]
CSR Level of Service	61.61%	70.24%

IRS Customer Satisfaction surveys continue to place "Ease of Getting Through By Phone" and "The Automated Phone System" as the aspects of IRS toll-free service that customers find least satisfactory even though they report high marks for many other aspects of service.[267] This graph shows the two lowest rated customer survey categories with the overall customer satisfaction rating. A zero indicates dissatisfaction while a four indicates a very satisfied response.

TABLE 1.18.2
CUSTOMER SATISFACTION



[264] U.S. General Accounting Office, *Assessment of Budget Request for Fiscal Year 2003 and Interim Results of 2002 Tax Filing Season*, April 9, 2002.

[265] Florida Taxpayer Advocacy Panel Recommendation with letter from E. W. Gargiulo, Chairperson, to John M. Dalrymple, Commissioner, Wage and Investment Division (January 28, 2002).

[266] IRS no longer uses Level of Access (LOA) as an official measure. The calculation, measured at the network level, is network attempts that entered the system vs. total network attempts. E.g.: The LOA for October 1, 2002 was 99 percent of 142,268 calls. (Daily Toll-Free Detail Executive Level Summary Report).

[267] IRS Customer Satisfaction Survey National Report, National Toll Free: SB/SE results covering April-June 2002, Pacific Consulting Group August 2002, pages 21 & 28.

The challenge for the IRS is not only to improve service statistics with limited resources, but to determine how services can best meet the expectations of taxpayers. For example, the use of automated services noted above is designed to split off the inquiries that can be adequately handled without human interaction. Automation is a strategic tool to increase the number of callers served by a limited number of representatives.[268] However, if taxpayers expect or want to speak with a "live" person, they will be disappointed with automated service.

The IRS says it is committed to providing "world class" customer service.[269] Although the agency has studied the characteristics of such service, it has not defined specific targets. A General Accounting Office (GAO) report also notes that "there is not an industry standard service level. Each organization must determine its ... own unique circumstances."[270] Service improvement numbers will not increase until customers, stakeholders, and the IRS agree on the definition of "world class" service.

IRS COMMENTS

In its efforts to deliver world class service, the IRS continues to make toll free telephone access one of its top priorities as reflected in its business performance measures. These measures are based on the number of services provided and the time taken to provide them. During the 2002 filing season, accessibility measures improved from the prior filing season. As stated above, a higher percentage of customers were successful reaching a customer service representative (CSR) in comparison to the past year. In addition, the overall length of time a customer waited before speaking with a CSR decreased by more than a minute. This is determined by measuring average speed of answer (ASA) that was 337 seconds and 268 seconds in 2001 and 2002, respectively. Another indicator is the percentage of customers who waited 30 seconds or less before speaking to a CSR. This measure increased 12 percentage points, from 39 percent during 2001 to 51 percent during 2002.

In addition, to simplify and make clearer the topic choices on the toll-free line, several of the announcements were eliminated or streamlined. This reduced the percentage of customers who hung-up prior to reaching a CSR by 13 points, a significant decrease.

[268] Letter from J. R. Watson, Director Customer Account Services (Wage and Investment Division), to John Boehm, Chairman Midwest Taxpayer Advocacy Panel (February 14, 2002).

[269] Charles M. Rossotti, *Progress Report From the Commissioner of the Internal Revenue Service*, page 14, December 2001.

[270] U.S. General Accounting Office, *Customer Service Human Capital Management at Selected Public and Private Call Centers*, GAO/GGD-00-161, August 2000.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS will implement the realignment of the Customer Response Toll-Free numbers effective January 1, 2003. The implementation of this initiative will enable the IRS to better serve its customer base by providing a toll-free environment that will segment customers according to their type. This will establish a clear accountability to the specific IRS operating division for the delivery of services consistent with the customer base of the operating division.

In an example of the expansion of service for specific issues, starting in December 2002, customers with business or specialty tax questions can call the new Business and Specialty Tax Line on 1-800-829-4933. Customers calling this number can apply for a new Employer Identification Number (EIN), and receive help on Employment Taxes, Partnership, Corporation, Estate, Gift, Trust and Excise Taxes, or other small business issues. This new number will enable IRS to provide better service for businesses, with a number dedicated just for them, and better service for customers with individual income tax questions by reserving the traditional 1040 help line (1-800-829-1040) for them.

The December 2002 realignment will also increase customer satisfaction by offering fewer and more focused menu choices to navigate within the separate individual and business service lines. Separating the incoming calls by individual and business issues means customers will reach CSRs specially trained in their topics, more quickly and efficiently. Customers can continue to obtain assistance with any Form 1040 issue by calling 1-800-829-1040.

The Business and Individual Tax Lines are designed to handle general inquiries. If customers receive correspondence from IRS directing them to call a different number, they should call that number to receive the quickest resolution of their specific issue. They will not be competing for service with customers seeking general assistance.

If customers need information about individual income tax refunds, and have access to the Internet, the fastest way to get assistance is through the "Where's my Refund?" automated self-service feature, available 24 hours a day, 7 days a week at http://www.irs.gov/. Otherwise, customers may call the Refund Hotline at 1-800-829-1954, which is the second new toll free number IRS has established to provide more efficient service to customers.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud IRS improvements in toll-free service provided during FY 2002, and recognize that overall satisfaction is high. Surveys give high marks for employee responsiveness, politeness, courtesy, fairness, and attitude.[271] *Beyond the changes mentioned by the IRS, a simplified script was employed during the 2002 filing season and the hours of toll-free service were shortened from 24/7 to 15/6 based on analysis of call patterns so that more staff are available during the hours when customers generally call.*[272]

The IRS continues to make strides to improve service by:

- *reducing busy signals,*
- *simplifying menus,*
- *improving call handling, and*
- *decreasing the time customers spend waiting on hold.*

Yet customer satisfaction ratings of the "Automated Answering System" and of "Ease of Getting Through By Phone" remain in the "neutral" category, well below "completely satisfied."[273] *While the IRS indicates plans to improve the way customers reach assistors in FY 2003, the IRS does not discuss either the growing number of customers who will reach an electronic voice instead of an assistor, or any involvement of customers and stakeholders in developing service improvements. Successful renovation of toll-free service and improved customer satisfaction requires two elements not yet in evidence.*

First, the IRS must work with stakeholders such as the Oversight Board, the Taxpayer Advocacy Panel (TAP), practitioners and focus groups to assess what strategies are currently acceptable and/or what changes could render a strategy acceptable. The menu system affords an example of the potential impact of such a partnership. IRS menus lack several elements found in leading private sector customer service operations. We were pleased to find that the IRS plans to add menu features for FY 2003 to allow customers to repeat a menu or return to a previous one. However, when the former Citizens Advocacy Panel (now TAP) recommended adding a menu option for live assistance, they were told the IRS avoided the practice to reduce the number of staff devoted to routing calls.[274] *With greater interaction as a standard practice, perhaps a compromise could have satisfied the customer needs while meeting the strategic objective. We suggest the IRS state an option for live assistance when menu layers number more than two.*

[271] W&I Customer Satisfaction Survey, National Report; National Toll-Free Results; Pacific Consulting Group; Covering April through June 2002; SB/SE Customer Satisfaction Survey, National Report: National Toll Free Results: Pacific Consulting Group; Covering April through June 2002.

[272] Treasury Inspector General for Tax Administration, *Significant Efforts Have Been Made to Provide Taxpayers Better Access*, TIGTA 2003-30-001; October 2002.

[273] See Table 1.18.2, Customer Satisfaction.

[274] Letter from E. W. Gargiulo, Chairman Florida Citizen Advocacy Panel, to John Dalrymple, Commissioner Wage and Investment Operating Division, January 28, 2002 and response from J. R. Watson, Director, Customer Account Services, February 19, 2002.

Second, the IRS needs to communicate service strategies to the public. In the case of automated services, this might be accomplished through the use of a brief preamble that advises a taxpayer why the call is being answered by automation and what options the caller will have for human contact if the automated service is not sufficient.

The IRS should consider conducting observational studies, in which taxpayers with actual problems are observed navigating through the phone system – automated and live assistor. Was the taxpayer satisfied? If not, when did the taxpayer begin to feel frustrated, impatient, or dissatisfied. What additional information, prompts, or assistance might have mitigated this dissatisfaction?

In general, the IRS efforts and rationale to improve toll-free service, while significant, have not been well communicated to the customer base. The IRS needs to reevaluate the involvement of stakeholders and taxpayers in defining acceptable quality service goals and methods.

PROBLEM TOPIC #19 REFUND INQUIRIES

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Peggy Bogadi – Acting Director, Information Systems Service Center Operations

DEFINITION OF PROBLEM

In fiscal year (FY) 2001, the Taxpayer Advocate Service (TAS) received 24,586 cases concerning refund inquiries. An analysis of 451 of these cases reveals two major contributing factors:[275]

- The IRS failed to process refund inquiries by the promised date after the taxpayers provided the missing information.
- The IRS mailed refund checks separately from notices of changes to the refunds taxpayers were expecting.

ANALYSIS OF PROBLEM

During fiscal year 2001, the IRS' toll-free operations provided service to 42,248,737 taxpayers, 13,084,891 of whom made refund inquiries. The toll-free function records the total volume of calls and summarizes them by category, such as tax law, refund, and accounts. However, the toll-free unit does not record specific issues within each major category, such as when the refund was mailed, how much it was for, whether the IRS received an address change, or why the refund issued differed from the amount claimed on the return. The sample of 451 TAS cases reviewed provided some insight into these underlying issues.

- Twenty-five percent of the contacts were due to missing information, forms, signatures, or incorrect addresses, and were in the control of the servicing campus (service center). The TAS referrals were taxpayer inquiries received after the taxpayer had sent the required information and IRS failed to reply by the date promised.
- Ten percent of the contacts made by taxpayers concerned undeliverable refunds. The TAS inquiries were a result of previous or repeated requests to the IRS by the taxpayer to input a change of address. Problems developed when the IRS either delayed or did not perform the input, and the refund was then returned as undeliverable.
- The remaining 65 percent were due to various reasons such as criminal investigations, injured spouse claims, refund offsets, and math errors.

[275] TAS Quality Sample for a population of 24,586 Major Issue Code (MI) 020 (Random sample of 451 cases reviewed) from TAMIS (Taxpayer Advocate Management System) for FY 2001

- The delay between the mailing of a refund check and notification of the change in the refund amount confuses taxpayers and generates telephone inquiries. Since IRS Operations does not capture the details of each contact, we cannot be sure how many contacts were due to inquiries about reductions or changes in the refund amount. The number was significant enough to lead Operations to develop a program that combined the refund check and the IRS notice into one mailing. This process was known as the Refund/Notice Integration Project.[276] However, to date this program has not been implemented due to budget constraints.

IRS COMMENTS

The IRS agrees that timely refunds are a taxpayer priority. In addition, we concur that answering and managing refund inquiries requires considerable resources and that the root causes of these inquiries should receive increased attention and analysis. However, we do not agree that it is a problem when refunds are delayed due to criminal investigations, refund offsets, math errors, or injured spouse claims (65 percent of the refund cases reported as problems). These cases, by definition, require more careful consideration and increased time to resolve prior to release of a refund that the taxpayer may, or may not, be entitled to receive.

We agree there are opportunities to increase the accuracy and efficiency of IRS processing of refund claims. However, considerable additional analysis of the many problems cited in this report will be necessary before effective remedies to such long-standing problems as missing signature and incorrect addresses on returns could be developed.

Increased taxpayer education and outreach efforts will definitely assist in preventing taxpayer errors that contribute to delays in refunds. Also, it is agreed that the combined mailing of refunds that have been adjusted and notices explaining the adjustments is an improvement that IRS has planned for quite some time in cooperation with the Financial Management System (FMS). However, as noted in this report, funding issues are limiting progress on the Refund/Notice Integration project and additional design work is needed.

The Service is undertaking many large modernization projects and these projects require annual prioritization to best utilize limited resources. Effective submission processing operations provides the vast majority of taxpayers' seamless and timely receipt of over 92 million individual income tax refunds. The volume of subsequent inquiries received in relation to those that experience an actual delay in the refund is very small especially considering 65 percent of such contacts are attributed in this report to criminal investigation, etc. However, we do agree that reducing these contacts would enable IRS to devote more resources to responding to substantive tax law and account inquiries.

[276] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001), page 24.

IRS INITIATIVES TO RESOLVE PROBLEM

The IRS continues to improve the refund inquiry process and this year offered taxpayers a significant new service. Beginning in late May 2002, taxpayers were able to check the status of their refund with a new Internet application "Where's my refund" located on the main page of the "IRS.gov" page (formerly "The Digital Daily). To date, 1.1 million successful requests have been processed by the system. The Service will also provide new dedicated toll free lines and automated refund services through Teletax. The Refund Inquiry function will use a new system to view negotiated refund checks in the Financial Management Services database, enabling better service to the taxpayer. IRS increases in electronic filing and refund direct deposits, are also contributing to the overall increase in refund timeliness.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate shares the IRS concern about taxpayers receiving timely refunds. TAS does not concur that refund delays outside of submission processing operations are not problematic. TAS received 24,586 refund inquiries with varying issues in fiscal year 2001.[277] *However, the underlying problem was the failure of the IRS to respond by the date promised. We welcome the IRS commitment to analyze the root causes of this longstanding problem of the refund inquiries and develop effective remedies. We also recommend that the IRS give equal consideration to the entire process.*

The National Taxpayer Advocate recommends full, immediate implementation of the Refund/Notice Integration (R/NIP) project. This would benefit the taxpayer by providing an explanation of proposed corrections in addition to the refund check. We strongly recommend that the R/NIP project remain a priority in the IRS modernization initiative. The National Taxpayer Advocate remains concerned about the impact of withholding entire refunds while the IRS determines the taxpayers' Earned Income Tax Credit (EITC) eligibility.

The National Taxpayer Advocate commends IRS newest internet innovation, the application known as "Where's my refund." This service will assist taxpayers with unclaimed refunds. However, a significant number of low income taxpayers still have no internet access.

The IRS comments that it provides the timely receipt of over 92 million individual income tax refunds. We applaud the Service's efforts. However, we advocate that the IRS give top priority to ensuring that 1) delayed refund inquiries are resolved by the date promised, and 2) that increased emphasis be placed on modernization projects that would reduce the need for taxpayers to make subsequent or repetitive refund inquiries.

[277] TAMIS database, MI codes 020 for FY 2001.

While the ability to electronically file Form 8379, Injured Spouse Claim and Allocation, will speed the receipt of the claim, it still requires the manual computation of a refund by an IRS employee, which adds four to eight weeks to the Form 1040 processing timeframe.[278] *The National Taxpayer Advocate recommends the computation of Form 8379 be automated, so that the entire process would be completed in the Form 1040 processing timeframe. This also will reduce taxpayer inquiries about injured spouse refunds.*

A Systemic Advocacy project team completed a proposal to automate the computation for both the electronic and paper-filed injured spouse claims. This would eliminate any manual computations, and the taxpayer would then receive their refunds more expeditiously. The National Taxpayer Advocate welcomes partnering with the IRS in implementing the above proposal.

The IRS has stated that "The volume of subsequent inquiries received in relation to those that experience an actual delay in the refund is very small, especially considering 65 percent of such contacts are attributed in this report to criminal investigation, etc." Within that 65 percent are taxpayers whose refunds are delayed because of the manually computed Form 8379, Injured Spouse Claim and Allocation; refund offsets to IRS tax and non-tax debts, such as student loans and child support; math error notices that would be abated if taxpayer information is timely processed; and criminal investigation freezes where the taxpayer's case was already cleared and Operations failed to release the freeze. We do not think any of these cases are insignificant. In each of these cases, regardless of the underlying technical issue, the IRS failed to respond timely to the taxpayer's concern.

The National Taxpayer Advocate will continue to advocate for timely response to this 65 percent of the refund inquiries. Failure to adequately respond to these inquiries creates downstream cases requiring expensive and time-consuming attention. It also creates dissatisfied, disaffected taxpayers.

[278] Married Filing Jointly taxpayers, who file an individual income tax return with a refund due, may file the Form 8379, Injured Spouse Claim and Allocation. Generally, one of the spouses owes a non-federal debt, such as child support, student loans, etc. The spouse not owing the debt is called the injured spouse and may receive his/her portion of the joint overpayment based on an allocation of his/her income and refundable credits.

PROBLEM TOPIC #20 OBTAINING EMPLOYER IDENTIFICATION NUMBERS (EINS)

IRS RESPONSIBLE OFFICIAL

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Taxpayers still have difficulty obtaining Employer Identification Numbers (EINs).

ANALYSIS OF PROBLEM

The IRS issues approximately four million Employer Identification Numbers (EINs) every year.[279] For many taxpayers, securing an EIN is a crucial first step in establishing a new business or establishing an estate for a deceased person. Taxpayers who are unable to obtain EINs within specified timeframes are hindered in filing federal and state returns, setting up bank accounts or conducting other business activities.[280] The National Taxpayer Advocate identified the process of obtaining these numbers as a serious problem for taxpayers in the FY2001 Annual Report to Congress.[281] In fiscal year 2002, the IRS planned and implemented a number of improvements aimed at reducing the burden of applying for an Employer Identification Number (EIN). For example, the IRS:

- Consolidated the EIN Program into three Small Business/Self-Employed Accounts Management sites;
- Established a new toll-free number, which now allows calls to be directed to the next available assistor in any of the three locations;
- Established hours of operations as 7:30 a.m. to 5:30 p.m. in the customer's local time zone;
- Revised the Form SS-4, Application for Employer Identification Number, which now includes an embedded third party authorization;
- Installed a fax file server, which now allows the receipt of multiple faxes without burdening the taxpayer with busy signals;
- Created a team, with members selected from all three sites, to develop consistent procedures. This team must approve all new procedural changes that are developed, before they are implemented; and

[279] Treasury Inspector General for Tax Administration (TIGTA) Management Advisory Report, *Progress in Issuing Employer Identification Numbers Has Been Made, but Enhancements Are Needed*, Number 2002-30-182, September 2002, page 3.

[280] IRM 21.7.13.1.8 provides the IRS' timeframes for issuing EINs as follows:
a. Tele-TIN request should receive an EIN within 15 minutes.
b. Fax-TIN request should receive an EIN within four workdays if a return fax number is available, otherwise, see timeframe for Mail SS-4 below.
c. Mail in SS-4s should receive an EIN within four weeks.

[281] National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001), page 43.

- Developed an EIN Internet application to provide taxpayers with the ability to request and receive EINs online.[282]

A review of IRS management inventory reports,[283] a recent Treasury Inspector General for Tax Administration (TIGTA) review[284] and an analysis of Taxpayer Advocate Service (TAS) inventory[285] indicate that IRS initiatives have reduced the EIN burden for taxpayers in fiscal year 2002. But while the problem has diminished, the IRS continues to receive complaints about the EIN application process from individuals as well as practitioner groups, although at a much lower rate than in prior years. The following issues still exist:

The IRS continues to mishandle requests for EINs by third parties. IRS employees are not identifying third party requests and not faxing the assigned EIN back to the third party requestor.

Example

> Comments from a legal professional association: *"While the new third party designation is extremely useful in assisting our clients, the process for obtaining Employer Identification Numbers (EINs) has not been very "user friendly." On two separate occasions, we have faxed Form SS-4, Application for Employer Identification Number, to the IRS. On both occasions, the assigned EIN was not faxed back to the fax number shown on the form (the third party designee fax number) within the IRS' promised four days."*[286]

The IRS is not processing bulk requests for EINs expeditiously. Internal Revenue Manual (IRM) procedures do not allow for a new block of EINs to be issued when the current block of numbers is not depleted.[287] Consequently, practitioners who have only a limited supply of EINs remaining may experience delays in receiving a new block. This is of particular concern to estate attorneys, who have difficulty projecting or scheduling the number of EINs they would need to request for decedents. This issue seriously affects their ability to open estate accounts in a timely fashion.

[282] IRS is planning an implementation date of December 2002 for this program.

[283] Management reports provided by SB/SE, dated 07/29/2002.

[284] Treasury Inspector General for Tax Administration (TIGTA) Management Advisory Report, *Progress in Issuing Employer Identification Numbers Has Been Made, but Enhancements Are Needed*, Number 2002-30-182, dated September 2002.

[285] The TAS sample consisted of Major Issue Codes 340–Initial Processing of Documents and 413–SS-4 Application & Entity Changes. The review of 174 cases was based on all receipts in these Major Issue codes that contained the words "SS-4 or EIN," between March 01, 2002, and May 29, 2002.

[286] Letter from Michael J. Zaino, Zaino & Humphrey, A Legal Professional Association, to Joseph W. Budd, Local Taxpayer Advocate, Cincinnati Campus (Service Center.), May 1, 2002.

[287] IRM 21.7.13.13.2 states: Do not issue additional BULK EINs to institutions that have not yet submitted all Forms SS–4 from the last BULK request filled.

Example

> A practitioner who requires 10 EINs to meet client needs and may have only three on hand may have to wait several weeks to receive a new block of numbers in order to issue the seven additional numbers.[288]

Periodic Tele-TIN Downtime. The IRS is not processing Tele-TIN applications received during yearly computer system (the Integrated Data Retrieval System or IDRS) downtime within promised timeframes. The yearly down time is generally the last week in December and the first few weeks of January.

Example

> The annual shutdown of the IRS' computer system, Integrated Data Retrieval System (IDRS), coincides with the peak demand period for requests for new EINs. The current contingency plan to address IDRS downtime provides for keeping the toll-free telephone service operational and taking requests by manually completing Forms SS-4. Once IDRS is available, the tax examiner processes the Forms SS-4, issues and mails the EINs. While this ultimately yields the needed EINs, it does not meet the customer's expectation of receiving a number immediately.[289]

IRS COMMENTS

In fiscal year 2002, the IRS centralized and significantly improved its program for providing Employer Identification Numbers (EINs) to business taxpayers. We consolidated the EIN program from ten sites to three sites and, in January 2002, established a toll-free environment for requesting EINs. Initially, the demand for service far exceeded our estimates and our capacity to respond timely. However, the Small Business/Self-Employed (SB/SE) Division took immediate action to resolve these problems. We hired and trained additional assistors who were in place by the end of February 2002. Beginning in March, we achieved dramatic improvement in both paper and telephone programs. Through September 30, 2002, IRS processed 1,921,000 paper EIN requests and handled over 1,711,000 EIN telephone calls.

Despite the tremendous success of our streamlined EIN application process, we recognize that there are some continuing problems, including those cited by the National Taxpayer Advocate. We already have taken steps to address these issues as described below.

[288] The National Taxpayer Advocate received additional feedback at several speaking engagements during 2002 in which practitioners indicated they still experience delays in requesting blocks of Employer Identification Numbers (EINs).

[289] Treasury Inspector General for Tax Administration (TIGTA) Management Advisory Report, *Progress in Issuing Employer Identification Numbers Has Been Made, but Enhancements Are Needed*, Number 2002-30-182, dated September 2002, page 6.

IRS INITIATIVES TO RESOLVE PROBLEM:

The IRS has undertaken several initiatives to continue to improve the EIN application process. Third parties now can receive an EIN immediately by utilizing our toll-free service. We place the third party caller on hold while he or she faxes in Form 2848/8821 or Form SS-4 with the third party designee box checked. After we verify the information, the EIN is given immediately to the third party designee. If the third party chooses to use our Fax-TIN service, we verify the information on the Form SS-4 and then fax the EIN back to the customer within four business days.

Under the bulk/bank EIN program, the IRS assigns blocks of EINs to a fiduciary or any other person authorized to represent ten or more trusts or estates. This includes bankruptcy estates created under Chapters 7-11 of the U.S. Bankruptcy Code, pension/retirement trusts, and GNMA (Governmental National Mortgage Association) pool requests. During this process, the Forms SS-4 are faxed daily to the campus of record for verification and disclosure. If the entire block of EINs is not used within a 45-day timeframe, the unused numbers must be returned to the IRS. This allows us to maintain consistency and control of the numbers that we have assigned. After we receive the unused numbers from the block, we process a subsequent EIN application for a new block of numbers within 48-72 hours.

To reduce taxpayer burden during FY 2003, we are changing how the EIN Program will provide services during the yearly downtime for computer system maintenance. Taxpayers will be able to request an EIN during this period through our toll-free service (1-866-816-2065) or by faxing or mailing their Forms SS-4 to the campus that serves their state. These taxpayers will receive a provisional number that can be used for banking purposes only. Once our computer system maintenance is completed, these taxpayers will receive their permanent EINs.

TAXPAYER ADVOCATE SERVICE COMMENTS

We applaud the IRS on its initiatives to further enhance the EIN Application Process and agree that taxpayer burden has been reduced in this area. The Taxpayer Advocate Service will continue to monitor the IRS' progress on this issue. Continued support is essential to ensure that the IRS has the proper tools and resources to implement the Employer Identification Number (EIN) Internet Program as planned for Fiscal Year 2003.

We suggest that the IRS reexamine its policy of not issuing additional bulk EINs until the user has diminished his or her current supply. The requirement to use all numbers before receiving a new block, when the customer is aware of future needs, is unacceptable. We would recommend that procedures

allow customers to request additional bulk numbers when their current supply is low. Additionally, we would advocate a change to Revenue Procedure 89-37 to extend the time from 45 to 90 days to use the block of numbers. This would reduce the administrative burden of issuing additional blocks and handling of unused numbers. It would also allow additional participants into the program that currently would not be able to use a block of numbers within the 45 days.

PROBLEM TOPIC #21 DELAY IN RECEIVING REQUESTED DOCUMENTS

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Requests for documents, copies of tax returns, audit reports, income information and account transcripts are unfilled or not processed within the prescribed timeframes.

ANALYSIS OF PROBLEM

Taxpayers and IRS employees who need to obtain stored tax information do not always receive requested documents or responses within the prescribed time limits.[290] For example, IRS employees may need stored documents to respond to taxpayer inquiries about audit reconsiderations or to process offers-in-compromise. Taxpayers may request stored documents to help in reviewing an audit report or securing a mortgage. The IRS must locate these documents among millions of paper records scattered in various offices and warehouses throughout the country. The majority of filed returns are stored in Federal Record Centers (FRCs), part of the National Archives and Retrieval Administration (NARA).[291] The FRCs are contractually obligated to fill all document requests within eight hours of receipt.[292]

An out of region request takes longest to fill.[293] An IRS campus (formerly service center) receiving such a request must first forward it to the campus where the document would normally be housed. The receiving campus then determines if the document is stored in its file area or whether the request must go to the local FRC. That FRC is then obligated to fill any request within eight hours of receipt and return the document or unfilled request to the local campus. The document request is ultimately routed back to the requesting campus and then back to the requester.

Requests for copies of returns from photocopy units are exempt from this eight-hour timeframe requirement. Under the contract, FRCs are required to fill these requests, including out of region requests, within five calendar days of receipt. But while FRCs are

[290] Internal Revenue Manual 3.30.123.13.11. Document requests are to be sorted and pulled within four workdays or six workdays during the peak-processing season within the campuses.

[291] Each IRS campus has its own storage schedule for returns for the current processing year based on the availability of space. For example, in the 1040 series, some campuses maintain current returns for eight weeks and others for up to one year before sending to the FRC for storage.

[292] Bulk requests to the FRCs take longer. The FRCs have a contractual agreement with each local IRS campus to coordinate the processing time on bulk requests.

[293] An out of region request is a request for a document stored in another office; for example, when an employee in Philadelphia needs a return that was processed at the Fresno Submission Processing Center.

required to retrieve documents within contractual timeframes, the entire process of requesting and receiving a document out of region can realistically take up to four weeks and often longer. There is no data collected to help management determine where delays are occurring in the process.

The IRS reorganization has also significantly affected the document retrieval process. Since the reorganization, the volume of out of region requests has increased at all campuses.[294] In addition, shipping documents to multiple sites, increased workloads, revised document routing procedures and space limitations at some facilities have exacerbated pre-existing document retrieval problems.

Refiling backlogs cause further difficulty, as the timeframe for refiling a document varies with the volume of refiles in the FRCs. Quality controls to prevent misfiling are minimal.[295] Misfiled documents and documents awaiting refiling further contribute to delays in receipt of documents (i.e., the taxpayer may be requesting a document that has not yet been refiled or is misfiled) and increase the number of unfilled requests. The inability to find these documents adversely affects not only taxpayers but also the IRS, by increasing processing time in responding to taxpayer inquiries.

Nearly one in four document photocopy requests is unfilled. The percentage of documents not found at FRCs has risen from 17.1 percent in fiscal year (FY) 1999 to 25.1 percent in FY 2001.[296] Unfortunately, there is no statistical data gathered nationally (other than for photocopy requests) to indicate the extent to which documents are not located. Taxpayers pay a fee when requesting a copy of a tax form and receive a refund of the fee if the IRS fails to locate the form.[297] The IRS refunded $2,395,754 in photocopy fees in FY 2001 and another $2,564,888 in FY 2000.[298] Although photocopy refunds have declined somewhat, the amount is still significant. The IRS does not track the reasons the fee is refunded.

As noted, IRS employees request documents for internal use to assist taxpayers and respond to inquiries. Both employees and taxpayers may unnecessarily request documents, or an employee may request an incorrect document. These conditions add cost and time to the process. The number of errors in these categories is also not tracked.

[294] Email response dated July 22, 2002 from Program Analyst for Wage & Investment. All ten campuses have acknowledged that the reorganization has adversely impacted their document retrieval process.

[295] Random checks, management reviews, or reviews conducted by Quality Review Units are just some of the different quality checks used in the campuses.

[296] National Photocopy Reimbursable Reports from service centers for 1999 and 2001.

[297] IRS charges a fee of $23.00 per return. When a third party requests a copy of an exempt or political organization's return, there is a fee of $1.00 for the first 100 pages and 20 cents for each additional page.

[298] National Photocopy Reimbursable Report from service centers for 2000.

Knowing the extent of unnecessary requests could enable the IRS to better train its employees and educate the public. This would reduce inefficiencies that frustrate taxpayers, delay responses to taxpayer inquiries and add to delays in other IRS programs (e.g. audit reconsideration).

The timeframe for securing copies of tax returns, Forms W-2, Wage and Tax Statement, and audit reports is 60 calendar days; and for obtaining return and account transcripts, seven to 10 workdays.[299] In February 2000, the Treasury Inspector General for Tax Administration (TIGTA) conducted reviews in the Kansas City, Memphis and Fresno campuses to improve controls over the photocopy user fees. The reviews determined that personnel in those campuses did not always adequately respond to taxpayer requests and locate returns. Management agreed with the findings and responded by ensuring that all follow up actions to secure returns would be taken and the case files would be documented. However, the number of unfilled requests continues to grow.[300] The IRS directs its employees to issue an interim response when they cannot meet the timeframe for processing a document request.[301] The number of cases referred to TAS may be an indicator that the IRS is not following that procedure.[302]

In addition, taxpayers are having difficulty obtaining Form W-2 information for state wages and withholding. The IRS no longer collects state income information. Taxpayers must pay to secure state data (a copy of the Form W-2, if available), or must contact the Social Security Administration (SSA) and pay the required fee.[303] Sometimes neither the IRS nor the SSA possesses this data.[304] Unavailability of this information can be a prob-

[299] Internal Revenue Manual 21.3.6.4.3.1 and 21.3.6.4.11.1.

[300] Treasury Inspector General for Tax Administration, Management Advisory Reports: *The Internal Revenue Service Should Improve Controls over Photocopy User Fees at the Kansas City Service Center*, Reference No. 2000-40-038; *The Internal Revenue Service Should Improve Controls over Photocopy User Fees at the Memphis Service Center*, Reference No. 2000-40-037; *The Internal Revenue Service Should Improve Controls over Photocopy User Fees at the Fresno Service Center*, Reference No. 2000-40-036, February 2000, at page 2.

[301] Internal Revenue Manual 21.2.5.4.13.4.

[302] There were 4,644 cases referred to TAS in FY 2001 under Major Issue Code 420, Requests for forms, publications, copies of returns and transcripts. Eighty-eight percent of the TAS cases received were comprised of requests for copies of tax returns, account transcripts and income information requests where IRS failed to respond to the taxpayer, did not process the request within the prescribed timeframe, or by the date promised.

[303] Internal Revenue Manual 21.2.5.4.13.16.

[304] The SSA collects information from Forms W-2. The Wage Information Retrieval System (WIRS) maintains data through Document Image Microfilm (DIM) and Computer Output Microfilm (COM). DIM is comprised of photographs of the Forms W-2 and Forms W-3, which include state data. COM is a listing of data that has been reformatted from a magnetic media-reporting source that does not reflect state information.

lem for taxpayers and the IRS' Fed/State Exchange Program.[305] Taxpayers also receive misinformation on external web sites regarding how to secure copies of Forms W-2.[306]

Taxpayers also incur problems in securing transcripts and income information needed on an expeditious basis. Delays can cause significant hardship for taxpayers who, for example, need the information for court proceedings, college financial aid, mortgages, interviews with the Immigration and Naturalization Service, loan approvals, social service agencies or state tax returns.

Furthermore, instructions on Form 4506, Request for Copy or Transcript of Tax Form, could more clearly describe the contents of a return transcript so that taxpayers and third party requesters can better determine when to ask for a transcript. Taxpayers may unnecessarily pay for copies of tax forms when a free return transcript would suffice. Improved guidance would also help the taxpaying public request only the information needed, speed delivery, and reduce processing costs. Free return transcripts can be obtained quickly at Taxpayer Assistance Centers (walk-in sites) or from IRS call sites.

An initiative is underway to improve customer service by offering online delivery of taxpayer transcripts through the Transcript Delivery System. We are not aware of any modernization plans for requesting paper copies of returns or other documents.

IRS COMMENTS/INITIATIVES TO RESOLVE PROBLEM

This problem outlines numerous issues related to delays in taxpayers receiving requested documents. Principal among these are:

1) IRS must locate documents among millions of paper records stored in various offices and warehouses throughout the country.
2) Out of region requests take longest to fill.
3) Re-filing backlogs are leading to further difficulty.
4) Taxpayers have difficulty obtaining Forms W-2 and other income information.

[305] The Fed/State Exchange Program shares tax information between federal and state tax authorities.

[306] For example, some web sites advise taxpayers to contact the IRS for copies of their Form(s) W-2 at no charge using the Form 4506. However, there is a $23 fee for securing a copy of Form(s) W-2. Taxpayers may receive a computer printout of Form(s) W-2 information at no charge online, but they do not have state income information (see e.g. Seton Hall University, "Financial Planning/Obtaining Copies of Income Tax Returns," 2002 at http://www.shu.edu/fataxinfo.html).

IRS must locate documents among millions of paper records stored in various offices and warehouses throughout the country

IRS tax records are either stored at the 10 IRS Campus Files functions or the 14 National Archives and Record Administration (NARA) record centers. The IRS Campus Files functions and NARA headquarters can track where each year's tax records are located. These records are filed and stored in document locator number (DLN) order for ease of retrieval. The IRS/NARA Interagency Agreement (IA) requires that NARA service document requests as follows:

- Normal requests within eight (8) working hours after receipt;
- Photocopy requests within a five day period;
- Priority or special servicing requests within the same day; and
- Bulk requests (i.e., Collection Statute Extension Date (CSED) prior to the end of the fiscal year and Automated Underreporter (AUR)) within a reasonable timeframe (usually agreed upon by the AUR project area, Files function and NARA).

IRS processes and files over 200 million multiple-page tax returns each year. These returns and related documents move in and out of storage and between IRS and/or NARA facilities as part of routine IRS operations, such as examinations of returns and other compliance programs. As a result, at times returns or other documents cannot be located immediately. However, free transcripts of accounts in lieu of copies of returns will fulfill most taxpayers' needs for IRS records of income for such things as applying for college financial aid, mortgages and other loans, or completing current year returns.

An out of region request takes longest to fill

Since the reorganization (realignment of states among the IRS sites), the number of out of region requests has increased significantly. However, the following steps have been taken to minimize delays in routing these requests:

- A unit address listing (UAL) supporting the new organizational alignment and state mapping was developed and placed on the Submission Processing Web page.
- A programming change was made to require that the requestor input a complete mailing address on Form 4251, Document Request. This will result in filling requests more expeditiously.

In addition, a programming change will be implemented in January 2003 to print an address number, mail-out city and state on the return request form, based on the unit address list. This will assist in sorting requests and will further minimize timeframes for routing of documents between IRS campuses and NARA sites.

Re-filing backlogs are leading to further difficulty.

This problem affects only a few NARA record centers (approximately three of the 14), which have periodically experienced large refile backlogs. To address this problem, the following steps have been taken:

- The volume of refile returns shipped between the IRS campuses and NARA record centers are being tracked. NARA submits a weekly backlog report to IRS that includes refile volumes.
- Beginning October 1, 2002, the IRS campuses are required to submit a quarterly inventory report to IRS headquarters. This report will contain the volume of refile returns shipped to NARA.
- IRS headquarters will monitor both reports. Therefore, when it is evident that a problem exists the IRS Headquarters analyst and NARA account representative will coordinate a resolution.

W&I will be coordinating with the Advocate's office to further explore the problems resulting from misfiled documents.

Taxpayers are having difficulty obtaining Forms W-2 and other income information.

The next revisions of the Request for Copy or Transcript of Tax Form, (Form 4506), are targeted for implementation before June 2003 and will include in the instructions how many years of information IRS can provide and when taxpayers must go to the Social Security Administration to obtain Form W-2 information. The form will also be revised to include the same information with regard to the availability of IRS forms and emphasize the cost saving and faster service available through securing a transcript instead of a photo copy.

The report includes a statement that *"taxpayers also incur problems in securing transcripts and income information needed on an expeditious basis."* The IRS is not aware of any significant issues or delays in processing of transcript requests. Without additional information, IRS is unable to comment on this assertion.

TAXPAYER ADVOCATE SERVICE COMMENTS

This issue continues to be a problem for taxpayers and IRS employees. In last year's National Taxpayer Advocate Report to Congress, the IRS stated that it would assemble a study group comprised of IRS personnel and representatives from TAS and NARA to explore ways of improving the tracking and availability of returns as they are retrieved and refiled. We appreciate the IRS' efforts to require NARA to locate documents by searching refiles when a document cannot be found. However,

our analysis of the document request and photocopy processes confirms the need for the establishment of this study group to identify problem areas and strengthen customer service.

The IRS is to be commended for working to identify trends and improve customer service by tracking the reasons for the issuance of photocopy fee refunds. However, IRS management must ensure that employees follow current procedures for processing photocopy requests that include taking follow-up actions to secure documents and initiating interim responses when appropriate.

The IRS needs to identify training and educational opportunities for employees and taxpayers by collecting statistical data. One option would be to solicit feedback from both internal and external customers about how to improve service in both the photocopy and Files areas.

The IRS is in the process of revising Form 4506. The Taxpayer Advocate Service will participate in this initiative. The NTA recommends including additional examples of when a return transcript would be sufficient, in order for the taxpayer to avoid the expense of requesting a copy of the return or the actual Form(s) W-2. We appreciate plans to include additional guidance for taxpayers requesting information from the IRS and when SSA assistance is needed to obtain W-2 information. As a cautionary note, TAS is concerned that SSA does not currently have the capability of receiving all state information on transmissions received through magnetic media from employers.

The National Taxpayer Advocate also recommends that the IRS clarify the instructions for line 8c on Form 4506, which states that there is no charge for requesting Form(s) W-2 information. Presently, the Form 4506 provides conflicting instructions to taxpayers on when to request Form(s) W-2 information for a fee.[307]

To modernize the photocopy request process, we recommend that the IRS develop an electronic Form 4506 and automate the photocopy process by allowing taxpayers to request documents over the internet. This could be accomplished by developing a program that would walk the taxpayer through the request process, and advise the taxpayer when a return or account transcript would be appropriate at no cost. If a fee were to be required, the taxpayer could pay online via credit card.

The Transcript Delivery System (TDS) allows authorized customers and IRS employees to submit a request for a transcript and to receive it on-line. We applaud the IRS for this initiative and recommend the process be expanded to include imaging returns for electronic storage. This will allow receipt of copies of returns online.

The IRS needs to work further with state governments to determine who is required to store state income and withholding information and to explore a more efficient method of sharing state tax data under the Fed/State Exchange Program.

[307] The instructions to line 8 of the form state there is no charge for requesting Form(s) W-2 information that can be in the form of a transcript or actual Form(s) W-2. However, in the instructions for line 8c, it states that if a taxpayer needs the actual Form(s) W-2, he or she is required to request a complete copy of the return and pay the required fee.

PROBLEM TOPIC #22 MISAPPLIED/LOST PAYMENTS

IRS RESPONSIBLE OFFICIALS

John Dalrymple – Commissioner, Wage & Investment Division

Joe Kehoe – Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Payments lost or misplaced by the IRS cause additional burden on taxpayers, requiring them to substantiate their initial payments. Misapplied payments require the taxpayer to submit a copy of both the front and back of the cancelled check.

ANALYSIS OF PROBLEM

Once the IRS has determined that a taxpayer sent a payment and the check has not cleared the taxpayer's account, IRS considers the payment to be lost or misplaced. The taxpayer must stop payment on the previously written check and submit a Form 8546, Claim for Reimbursement of Bank Charges Incurred Due to Erroneous Service Levy or Misplaced Payment Check, to receive reimbursement of any bank fees that may have been charged.[308]

In a review of 289 Taxpayer Advocate Service (TAS) cases identified as having problems with payments posting, 46 cases, or 16 percent, had missing or lost payments. [309] TAS requested the original returns from the IRS campus' (formerly service centers) files sections to determine if the checks were still attached, and learned that those payments could not be found and were thus considered lost.[310] However, in two of these cases, the checks were found to be attached to the original returns that had been processed and filed.

In the same review, 88 cases, or 30 percent, involved misapplied payments. Thirty-seven percent of the misapplied payments were caused by taxpayer error, but 63 percent were due to IRS errors. The latter cases included payments applied to the wrong taxpayer's account, late posting of credit, and incorrect dates recorded with credit transfers.

Chapter 21 of the Internal Revenue Manual states that when the taxpayer reports the payment as not applied to the correct account, it becomes the taxpayer's responsibility to prove payment to the IRS.[311] The burden on the taxpayer includes paying all expenses required to obtain a copy of the front and back of the cancelled check.

[308] IRS Policy Statement P-5-39, Reimbursement of Bank Charges Due to Erroneous Levy and Service Loss or Misplacement of Taxpayer Checks.

[309] The quality sampling from Taxpayer Advocate Management Information System (TAMIS), Major Issue Code 210, Lost or Misapplied Payment Issues, was based on a population of 11,058 cases that included both individual & business cases from October 1, 2000 to September 30, 2001.

[310] IRM 21.5.7.3.4, Payment Tracers.

[311] IRM 21.5.7.3(2).

IRS COMMENTS

In fiscal year 2001, IRS processed approximately 217 million payments, and nearly all are processed without any problem. However, there are some payments that are lost or misapplied due to IRS or taxpayer error. We are always concerned when taxpayers' payments do not get properly credited to their accounts. We agree with the National Taxpayer Advocate that it is a burden for the taxpayer to obtain a copy of both sides of the cancelled check, and we attempt to take every step possible to locate the payment and rectify the problem before contacting the taxpayer. However, when all our internal efforts fail, getting a copy of the cancelled check greatly increases the likelihood that we will be able to locate the payment and have it credited to the proper account as expeditiously as possible.

The part of our Internal Revenue Manual (IRM), which deals with procedures for missing payments (IRM 21.5.7), mandates that we perform internal research before the taxpayer is contacted and asked to submit a copy of the cancelled check. It provides at least 15 different research tools to use in locating the missing payments. Unfortunately, we are not always able to locate a payment through internal research. Once the taxpayer provides us a copy of both sides of the cancelled check, we usually are able to locate the payment and apply it to the taxpayer's account. If the payment still cannot be located, the specialized Hardcore Payment Tracer Function (HPTF) takes over the case. The HPTF is composed of personnel specifically trained to find hard to locate payments. They also need a copy of the cancelled check to handle the case. Therefore, while we do not wish to overburden the taxpayer, in many cases we must request a copy of the cancelled check in order to restore the proper credit to his or her account.

It is an extremely rare situation when a "lost check" is later found with the original return, as the Advocate noted happened in two cases in the sample. When this does happen, the taxpayer may file a Form 8546, Claim for Reimbursement of Bank Charges Incurred Due to Erroneous Service Levy or Misplaced Payment Check. This claim allows the taxpayer to recoup the expense he or she incurred due to our not identifying the check and posting the payment when the taxpayer's return was received.

IRS INITIATIVES TO RESOLVE PROBLEM

Due to the large volume of payments we handle each year, it is virtually impossible to ensure that the process is error free. However, we do provide annual training to all functions involved, in an effort to prevent such errors and handle expeditiously those that do occur. As a last resort, contacting the taxpayer for a copy of both sides of the cancelled check is necessary to provide a speedy resolution and properly credit the taxpayer's account.

For individual taxpayers (Form 1040 series), IRS is developing an initiative called Remittance Transaction Research (RTR) to scan payments (checks and/or vouchers) received at submission processing centers and through the lockbox process. The images will be made available nationwide through RTR. We anticipate that this initiative will alleviate the burden on many taxpayers to have to submit a copy of both sides of their cancelled check. RTR will be piloted in August 2003 and is tentatively scheduled for nationwide implementation in late 2003. Additional payments (including business return payments) will be included in future enhancements available after 2003.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that the IRS processes a great number of payments each year. We also realize that taxpayers do not always identify where they expect the payment to be credited.

However, we know that for those taxpayers whose checks have been lost or misapplied, it is burdensome to obtain a copy of the cancelled check or to stop payment. The instructions on locating payments in IRM 21.5.7.3 do not clearly state what steps should be taken prior to asking the taxpayer for a copy of the check. The instructions should clarify that requesting a copy of the check is a last resort when the payment cannot be located.

We are extremely pleased with the development of the Remittance Transaction Research initiative and urge Congress and the IRS to ensure that this initiative is appropriately funded. The National Taxpayer Advocate believes, as does the IRS, that this technology will eliminate much of the taxpayer burden associated with lost or stolen checks.

FOLLOW-UP REPORT

CLAIMS FOR RELIEF FROM JOINT AND SEVERAL LIABILITY

IRS RESPONSIBLE OFFICIAL

John Dalrymple – Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Taxpayer concern about the status of claims for relief from joint and several liability was among the most serious problems highlighted in the National Taxpayer Advocate's 2001 Annual Report to Congress.[312] Taxpayers seeking this relief were not always told their claims had been received or kept informed of progress on their claims.[313] Further, taxpayers were not made aware that, even under optimal conditions, the administrative actions required by law can add as much as 165 days to the processing of a claim. The IRS did not regularly update taxpayers about delays or what was happening on individual claims.

FOLLOW-UP DISCUSSION

Joint and several liability issues have been a recurring problem for taxpayers, as detailed in prior National Taxpayer Advocate Reports to Congress. The IRS has made continuing progress in easing problems associated with the increased volume of claims for relief. This year, the National Taxpayer Advocate highlights the program not as a problem for taxpayers, but rather, as an IRS success story.

The Restructuring and Reform Act of 1998 (RRA98) granted considerable new rights to taxpayers and expanded others, including provisions granting relief from joint and several liability.[314] The additional avenues for relief under these provisions caused an unexpected flood of claims. [315] The IRS placed thousands of these claims in suspense, pending issuance of regulatory guidance required by statute. The complex tax law implications related to claims for joint and several liability relief further contributed to the growing backlog. Taxpayers received no word on their claims for extended periods. In some instances, the IRS did not acknowledge receipt of a claim. (These claims are commonly referred to as "innocent spouse" claims.)

Over time, the IRS succeeded in tackling the numerous challenges in programming and procedures for processing "innocent spouse" claims during a major reorganization of the agency. Notably, the implementation of the Innocent Spouse Tracking System (ISTS) was key to gaining control over inventory. The system provides valuable data for use in pro-

[312] Ranked # 22.

[313] Claims received under provisions of Internal Revenue Code (IRC) § 6015.

[314] Internal Revenue Service Restructuring and Reform Act of 1998(RRA98), Public Law 105-206.

[315] Since the passage of RRA98, IRS has received 213,467 claim years affecting approximately 112,351 taxpayers through 9/30/2002 (includes pre-ISTS tracking inventory) Source: Innocent Spouse Tracking System (ISTS), Sept. 30, 2002.

gram improvement. A web-based decision document guides IRS examiners to make timely, consistent and accurate determinations on joint and several relief eligibility. New Integrated Data Retrieval System (IDRS) programming has been developed to speed processing and improves accuracy in separating joint accounts where relief is granted.

Furthermore, improvements in inventory control have mitigated "innocent spouse" (IS) processing problems and significantly reduced staffing needs.[316] Staffing at the Cincinnati Centralized Innocent Spouse Operation (CCISO) has been stabilized at 168 employees, capable of processing 50,000 closures per fiscal year.[317] For FY 2002, CCISO closed 49,800 claim years; 49,600 closures were projected.[318] Additionally, more than half of CCISO "first read" screeners have been cross-trained in separating accounts where relief has been granted. During October, November and December, while awaiting peak filing of claims in a new filing season, screeners are projected to separate and close approximately 3,000 claims.[319] Separation is the process of splitting liability from a joint account into two separate accounts, one for each spouse, on cases where relief is granted. Until this occurs, the innocent spouse is not completely free from liability.

Full-time equivalents (FTEs) in Small Business and Self-Employed field offices were reduced.[320] The Innocent Spouse Project Office (ISPO) projected a decrease to 258 field staff employees for FY 2002. However, 304 employees remain to handle the 3,964 claims years affecting approximately 2,090 taxpayers.[321]

The development of specialized skills in CCISO examiners and the use of the automated decision-making tool helped employees at CCISO accurately resolve most claims. In FY 2002, fewer than 1,000 claims were transferred from CCISO to field offices for processing, allowing field personnel to concentrate on reducing the backlog of older claims forwarded previously.

Other enhancements affecting IS processing have included the following:

- Transmission of initial letters to taxpayers within 30 days of receipt of the IS claim to promptly inform them of receipt. Additionally, IRS has revised the initial letter

[316] Total IS Full-Time Equivalents (FTEs) in FY 2000 were 887; FTEs in FY 2002 were 469. Source: Innocent Spouse Tracking System (ISTS).

[317] Telephonic data sharing from CCISO on 10/15/02.

[318] Id.

[319] As of 7/1/2002, Small Business and Self-Employed Division began sending all non-protested post assessment partial and full grant claims to CCISO for end processing. The Master file Transaction 31 (MFT 31) processing of partial and full grant IS claims has recently been moved to the Andover Wage and Investment Campus. Source: Innocent Spouse Tracking System, July 2002.

[320] Field staff in Small Business and Self-Employed (SB/SE) Division has been reduced from 768 Full-Time Equivalents (FTEs) in FY 2000 to 304 FTEs in FY 2002. Source: Innocent Spouse Tracking System (ISTS).

[321] Source: Innocent Spouse Tracking System (ISTS).

to inform taxpayers of specific and realistic timeframes when they can expect actions to take place.[322]

- Centralized processing at the Cincinnati Centralized Innocent Spouse Operation (CCISO) site, with additional staffing and specialized training, resulting in timelier, more consistent and accurate responses to taxpayers.
- Implementation of an automated decision-making tool leads examiners through the complex decision-making process. The tool was enhanced to include the initial screening to improve accuracy and timeliness.
- Revision of the IS claim form, instructions and publication to assist taxpayers in filing more accurate and complete claims.[323] The IRS developed these revisions in coordination with analysts from the Taxpayer Advocate Service's (TAS) Office of Individual Advocacy. A Spanish version of the claim form was also developed.[324]
- Development of a revised questionnaire to standardize assistance for taxpayers seeking innocent spouse. The revisions included feedback from practitioners and suggestions from TAS Systemic Advocacy, and will be available on the IRS website.[325] This should help taxpayers and practitioners file claims and reduce the need for burdensome subsequent contacts or information requests.

IRS is currently meeting IS program objectives in this area and continues to set goals for further improvement. Notable ongoing initiatives include:

- Modifying IS letters to provide accurate, understandable explanations about the disposition of IS claims and entitlement to appeal rights. The practitioner community and TAS are participating in this effort.
- Revising the Internal Revenue Manual (IRM), providing examiners with improved technical and procedural guidance.[326]
- Addressing issues related to domestic abuse. Examiners at the CCISO site are trained to deal with sensitive issues, including assistance with guidance relating to IRS regulations published in July 2002.[327] That regulation provides exception to the lack of actual knowledge requirement under the IRC §6015(c) election to separate liability where domestic abuse has existed in a marriage.

[322] Source: Innocent Spouse Tracking System (ISTS), July 2002.

[323] Form 8857, Request for Innocent Spouse Relief, (Rev. 5/02) and Publication 971, Innocent Spouse Relief, (Rev. 6/02).

[324] Form 8857SP, Request for Innocent Spouse Relief (in Spanish)(Rev. 6/02).

[325] Form 12510, Questionnaire for Requesting Spouse, published in June 2002, will be posted to the IRS Website in the near future.

[326] Internal Revenue Manual (IRM) 25.15.1.

[327] Internal Revenue Service Final Regulations, (T.D. 9003), Guidance on Innocent Spouse Relief Under Section 6015, July 17, 2002.

- Developing a customer satisfaction survey with assistance of the Gallup Organization and input from taxpayer and practitioner groups.
- Continuing outreach to seek feedback on innocent spouse issues from the practitioner community.

The following statistical indicators demonstrate how the implementation of these changes have positively impacted IS program results:

TABLE 1.23.1
PRE NOTIFICATION INVENTORY

FY 2000 - 9/30/00		FY 2001 - 9/30/01		FY 2002 – 9/30/02	
Modules	Taxpayers	Modules	Taxpayers	Modules	Taxpayers
40,158	21,136	28,187	14,835	20,467	10,772

There has been a significant decrease in the number of taxpayers who have not been notified of claim disposition (Innocent Spouse pre-notification inventory). This inventory declined 27 percent in FY 2002, as of Sept. 30, 2002.[328] Overall, pre-notification inventories have dropped by 49 percent in the last two years, including a 30 percent decline in FY 2001.[329] Advising taxpayers of a decision regarding their claim as soon as possible is an important IRS goal for the program. The marked improvement in notifying taxpayers of the status of their IS claim occurred while the number of received claims remained fairly constant (a two percent decrease) during a similar timeframe in fiscal year 2001.[330]

The decrease in Innocent Spouse pre-notification inventories has also positively impacted TAS, as evidenced by the following table reflecting TAS receipts:[331]

[328] Source: Innocent Spouse Tracking System, Sept. 2002.

[329] Source: Innocent Spouse Tracking System.

[330] IRS received 50,616 claims in FY 2002 as compared to 51,609 in FY 2001. Source: Innocent Spouse Tracking System (ISTS).

[331] Source: Taxpayer Advocate Management Information System (TAMIS).

PROBLEMS

TABLE 1.23.2
TAXPAYER ADVOCATE SERVICE INNOCENT SPOUSE CASE RECEIPTS
FISCAL YEAR - MONTH

	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUNE	JULY	AUG	SEPT	TOTAL
FY 2000	232	276	200	255	377	384	262	289	269	245	291	183	3263
FY 2001	227	179	140	236	314	331	247	209	182	159	187	141	2552
FY 2002	175	159	113	169	196	190	204	169	121	127	103	92	1818

In addition to the significant decrease in TAS Innocent Spouse case receipts, both the General Accounting Office (GAO) [332] and the Treasury Inspector General for Tax Administration (TIGTA)[333] have recently reported significant improvements in IS claim processing and management during 2002.

A Continued Commitment to IS Program Improvements

IRS operational priorities contain commitments for future improvement in the IS program. The IRS continues to identify weakness and address process improvements. For example, the standard for keeping taxpayers apprised of their case status is contact at least every 90 days. IRS's Centralized Innocent Spouse Case Review (CISCR) examines a statistically valid sample of closed innocent spouse cases. The success rate for meeting the 90-day contact goal is approximately 50 percent. Technological improvements are expected to be in place for FY 2004 to enable management to track and systematically address whether follow-up has occurred in 90 days.

The IRS found that many cases selected for CISCR resulted from a workload backlog, which has been substantially reduced. Because of customer service concerns, and to determine if employees are doing a better job on the more current cases than the aforementioned goal reflects, the IRS is sampling its 90-day status inventory.

[332] GAO Report, 02-558, *TAX ADMINISTRATION, IRS's Innocent Spouse Program Performance Improved; Balanced Performance Measures Needed*, April 24,2002.

[333] TIGTA Report, 2002-40-067, *Numerous Efforts Are Taken to Educate Taxpayers on Innocent Spouse Eligibility Requirements*, March 2002.

As of July 1, 2002, the Small Business/Self-Employed Division began sending all non-protested post assessment partial and full grant claims to CCISO for end processing, including IDRS Master file 31 (MFT 31) adjustments.[334] In anticipation of improved accuracy and shorter processing timeframes, the MFT 31 process for CCISO has been moved to the Andover Wage & Investment Campus. Cross-trained screeners at CCISO are helping to close these accounts as Andover employees become more proficient in the process.

The recent TIGTA review did point out that untimely routing to CCISO of Form 8857, Request for Innocent Spouse Relief, still needs attention. The Innocent Spouse Project Office had addressed this concern in October 2000. However, in light of the review, a memorandum was issued in September 2002 with simplified procedures that require any IRS employee receiving an Innocent Spouse claim to promptly date stamp it and immediately forward the claim to CCISO.[335]

The National Taxpayer Advocate commends the IRS for its efforts to address the many administrative challenges presented by the statutory changes in the law regarding relief from joint and several liability. Oversight and responsibility for the innocent spouse program have in the past few months shifted to the Compliance unit of the Wage and Investment Division. The National Taxpayer Advocate will continue to monitor the management of the program under this restructuring to ensure that innocent spouse claims processing continues to improve.

[334] This is the process of separating the tax liability from a joint account to two separate accounts (one for each spouse) on claim cases in which relief has been granted.

[335] Source: Innocent Spouse Project Office (ISPO) Memorandum, 9/26/2002.

INTRODUCTION

The National Taxpayer Advocate has a statutory requirement that is unique within the Internal Revenue Service. The Advocate is directed by Section 7803 (c)(3)(B)(viii) of the Internal Revenue Code to formulate and present in the Annual Report to Congress, proposals for legislative action that will ameliorate or eliminate problems affecting Taxpayers. Frequently, these difficulties impede a taxpayer's ability to comply with federal law. Our mandate is to identify actual and potential barriers confronting taxpayers, and to propose viable legislative options.

The following recommendations arose from a variety of sources, including those internal to the Taxpayer Advocate Service, and the Internal Revenue Service. Suggestions and comments from external groups, including tax professionals, Taxpayer Advocacy Panels, the IRS Oversight Board, and Low Income Taxpayer Clinics were an invaluable source of ideas. We also analyzed data and commentary compiled through customer satisfaction surveys, research projects, and academic treatises.

Our discussion is grouped into two categories: Key Legislative Recommendations, and Additional Legislative Issues. The former details proposed changes in six areas of tax law, and provides an issue summary, practical example of its impact, and a description of our proposal as it relates to current law. We have included information about the impact on taxpayers, and the potential administrative requirements each proposal imposes upon the IRS. As with other sections of this Report, the issue of taxpayer rights figure prominently in our discussion.

The section on Additional Legislative Issues contains five areas which are worthy of mention, but require further development. These issues will be explored by the Taxpayer Advocate Service during the next year, and evaluated for possible inclusion in our formal legislative proposals. We note that the majority of these recommendations were proposed by employees of IRS Operating Divisions and functions other than the Taxpayer Advocate Service.

The Key Recommendations meet the criteria identified in our "Most Serious Problems" section. There are linkages, for example, between the discussion related to Math Error Authority and oversight of EITC return preparers, and the legislative proposals that follow. Several of the issues that surface in the "Most Litigated" section are also subsequently addressed by a suggested legislative remedy. For example, the inconsistent tax treatment of attorney fee awards and settlements in civil rights or similar cases was first identified in our analysis of litigation about deductions or unreported income.

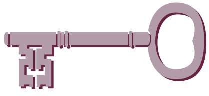
Several of the Key Legislative Recommendations in our 2001 Annual Report received serious consideration by legislators, and were introduced in proposed bills. Provisions related to the uniform definition of a qualifying child struck a particularly responsive chord among both taxpayers and their elected representatives. Although the Alternative Minimum Tax did not receive the level of attention that we believe the problem warrants, its inclusion in last year's report heightened both legislators' and taxpayers' awareness of a looming tax administration debacle.

This legislative activity emphasizes that one of the primary functions of our report is to intensify the scrutiny of problems in either the complexity of the Code or the implementation of the tax law by the Internal Revenue Service. Although the TAS organization works to resolve these issues administratively, often a legislative solution is required. We believe that the submissions which follow are among that group.

STATUS OF 2001 LEGISLATIVE RECOMMENDATION WITH CONGRESSIONAL ACTION

RECOMMENDATION	BILL NO.	SPONSOR	DATE	CURRENT STATUS
Family Issues				
Uniform Definition of a Qualifying Child	HR 5166	Portman	7/18/2002	referred to the Ways & Means Committee
	HR 5505	Houghton	10/1/2002	referred to the Ways & Means Committee
Means Tested Public Assistance Benefits	HR 5505	Houghton	10/1/2002	referred to the Ways & Means Committee
Credits for the Elderly or the Permanently Disabled	S 2131	Bingaman	4/15/2002	referred to the Senate Finance Committee
Alternative Minimum Tax				
Repeal	HR 437	English	2/6/2001	referred to the Ways & Means Committee
	S 616	Hutchinson	3/26/2002	referred to the Senate Finance Committee
	HR5166	Portman	7/18/2002	referred to the Ways & Means Committee
Index AMT exemption	HR 5505	Houghton	10/1/2002	referred to the Ways & Means Committee
Penalties & Interest				
Interest Abatement on Erroneous Refunds	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
First Time Penalty Waiver	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Federal Tax Deposit (FTD) Avoidance Penalty	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Home-based Service Workers				
	S 2129	Bingaman	4/15/2002	referred to the Senate Finance Committee
Joint & Several Liability				
Community Property	HR4070	Shaw	3/20/2002	11/18/02 as amended passed by the Senate

RECOMMENDATION	BILL NO.	SPONSOR	DATE	CURRENT STATUS
IRS Collection Procedures				
Return of Levy or Sale Proceeds	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Reinstatement of Retirement Accounts	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Partial Payment Installment Agreements	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Employment Tax Issues				
Health Insurance Deduction for Self-Employed Individuals	S 2130	Bingaman	4/15/2002	referred to the Senate Finance Committee
Small Business Issues				
Income Averaging for Commercial Fisherman	S 312	Grassley	2/13/2001	referred to the Senate Finance Committee
	HR 2347	Nussle	6/27/2001	referred to the Ways & Means Committee
	S 1676	Kerry	11/13/01	referred to the Senate Finance Committee
Other Issues				
Disclosure Regarding Suicide Threats	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Tolling the Statute of Limitations 7811(d)	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Low-Income Taxpayer Clinics	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
	HR 7	Baucus	7/16/2002	reported by Chairman Baucus, with an amendment referred to the Senate Finance Committee



1 ATTORNEY FEES IN NONPHYSICAL PERSONAL INJURY CASES

DID YOU KNOW?

- Nonphysical personal injury cases are filed by victims of employment, race, sex, or age discrimination, breach of contract, or wrongful termination.
- Contingent attorney fees and attorney fee awards are treated differently depending on where the taxpayer lives and which court hears the case.
- The United States Courts of Appeal for the Fifth, Sixth, and Eleventh Circuits now exclude the fees from income.
- The First, Third, Fourth, Seventh, Ninth, Tenth, and Federal circuits hold that the fees are includible in income.
- The United States Tax Court generally considers the fees includible in gross income unless the case can be appealed to the Fifth, Sixth, or Eleventh Circuit Courts.
- The United States Supreme Court has declined to accept cases that might resolve this conflict.
- The current IRS position is that the fees are includible in income.
- If the fees are includible in income, they may be deductible on Schedule A, Itemized Deductions, as a miscellaneous deduction subject to the limitation of two percent of adjusted gross income.
- Miscellaneous deductions on Schedule A, Itemized Deductions, are reduced if adjusted gross income exceeds certain amounts (for 2002: $137,300 or 68,650 if married filing separately).
- Miscellaneous deductions on Schedule A, Itemized Deductions, are subject to the Alternative Minimum Tax (AMT) because they are not deductible for AMT purposes.
- The treatment of miscellaneous deductions under the AMT may result in the combined attorney fees and tax on the settlement or award consuming the majority, or possibly all, of the damages received by the taxpayer. Indeed, it is possible that the tax liability of a prevailing party may **exceed** the damages awarded, resulting in a **reduction** in the individual's assets.

PROBLEM

Nonphysical personal injury cases are usually filed by victims of employment, race, sex, or age discrimination, breach of contract, or wrongful termination. In such cases, contingent attorney fees and attorney fee awards are treated differently depending on where the taxpayer lives and which court hears the case. The United States Courts of Appeal for the Fifth, Sixth, and Eleventh Circuits now exclude the fees from the taxpayer's gross income. The First, Third, Fourth, Seventh, Ninth, Tenth, and Federal circuits hold that the fees are includible in gross income. The United States Tax Court generally considers the fees includible in gross income unless the case can be appealed to the Fifth, Sixth, or Eleventh Circuit Courts. The United States Supreme Court has declined on at least four occasions to accept cases that might resolve this conflict.[1] The current IRS position is that the fees are includible in gross income.[2]

The disparate treatment of attorney fee awards or settlements in nonphysical personal injury cases results in some taxpayers being able to completely exclude these legal fees from gross income while other taxpayers must include them. If the fees are includible in gross income, the taxpayer may be able to deduct them as a miscellaneous itemized deduction subject to the limitation of two percent of adjusted gross income (AGI). However, miscellaneous itemized deductions are not deductible for alternative minimum tax (AMT) purposes and may be subject to the Internal Revenue Code section 68 limitation on itemized deductions for high-income taxpayers.[3] The treatment of miscellaneous deductions under the AMT may result in the combined attorney fees and tax on the settlement or award consuming the majority, or possibly all, of the damages received by the taxpayer.[4]

EXAMPLES

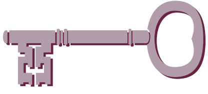
- A New York Times article stated that a police officer who sued her employer for sex discrimination and harassment prevailed in court and was awarded $300,000 in damages and almost $950,000 in attorneys' fees and costs. Her state falls under the jurisdiction of the U.S. Court of Appeals for the Seventh Circuit, so she must include almost $1,250,000 in taxable income on her federal return. Her tax liability will consume the entire $300,000 of the damage award, *and she will owe an additional $99,000 in federal taxes*. The net effect of her successful lawsuit against her

[1] Benci-Woodward v. Commissioner, 121 S. Ct. 855 (2001); Coady v. Commissioner, 121 S. Ct. 1604 (2001); Hukkanen-Campbell v. Commissioner, 122 S. Ct. 1915 (2002); Sinyard v. Rossotti, 122 S. Ct. 2357 (2002).

[2] Internal Revenue Service Market Segment Specialization Program (MSSP) Audit Guide, *Lawsuit Awards and Settlements*, Chapter 3, Other Related Topics, Deduction for Attorneys' Fees.

[3] The effect of the IRC § 68 limitation is such that, as a taxpayer's adjusted gross income exceeds the threshold level, the amount of itemized deductions that can be claimed is reduced. For tax years beginning in 2002, the applicable amount is $137,300 (or $68,650 if married filing separately).

[4] Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, 2001 Tax Notes Today, 126-42.



employer will be to leave her worse off financially than before she filed the discrimination claim.[5]

- A different result would occur if the police officer lived in a state under the jurisdiction of the U.S. Court of Appeals for the Fifth Circuit. In this circuit, the taxpayer could exclude the $950,000 in attorney fees and costs from her taxable income and would only owe tax on the $300,000 damage award. Assuming her total award would be taxed at the maximum tax rate of 38.6 percent for 2002, she would owe $115,800 in federal income tax, leaving her with $184,200.

The above examples represent a $283,200 difference in tax liabilities between identically situated taxpayers, solely as a consequence of the judicial district in which the taxpayer resides. The result would be the same whether the attorney's fee arose from a contingent fee agreement or a court-ordered award.

RECOMMENDATION

The following three recommendations eliminate the unequal treatment under current law of legal fees in cases involving nonphysical personal injury. The first recommendation is the easiest for taxpayers to understand and requires less computational ability in preparing the tax return. Recommendations two and three achieve the same result but with greater complexity than the first proposal. They would, however, enable the IRS to track whether taxpayers are reporting attorney fees and taxable awards correctly.

1. Amend IRC § 104(a)(2) to exclude from gross income legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments.
2. Include legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments in gross income, and amend IRC § 62 to allow an adjustment to income for such fees in calculating adjusted gross income (AGI).
3. Include legal fees agreed upon or awarded in nonphysical personal injury settlements and judgments in gross income but allow an itemized deduction that is not subject to the two percent of AGI limitation of IRC § 67(a). In addition, an exception should be included in IRC § 68 regarding the limitation rules for itemized deductions and a deduction should be allowed for AMT purposes under IRC § 56.

The National Taxpayer Advocate recommends the second alternative.

[5] Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, Because of the restrictions against public disclosure of confidential taxpayer records, none of the information in the above example was verified against official IRS records or sources. Aug. 11, 2002, page 18.

PRESENT LAW

INCLUSION OF LEGAL FEES IN GROSS INCOME

Internal Revenue Code section 61(a) defines gross income as including "all income from whatever source derived" unless otherwise excluded under the Internal Revenue Code. In general, non-punitive damages received in a personal injury case are excludable from income only if the payments are received on account of injury or sickness and the injury or sickness is physical in nature.[6] Punitive damages are not excludible from income.[7] Damages received for emotional distress are not excludable, except to the extent that amounts received are attributable to medical expenses incurred as a result of the emotional distress.[8]

Nonphysical personal injury may result from employment, race, sex, or age discrimination, breach of contract, or wrongful termination. Prior to 1996, the Internal Revenue Code did not distinguish between physical and nonphysical injury and allowed damages from both types of injury to be excluded from income.[9] However, courts reached differing conclusions about whether discrimination resulted in personal injury and thus came within the scope of IRC § 104(a)(2).[10] The Small Business Job Protection Act of 1996[11] amended IRC § 104(a)(2) to exclude from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or *physical* sickness.[12] Therefore, a claimant who pays legal fees to pursue damages for other than personal physical injuries or physical sickness and who receives reimbursement of these fees pursuant to a settlement or judgment is required to include the reimbursement in gross income.[13]

6 IRC § 104(a)(2).

7 *Id.*

8 *Id.*

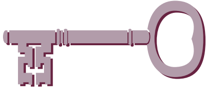
9 IRC § 104(a)(2) prior to the 1996 amendment read as follows: "(2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness;"

10 Robert H. Scarborough, *NYSBA Tax Section Analyzes Civil Damages Legislation*, 2001 Tax Notes Today 36-18, footnote 7.

11 Pub. L. No. 104-188.

12 IRC § 104(a)(2), as amended by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, section 1605(a).

13 S. Rep. No. 104-281, at 115 (1996); H.R. Rep. No. 104-586, Part II, Revenue Offsets, section 5, reprinted at 1996-3 C.B. at 480-81.



Federal courts are divided regarding the treatment of legal fees paid out of a settlement or judgment awarded to the claimant.[14] In most cases involving nonphysical personal injury, an attorney is hired on a contingent fee basis and agrees to represent the client in return for a specified percentage of the recovery, if any. In other cases, the court may award a specified amount to cover the attorneys' fees and court costs incurred in prosecuting the claim. At the end of the case, the attorney usually receives the full amount of the recovery, retains an amount equal to the contingent fee or the award made by the court, and transfers the balance to the client.

There are two predominant legal theories governing the inclusion in or exclusion from the plaintiff's income of the attorney fee portion of settlement proceeds. The United States Court of Appeals for the Fifth, Sixth, and Eleventh Circuits have held that the legal fees may be excluded from a claimant's income if, under state law, the attorney has an equitable interest in the cause of action or recovery to the extent of the agreed upon fee.[15] This theory is based on state law in those jurisdictions that grant attorneys lien rights (or ownership rights) to income attributable to a settlement or judgment award that the attorneys' efforts brought into existence. Thus, those courts have held that, since the attorney had a right to the income, the plaintiff may exclude that portion of the award from gross income.[16] See Table 2.1.1, Legal Fee Cases by Federal Circuit Court, to review a listing of U.S. Circuit Court rulings.

The U.S. Court of Appeals for the First, Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits have held that attorney fees in nonphysical personal injury cases must be included in a claimant's income under the assignment of income doctrine, regardless of the attorney's interest in the award.[17] This doctrine holds that a taxpayer who is entitled to income cannot avoid being taxed on that income by assigning it to another.[18]

[14] For a detailed discussion of the treatment of these legal fees, *see* Paul M. Jones, Jr., *Nonphysical Personal Injury Settlements and Judgements: Amending the Internal Revenue Code to Exclude Attorney Fees,* 35 Ind. L. Rev. 245 (2001).

[15] See, e.g., Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959) (reviewing Alabama statute creating lien on the cause of action); Clarks Estate v. United States, 202 F.3d 854 (6th Cir. 2000) (relied on Michigan state statute giving an attorney a lien on a portion of a client's judgment); Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000) (allowing for excludability of contingency fees in Texas because court stated they were bound by Cotnam); Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000) (court followed Cotnam and held fees were not income to client).

[16] Jones, *supra* note 14, at 247.

[17] See, e.g., Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995) (fees paid directly from the settlement to the attorney benefited the client by discharging his obligation to the attorney); Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000) (because the taxpayers received benefit from the full amount of judgment, the entire amount was income); Kenseth v. Commissioner, 114 T.C. 399 (2000) (fees are income under IRC § 61; no specific exclusion from income found); O'Brien v. Commissioner, 38 T.C. 707 (1962) (it made no difference whether under a state attorneys' lien statute the attorney had a lien or the taxpayer irrevocably assigned a portion of his claim to the attorney).

[18] Lucas v. Earl, 281 U.S. 111 (1930).

The United States Supreme Court has declined to grant certiorari to resolve the conflict between the circuits.[19] The IRS takes the position that attorney fees in nonphysical personal injury cases are includible in the claimant's gross income.[20] The United States Tax Court, in numerous cases, has upheld the IRS's position, although there has been disagreement among the judges.[21] The Tax Court has held that taxable recoveries in lawsuits are gross income in their entirety to the party-client and that associated legal fees – contingent or otherwise – are to be treated as miscellaneous itemized deductions.[22]

DEDUCTION OF LEGAL FEES

Under current law, legal fees paid or incurred by a claimant are deductible to the extent they are allocable to amounts received in a settlement or judgment that are included in the claimant's gross income.[23] The fees are treated as miscellaneous itemized deductions to the extent that the claimant's total miscellaneous itemized deductions exceed two percent of the claimant's adjusted gross income (AGI).[24] Thus, a taxpayer often will not be entitled to deduct some or all of the amount of attorney fees includible in gross income. In addition, any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the claimant's AGI exceeds a threshold amount.[25] Finally, no deductions are allowed for any miscellaneous itemized deductions in computing the claimant's alternative minimum taxable income (*AMTI*).[26]

[19] Benci-Woodward v. Commissioner, 121 S. Ct. 855 (2001); Coady v. Commissioner, 121 S. Ct. 1604 (2001); Hukkanen-Campbell v. Commissioner, 122 S. Ct. 1915 (2002); Sinyard v. Rossotti, 122 S. Ct. 2357 (2002).

[20] Market Segment Specialization Program (MSSP) Audit Guide, *Lawsuit Awards and Settlements*, Chapter 3, Other Related Topics, Deduction for Attorneys' Fees.

[21] Kenseth v Commissioner, 114 T.C. 399 at 421 (2000) (Beghe, J., dissenting). The disagreement was with the assignment of income doctrine on which the court decided the case and whether the full amount of the settlement proceeds was Kenseth's to assign, given the lien held by his attorneys.

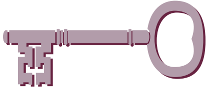
[22] Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[23] IRC § 212 (deduction for ordinary and necessary expenses paid or incurred for the collection or production of income); Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[24] IRC § 67(a) and (b). Benci-Woodward v. Commissioner, T.C. Memo. 1998-395 at *1; Biehl v. Commissioner, 118 T.C. No. 29 at *3 (2002); Hukkanen-Campbell v. Commissioner, T.C. Memo. 2000-180 at *20; Kenseth v. Commissioner, 114 T.C. 399 at 407 (2000).

[25] IRC § 68.

[26] IRC § 56(b)(1).



The Tax Court in Kenseth v. Commissioner agreed that including the attorney fee in income without a dollar-for-dollar offset is harsh and inequitable, but noted that it is Congress' responsibility to remedy the situation. In his dissenting opinion in Kenseth, Judge Renato Beghe stated,

> Although this case is not the most egregious recent example, the mechanical interplay of the itemized deduction rules with the AMT can result – in cases in which the contingent fee exceeds 50 percent of the recovery – in an overall effective rate of federal income tax and AMT on the net recovery exceeding 50 percent; in cases in which the aggregate fees exceed 72-73 percent of the recovery, the tax can exceed the net recovery, resulting in an overall effective rate of tax that exceeds 100 percent of the net recovery.[27]

REASONS FOR CHANGE

Legislation is needed to resolve the split among the circuit courts of appeals regarding the taxation of attorney fees. A change would bring about a fair result for plaintiffs in nonphysical personal injury cases. Currently, plaintiffs are subjected to unpredictable tax consequences as well as reduced settlement proceeds.

Under current law, taxpayers who are complainants in nonphysical personal injury suits are subject to disparate tax treatment regarding any attorney fees awarded or received in settlement of those suits. Depending on where a taxpayer-complainant resides, such attorney fees may be subject both to a reduction under IRC § 68 and to the Alternative Minimum Tax under IRC § 55.

The AMT consequences of the approach adopted by the IRS and the majority of the federal circuit courts deviates from the concept of taxing net income. By treating these fees as a miscellaneous itemized deduction and prohibiting a deduction of itemized deductions for AMTI purposes, plaintiffs must pay tax on the full amount of their settlement without a corresponding deduction for the costs of the litigation.[28] On the other

[27] Kenseth v. Commissioner, 114 T.C. 399 at 425 (2000).

[28] Jones, *supra* note 14, at 254.

hand, full exclusion or deductibility of these legal fees, whether contingent or awarded by the court, requires taxpayers to pay tax on only the net amounts actually received from the litigation, a result that more accurately reflects the taxpayers' actual economic circumstances.[29]

The full exclusion or deductibility of attorney fees relating to nonphysical personal injury awards or settlements would promote consistency and predictability of tax consequences on two levels. First, the tax treatment of settlement and judgment income would be consistent regardless of where the taxpayer-claimant resides in the United States. Second, the tax treatment of such income would be consistent despite differences in state attorney lien statutes.[30]

Finally, the full exclusion or deductibility of attorney fees in nonphysical personal injury cases would eliminate significant litigation over this issue.[31] Consistent resolution of this issue will enable taxpayer-claimants to determine clearly what the tax consequences of any such award or settlement may be.

EXPLANATION OF RECOMMENDATION

There are several alternatives available for clarifying the tax treatment of attorney fee payments in nonphysical personal injury awards or settlements. Although each proposal results in the consistent treatment of these attorney fee payments, each has different consequences in terms of taxpayer burden, compliance monitoring, and effects on related tax calculations.

Amend the Definition of Gross Income

One possible solution is to amend IRC § 104(a)(2) to exclude legal fees from gross income in nonphysical personal injury cases. This approach would eliminate the disparate treatment that plaintiffs now experience based solely on the place where they live or the jurisdiction in which the cases are heard. It would eliminate situations in which successful plaintiffs finish their journeys through the court system with a tax burden that may consume most, if not all, of their settlements. Indeed, as discussed above, some plaintiffs may even owe more in tax than they received from their settlements or judgments.[32]

[29] *Id. at 256.*

[30] *Id.*

[31] See Table 2.1.1, Legal Fee Cases by Federal Circuit Court.

[32] *See* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, Aug. 11, 2002, at 18; *see also* 146 Cong. Rec. S7160-03 at *S7162-64 (2000) (statement of Sen. Grassley discussing a letter sent by an attorney representing a client who owed more in tax than the damages he received).

The exclusion from gross income of the legal fee portion of the settlement or award would be the easiest approach to implement for both the IRS and the taxpaying public. The taxpayer would simply report the amount of the settlement received, net of the legal fees. Although this proposal would not require a change to the Form 1040, the IRS would have to alter its instructions to provide a worksheet and guidance for calculating the net amount of the award or settlement. This proposal would not enable the IRS to track the full amount of the settlement.[33]

Allow an Above-the-Line Deduction for Legal Fees

An alternative solution is to retain the present law's inclusion in gross income of the legal fee portion of a nonphysical personal injury settlement or award and amend IRC § 62 to allow those legal fees to be deducted from gross income in calculating Adjusted Gross Income.

Under this alternative, the legal fees would be treated as an adjustment to income ("above-the-line"). Thus, they would not be subject to the Alternative Minimum Tax. Further, the fees would not be subject to the limitation on itemized deductions under IRC § 68. The proposal would have the same net effect as the first recommendation, but it would require a forms change by the IRS and additional work on the part of the taxpayer or return preparer.

This proposal would enable the IRS to track the amounts of damages received by taxpayers and the associated legal fee adjustments for compliance purposes. Under current law, attorneys are required to file Forms 1099 reporting payments received by business clients for legal services.[34] The IRS could modify that reporting requirement to require identifying the fees and costs received by attorneys in nonphysical personal injury cases in a separate box on the form. The IRS would then have the ability to conduct document matching to ensure that the taxpayer-complainant was deducting the correct amount from the gross award.

Allow Itemized Deduction (Not Subject to 2% or IRC § 68 Limitations) and AMT Deduction

Another approach is to amend IRC § 67(a) to allow legal fees as an itemized deduction not subject to the two-percent-of-AGI limitation. This proposal would require creating an exception to the IRC § 68 rules regarding the limitation of itemized deductions for high income taxpayers, and allowing a deduction for AMT purposes under IRC § 56 in order to mitigate the AMT effect under current law.

[33] Gross taxable damages are required to be reported to the IRS in Box 3, Other Income, on Form 1099-MISC.

[34] IRC § 6045(f).

This alternative would not have the same net effect as the other two proposals. Although the complete amount of the legal fees would be deductible, the entire amount of any settlement or award would be included in AGI, thus decreasing all other itemized deductions that are subject to AGI limitations, such as medical expenses and miscellaneous itemized deductions, and affecting other computations that are dependent on the AGI amount, such as AMT. Further, the proposal would increase taxpayer and IRS burden, because it would increase the time needed to prepare a tax return and require additional form changes by the IRS.

The National Taxpayer Advocate recommends the second of the three approaches described above. Legal fees awarded or received in settlement of nonphysical personal injury cases should be included in gross income. Internal Revenue Code section 62 should be amended to permit an adjustment to gross income for that portion of a nonphysical personal injury award or settlement that is attributable to legal fees. This proposal would enable the IRS to track accurate reporting of these awards and fees. It would avoid triggering the Alternative Minimum Tax and would not reduce other itemized deductions dependent on Adjusted Gross Income. Most importantly, it would effect uniform treatment of all taxpayer-complainants who receive these awards and settlements, irrespective of their place of residence.

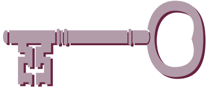


TABLE 2.1.1
LEGAL FEE CASES BY FEDERAL CIRCUIT COURT

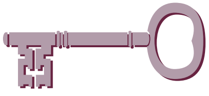
CIRCUIT	STATE	NAME	CITATION (YEAR)	DECISION	BASIS
1	Maine				
	Massachusetts	Alexander	72 F.3d 938 (1st Cir. 1995)	Include	"In lieu of" test
	New Hampshire				
	Puerto Rico				
	Rhode Island				
2	Connecticut		None litigated in this circuit.		
	New York				
	Vermont				
3	Delaware				
	New Jersey				
	Pennsylvania	O'Brien	319 F.2d 532 (3d Cir. 1963)	Include	Assignment of income
	Virgin Islands				
4	Maryland				
	North Carolina	Young	240 F.3d 369 (4th Cir. 2001)	Include	Assignment of income
	South Carolina				
	Virginia				
	West Virginia				
5	Louisiana				
	Mississippi				
	Texas	Srivastava	220 F.3d 353 (5th Cir. 2000)	Exclude	State attorney lien statute
6	Kentucky				
	Michigan	Estate of Clarks*	202 F.3d 854 (6th Cir. 2000)	Exclude	State attorney lien statute
	Ohio				
	Tennessee				
7	Illinois				
	Indiana				
	Wisconsin	Kenseth	259 F.3d 881 (7th Cir. 2001)	Include	Assignment of income
8	Arkansas				
	Iowa				
	Minnesota		None litigated in this circuit.		
	Missouri				
	Nebraska				
	North Dakota				
	South Dakota				

TABLE 2.1.1: LEGAL FEE CASES BY FEDERAL CIRCUIT COURT *(cont.)*

CIRCUIT	STATE	NAME	CITATION (YEAR)	DECISION	BASIS
9	Alaska	Coady	213 F.3d 1187 (9th Cir. 2000)	Include	Economic benefit
	Arizona	Sinyard	268 F.3d 756 (9th Cir. 2001)	Include	Fee shifting, constructive income
	California	Benci-Woodward	219 F.3d 941 (9th Cir. 2000)	Include	Refuted state attorney lien statute
	Guam				
	Hawaii				
	Idaho				
	Montana				
	Nevada				
	Oregon				
	Washington				
10	Colorado				
	Kansas	Hukkanen-Campbell	274 F.3d 1312 (10th Cir. 2001)	Include	Assignment of income
	New Mexico				
	Oklahoma				
	Utah				
	Wyoming				
11	Alabama	Cotnam**	263 F.2d 119 (5th Cir. 1959)[35]	Exclude	State attorney lien statute
	Alabama	Davis**	210 F.3d 1346 (11th Cir. 2000)	Exclude	State attorney lien statute
	Alabama	Foster**	249 F.3d 1275 (11th Cir. 2001)	Exclude	State attorney lien statute
	Florida				
	Georgia				
D.C.	D.C.		None litigated in this circuit.		
U.S. Court of Appeals for the Federal Circuit	Maryland	Baylin	43 F.3d 1451 (Fed. Cir. 1995)	Include	Assignment of income, capital expense under origin of claim test

* The IRS' position is that this precedent is limited to cases arising under Michigan law.
** The IRS' position is that these precedents are limited to cases arising under Alabama law.

[35] Cotnam is an Alabama case that was decided when Alabama was in the Fifth Circuit. In 1981 the Fifth Circuit was split into the Fifth and Eleventh Circuits.



2 MARRIED COUPLES AS BUSINESS CO-OWNERS

PROBLEM

An unincorporated business jointly owned by a married couple is classified as a partnership for federal income tax purposes. As such, the business is subject to complex record-keeping requirements and must file a partnership income tax return (Form 1065, U.S. Return of Partnership Income). The IRS estimates that it takes the average partnership approximately 165-200 hours to complete and file this return.[36] If one member of the couple were to treat this task as a 40-hours-per-week job, it could take him or her four to five weeks of work each year.

Notwithstanding that unincorporated husband-and-wife-owned businesses are required to file partnership tax returns, there is compelling anecdotal evidence that many do not. Instead, they report the results of their business operations on Form 1040, Schedule C (Profit or Loss From Business (Sole Proprietorship)). The IRS estimates that it takes the average taxpayer about 11 hours to complete a Schedule C and about two hours to complete a Schedule C-EZ – a tiny fraction of the time required to file a partnership return.[37] By statute, these businesses and/or their owners are subject to penalties for failing to comply with the partnership tax return requirements.[38]

A couple's decision to file a Schedule C in lieu of a partnership tax return can also have nontax ramifications. By its terms, a Schedule C can only be filed by a sole proprietor. If married co-owners of a business file a single Schedule C, they must report all income from the business under the name of one spouse. Because the husband and wife are self-employed, they must also complete a Form 1040, Schedule SE (Self-Employment Tax) to report and pay Social Security and Medicare taxes. If all business income is reported on a Schedule C under the name of one spouse, only that spouse can file a Schedule SE and receive credit for paying into the Social Security and Medicare systems. Reporting all income under the name of one spouse may lead to two unanticipated problems:

- **Inability to Obtain Social Security and Medicare Benefits**. The spouse for whom no earned income is reported (the "ineligible spouse") does not receive credit for paying Social Security or Medicare tax. In the event of disability, the ineligible

[36] 2001 Instructions for Form 1065, *U.S. Return of Partnership Income*, page 32; 2002 Form 1040 Instructions, page 76. This range reflects the amount of time the IRS estimates it would take to prepare both Form 1065 and Form 1040, Schedule E (Supplemental Income and Loss). A partner must file Schedule E with his or her individual income tax return. The lower end of the 165-200 hour estimate range assumes that the partnership completes Form 1065 and the associated Schedule K-1. The upper end of the estimate range assumes that the partnership completes all schedules associated with Form 1065.

[37] 2002 Form 1040 Instructions, page 76.

[38] As discussed below, the IRS generally does not assess the penalty where the failure to file a partnership tax return was inadvertent. *See* Rev. Proc. 84-35, 1984-1 C.B. 509.

spouse would not qualify for Social Security disability benefits. In the event of death, the surviving spouse and children would not qualify for Social Security survivor benefits. The ineligible spouse also would not qualify for Medicare benefits.

- **Adverse Consequences Upon Divorce**. Depending on the applicable state law, the inaccurate classification of a jointly owned business as a sole proprietorship can have adverse consequences if the couple gets divorced. If the couple had operated the business on a 50/50 basis but reported the business for tax purposes as wholly owned by one spouse, the other spouse would have to prove that the tax return was inaccurate to substantiate his or her interest in the business. If the couple had filed joint tax returns (as do 97 percent of married couples filing Schedules C[39]), both spouses would have signed the returns and the ineligible spouse would be placed in the difficult position of having to argue that a document that he or she had signed contains false statements.

EXAMPLE

A married couple with two young children jointly owns and operates a small dairy farm. The wife keeps the books, orders supplies, and coordinates deliveries. The husband takes care of the cows, milks them, and delivers the milk to customers. The couple has reported an average business profit of $40,000 each year for the past 15 years.

Instead of dividing the business income between them on a partnership income tax return and filing two Schedules SE, the couple has chosen to file a Form 1040, Schedule F (Profit or Loss From Farming) and one Schedule SE (Self-Employment Tax) and to report all earnings under the husband's Social Security number.[40] The couple had considered hiring a bookkeeper and using a paid tax preparer but determined it would be too costly.

The wife dies unexpectedly at age 40. Because all contributions to the Social Security system had been made in her husband's name and not her own, the husband and children cannot collect Social Security survivor benefits. Without the wife's contributions to the business, the husband must now either hire someone to perform her business duties or take over her tasks himself. Social Security benefits would have assisted the husband in meeting these additional responsibilities.

If the couple had divided the farm income between them and each had paid self-employment tax, the surviving family members would have been eligible for Social Security survivor benefits based on the wife's contributions.[41]

[39] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002.

[40] A farmer would report the results of his or her business operations on a Schedule F in lieu of a Schedule C.

[41] The couple's aggregate self-employment tax would not increase as long as the net income of the business remains below the Social Security wage base cap. For 2003, the cap will be $87,000.

RECOMMENDATIONS

- Amend Internal Revenue Code section 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the Code and file one Schedule C (or one Schedule F in the case of a farming business) and two Schedules SE if –[42]
  1. all of the capital and profits interests in the partnership are owned by two individuals who are married to each other; and
  2. the couple makes an election; and
  3. the couple files a joint return for all taxable years that includes the items of the partnership, provided that the couple maintains adequate records to substantiate their respective interests in the partnership.
- Amend Internal Revenue Code section 6017 to require each spouse who operates an unincorporated business solely with his or her spouse as co-owners to file separate Schedules SE.

The National Taxpayer Advocate recommends that, if this proposal is enacted, the IRS create a Schedule C supplemental form for married co-owners of a business. All income and expenses of the business would be reported on this form, and the business' net profit or loss would be allocated between the spouses.

PRESENT LAW

Income Tax Law

An unincorporated business owned by more than one individual is classified as a partnership for federal tax purposes. Internal Revenue Code section 761(a) defines a partnership to include "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not … a corporation or a trust or estate."

Internal Revenue Code section 761 is a part of subchapter K of the Code, which sets forth the rules governing the taxation of partners and partnerships.[43] The rules of subchapter K are extraordinarily complex and require partnerships to maintain extensive records. While a detailed description of the partnership tax rules is beyond the scope of this report, the complexity of the partnership tax rules was elegantly characterized in an often-quoted passage from a 1964 U.S. Tax Court decision written by Judge Arnold Raum:

[42] Subchapter K is a portion of the Internal Revenue Code that contains rules and regulations governing the taxation of partnerships and partners. The complexity of these rules is discussed in the "Present Law" section below.

[43] Subchapter K consists of IRC §§ 701-777.

> The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field … Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.[44]

Over the past 38 years, the complexity of subchapter K has increased. Today, there are several multi-volume treatises devoted to the subject and a leading guide to general income tax law devotes nearly 700 pages to partnership taxation.[45]

As discussed above, if a husband and wife jointly own a business, they are considered to be operating a partnership for federal tax purposes and are subject to subchapter K. Significantly, even absent a formal partnership agreement, a husband and wife may be deemed to be carrying on a partnership if they operate a business together and jointly share in the business's profits and losses.[46]

Where a married couple is carrying on a partnership – or is deemed to be carrying on a partnership – the couple must report the results of its business operations on a Form 1065 (U.S. Return of Partnership Income).[47] As part of Form 1065, a Schedule K-1 must be prepared for, and sent to, each partner that lists, among other things, the partner's share of the partnership income or loss for the taxable year. Each partner must include this amount on his or her joint or separate Form 1040 (U.S. Individual Income Tax Return).

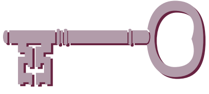
The Internal Revenue Code imposes both criminal and civil penalties on taxpayers that fail to file required returns. Internal Revenue Code section 7203 provides that a person who willfully fails to file a required return is guilty of a misdemeanor, is subject to a fine of up to $25,000 and imprisonment of up to one year, and is liable for prosecution costs. Therefore, a married couple that jointly owns a business and is aware of the requirement

[44] Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964), *acq.*, 1966-2 C.B. 4, aff'd, 352 F.2d 466 (3d Cir. 1965).

[45] *See* William S. McKee et al., *Federal Taxation of Partnerships and Partners* (3d ed. 1997); Arthur B. Willis et al., *Partnership Taxation* (6th ed. 1997); *CCH Standard Federal Tax Reporter* (2002).

[46] The Supreme Court has held that a partnership exists for federal income tax purposes when "considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Commissioner v. Culbertson, 337 U.S. 733, 742 (1949) (footnote omitted). While a number of factors are considered in determining whether a partnership exists, the joint ownership of material income-producing capital typically ensures partnership classification. *See* Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970), *acq.*, 1978-2 C.B. 2.

[47] IRC § 6031.



that it must file a partnership tax return can face serious consequences for failing to do so. Internal Revenue Code section 6698 provides that each partnership shall be liable for a penalty of up to $250 per partner for each required tax return that is not filed. In the case of a married couple that jointly owns a business, the penalty for failure to file could be $500 per year. This penalty may apply even if the couple is not aware that its business is classified as a partnership and that a partnership return is required.

As a practical matter, these penalties are rarely, if ever, imposed. Criminal penalties under IRC § 7203 generally are not imposed in the absence of willful tax evasion. And the IRS has issued guidance stating that the penalty under IRC § 6698 ordinarily will not be imposed on partnerships with 10 or fewer partners on the ground that such partnerships, based on their size, have "reasonable cause" for failing to file a partnership return.[48] Notwithstanding the IRS's exercise of administrative restraint, married co-owners of a business and/or the business itself remain subject to these penalties by statute.

Employment Tax Law

A partner generally is considered to be self-employed for purposes of Social Security and Medicare taxes and is therefore required to report his or her net earnings from self-employment on Form 1040, Schedule SE (Self-Employment Tax).[49] Where a married couple jointly owns a business and files a Form 1065, each spouse must include his or her respective share of self-employment income on a separate Schedule SE.[50] Where a married couple jointly owns a business but files one Schedule C (or Schedule F) in lieu of a Form 1065, it is reporting that one spouse earned all of the business income. Thus, only one spouse would report self-employment earnings on a Schedule SE.[51]

[48] Rev. Proc. 84-35, 1984-1 C.B. 509. This revenue procedure is based on legislative history relating to IRC § 6698. A House-Senate conference committee report states: "The penalty [under IRC § 6698] will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions, and credits of the partnership." H.R. Conf. Rep. No. 95-1800, at 221 (1978), reprinted in 1978-3 (vol. 1) C.B. 521,555.

[49] *See* IRC § 6017; 2002 Instructions for Schedule SE, Self-Employment Tax, page SE-2.

[50] *Id.*

[51] A married couple might avoid filing a Form 1065 and get Social Security credits for both spouses by filing a Schedule C that reports one spouse as the sole owner and the owner pay a salary to the other spouse. However, there are two drawbacks to this approach under current law. First, it may not be legal. If the husband and wife operate the business jointly, the business likely is a partnership. Second, if one spouse paid the other a salary, the paying spouse would be required to file employer tax returns and to withhold tax, effectively trading one set of complex rules for another. *See* IRS Publication 15, Circular E, Employer's Tax Guide, page 7.

REASONS FOR CHANGE

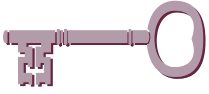
Married co-owners of a business who file joint tax returns face a difficult choice when determining whether to report the results of the business operations on a partnership tax return or a sole proprietorship return. If they file as a partnership, they must learn and apply the daunting complexities of subchapter K and either devote an average of up to nearly 200 hours of their own time to tax return preparation or pay an attorney, accountant or other tax preparer to do the job. If they file as a sole proprietorship, they may face penalties and one spouse generally must forego Social Security and Medicare coverage. As demonstrated in the example above, the ineligibility of one spouse for Social Security benefits can have a devastating impact on a family upon the spouse's death or disability. Other unfortunate consequences are the spouse's ineligibility for Medicare coverage and difficulty substantiating an ownership interest in the family business in the event of a divorce.

This dilemma is unnecessary and should be eliminated for the following reasons:

- **No Adverse Effect on Tax Collection.** Because our proposal would amend Internal Revenue Code section 761(a) only with respect to married co-owners of a business who file *joint* income tax returns, the revenue impact of the proposal would be negligible. And in the overwhelming majority of cases, married co-owners do file joint returns.[52] In the unusual case where two partners in a partnership file separate returns and face different marginal tax rates, the possibility of shifting income to the lower-taxed individual exists. But a husband and wife who file a joint return each year cannot engage in income shifting and therefore generally would not be able to reduce their tax liability under our proposal.
- **Recordkeeping/Regulatory Burden is Unreasonable.** The burden of maintaining partnership records, complying with the intricacies of subchapter K, and filing a partnership tax return is unreasonably onerous for a married couple owning a small business. Regulatory burdens are justifiable only when the compliance benefits to the system outweigh the burdens imposed on the individuals or entities that must bear them. In this case, the systemic benefits of the existing rules are few, if any.

  Moreover, the consequences to taxpayers who do not comply with these technical rules – even though they generally will owe the same amount of tax – are severe. As discussed above, Social Security and Medicare benefits are available only if

[52] The percentage of all married couples who file joint tax returns is approximately 95 percent (Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002). The percentage of all married couples filing at least one Schedule C who file joint tax returns is approximately 97 percent (Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2002). While we cannot determine precisely the percentage of all married couples jointly operating a business who file joint tax returns, we do not believe the percentage would differ materially.



Social Security and Medicare contributions are made, and the inability to obtain credits for both spouses if one Schedule C is filed can have serious long-term consequences where the uncovered spouse becomes injured or dies.[53] The attribution of all business income to one spouse also may, depending on the applicable state law, lead to an inequitable division of property in the event of a divorce. While the amount of income reported for each spouse on a tax return is not controlling for non-tax purposes, a joint tax return is signed by both spouses under penalties of perjury, and the return therefore carries a strong presumption of correctness. A spouse later claiming that the return did not accurately reflect his or her income or ownership interest in the property could theoretically be exposing himself or herself to a charge of perjury, although it is quite unlikely that a criminal charge would be brought under this circumstance.

The partnership return filing requirement affects a significant number of businesses jointly owned by married couples. While the actual number of married couples owning businesses as co-owners cannot be determined with precision, one can infer some sense of the nature and magnitude of this problem from tax return data. A review of 1999 Forms 1040 shows that over 2,130,000 joint tax returns with Schedules C were filed on which one spouse reported no wages. Many of the reported business activities seem likely to have been undertaken jointly. Consider the following examples culled from tax returns where one spouse reported income as a sole proprietor and the other spouse reported no earned income:

- In California, over 6,800 businesses that provide accommodations, food, or drink;
- In Pennsylvania, over 2,900 dairy farms;
- In Montana, 480 cattle ranches;
- In Hawaii, 290 fruit and vegetable markets;
- In Iowa, 684 hog and pig farms; and
- In Idaho, 1,243 hotels, motels or bed and breakfast establishments.[54]

The burden of the partnership-return filing requirement falls heavily on lower and middle income taxpayers. According to the U.S. Small Business Administration,

[53] The tax reporting of a couple's income from a business is not necessarily controlling for purposes of Social Security. In some instances, individuals who discover that they will not be receiving Social Security benefits because their spouse was reported as the sole owner of a joint business on a Schedule C have challenged their tax return position and sought a reallocation of Social Security credits between the two spouses. *See* Royer v. Apfel, 2000 U.S. Dist. LEXIS 16661 (S.D. Ind. Oct. 16, 2000). Indeed, the issue has arisen with sufficient frequency that the Social Security Administration has issued a ruling that provides guidance on reallocating Social Security credits between spouses in such cases. *See* Soc. Sec. Rul. 84-11. However, no one would reasonably plan to obtain a reallocation of Social Security credits on the basis of this ruling. Compliance with the requirements of the ruling is itself burdensome, and the prospects of success are uncertain.

[54] Tax Year 1999, Compliance Research Information System (CRIS), Model IFM 2001.

86.9 percent of self-employed individuals earned less than $50,000 for their business efforts in 1997.[55] Regulatory requirements impose a considerable burden on small businesses, because small firms have fewer resources to apply to overhead costs such as accounting and tax preparation. According to a report prepared by the Chief Counsel for Advocacy of the U.S. Small Business Administration, tax compliance and payroll record keeping create the heaviest regulatory burdens today with small businesses, including "mom and pop" partnerships, bearing a greater relative load of tax compliance costs based on their revenue.[56]

In light of the fact that the income tax liability of married co-owners of a business generally will be the same regardless of whether the results of the couple's business operations are reported on a Form 1065 or a Schedule C, there is no reasonable justification for requiring these taxpayers to comply with the intricate complexities of subchapter K.

- **Unnecessary, Unenforced Requirements Undermine Respect for Tax System.** Respect for the integrity of the tax system suffers when rules are imposed that place an unnecessarily heavy compliance burden on taxpayers, that many taxpayers ignore (precisely because of the heavy compliance burden), that the IRS (for good reason) does not enforce, and that have no impact on tax liability. It is confusing and pointless for the Internal Revenue Code to require all partnerships to file a partnership tax return, while the IRS (on the basis of clear legislative history) does not enforce the requirement in the case of partnerships with 10 or fewer partners. Why not simply change the law to reflect the desired policy and then enforce it?

EXPLANATION OF RECOMMENDATION

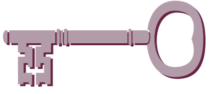
The National Taxpayer Advocate recommends that Internal Revenue Code section 761(a) be amended to allow husband and wife co-owned businesses to elect out of Subchapter K – Partners and Partnerships.[57] At this time, we recommend that the election be made avail-

[55] Office of Advocacy, U.S. Small Business Administration, *Annual Report on Small Business and Competition,* 1998.

[56] Office of the Chief Counsel for Advocacy, U.S. Small Business Administration, *The Changing Burden of Regulation, Paperwork, and Tax Compliance on Small Business: A Report to Congress* 1995.

[57] In Rev. Proc. 2002-69, the IRS authorized this election for married co-owners of businesses located in states with community property laws. Married co-owners in these states may now, at the couple's discretion, treat the business as either a partnership or a sole proprietorship. However, residents of states that do not have community property laws, which constitute a significant majority of the states, do not have this option. Moreover, Rev. Proc. 2002-69 does not address whether or how a couple that elects to treat the business as a sole proprietorship would be entitled to file two Schedules SE.

[58] As discussed above, if the husband and wife elect to file separate returns and face different marginal tax rates, the couple might be able to allocate disproportionate amounts of income to the lower-taxed spouse. The partnership tax rules ordinarily would not allow this, because special allocations can be made under subchapter K only if such allocations have "substantial economic effect." If the husband and wife were to file separate returns and the "substantial economic effect" rule in subchapter K were not to apply, the couple might be able to take advantage of this election to reduce its tax liability. For that reason, we believe that further study is required if the election we are proposing is to be made available to married couples filing separate returns.



able only to married couples who file joint income tax returns.[58] By making the election, the business would be exempt from the application of the complex rules of subchapter K and the husband and wife would be entitled to file a Schedule C instead of a Form 1065, (U.S. Return of Partnership Income). Internal Revenue Code section 761(a) already allows certain categories of taxpayers to opt out of subchapter K, so there is precedent for this approach.[59]

Amending IRC § 761(a) to allow a husband and wife co-owned business to elect out of subchapter K would not require an additional amendment to Internal Revenue Code section 6031 regarding filing partnership returns.[60] Treasury Regulations currently state that a taxpayer who has made an election to be exempt from subchapter K is not required to file a partnership return except in the year of the election.[61] In the election year, the taxpayers would only need to file a partnership return with the election statement. All income and deductions would then be reported on a Schedule C in the election year and for all subsequent years.

If this proposal is enacted into law, we recommend that the IRS design a form to supplement Schedule C for married co-owners who make the election to opt out of subchapter K. It could be called Schedule C-MC (for "Married Couple"). The business entity's income and expenses would be reported on Schedule C. The net profit (or loss) would then be allocated between the husband and wife on Schedule C-MC.

The supplemental form would serve three important purposes. First, the amount of income allocated to each spouse – and thus carried to separate Schedules SE – would be shown on the form.

Second, the form could be used to record each spouse's respective interest in the business. This could become important if, for example, one spouse dies and the value of his

[59] Section 761(a) provides that the Secretary may, at the election of all of the members of an unincorporated organization, exclude such organization from the application of all or part of subchapter K, if it is availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

[60] Senator Christopher Bond (R-Mo.), and Representative Donald Manzullo (R-Il.) have introduced legislation that aims to achieve the same objective as our proposal by simply exempting businesses owned jointly by married couples from the IRC § 6031 requirement to file a partnership income tax return. *See* S. 189 and H.R. 1037 (107th Congress). Under their proposal, however, businesses owned jointly by married couples would remain subject to all other partnership tax rules of subchapter K. After studying the issue, we believe that exempting such businesses from the definition of a partnership under Internal Revenue Code section 761 would provide more comprehensive relief.

[61] Treas. Reg. § 1.6031(a)-1(c).

or her interest must be determined for purposes of computing the estate tax.

Third, the form could be designed to allow the business to make certain tax elections that are only available at the entity level. This issue arises because even if a business co-owned by a husband and wife is excluded from the definition of a partnership for purposes of subchapter K, the business generally remains a partnership for all other purposes of the Code.[62] The principal significance of partnership classification outside the context of subchapter K is that a partnership may make certain tax elections available only to an entity and not to individuals. For example, a partnership may make an election under IRC § 179 to expense depreciable business assets.[63] We see no reason to prohibit husband-and-wife-owned partnerships that elect out of subchapter K from making tax elections of this nature.

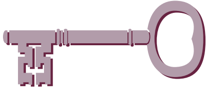
In sum, our legislative proposal would reduce the tax compliance burden on many husband-and-wife-owned businesses, would facilitate the coverage of both spouses under the Social Security and Medicare systems and, depending on state law, could facilitate more equitable divisions of property in the event of divorce. The revenue impact of the proposal should be negligible. Regardless of how the net earnings from the business are reported – either as a flow-through item from the partnership return or as net earnings from Schedule C – the income tax liability of the husband and wife generally will be the same.[64] Social Security and Medicare receipts generally will also be the same.[65]

[62] Internal Revenue Code section 761(a) defines a partnership *for purposes of subchapter K only*, and IRC § 7701(a)(2) provides a similar definition of a partnership *for all* purposes of the Code. There is some authority that suggests an entity excluded from the definition of a partnership under subchapter K is also excluded from treatment as a partnership under other provisions of the Code, but this interpretation has not been generally accepted. For discussion of this point, *see* William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 3.05[3] (3d ed. 1997).

[63] *See also* IRC § 614 (election to treat multiple mineral interests in a single parcel of land as separate assets for purposes of the depletion allowance for mines, wells, and other natural deposits); IRC § 1033 (election to avoid gain recognition upon certain involuntary conversions).

[64] In unusual cases, the income tax liability of married co-owners of a business might be different if they file a Schedule C instead of a partnership tax return. For example, IRC § 1031(a)(2)(D) provides that partnership interests may not be exchanged under the like-kind exchange rules, but IRC § 1031(a)(2) also provides that an interest in a partnership that has elected out of subchapter K (which a small category of partnerships are authorized to do under current law) is treated as an interest in each of the assets of the partnership. *Id.* Therefore, married co-owners could engage in certain tax-deferred like-kind exchanges as Schedule C filers that would be unavailable to them under subchapter K.

[65] Approximately 3 percent of Schedules C and Schedules F report income that exceeds the Social Security wage base limitation, which will be $87,000 in 2003. Tax Year 2000, Compliance Research Information System (CRIS), Model IMF 2002. This cap applies to each spouse separately. Therefore, a couple with significant earned income that allocates all business income to one spouse would pay less Social Security tax than a couple that divides the same income between both spouses. However, our proposal would not increase the Social Security tax liability of married co-owners of a business for two reasons. First, our proposal merely provides partnerships with an election. Second, if a business is classified as a partnership under current law, both spouses already are required to report a share of the partnership's business income. If they are reporting all income in the name of one spouse and are therefore subject to only one cap, it is only because they are not complying with current law.



APPENDIX I: TAXPAYER BURDEN

The IRS estimates it takes almost 13 times longer to prepare a partnership return and its related forms than a Schedule C and its related forms. It takes an average of 160 hours and 58 minutes to keep basic partnership records, read and learn about the law and forms, prepare the forms, and send the information to the IRS.[66] In contrast, a Schedule C can be prepared in approximately 12 hours and 16 minutes.[67]

Table 2.2.1 shows the estimated paperwork burden placed on sole proprietors and partners. Although business and individual taxpayers incur other burdens such as audits, litigation, and payroll that are not included in the model, it provides a useful starting point for measuring taxpayer burden.

TABLE 2.2.1
ESTIMATED IRS PAPERWORK BURDEN[68]

FORM NUMBER OR SCHEDULE	RECORD KEEPING	LEARNING ABOUT THE LAW OR FORM	PREPARING THE FORM OR SCHEDULE	COPYING, ASSEMBLING, AND SENDING THE FORM TO THE IRS	TOTAL TIME
Sch. C	6 hr.4 min.	1 hr.31 min.	2 hr. 19 min.	41 min.	10 hr. 35 min.
Sch. SE	26 min.	20 min.	35 min.	20 min.	1 hr. 41 min.
					12 hr. 16 min.
Form 1065	41 hr. 54 min.	23 hr. 35 min.	41 hr. 17 min.	4 hr. 1 min.	110 hr. 47 min.
Sch. K-1	26 hr. 46 min.	10 hr. 25 min.	11 hr. 19 min.	N/A	48 hr. 30 min.
Sch. SE	26 min.	20 min.	35 min.	20 min.	1 hr. 41 min.
					160 hr. 58 min.

[66] 2001 Instructions for Form 1065, *U.S. Return of Partnership Income*, page 32. This assumes that the partnership files only the basic Form 1065 and Schedules K-1. Depending on the circumstances of the partnership, there are additional schedules that it may be required to complete that accompany Form 1065. If all schedules must be completed, the estimated average time is approximately 200 hours. *Id.*

[67] 2001 1040 Instructions, Paperwork Reduction Act Notice, p. 72; 2001 Instructions for Form 1065, U.S. Return of Partnership Income, Paperwork Reduction Act Notice, p. 32.

[68] Figures in this table are based on information from Arthur D. Little, *Development of Methodology for Estimating the Taxpayer Paperwork Burden*, Report to the Department of the Treasury, Internal Revenue Service, June 1988. The figures from this report are included on IRS forms and instructions as part of the Paperwork Reduction Act Notice. Although some have criticized this report as flawed and outdated, it is the currently the only information available to estimate taxpayer paperwork burden.
Figures were taken from: 2001 1040 Instructions, Paperwork Reduction Act Notice, p. 72; 2001 Instructions for Form 1065, U.S. Return of Partnership Income, Paperwork Reduction Act Notice, p. 32.
The timeframes for preparing Form 1040 (U.S. Individual Income Tax Return) were not considered in these calculations because these would be required and remain constant under any of the filing options.

APPENDIX II: SOCIAL SECURITY IMPACT

Filing a Schedule C in lieu of a partnership return may immediately save taxpayers time, but it may result in long-term consequences, notably lost Social Security and Medicare benefits. Unless both spouses file Schedules SE and pay self-employment tax, they may not be eligible for the full range of Social Security and Medicare benefits.

The following tables summarize different scenarios under which a spouse might receive Social Security benefits based on whether he or she paid self-employment tax.

TABLE 2.2.2
ELIGIBILITY OF SOCIAL SECURITY RETIREMENT BENEFITS[69]

	RETIREMENT BENEFITS FOR BOTH IF COUPLE STAYS MARRIED	RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES AFTER 10 YEARS OF MARRIAGE	RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES BEFORE 10 YEARS OF MARRIAGE	RETIREMENT BENEFITS FOR BOTH IF COUPLE DIVORCES AFTER 10 YEARS OF MARRIAGE AND ONE REMARRIES
Only Husband Pays Into Social Security System	YES	YES	NO	NO
Only Wife Pays Into Social Security System	YES	YES	NO	NO
Both Spouses Pay Into Social Security System	YES	YES	YES	YES

[69] *Social Security Survivors Benefits*, Publication No. 05-10084, August 2000; *Social Security: Understanding The Benefits*, Publication No. 05-10024, February 2002; *Social Security Administration: What Every Woman Should Know*, SSA Publication No. 05-10127, March 2002.

TABLE 2.2.3
ELIGIBILITY OF SOCIAL SECURITY SURVIVOR AND DISABILITY BENEFITS[70]

	SURVIVOR BENEFITS RECEIVED IF WIFE DIES	SURVIVOR BENEFITS RECEIVED IF HUSBAND DIES	DISABILITY BENEFITS FOR WIFE	DISABILITY BENEFITS FOR HUSBAND
Only Husband Pays Into Social Security System	NO	YES	NO	YES
Only Wife Pays Into Social Security System	YES	NO	YES	NO
Both Spouses Pay Into Social Security System	YES	YES	YES	YES

[70] *Social Security Survivors Benefits*, Publication No. 05-10084, August 2000; *Social Security: Understanding The Benefits*, Publication No. 05-10024, February 2002; *Social Security Administration: What Every Woman Should Know*, SSA Publication No. 05-10127, March 2002.

3 MATH ERROR AUTHORITY

PROBLEM

Internal Revenue Code section 6213(b) authorizes the Internal Revenue Service to assess an addition to tax, without issuance of a notice of deficiency, where the adjustment is the result of a mathematical or clerical error on the tax return. Section 6213(g) defines mathematical or clerical error. This summary assessment authority allows the IRS to assess and collect the additional tax and provides no opportunity for review in the United States Tax Court.

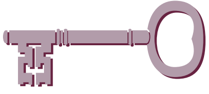
In recent years, this "math error" summary assessment authority has been extended to errors that do not fall within the traditional definition of mathematical or clerical errors. The application of this authority to return items that are not numerical or quantitative in nature can lead to incorrect assessments, administrative re-work, and even denial of taxpayer access to the United States Tax Court.

EXAMPLE

Taxpayer and Ex-spouse have joint custody of their three children. Taxpayer and Ex-spouse's custody decree granted Taxpayer physical custody of two children and Ex-spouse physical custody of one child. The custody decree was registered with the appropriate state agency. Under that state's procedures, all joint custody decrees are entered into the database showing the father (here, the Ex-spouse) as the custodial parent.

In 2004, Taxpayer claims dependency exemptions, child credit and Earned Income Tax Credit (EITC) for the two children who live with her. Taxpayer's return is flagged by the Federal Case Registry database as that of a non-custodial parent and the IRS, under its math error authority, summarily assesses additional tax by disallowing the dependency exemptions, child credit, child and dependent care credit, and Earned Income Tax Credit (EITC) for those children. If the father (Ex-spouse) erroneously claimed tax benefits for all three of his children on his return, the Federal Case Registry would identify him as the custodial parent.

In 2005, Taxpayer and Ex-spouse agree that it would be in the best interests of the third child if he resides with Taxpayer and the other two children for the entire year. Since they reached an agreement between themselves, Taxpayer and Ex-spouse see no reason to spend money going back to court to modify their custody decree. The IRS, through the Federal Case Registry identification of a "math error" (i.e., Taxpayer deemed "non-custodial parent"), can summarily assess additional tax against Taxpayer resulting from the disallowance of all three dependency exemptions, child credit and EITC, even though the children satisfy all eligibility requirements for these provisions.



RECOMMENDATION

- Amend IRC § 6213(g)(2) to limit the definition of mathematical and clerical error to the following items:
  - Inconsistent items in which the inconsistency is determined from the face of the return;
  - Omitted items, including schedules, that are required to be included with the return; and
  - Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.
- Repeal Internal Revenue Code section 6213(g)(2)(M), which authorizes the Internal Revenue Service to use math error summary assessment procedures for an entry on the return with respect to a qualifying child for the Earned Income Credit, where the taxpayer has been identified as the non-custodial parent of that child by the Federal Case Registry of Child Support Orders established under section 453(h) of the Social Security Act.

Where Congress authorizes the expansion of the math error summary assessment authority beyond inconsistencies in numerical or quantitative items included on the face of the return, such authorization should be preceded by a detailed analysis providing both a justification for the expansion and a thorough impact analysis relating to taxpayer rights and taxpayer burden. Specifically, this report, prepared by the Department of Treasury in consultation with the National Taxpayer Advocate, should analyze the specific need for such expansion, the alternative methods for resolving the identified need, the projected revenue and cost savings attributed to the expansion of math error notices, and the alternative methods identified. Further, the report should include an analysis, prepared by the National Taxpayer Advocate, of the impact on taxpayer rights of such expansion. This taxpayer rights impact statement should identify the substantive and procedural rights that may be affected by the expansion, and provide an analysis of the taxpayer segments most likely to be impacted by the proposed expansion. It should also include a discussion of the potential resource consequences for both the taxpayer and the IRS in trying to address and resolve post-assessment matters flowing from the expanded math error authority.

PRESENT LAW

Deficiency Procedures

In general, when the Internal Revenue Service (IRS) identifies an error on a taxpayer's income tax return that will result in an understatement of tax, the IRS undertakes a series of administrative steps to notify the taxpayer of the proposed deficiency.[71] The taxpayer is first provided with a report, setting forth the items to be adjusted, the tax, if any, reported on the original return, and the correct tax according to the IRS. The taxpayer has thirty days in which to accept this adjustment or request an administrative appeals conference with an Appeals Officer.

If the taxpayer does not respond to the initial report, or if the taxpayer does not prevail in the appeals conference, the IRS will issue a Statutory Notice of Deficiency (SNOD).[72] This notice sets forth the proposed deficiency in tax, and informs the taxpayer that he or she has ninety days from the date of the notice to file a petition in the United States Tax Court to challenge the proposed deficiency.[73] The SNOD, which is sent by certified mail to ensure that the taxpayer pays attention to this notice, provides important procedural rights and protections. If the taxpayer does not timely file a petition with the Tax Court, the proposed deficiency will be assessed.[74]

The Tax Court is the only judicial forum in which a taxpayer can challenge a tax liability (proposed or assessed) before paying the actual liability in full. Thus, for most taxpayers, the Tax Court is effectively the only forum for tax litigation. Congress has recognized the importance of the Tax Court for U.S. taxpayers by mandating "small case" procedures, in which discovery is limited and the court's procedures are user-friendly.[75] The Notice of Deficiency provides the taxpayer with the "ticket" to the Tax Court – that is, without the issuance of a Notice of Deficiency and the subsequent timely filing of a petition, the Tax Court has no jurisdiction over the proposed deficiency.

Mathematical or Clerical Error Procedures

Internal Revenue Code section 6213(b) authorizes the IRS to make a summary assessment of an addition to tax due where that addition is the result of a mathematical or clerical error and without providing the taxpayer with an opportunity to petition the United States Tax Court. In order to make this summary assessment, the IRS must give the taxpayer an explanation of the error.[76] The taxpayer has 60 days from the date of the

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[71] A "deficiency" is defined as the amount by which the tax exceeds "the excess of (1) the sum of (A) the amount shown as the tax by the taxpayer upon his return … plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates … made." IRC § 6211(a).

[72] IRC § 6212.

[73] IRC § 6213(a).

[74] IRC § 6213(a).

[75] IRC § 7463.

[76] IRC § 6213(b)(1).

notice to request that the IRS abate the tax.[77] The IRS cannot begin to collect the tax due until the taxpayer has agreed to the tax or the 60-day period has ended.[78] If the taxpayer requests the tax be abated, the IRS must use the deficiency procedures under IRC § 6212 if it believes that the additional tax is in fact due.[79] The abatement request is the only procedure for protesting the tax liability available to a taxpayer receiving a math error adjustment without first paying the tax in full.[80]

The mathematical or clerical error ("math error") summary assessments are statutorily authorized in the following circumstances:

1. An error in addition, subtraction, multiplication, or division shown on any return;[81]
2. An incorrect use of any table provided by the IRS with respect to any return if other information on the return makes the incorrect use apparent;[82]
3. An entry on a return of an item which is inconsistent with another entry of the same or a different item on that return;[83]
4. An omission of information which is required to be supplied on the return to substantiate an entry on that return;[84]
5. An entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on that return;[85]
6. A correct Taxpayer Identification Number is not provided on the return as required for:

   the Earned Income Credit (IRC § 32),[86]
   the child and dependent care credit (IRC § 21),[87]
   the personal or dependent exemption (IRC § 151),[88]
   the child tax credit (IRC § 24(e)),[89] and
   the Hope and Lifetime Learning credits (IRC § 25A(g)(1));[90]

[77] IRC § 6213(b)(2)(A).
[78] IRC § 6213(b)(2)(B).
[79] IRC § 6213(b)(2)(A).
[80] IRC § 6213 (b)(1).
[81] IRC § 6213(g)(2)(A).
[82] IRC § 6213(g)(2)(B).
[83] IRC § 6213(g)(2)(C).
[84] IRC § 6213(g)(2)(D).
[85] IRC § 6213(g)(2)(E).
[86] IRC § 6213(g)(2)(F).
[87] IRC § 6213(g)(2)(H).
[88] IRC § 6213(g)(2)(H).
[89] IRC § 6213(g)(2)(I).
[90] IRC § 6213(g)(2)(J).

7. A return claiming an earned income credit for net earnings from self-employment, where the self-employment tax imposed by IRC § 1401 on those net earnings has not been paid;[91]
8. An omission of information required for recertification of eligibility for the earned income credit;[92]
9. An entry on the return of a TIN required for the EIC, the child credit, and the child and dependent care credit, when information associated with that TIN indicates the child does not meet the age eligibility requirements for those credits;[93] and
10. Effective 2004, an entry on the return of a claim for the EIC where the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of that child.[94]

REASONS FOR CHANGE

The legislative history to the early authorizations of summary assessments for mathematical or clerical errors makes very clear that this deviation from the protections of deficiency procedures was intended to be limited in scope. Math error authority was to be used only in those instances where errors were apparent on the face of the return or from information that was provided on the return. It is clear from the above list of items to which math error authority today applies, that math error authority has expanded well beyond that limited scope. Where once math error assessments were the exception, today these exceptions have swallowed up the rule.[95] To understand how far we have deviated from the original conception, it is worth reviewing the legislative history of this authority.

Legislative History

Math error assessments were first authorized by the Revenue Act of 1926, which denied the taxpayer a right to appeal to the Board of Tax Appeals where a deficiency was based on a mathematical error. It further authorized the Commissioner to make an assessment and collect the tax due as a result of that mathematical error.[96]

In 1976, Congress expanded the summary assessment authority to include clerical errors as well as mathematical errors. The Tax Reform Act of 1976 set forth for the first time a definition of the phrase "mathematical or clerical error." The phrase encompassed the first five instances of the present law described above, namely,

[91] IRC § 6213(g)(2)(G).

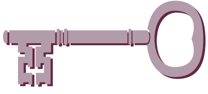
[92] IRC § 6213(g)(2)(K).

[93] IRC § 6213(g)(2)(L).

[94] IRC § 6213(g)(2)(M).

[95] 7 million Individual Master File Notices and 2 million Business Master File Notices are issued annually. IRS Notice Volume Report.

[96] Revenue Act of 1926, enacting IRC § 274(f). See H.Rep. 69-1, pp. 10-11.



- an error in adding, subtracting, etc., *on the return*;
- an incorrect use of a *table related to the return*;
- inconsistent *entries on the same return*;
- omitted information that is required to substantiate an *entry on the return*; and
- an *entry* that claims a deduction or credit amount in excess of the statutory limit, where that limit is described as a *specific monetary amount or as a percentage, ratio or fraction*.[97]

In making these changes, the House Committee on Ways and Means noted that the IRS advised the committee that the deficiency notice procedure was significantly more costly than the math error procedure, both in terms of personnel and processing costs as well as in collection delay costs. In justifying its request for expanded summary assessment authority, the Service maintained that it properly used that authority in cases where most taxpayers do not dispute the Service's conclusions, thereby reducing administrative and other costs. While mindful of these issues, the committee was concerned that the Service should not be able to move forward summarily where it might have made an error in its determination.[98]

Congress attempted to strike a balance between these two concerns by providing greater protection to taxpayers who wished to contest a math error assessment. Further, Congress attempted to restrict the Service's powers in these cases by clarifying the types of cases in which this limited summary assessment procedure could be used.[99]

The committee reports make clear that the lawmakers were very concerned that the IRS might use this procedure in ways that would undermine taxpayer rights.[100] For example, the committees cautioned the IRS that where a taxpayer supplied an omitted schedule, the related summary assessment must be abated. Disputes as to the adequacy of the submitted schedule were to be dealt with under normal administrative (deficiency) procedures and not by use of the extraordinary summary assessment procedure.[101]

97 Pub. Law 94-455, Section 1206(b), enacting IRC § 6213(f)(2).

98 H. Rep. 94-658, p. 289.

99 Both the Ways and Means and Senate Finance Committees noted that, prior to 1976, the IRS interpreted the term "mathematical error" to include much more than the phrase's literal meaning of arithmetical error. The committees also noted that court opinions had generally limited the scope of the phrase "mathematical error" to arithmetic errors involving numbers which are themselves correct. Accordingly, the committees added the words "or clerical" to the statute, to permit the Service to lawfully do what it was already doing. See H. Rep. 94-658, p. 289; S. Rep. 94-938, p. 375.

100 The Senate modified the House provision by giving the taxpayer 60 days within which to request an abatement of tax. If the taxpayer filed an abatement request, the IRS was required to abate the tax and assert the tax under the deficiency procedures. See S. Rep. 94-938, p. 378.

101 H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377.

Where there are inconsistent entries on the return, the committee reports stated that "[t]his category is intended to encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect."[102] The reports discussed two examples, one in which the use of math error is permitted, and the other where it is not.

- In the first instance, a taxpayer listed six taxpayers or dependents on the face of the return, and entered the number '6' as the total number of exemptions. However, on the second page of the return, the taxpayer entered a dollar amount for the personal and dependent exemptions that was equal to a multiple of '7'. The committees stated that the IRS may treat this as a math error and correct the exemption amount to the multiple of '6'. However, the committees further stated that "your committee expects that the Service will so phrase its notification to the taxpayer as to include questions designed to show whether the taxpayer is indeed entitled to the greater number of exemptions."[103]
- The second example involved a taxpayer who listed three names as dependents but entered '4' in the box for the total number of dependents. The committee stated that it is not clear from the face of the return whether the taxpayer inadvertently omitted a dependent's name from the face of the return or simply added incorrectly. Here, the committee believed that *"the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one."*[104] (Italics added.)

The next series of changes to IRC § 6213(g)(2) involved the use of math error procedures where a taxpayer's identification number (TIN) was not supplied as required for eligibility under various code provisions and for tax benefits. In 1996, Congress authorized the use of summary assessment procedures where the taxpayer failed to supply a TIN for a dependent (leading to the denial of the dependency exemption and indirectly impacting a claim for head of household status or the dependent care credit).[105] Also in 1996,

[102] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 376.

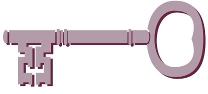
[103] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377.

[104] The Committee stated on several occasions that it expected the Service to send to the taxpayer detailed, itemized, line-by-line explanations of the math or clerical errors. In one example, the committee stated,

> [I]t is expected that the notification to the taxpayer will indicate that the taxpayer used the single person's rate schedule, that the taxpayer checked line 3 on the Form 1040, that such a taxpayer should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule). The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married.

The National Taxpayer Advocate has already noted the inadequate and confusing nature of math error notices in the "Most Serious Problems" section of this report. *See infra* Problem Topic #3, Math Error Authority.

[105] Pub. Law 104-188, The Small Business Job Protection Act of 1996, section 1615(c) (H.R. 3448) 8/20/96, amending IRC 6213(g)(2).



Congress authorized the use of math error procedures where a required TIN was not supplied with respect to the earned income tax credit, and where a taxpayer, receiving the EITC on the basis of self-employment income, did not pay self-employment tax on that income. Under this math error authority, the IRS could summarily assess the disallowed EITC and the omitted self-employment tax.[106]

In 1997, the 105th Congress extended math error summary assessment authority to omitted TINs for purposes of the Hope and Lifetime Learning Credits[107] and the Child Tax Credit.[108] Math error procedures were also authorized where the taxpayer had been denied the earned income credit in prior years and did not provide "recertification" information with the return.[109]

The attention focusing specifically on Taxpayer Identification Numbers arose from Congress' concern that taxpayers were claiming tax benefits involving children – dependency exemptions, earned income and child credits, education credits, among others – for which they were not eligible. Checking the child's social security number as listed on the return or the child's age against the information held by the Social Security Administration (the name, age, date of birth, and Social Security Number) was viewed as an effective means to limit such erroneous claims.[110]

The amendments to math error authority in the mid-1990s expanded this summary assessment procedure to take into account inconsistencies beyond the "four corners" of the income tax return itself. Whereas early math error authority was designed to be limited to those inconsistencies apparent on the return itself, Congress in the nineties was concerned about the revenue loss associated with erroneous claims for various newly enacted or expanded credits. Although math error authority was perceived as a useful tool for stopping erroneous claims before payments left the Treasury, Congress still limited the expansion of math error authority to numerical or quantitative items (the social security number, or the child's birth date or age) that could be verified against an inherently accurate source (the provider of the number, i.e., the Social Security Administration). Although not explicitly stated, Congress in the nineties attempted to balance the need for efficient tax administration against possible overreaching by the Service and protection of taxpayer rights.

[106] Pub. Law 104-193, The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, section 451(c), H.R. 3734, amending IRC 6213(g)(2).

[107] Pub. Law 105-34, section 1201(b), adding IRC § 6213(g)(2)(J).

[108] Pub. Law 105-34, Section 101(d)(2), adding IRC § 6213(g)(2)(I).

[109] Pub. Law 105-34, Section 1085(a)(3), as amended by Pub. Law 105-206, Section 6010(p)(3), adding IRC § 6213(g)(2)(K).

[110] Pub. Law 105-277, section 3003, adding IRC § 6213(g)(2)(L) to authorize the IRS obtain such information from the issuer of the Taxpayer Identification Number. See Conf. Rep. 105-825, 1588-89.

In 2001, Congress took a different approach to math error authority. In response to reports of a high percentage of erroneously paid EIC claims,[111] Congress authorized the use of summary assessment procedures, beginning in 2004, where data from the Federal Case Registry (FCR) of Child Support Orders indicates that the taxpayer is the noncustodial parent of the qualifying child.[112] The Federal Case Registry (FCR) is a national database maintained by the Department of Health and Human Services. States are required to electronically submit specified data regarding all child support cases handled by State Title IV-D child support agencies and all non-Title IV-D support orders established or modified on or after October 1, 1998.[113]

While the changes in the 1990s targeted a numerical item on the face of the return and checked for inconsistencies against a numerical or quantitative database maintained by a single, reliable source, the expansion of math error authority in 2001 involves a highly qualitative, subjective, and inherently fluid item (the residence of a child over a period of time) and checks for inconsistencies against a source that is composed of data maintained by 52 different jurisdictions[114] in a non-uniform fashion, reporting a single condition that is subject to different interpretations in each of those jurisdictions, and that does not necessarily reflect the actual living arrangements of the child at the time in question. Unlike the child's date of birth, age, or social security number, a child's physical residence can change over time, despite the terms of a custody order that might have been entered into over 5 years ago.

It is this expansion of math error authority that concerns the National Taxpayer Advocate. Under the limited approach taken by Congress in 1976, math error assessments are appropriate where *"not only is the error apparent from the face of the return, but the correct amount is determinable with a high degree of probability from the information that appears on the return."*[115] The 1990 legislation went beyond the face of the return to determine the correct item, but retained the high degree of probability that the summary correction was accurate. The same cannot be said about the 2001 expansion into the fluid arrangements parents make between themselves, over time, regarding the residence of their children. This type of item more accurately fits into the category of adjustments Congress specifically required the IRS to address through deficiency procedures.

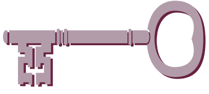
[111] *See* Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (Sept. 2002).

[112] Pub. Law 107-16, The Economic Growth and Tax Relief Reconciliation Act of 2001, Section 303(g). The National Taxpayer Advocate expressed concerns regarding the accuracy of the FCR and the appropriateness of the expansion of math error authority to inconsistencies between the return and the FCR. The Senate Report requested a study of the FCR database by the Department of Treasury, in consultation with the National Taxpayer Advocate, which would cover the accuracy and timeliness of the data in the FCR; the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims; and the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data. S. Rep. 107-30, p 16-22.

[113] 42 USC § 653.

[114] 50 states plus Guam and the District of Columbia. IRM 21.8.1.2.4.8 (Rev. 12/2000).

[115] H. Rep. 94-658, p. 292; S. Rep. 94-938, p. 378. (Italics added.)



Taxpayer Rights Concerns

Basic principles of tax administration require that administrative efficiency be balanced against taxpayer rights. Striking the right balance is often a difficult task, but we believe that the breadth of the IRS's current math error assessment authority under IRC § 6213 imposes too heavy a burden on taxpayer rights. The summary assessment procedure should be used very cautiously, and only in those instances where items on the return are numerical, quantifiable, and verified against reliable, quantifiable sources.

Here is what is being compromised with the expansion of math error authority: under normal examination procedures, if the taxpayer makes no response at all to the IRS correspondence *proposing* an adjustment, the taxpayer will receive a Notice of Deficiency by certified mail, providing the taxpayer an opportunity to petition the Tax Court. Under the math error summary assessment procedure, if the taxpayer makes no response to the IRS correspondence *summarily assessing* the adjustment, the taxpayer will *not* have an opportunity to petition the Tax Court.

Consider the population targeted by the 2001 changes – those taxpayers who are eligible for the Earned Income Tax Credit. By definition, these taxpayers are the working poor. Congress acknowledged in the IRS Restructuring and Reform Act of 1998 (RRA98) that these taxpayers do not have access to representation, are often afraid to communicate with the IRS, or are unable to take time off from work to call, or do not understand the IRS notices they receive.[116] The Service's own studies show a high no-response rate for this population.[117] We may be able to justify the summary denial of this important taxpayer right (the access to Tax Court) where we are dealing with true math or clerical errors. But support for this justification diminishes "where the Service is merely resolving an uncertainty against the taxpayer."[118]

The National Taxpayer Advocate believes that it is inappropriate to use the summary math error assessment where there is merely uncertainty on the return. Thus, where a taxpayer lists 4 dependents who lived with her, including their social security numbers, on the Form 1040, but lists two children as eligible for the earned income tax credit (the

[116] In response to these concerns, Congress enacted IRC § 7526, which provides for matching funding of Low Income Taxpayer Clinics that represent low income taxpayers in IRS disputes for free or a nominal charge, and that conduct education and outreach to taxpayers who speak English as a second language.

[117] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns, 8 (Feb. 28, 2002). A recent attempt by the Small Business/Self-Employed Division to determine the reasons for the high level of no-response to service center correspondence ended up with only 8 individuals participating in focus groups out of 1,767 people contacted. Study of Service Center Correspondence Examination No Reply Assessments, Project 2.08, SB/SE Research, April 2001.

[118] H. Rep. 94-658, p. 291; S. Rep. 94-938, p. 377. This is not to say that the IRS should pay out credit amounts that are in error. The IRS is currently exploring many different means of identifying erroneous claims of various credits. The IRS can freeze refunds pending the resolution of these inconsistencies. It can, and is, developing taxpayer-friendly approaches to this problem resolution.

maximum number of children for eligibility), and one of those two children's social security number is incorrect, the use of math error authority is inappropriate. It is not clear from the face of the return which is the correct entry – that is, another of the remaining two children might make the taxpayer eligible for the same amount of credit. To utilize summary assessment procedures in such a case, without the inquiries and contacts that attend to other administrative return examinations, erodes taxpayer confidence, results in repeat-work for other functions (including the Taxpayer Advocate Service and the audit reconsideration function), and impairs taxpayer rights by limiting their access to the United States Tax Court.

Today, the IRS has 500 math error codes that it enters into IDRS to indicate the type of math error identified on the return. There are approximately 35 million errors identified in the Error Resolution Section (ERS) each year, resulting in the generation of 7 million Individual Master File (IMF) and 2 million Business Master File (BMF) math error notices.[119] The Taxpayer Advocate Service received 27,480 cases during FY 2002 in which math errors were the major issues, accounting for 12 percent of all TAS case receipts (227,373) for that period.[120] Math error cases involving EITC constituted 1.2 percent of Taxpayer Advocate Service cases closed in FY 2002. In 61 percent of those 2,813 cases, intervention by TAS resulted in a positive change for the taxpayer.[121]

Explanation of Recommendation

The National Taxpayer Advocate recommends that Internal Revenue Code sections 6213(b) and 6213(g)(2), as appropriate, be amended to specifically limit the scope of the summary assessment authority for mathematical or clerical errors and provide standards by which to judge any proposed expansion of this authority. Specifically, she proposes that "math error" assessments be limited to the following situations:

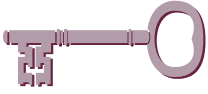
- Inconsistent items in which the inconsistency is determined from the face of the return;
- Omitted items, including schedules, that are required to be included with the return; and
- Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.

By limiting the scope of math error assessment authority to items that are either self-contained on the return, or that are numerical or quantitative, Congress can ensure that the delicate balance between efficient tax administration and taxpayer rights is maintained.

[119] MIS24 Report (12/10/02), 2-Year Trend Report and Notice Volume Reports.

[120] TAMIS Data Base.

[121] *See* the discussion of Math Error under Most Serious Problems, Problem Topic #3.



Under this approach, math error summary assessment authority would not be permitted where the inconsistent items are of a qualitative nature, dependent on facts and circumstances, and inherently subject to change or interpretation. By their very nature, such items should be subject to the IRS' normal examination and deficiency procedures from the very outset of the dispute.

Thus, the National Taxpayer Advocate recommends that Congress repeal Internal Revenue Code section 6213(g)(2)(M), which defines as math or clerical error and authorizes the Internal Revenue Service to use summary assessment procedures for an entry on the return with respect to a qualifying child for the Earned Income Tax Credit, where the taxpayer has been identified as the non-custodial parent of that child by the Federal Case Registry of Child Support Orders established under section 453(h) of the Social Security Act. This provision fails the limited scope test for math error authority, since the underlying factual situation is inherently qualitative in nature and subject to change from year to year. A facts and circumstances analysis, using deficiency procedures, is the appropriate approach to the earned income tax credit's statutory requirement of where a child resided for more than half the year.[122]

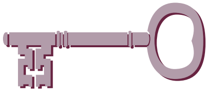
The National Taxpayer Advocate understands the need for efficient, cost-effective methods to deal with noncompliance and tax administration programs. However, she believes that administrative efficiency is only one component of a fair and just tax system. Administrative efficiency must be balanced by protections for taxpayers where there is a likelihood of IRS error or where the category of taxpayers impacted by the procedure is likely to experience obstacles in exercising their rights under the Internal Revenue Code.

Where Congress authorizes the expansion of the math error summary assessment authority beyond inconsistencies in numerical or quantitative items included on the face of the return, the National Taxpayer Advocate recommends that IRC § 6213(g) be amended to require the Department of Treasury to submit to Congress a study of the proposed expanded authority prior to granting such expansion. This report, prepared in consultation with the National Taxpayer Advocate, should set forth and analyze the specific need for such expansion, the alternative methods for resolving the identified need, and the projected revenue and cost savings attributed to the expansion of math error notices and the alternative methods identified. Further, the report should include an analysis, prepared by the National Taxpayer Advocate, of the impact on taxpayer rights of such expansion. This taxpayer rights impact statement should identify the substantive and procedural rights that may be affected by the expansion and include an analysis of the

[122] The National Taxpayer Advocate is not impressed by arguments that the FCR is the most effective means to screen out erroneous claims of EITC qualifying children. During 2002 the NTA served on a joint Treasury-IRS EITC Steering Committee, which identified several approaches to better administration of the EITC. None involved the use of math error authority, and all had a significant likelihood of reducing erroneous EITC claims.

taxpayer segments most likely to be impacted by the proposed expansion of math error authority. The report should also include a discussion of the consequences for both the taxpayer and IRS in attempting to address and resolve post-assessment matters arising from the expanded math error authority.

The approach outlined above will enable Congress to maintain the delicate balance between efficient administrative processes and taxpayer rights. Given the importance of the Tax Court as the prepayment judicial forum for resolving tax disputes and the deficiency procedure's gatekeeping to that forum, summary assessment authority should be the exception rather than the rule.



4 THE OFFICE OF THE TAXPAYER ADVOCATE

PROBLEM

It is now almost five years since the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) and three years since the Taxpayer Advocate Service "stood up." During this period, all of RRA 98's provisions relating to the National Taxpayer Advocate and the Office of the Taxpayer Advocate (OTA) have been implemented in some fashion. Further, the National Taxpayer Advocate and the OTA have had almost three years of experience with operating independently within the IRS. Based on the experience of the last three years, the National Taxpayer Advocate believes that additional statutory measures are required to protect the independence of the Office of the Taxpayer Advocate and taxpayer rights through that office.

The following recommendations are designed to enhance the independence of the Office of the Taxpayer Advocate and the ability of the National Taxpayer Advocate to protect taxpayer rights and taxpayer confidences both within the Internal Revenue Service and in federal courts.

RECOMMENDATION

The National Taxpayer Advocate (NTA) recommends that the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate be strengthened by amending Internal Revenue Code sections 7803(c)(3) and 7811 as follows:

- Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.
- Amend IRC § 7803(c)(3) to authorize the National Taxpayer Advocate to intervene as amicus curiae in any federal litigation, excluding litigation before the United States Supreme Court, that raises issues relating to taxpayer rights under the Internal Revenue Code.
- Amend IRC § 7811 to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.

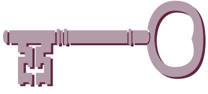
- Amend IRC § 7811 to include "impairment of taxpayer rights" as a definition of "significant hardship" for purposes of issuing a Taxpayer Assistance Order or Taxpayer Advocate Directive.
- Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.
- Amend IRC § 7803(c)(4)(A) to provide that in litigation before a federal court, Local Taxpayer Advocates shall not through discovery or compulsory process be required to disclose the fact that the taxpayer contacted the Taxpayer Advocate Service or any information provided by the taxpayer to TAS, unless the court determines that such testimony or disclosure is necessary to:

  (a) prevent a manifest injustice;

  (b) help establish a violation of law; or

  (c) prevent harm to the public health or safety,

  of sufficient magnitude in the particular case to outweigh the integrity of the Taxpayer Advocate Service in general by reducing the confidence of taxpayers in future cases that their communications will remain confidential.



PRESENT LAW

The Office of the Taxpayer Advocate was created in 1996 by the Taxpayer Bill of Rights 2 (TBOR 2).[123] This Act also established the position of the Taxpayer Advocate. The Taxpayer Advocate replaced the position of the Taxpayer Ombudsman, which was created in 1979 by the Internal Revenue Service to serve as the primary advocate for taxpayers within the IRS and which was later codified in the Taxpayer Bill of Rights 1 (TBOR 1).[124]

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[125] significantly strengthened the Office of the Taxpayer Advocate (OTA) and renamed the Taxpayer Advocate as the National Taxpayer Advocate (NTA). The Act established the OTA as a separate, independent entity within the IRS. The National Taxpayer Advocate reports directly to the Commissioner of Internal Revenue[126] and the employees of the Office of the Taxpayer Advocate, including Local Taxpayer Advocates, report directly to the National Taxpayer Advocate or a delegate thereof.[127]

The Office of the Taxpayer Advocate has four statutory general functions:

1. Assist taxpayers in resolving problems with the Internal Revenue Service;
2. Identify areas in which taxpayers have problems in dealings with the Internal Revenue Service;
3. To the extent possible, propose changes in the administrative practices of the IRS to mitigate the identified systemic problems; and
4. Identify potential legislative changes which may be appropriate to mitigate such systemic problems.[128]

In addition to these general functions, the National Taxpayer Advocate is required to submit two reports a year directly to Congress, without any prior review or comment from the Commissioner, the Secretary of the Treasury, the IRS Oversight Board, or any other officer or employee of the Department of the Treasury or the Office of Management and Budget. These two reports, one of which is due on June 30th and the other on December 31st of each year, respectively address the objectives of the OTA for the upcoming fiscal year and the activities of the OTA for the past fiscal year.[129]

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[123] Pub. L. No. 104-168, § 101 (1996).

[124] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6230(a) (1988).

[125] Pub. L. No. 105-206 (1998).

[126] IRC § 7803(c)(1)(B).

[127] IRC § 7803(c)(4)(A)(i).

[128] IRC § 7803(c)(2)(A)(i) – (iv).

[129] IRC § 7803(c)(2)(B). The December 31st report includes, among other statutorily required items, a listing and discussion of the top 20 problems experienced by taxpayers; a listing of the 10 most litigated issues for each category of taxpayers, including recommendations for mitigating such disputes; and recommendations for administrative and legislative action that may be appropriate to resolve taxpayer problems. *See* IRC § 7803(c)(2)(B)(ii).

In 1998, Congress expanded the circumstances in which the National Taxpayer Advocate could issue a Taxpayer Assistance Order, a directive that orders the IRS either to take a specific action or to review or reconsider specific information or evidence relating to a particular taxpayer's case.[130] RRA 98 provided for four specific instances of "significant hardship": (1) an immediate threat of adverse action; (2) a delay of more than 30 days in resolving taxpayer account problems; (3) the taxpayer's incurring of significant costs (including professional services fees) if relief is not granted; and (4) the taxpayer's suffering of irreparable injury or long-term adverse impact if relief is not granted.[131] The committee reports make clear that this list is a non-exclusive list of what constitutes "significant hardship" for purposes of IRC § 7811.[132]

The 1998 legislation also provided Local Taxpayer Advocates with the discretion to withhold from the IRS the fact that a taxpayer contacted TAS and any information provided by a taxpayer to TAS.[133] In order to protect the confidential communications between taxpayers and the Office of the Taxpayer Advocate, each Local Taxpayer Advocate must have phone, facsimile, electronic communication and mailing addresses separate from those of the IRS.[134] Further, the Local Taxpayer Advocate must advise taxpayers at their first meeting of the fact that "the taxpayer advocate offices operate independently of any other Internal Revenue Service office and report directly to Congress through the National Taxpayer Advocate."[135]

REASONS FOR CHANGE

As noted above, the Office of the Taxpayer Advocate has four statutory functions, which include identifying both specific and systemic problems that taxpayers encounter in their dealings with the Internal Revenue Service and making administrative and legislative recommendations for mitigating those problems. This mission is achieved through advocacy in specific taxpayer cases (case advocacy) and through advocacy in matters impacting taxpayer rights and tax administration (systemic advocacy).

[130] IRC § 7811. See H.R. Conf. Rep. No. 105-599, at 26, 28 (1998). In 1988, Congress granted the Taxpayer Ombudsman the statutory authority to issue a Taxpayer Assistance Order (TAO) if, "in the determination of the Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the IRS is administering the internal revenue laws." S. Rep. No. 100-445 (1988). TBOR 2 extended the scope of the TAO by providing the Taxpayer Advocate with broader authority "to affirmatively take any action as permitted by law with respect to taxpayers who would otherwise suffer a significant hardship as a result of the manner in which the IRS is administering the tax laws." JCT General Explanation of the Tax Legislation Enacted in the 104th Congress (JCS-12-6) December 18, 1996, at 22.

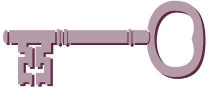
[131] IRC § 7811(a)(2)(A) – (D).

[132] See H.R. Conf. Rep. No. 105-599, at 26, 28 (1998).

[133] IRC § 7803(c)(4)(A)(iv).

[134] IRC § 7803(c)(4)(B).

[135] IRC § 7803(c)(4)(A)(iii).



Throughout the hearings of the National Commission on Restructuring the Internal Revenue Service and the 1998 legislative process, the Commission and the Congress expressed their concern about the lack of independence of the Office of the Taxpayer Advocate. The reforms enacted in RRA 98 were designed both to strengthen the office and to make it as independent of the Internal Revenue Service as possible while it remained a part of the IRS. The office's effectiveness and success in achieving its mission is dependent on its ability to maintain the delicate balance between being "independent" and being "inside." The proposals discussed below are designed to strengthen and enhance the independence of the Office of the Taxpayer Advocate while preserving the Advocate's role within the IRS organization.

Counsel to the National Taxpayer Advocate

Currently, the National Taxpayer Advocate receives legal advice from the Special Counsel to the National Taxpayer Advocate. The Special Counsel to the NTA advises the National Taxpayer Advocate on matters pertaining to the Office of the Taxpayer Advocate as well as matters pertaining to tax administration, including taxpayer rights. The Special Counsel to the NTA reports directly to the Chief Counsel of the Internal Revenue Service. This reporting structure impairs the National Taxpayer Advocate's ability to receive independent legal counsel since her counsel may be placed in a position of rendering advice that is directly contrary to the advice of the Office of Chief Counsel, to whom the Special Counsel to the NTA reports and by whom she is evaluated.

The National Taxpayer Advocate and the Office of the Taxpayer Advocate play a particularly important role in tax administration with respect to the protection of taxpayer rights. It is possible, and it has in fact occurred, that the IRS's corporate decision to proceed in a particular fashion for administrative and cost efficiencies directly and negatively impacts on taxpayer rights or causes significant hardship to an unwarranted extent. While the IRS's corporate decision may be well within the bounds of the law, the National Taxpayer Advocate may also have a legally supportable position. For the National Taxpayer Advocate to develop the most persuasive case to present to the Commissioner for consideration, the National Taxpayer Advocate's legal advisor must be free to render such advice without concern that her advice would create an untenable conflict between her duties to her client and her duties to her supervisors.

In RRA 98, the Senate passed legislation providing for counsel to the National Taxpayer Advocate, to be appointed by and report directly to the National Taxpayer Advocate and to operate within the Office of the Taxpayer Advocate.[136] Senator Grassley, the sponsor of this provision, provided the following rationale:

[136] H.R. Conf. Rep. No. 105-599, at 26 (1998).

> The purpose of doing this is to give the Taxpayer Advocate ready access to legal opinions and legal judgments. Currently, the Taxpayer Advocate must put requests into the Office of Chief Counsel.
>
> In order to make the Taxpayer Advocate more independent, which is what this bill does, it logically follows that the Taxpayer Advocate should have its own legal counsel. This will guarantee it fast, confidential legal advice to help those taxpayers in greatest need. Because it is the taxpayers in greatest need who go to the Taxpayer Advocate.[137]

This provision was eliminated in the conference agreement. However, the conference report noted that "[t]he conferees intend that the National Taxpayer Advocate be able to hire and consult counsel as appropriate."[138]

The ability of the National Taxpayer Advocate to hire and consult outside counsel is dependent upon the Office of the Taxpayer Advocate's having sufficient resources for this purpose. Since the initial pass and ongoing adjustments of the OTA's budget is determined by the Commissioner, who must balance the overall needs of tax administration against the specific needs of the OTA, it is highly likely that the NTA's retention of outside counsel (i.e., a contractor), on a continuing basis, would not be funded. Further, it is unlikely that an outside counsel would have the ability to participate in preliminary and pre-decisional discussions with attorneys in the Office of Chief Counsel and other employees of the IRS.

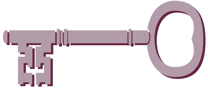
Unlike any other employee of the Internal Revenue Service, the National Taxpayer Advocate is alone authorized by statute to not only advocate within the IRS but also *publicly* advocate for positions, even where those positions differ from those of the commissioner. In order to effectively fulfill this role, the National Taxpayer Advocate must have access to equal counsel that is both independent and free of possible conflicts of interest.

Amicus Curiae Authority

As noted above, the National Taxpayer Advocate and the Office of the Taxpayer Advocate have a mission-related interest in the subject of taxpayer rights, particularly where an infringement, restriction, or redefinition of such rights will cause significant hardship to taxpayers or might undermine taxpayer confidence in the U.S. tax system. It is possible that the Commissioner or the United States will advance a position in litigation that would be justifiable with regard to efficient tax administration and yet would impact the legal rights of taxpayers. It is also possible that the Commissioner's or the United States' position would be supported and enhanced by the particular perspective and arguments made by the National Taxpayer Advocate with respect to taxpayer rights and tax administration.

[137] 144 Cong. Rec. SS40 (daily ed. May 7, 1998) (Statement of Sen Grassley)

[138] H.R. Conf. Rep. No. 105-599, at 28 (1998).



We believe that the National Taxpayer Advocate should have the opportunity to present such arguments, and the federal courts should have the opportunity to consider them.

Within the IRS, the National Taxpayer Advocate reports directly to the Commissioner and has access to discuss with him matters relating to tax administration and taxpayer rights. On occasion her views will not prevail, nor will they be accepted by the Office of Chief Counsel, which represents the United States before the United States Tax Court. Where the National Taxpayer Advocate is unsuccessful (or even partially successful) in advancing her position internally, she should be permitted to ask the court for permission to intervene in litigation, not as a party but as a friend of the court.

The only other "advocate" in the federal government – the Chief Counsel for Advocacy for the Small Business Administration – has amicus brief authority. The Office of Advocacy of the Small Business Administration was created in 1976.[139] The office has numerous statutory "primary functions," which include examining the role of small business in the American economy and the contributions that small business can make, assessing the effectiveness of existing Federal subsidies and assistance programs for small business, measuring the direct costs and other effects of government regulation on small businesses, and determining the impact of the tax structure on small businesses.[140] The most visible responsibility of the Office of Chief Counsel for Advocacy is to oversee agency compliance with the Regulatory Flexibility Act.

In 1980, Congress authorized the Chief Counsel for Advocacy to file amicus briefs to present his views with respect to the effect of the rule at issue on small entities.[141] In 1996, Congress amended the Regulatory Flexibility Act to allow the Chief Counsel for Advocacy also to file amicus briefs to present his views with respect to compliance with the Act and the adequacy of the rulemaking record.[142] Thus, the Regulatory Flexibility Act grants the Chief Counsel for Advocacy the authority to appear as amicus curiae in any action brought in a court of the United States to review a rule. In any such action, the Chief Counsel for Advocacy of the Small Business Administration is authorized to present his views regarding compliance with the Act, the adequacy of the rulemaking record with respect to small entities, and the effect of the rule on small entities.

On the one occasion when the Chief Counsel for Advocacy of the Small Business Administration sought and received permission from the court to file an amicus brief, the Department of Justice opposed the brief on the ground that the provision granting the Chief Counsel for Advocacy the authority to file an amicus brief violated the

[139] Small Business Investment Act, Pub. L. No. 94-305, § 201 (1976).

[140] 15 U.S.C. § 634(b).

[141] 5 U.S.C. § 612(b); Regulatory Flexibility Act, Pub. L. No. 96-354, § 3(a) (1980).

[142] Contract with America Advancement Act of 1996, Pub. L. No. 104-121, § 243(b) (1996).

Constitution because it impairs the ability of the executive branch to fulfill its constitutional functions.[143] The Chief Counsel for Advocacy ultimately withdrew his amicus brief.

As in the case of the Chief Counsel for Advocacy of the Small Business Administration, there is a compelling argument for providing the federal judiciary with the perspective of an independent advocate for taxpayers who functions within the IRS. This perspective will not necessarily be adopted by the Commissioner or the United States, nor would it be advanced by the specific taxpayers involved in the litigation. It is, however, a point of view that Congress has continually advanced through legislation and through the creation of the Office of the Taxpayer Advocate. Congress should consider allowing this viewpoint to be presented in judicial proceedings as well.

Taxpayer Advocate Directive

The Commissioner has delegated to the National Taxpayer Advocate the authority to issue Taxpayer Advocate Directives.[144] A Taxpayer Advocate Directive (TAD) may mandate administrative or procedural changes "to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment or provide an essential service to taxpayers."[145] The TAD provides the National Taxpayer Advocate with the authority to prevent IRS programs from being implemented before their impact on taxpayers has been fully considered.

The current National Taxpayer Advocate has advised the Commissioner or Operating Division Commissioners of her intent to issue a TAD on two occasions since March 2001. In the first instance, the Commissioner placed a moratorium on the implementation of the Federal Payment Levy Program against Social Security benefits until the National Taxpayer Advocate's concerns were addressed. In the second case, the Small Business/Self-Employed Operating Division clarified and modified its position regarding an offer-in-compromise procedure to address the NTA's concerns. In neither instance was it necessary for the National Taxpayer Advocate to issue a formal TAD.

[143] The United States Constitution requires the President to "take care that the laws be faithfully executed." U.S. Const. Art. II, §3. The Constitution also imposes a requirement that a case or controversy exist before a matter is presented before a United States court. U.S. Const. Art. III. With respect to the latter concern, the National Taxpayer Advocate is proposing only to intervene as a friend of the court in suits that are already justiciable. Such litigation will be between a taxpayer and the United States (or the Commissioner), not between the National Taxpayer Advocate and the United States (or the Commissioner). For a discussion of the "take care" clause of Article II and other objections to congressional grants of amicus brief authority to executive branch officials, see Memorandum of the American Law Division (Congressional Research Service), Constitutional Analysis of Section 612(b) of the Regulatory Flexibility Act Authorizing the Chief Counsel for Advocacy of the Small Business Administration to Appear as Amicus Curiae in Any Court Action to Review an Agency Rule (October 22, 1993).

[144] *See* Del. Order 250 (01/17/01) at IRM 1.2.2.151.

[145] *Id.*

Since the Taxpayer Advocate Directive derives from a delegation of the Commissioner's own authority, the National Taxpayer Advocate holds this authority at the pleasure of the Commissioner, and the Commissioner may revoke or modify it at any time. Although used infrequently, the TAD is a means for ensuring that systemic issues – those involving taxpayer rights, burden, equitable treatment, or service to taxpayers – are elevated to senior IRS leadership and given appropriate consideration. Thus, the TAD and the TAD process are powerful tools for effecting systemic change and help the National Taxpayer Advocate to advocate effectively for taxpayer rights.

Definition of Significant Hardship

The issuance of a Taxpayer Assistance Order is conditioned upon the National Taxpayer Advocate's finding that a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the Secretary is administering the internal revenue laws.[146] The Taxpayer Advocate Service uses the same standard in determining whether to accept a case. Therefore, the definition of "significant hardship" is critical to taxpayers gaining access to and assistance from the office of the Taxpayer Advocate.

As noted above, Congress has on two occasions expanded the definition of "significant hardship" under IRC § 7811(a). The definition of "significant hardship" now includes –

- An immediate threat of adverse action;
- A delay of more than 30 days in resolving taxpayer account problems;
- The incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or
- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.[147]

Each of these instances addresses some kind of economic or systemic hardship, yet none explicitly describes a situation where the violation of a taxpayer's rights under either a statute or an IRS regulation or procedure would constitute a significant hardship.

For example, a taxpayer timely requested a Collection Due Process hearing under IRC § 6320. The taxpayer was notified that a telephonic hearing was scheduled for January 10, 2001. On January 4th, the Appeals Officer returned a message from the taxpayer (who had requested a face-to-face hearing). The Appeals Officer informed the taxpayer that the January 4th call would constitute his CDP hearing. The court ruled that an unscheduled telephone call does not constitute a hearing.[148] Had the taxpayer contacted the Taxpayer Advocate Service for assistance prior to filing his complaint in court, it is doubtful that the taxpayer would meet the criteria under the current definition of significant hardship.

146 IRC § 7811(a)(1)(A).

147 IRC § 7811(a)(2).

148 Montijo v. United States, 2002 U.S. Dist. LEXIS 9602.

An explicit definition of significant hardship as the immediate threat of an impairment of a taxpayer's rights under the Code or regulations would eliminate any remaining questions about the National Taxpayer Advocate's ability to intercede on behalf of a taxpayer and to issue a Taxpayer Assistance Order in such a case.

Confidentiality of Taxpayer Communications with the Taxpayer Advocate Service

Internal Revenue Code section 7803(c)(4)(A)(iv) provides that a Local Taxpayer Advocate may, at his or her discretion, not disclose to the rest of the Internal Revenue Service the fact that the taxpayer has contacted the Taxpayer Advocate Service or any information provided to TAS by the taxpayer. This provision, enacted in 1998, was designed to give taxpayers assurances that they could contact the Taxpayer Advocate Service for assistance in difficult cases, including discussing the actions or proposed actions of an IRS employee, without those conversations being reported to the IRS. These protections were viewed as particularly important where the taxpayer feared repercussions or reprisals from the IRS employee working the taxpayer's case.[149]

Confidentiality has long been viewed as essential to relationships in which one party is charged with representing, advocating on behalf of, or negotiating for another party. Confidentiality is also a key element of alternative dispute resolution. Further, confidentiality is considered an essential characteristic of ombudsmen offices.

Both the Administrative Dispute Resolution Act of 1996[150] (ADR Act) and the American Bar Association Standards for the Establishment and Operation of Ombuds Offices explicitly acknowledge the role confidentiality plays in bringing parties in a dispute to resolution. The ABA Standards provide that

> [a]n ombuds does not disclose and is not required to disclose any information provided in confidence, except to address an imminent risk of serious harm. … An ombuds may, however, at the ombuds's discretion disclose nonconfidential information and may disclose confidential information so long as doing so does not reveal its source.[151]

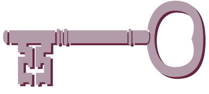
[149] Senator Breaux, a sponsor of RRA 98 in the Senate, made the following statement regarding the confidentiality of taxpayer communications with TAS:

> We are really trying to build some walls between the IRS and the Taxpayer Advocate and their work with the taxpayers, the American citizens of this country, to make sure that they, the taxpayers, know the person they are dealing with is independent, has their interests at heart, and doesn't have to go report to the Internal Revenue Service district director about what he or she has discussed or talked about with the taxpayer who is seeking assistance.

144 Cong. Rec. 54 (daily ed. May 5, 1998) (statement of Sen. Breaux).

[150] 5 U.S.C. §§ 571-584.

[151] American Bar Association, Standards for the Establishment and Operation of Ombuds Offices 3 (August 2001).



The ADR Act sets forth the rules governing alternative dispute resolution in federal agencies that elect to be covered by the Act. Under the ADR Act, dispute resolution communications between the parties and a neutral are held in confidence by the neutral unless –

1. All parties to the dispute resolution proceeding and the neutral agree in writing (and if the communication was provided by a nonparty, the nonparty agrees in writing);
2. The communication has already been made public;
3. The communication is required to be disclosed by statute (but should be disclosed by the neutral only if no other person is reasonably available to disclose the communication); or
4. A court determines that the testimony or disclosure is necessary to prevent a manifest injustice, help establish a violation of law, or prevent harm to the public health or safety. In making its determination, the court must find that the harm brought about by nondisclosure is "of sufficient magnitude in the particular case to outweigh the integrity of dispute resolution proceedings in general by reducing the confidence of parties in future cases that their communications will remain confidential."[152]

The Federal ADR Steering Committee developed and published guidance for the exercise of confidentiality under the ADR Act, which was approved by the Federal ADR Council, a group of high-level government officials chaired by the Attorney General. The Taxpayer Advocate Service has modeled its confidentiality policies and procedures after this guidance and the ABA Standards.

The Taxpayer Advocate Service is in a unique position to help taxpayers resolve their problems with the IRS. By design, taxpayers who contact TAS are concerned about the handling of their case and often fear that their coming to TAS will result in retaliation or bad acts by the IRS. However groundless these fears may be, taxpayers who have made a mistake on past returns and want to make amends are hesitant to admit their errors unless they have some assurances that these discussions will be held in confidence while the taxpayer and TAS attempt to solve the taxpayer's problem.

On the other hand, TAS is a part of the IRS. The Taxpayer Advocate Service must balance the need to protect the taxpayer's confidences with the tax system's need for compliance. Confidentiality is not an excuse or a means for getting around either TAS or the IRS. TAS cannot allow itself to be compromised in this way.

[152] 5 U.S.C. § 574(a). The Federal ADR Council guidance states that the "need for the information must be so great that it outweighs a loss of confidence among other potential parties that their dispute resolution communications will remain confidential in future proceedings." The Council noted the importance of confidentiality, identifying it as "a critical component of a successful ADR process." Federal Alternative Dispute Resolution Council, Department of Justice, Confidentiality in Federal Alternative Dispute Resolution Programs, 65 Fed. Reg. 83,085 (Dec. 29, 2000).

The National Taxpayer Advocate and the Taxpayer Advocate Service have developed guidance for TAS employees about confidentiality, particularly with regard to a taxpayer's statement about criminal acts or civil fraud. We believe that 99.9 percent of the taxpayers who come to TAS for help will want and need TAS to share information they provide with the IRS. In order to resolve a problem, TAS must tell the IRS it is working on the taxpayer's case and give the IRS the requisite information to resolve the taxpayer's problem.

The guidance recognizes that there will be a small number of cases where the taxpayer is reluctant or unwilling to "come clean" with the IRS. Here, confidentiality is an important tool for persuading the taxpayer to become compliant with the tax laws. As long as the taxpayer is working with TAS to become compliant and correct errors, TAS may keep the taxpayer-provided information confidential.

Where the taxpayer walks out the door and refuses to become compliant with his or her responsibilities under the tax laws, the Local Taxpayer Advocate (LTA) must exercise his or her discretion in determining whether to disclose taxpayer-provided information to the IRS. In exercising this discretion, the LTA should weigh the harm to the tax system against the harm to the confidence that future taxpayers would have in TAS if they knew TAS had disclosed this information.[153] In cases involving criminal violations of law, civil fraud, or threats of significant personal injury or harm, there is no discretion – TAS will disclose taxpayer-provided information relevant to these matters.

In the course of developing this guidance, a disagreement arose among the National Taxpayer Advocate, the Internal Revenue Service, and the Office of Chief Counsel regarding the scope of the statute and its interaction with pre-existing law. Although this dispute has been resolved, we believe that IRC § 7803(c)(4)(A)(iv) should be amended to clarify that the Local Taxpayer Advocate's discretion to not disclose taxpayer-provided information to the IRS is applicable notwithstanding any other provision of the Internal Revenue Code. This change will place all Internal Revenue Code provisions relating to confidentiality of taxpayer communications with TAS within the statute governing the operation of the Office of the Taxpayer Advocate, thereby reinforcing the essential importance of maintaining and protecting taxpayer communications in the work performed by that Office.[154]

[153] The ABA Standards note that "[a]n ombuds will rarely, if ever, be privy to something that no one else knows. Therefore, providing confidentiality protection to the ombuds allows the ombuds to perform assigned duties while at the same time, society continues to have access to the underlying facts." ABA Standards at 8. Thus, if the IRS already has access to taxpayer-provided information in one form or another, TAS would generally not disclose the information again.

[154] The statutory amendment will also reassure employees of the Office of the Taxpayer Advocate that so long as they comply with the confidentiality policies and procedures of the Office of the Taxpayer Advocate, they will not be subject to discipline under another Code section that requires disclosure. *See, e.g.,* IRC § 7214(a)(8).

The independence of the Taxpayer Advocate Service will be further enhanced if the language of the ADR Act relating to discovery or compulsory process is incorporated into IRC § 7803(c)(4)(A). Thus, where the Local Taxpayer Advocate has exercised his or her discretion not to disclose taxpayer-provided information to the IRS, he or she cannot be *compelled* to disclose the information unless a court finds that the need for the testimony or disclosure is so great that it outweighs a loss of confidence among other taxpayers that their communications with TAS will remain confidential in future cases.

EXPLANATION OF RECOMMENDATIONS

The Office of the Taxpayer Advocate serves an important role within the IRS by protecting taxpayer rights and solving taxpayer problems with the IRS.[155] The recommendations discussed in this section are intended to strengthen and support this important mission.

Counsel to the National Taxpayer Advocate

The National Taxpayer Advocate recommends that IRC § 7803(c)(3) be amended to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.

The position of Counsel to the National Taxpayer Advocate should be authorized within the statutory provision describing the position of the National Taxpayer Advocate and the Office of the Taxpayer Advocate. This placement reinforces the concept that the Counsel to the National Taxpayer Advocate is essential to the functioning of the Office of the Taxpayer Advocate but is not an encroachment on the authority of the office of the Chief Counsel.

The statute should clearly state that the Counsel to the National Taxpayer Advocate shall have the ability to participate in preliminary and pre-decisional discussions with the Office of Chief Counsel about rules, regulations, and other significant Chief Counsel work product to the same extent as the Special Counsel to the NTA does today. Thus, the Counsel to the National Taxpayer Advocate shall be consulted on and review such legal opinions and other guidance as may be required in the preparation and review of rulings and memoranda of technical advice, proposed legislation, regulations and Executive Orders relating to laws affecting the Internal Revenue Service.

Under current procedures, the employees of the Taxpayer Advocate Service receive their initial legal advice in specific taxpayer cases from the local Small Business/Self-Employed Area Counsel attorneys. Where TAS disagrees with this advice, the issue is elevated through TAS and Counsel management. The Special Counsel to the National Taxpayer Advocate reviews the issue and attempts to resolve any conflict.

[155] *See* S. Rep. No. 105-174.

The recommendation does not envision any change to this procedure. However, under the recommendation, if the Counsel to the NTA advises the National Taxpayer Advocate that TAS's position is legally justified but that Chief Counsel takes an opposing position, the NTA may bring the matter to the attention of the Commissioner. In doing so, she has the benefit of independent legal advice with respect to TAS's position. Under current procedures, the NTA may not necessarily have the benefit of such legal advice.

The National Taxpayer Advocate should be authorized to recruit the Counsel to the National Taxpayer Advocate from either within or outside the Office of Chief Counsel. The position should be of sufficient stature and rank that it will attract candidates of the highest caliber and experience.

Amicus Brief Authority

The National Taxpayer Advocate recommends that IRC § 7803(c)(3) be amended to authorize the National Taxpayer Advocate to intervene as amicus curiae in any federal litigation, excluding litigation before the United States Supreme Court, that raises issues relating to taxpayer rights under the Internal Revenue Code.

The National Taxpayer Advocate's authority to appear as amicus curiae would be invoked only in those rare instances in which all informal attempts to persuade the United States to consider the merits of the Advocate's position had failed. The National Taxpayer Advocate's authority to intervene as amicus curiae would extend only to cases involving issues of tax administration and taxpayer rights. Further, the intervention as amicus curiae would be reserved to those instances in which the particular issue at hand was of such significance that the use of this extraordinary step is justified. Finally, it would only be considered after administrative intervention or legislative proposals were rejected as not viable alternatives.

It is not necessary that the National Taxpayer Advocate intervene as a friend of the court in litigation before the United States Supreme Court. Intervention through amicus briefs in lower courts is sufficient to place the National Taxpayer Advocate's concerns regarding taxpayer rights and taxpayer administration on the record for consideration by the original and intermediate tribunals. This limitation may address possible concerns that the Executive branch should speak with one voice before the Supreme Court.

Taxpayer Advocate Directive

The National Taxpayer Advocate recommends that IRC § 7811 be amended to provide the National Taxpayer Advocate with the non-delegable authority to issue a Taxpayer Advocate Directive to the Internal Revenue Service with respect to any program, proposed program, action, or failure to act that may create a significant hardship for a taxpayer segment or taxpayers at large.

In the Taxpayer Bill of Rights 1 enacted in 1988, Congress provided authority for the Taxpayer Ombudsman to issue Taxpayer Assistance Orders.[156] Congress later expanded and modified the provisions regarding Taxpayer Assistance Orders in 1996 and 1998.[157] The Taxpayer Advocate Directive incorporates and applies the approach inherent in the expanded Taxpayer Assistance Order to groups of taxpayers or programs. It enables the National Taxpayer Advocate to provide relief on a systemic scale.

As discussed above, the National Taxpayer Advocate currently has the non-delegable authority to issue a Taxpayer Advocate Directive under Delegation Order 250, but this authority can be revoked or modified at any time by the Commissioner. The National Taxpayer Advocate may issue a TAD only where its implementation will improve the operation of a functional process or will grant relief to a group of taxpayers (or all taxpayers).

A TAD is authorized where its implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.[158] Under the proposal, a TAD would be authorized where a program creates a significant hardship for a group of taxpayers or all taxpayers. As discussed in the following recommendation, the National Taxpayer Advocate recommends that the definition of significant hardship be expanded to include impairment of taxpayer rights.

In codifying the Taxpayer Advocate Directive, Congress should consider the terms of a TAD and by whom a TAD can be rescinded or modified. As with the Taxpayer Assistance Order, only the National Taxpayer Advocate or the Commissioner or Deputy Commissioner should be able to rescind or modify a Taxpayer Advocate Directive, and he or she should be required to provide a written explanation of the reasons for modification or rescission. Further, the National Taxpayer Advocate should be required to report on any TADs issued, and the response thereto, in the Annual Report to Congress due on December 31st of each year.

Definition of Significant Hardship

The National Taxpayer Advocate recommends that IRC § 7811 be amended to include "impairment of taxpayer rights" as a definition of "significant hardship" for purposes of issuing a Taxpayer Assistance Order or Taxpayer Advocate Directive.

The existence of a "significant hardship" provides both access to the Taxpayer Advocate Service and a basis upon which relief, including a Taxpayer Assistance Order, can be granted. The current definition of significant hardship does not explicitly state that such access or relief can be granted where a taxpayer's rights have been violated. Historically, the criteria under the existing statute have been narrowly interpreted.

[156] Pub. L. No. 100-647, § 6230(a) (1988).

[157] Pub. L. No. 104-168, § 101 (1996); Pub. L. No. 105-206 § 1102 (1988).

[158] Del. Order Number 250 (Rev. 1) IRM 1.2.2.151 (Jan. 17, 2001).

The term "taxpayer rights" is broad and amorphous. This proposal contemplates that the term will be defined, in the context of a Taxpayer Assistance Order or Taxpayer Advocate Directive, to include those rights enunciated in Delegation Order 250. Specifically, taxpayer rights would include due process, prevention of undue burden, equitable treatment, and the provision of essential service to taxpayers.

Confidentiality of Taxpayer Communications with the Taxpayer Advocate Service

The National Taxpayer Advocate recommends that IRC § 7803(c)(4)(A)(iv) be amended to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates may have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.

Further, the National Taxpayer Advocate recommends that IRC § 7803(c)(4)(A) be amended to provide that in litigation before a federal court, Local Taxpayer Advocates shall not through discovery or compulsory process be required to disclose the fact that the taxpayer contacted the Taxpayer Advocate Service or any information provided by the taxpayer to TAS, unless the court determines that such testimony or disclosure is necessary to:

(a) prevent a manifest injustice;

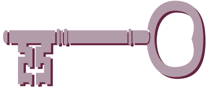
(b) help establish a violation of law; or

(c) prevent harm to the public health or safety,

of sufficient magnitude in the particular case to outweigh the integrity of the Taxpayer Advocate Service in general by reducing the confidence of taxpayers in future cases that their communications will remain confidential.

Confidentiality of taxpayer communications is essential to the Taxpayer Advocate Service's effective advocacy on behalf of taxpayers. Publicized instances of TAS sharing taxpayer-provided information with the IRS or in the courts may result in a loss of taxpayer trust in the integrity of the Taxpayer Advocate Service. These proposals will strengthen the ability of the Taxpayer Advocate Service to fulfill its mission of assisting taxpayers in resolving their problems with the IRS.

The proposals acknowledge that TAS is a part of the IRS organization. Thus, the decision by the Local Taxpayer Advocate to withhold taxpayer-provided information from other parts of the IRS is discretionary. The Taxpayer Advocate Service has as much interest as the rest of the IRS in ensuring that its programs are not abused to perpetrate a fraud or



otherwise cheat the tax system. To this end, with the advice of the Office of Chief Counsel, and outside counsel the National Taxpayer Advocate has provided policies and procedures that set forth clear disclosure requirements in appropriate cases.

The scope of the current provision has been the subject of debate within the Internal Revenue Service and the Office of Chief Counsel. While this particular debate has been resolved, to prevent future disagreements about the scope of IRC § 7803(c)(4)(A)(iv) and its relationship to other provisions in the Code, the National Taxpayer Advocate recommends that the section be amended to provide clearly that its provisions operate notwithstanding any other Code requirement.

While IRC § 7803(c)(4)(A)(iv) provides for the confidentiality of taxpayer-provided information from the IRS, there is no provision addressing the confidentiality of information provided by a taxpayer to the Taxpayer Advocate Service where a case ends up in court. The independence and integrity of the Taxpayer Advocate Service would be significantly eroded if a TAS employee were required to disclose taxpayer confidences through discovery or compulsory process without the court weighing the impact of such disclosure.

Internal Revenue Code section 6103 generally provides for the confidentiality of returns and return information. The restrictions imposed by IRC § 6103 are applicable to the Taxpayer Advocate Service. Thus, taxpayer returns and return information are generally protected from disclosure by TAS to third parties.

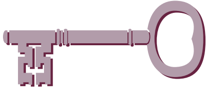
There are many exceptions under IRC § 6103.[159] This proposal does not impact the exceptions under IRC § 6103, except in the context of litigation in federal courts. To the extent that IRC § 6103 would allow the disclosure of information in litigation or preparation for litigation, those provisions of IRC § 6103 would no longer apply. All other sections of the statute continue to be applicable.

In sum, the effect of the two proposals is as follows: Where a taxpayer has provided TAS with information that the Local Taxpayer Advocate, in his or her discretion, has appropriately determined should not be disclosed to the IRS, that decision will stand. If an exception to the disclosure rules of IRC § 6103 applies to that information, the information will be disclosed in accordance with the provisions of the exception. In a judicial proceeding, an employee of the Taxpayer Advocate Service cannot be required to disclose such information through discovery or compulsory process unless the court has made a determination that the need for that information outweighs the chilling effect that disclosure in a court proceeding will have on the likelihood that taxpayers will seek help from TAS in the future.

[159] *See, e.g.,* IRC § 6103(i) (Disclosure to Federal Officers or Employees for Administration of Federal Laws Not Relating to Tax Administration).

This procedure is not designed to prevent the sharing of information with federal agencies, including the Department of Justice, as provided by IRC § 6103. The concern here is with the chilling effect on taxpayers' willingness to use TAS in the future if they see an employee of the Taxpayer Advocate Service take the witness stand against a taxpayer in a judicial proceeding. In these instances, we believe that the court should weigh the impact of the testimony on TAS's ability to perform its mission in the future against the need for that testimony.

Taken together, all of the foregoing recommendations will strengthen the independence of the Office of the Taxpayer Advocate and the ability of the National Taxpayer Advocate to protect taxpayer rights and taxpayer confidences both within the Internal Revenue Service and in the federal courts.



5 REGULATION OF FEDERAL TAX RETURN PREPARERS

PROBLEM

For many taxpayers, the tax filing season generates anxiety and frustration as they set out to fulfill their tax obligations. They are faced with a complex set of tax laws and a multitude of requirements for deductions, exemptions, and credits. Frequent tax law changes compound their confusion and concern.

Taxpayers who understand the tax laws may feel secure enough in this knowledge to complete their own income tax returns. The rest of the taxpaying public – over fifty percent – pay a tax return preparer to complete their income tax returns. Many tax preparers are not required to meet minimum standards of competency. Taxpayers are ill-equipped to assess the competency of someone's expertise in an area in which they have limited knowledge themselves.

Taxpayers must be confident that federal tax preparers meet basic standards of expertise and competence, and that these standards are maintained over time. Taxpayers would be better served, and compliance would likely be improved, if tax preparers were required to meet minimum standards of competency.

Currently there are no national standards that a person is required to satisfy before presenting him- or herself as a federal tax preparer and selling tax preparation services to the public. Anyone, regardless of his or her training, experience, skill or knowledge, is able to prepare federal tax returns for others for a fee.

EXAMPLES

Taxpayers can be harmed in a number of ways by tax preparers who lack basic standards of expertise and competence or don't maintain these standards over time.

- A married couple with two children paid a tax preparer to prepare their income tax return. The tax preparer informed the couple that since each spouse worked and contributed toward household expenses, it was appropriate to file two tax returns with each claiming head of household status, each claiming one child, and each receiving the earned income tax credit. The adjustments made to the taxpayers' accounts in subsequent examinations resulted in a bill in excess of $4,000, which the taxpayers have no means to pay.
- An immigrant laborer with a wife and child is uncertain about how to comply with the tax obligations of a new country and a new state. He relies on a tax preparer

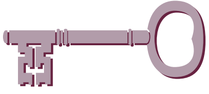
referred to him by other immigrants in their growing community. They are elated when their tax preparer informs them of a refund in excess of $1,000. Two years later, over 700 laborers in this community, including this taxpayer, received multiple year tax bills because the same tax preparer routinely made errors in filing status, exemptions, and earned income tax credits.

- A single taxpayer relied on the advice of a tax preparer to determine his tax home for employee business expenses. The tax preparer relied on an outdated provision of the tax home rules in effect over 15 years ago when preparing four consecutive years of income tax returns. The taxpayer arranged for an installment agreement to pay the tax bill that exceeded $40,000.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress enact a registration, examination, certification, and enforcement program for Federal Tax Return Preparers. This program should consist of the following components:

- A Federal Tax Return Preparer ("FTRP") is someone, other than an attorney, certified public accountant, or enrolled agent, who prepares more than five (5) federal tax returns in a calendar year and satisfies the registration, examination, and certification requirements described below.
- A requirement that all persons who prepare more than five (5) federal tax returns for a fee must register with the Internal Revenue Service. The IRS would be authorized to impose a per return penalty for failure to register, absent reasonable cause for the failure.
- A requirement that the IRS develop a series of examinations designed to test the technical knowledge and competency of unenrolled return preparers to prepare federal tax returns. The IRS should develop at least four examinations: an examination testing knowledge of individual income tax return preparation, including the Earned Income Tax Credit and simple Sole Proprietorship schedule preparation; an examination testing knowledge of business income tax return preparation, including more complex Sole Proprietorship schedule preparation and employment taxes; and an annual refresher and update examination in individual and one in business tax preparation.
- A requirement that all persons who prepare more than five (5) federal tax returns for a fee must pass, in their first year of preparing such returns, an initial examination testing their technical knowledge and competency to prepare individual and/or business tax returns. Each such preparer must also pass an annual refresher



examination (including tax law updates) in each succeeding year in which the preparer prepares returns. The IRS would be authorized to impose a per return penalty on unenrolled preparers who fail to take or pass the examination, absent reasonable cause.

- A requirement that the IRS annually certify as Federal Tax Return Preparers those unenrolled paid preparers who have successfully passed the required examinations and are authorized to prepare federal tax returns for a fee.
- Authorization for the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must (1) sign the return prepared for a fee; and (2) display their Federal Tax Return Preparer registration card, which demonstrates current skill and competency in federal tax return preparation (either individual or business).
- Authorization for the IRS to maintain a public list (in print and electronic media, including internet-based) of Federal Tax Return Preparers who are registered and certified, of Federal Return Preparers who are registered but not certified, and of Federal Tax Return Preparers whose registration has been revoked.
- Authorization for the IRS to notify any taxpayer about the fact that his or her return was prepared by an unenrolled return preparer who is not registered or by a Federal Tax Return Preparer who is registered but not certified.

PRESENT LAW

Today, taxpayers pay a third party to prepare their individual income tax returns more often than they prepare their own returns. Of these paid preparers, only attorneys, certified public accountants, and enrolled agents are subject to some form of regulation or oversight by the Internal Revenue Service or state licensing agencies. Unlike attorneys, certified public accountants, and enrolled agents (collectively known as "practitioners" because they are able to "practice" before the IRS), unenrolled return preparers are not required to demonstrate a minimum competency in the field of tax law, nor must they satisfy any continuing education requirements in order to prepare federal tax returns.

Practice before the Internal Revenue Service

Treasury Department Circular 230[160] describes who may practice before the IRS, establishes minimum standards for that practice, and sets forth a hierarchy of discipline for those who violate those standards.[161] The IRS Office of Professional Responsibility conducts disciplinary proceedings of practitioners authorized to practice before the IRS and makes recommendations for discipline, where warranted. Attorneys, certified public accountants, and enrolled agents who have violated one of the practice rules may be subject to censure, suspension, or disbarment.[162]

As noted above, three types of practitioners are authorized to practice before the IRS. Each of these categories of preparers is subject to stringent requirements, including examinations, continuing professional education, and ethics.

- **Attorneys** are subject to state licensing requirements and discipline. Prior to admission to a state bar to practice law, attorneys generally must complete a 3-year, post-graduate degree program in law and pass an initial examination (in most jurisdictions, this examination takes place over 2 days, and consists of a multi-state part and a part focusing on the local law of the testing jurisdiction). In 42 out of 51 jurisdictions (including the District of Columbia), attorneys must satisfy a minimum annual continuing education requirement, which often includes training in legal ethics.

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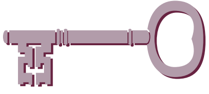
[160] 31 CFR part 10.

[161] Circular 230 defines "practice" before the IRS as comprehending

> all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

Circular 230, § 10.2.

[162] Circular 230, § 10.50(a), Sanctions. "Censure" is a public reprimand. This sanction was introduced in the recently issued final regulations. 67 F.R. 48760, amending CFR part 10.



- **Certified Public Accountants (CPAs)** are also subject to state licensing and regulation. CPAs must generally complete a defined course of study as well as work under the supervision of another CPA for a specified period of time. The CPA must successfully complete a multi-part examination testing his or her knowledge of a wide array of accounting topics, including tax law. CPAs in 50 out of 51 jurisdictions (including the District of Columbia) must satisfy a minimum annual continuing education requirement, which often includes training in tax law and procedure.
- **Enrolled Agents (EAs)** are persons who have successfully passed an IRS examination testing the applicant's knowledge of tax law and procedure and practice before the IRS.[163] Enrolled Agents generally must complete 72 hours of continuing professional education during each 3 year enrollment cycle.[164]

Tax Return Preparers

Internal Revenue Code section 7701(a)(36) defines an income tax return preparer as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, a tax return. This definition also includes any person who furnishes the taxpayer with sufficient information and advice so that the completion of a return is largely a mechanical or clerical matter.

Present law does not address skill, knowledge of tax rules, regulation, training or other basics that would define a minimum standard of competence for tax preparers. In fact, Treasury regulation 31 CFR section 301.7701-15(a)(3) states that "a person may be an income tax return preparer without regard to educational qualifications and professional status requirements."

Preparer Due Diligence Requirements and Penalties

Internal Revenue Code section 6694 imposes several penalties on income tax return preparers who understate a taxpayer's tax liability. Where a preparer has taken a position on a return or refund claim for which he or she knew or should have known that there was "not a realistic possibility of being sustained on its merits," that preparer shall be subject to a $250 penalty, absent a showing of reasonable cause for the understatement.[165] A preparer will be subject to a $1,000 penalty if the understatement is attributable to the preparer's willful attempt to understate the tax liability or is due to the preparer's reckless or intentional disregard of rules or regulations.[166]

[163] If the Director of Practice approves, a former IRS employee may become an enrolled agent, possibly subject to limitations on the type of representation he or she can undertake on behalf of taxpayers. Treas. Reg. 31 CFR 10 § 10.4(b) (2002).

[164] IRS Publication, *Practice before the IRS and Power of Attorney*, (Rev. April 2002), p. 5.

[165] IRC § 6694(a).

[166] IRC § 6694(b). The IRS rarely assesses this penalty. Office of Professional Responsibility (August 2002).

Tax return preparers must meet certain statutory requirements for each income tax return, including:

- Providing the taxpayer with a copy of the tax return;[167]
- Signing the tax return which he or she prepares;[168]
- Providing an identifying number on the tax return which he or she prepares;[169] and
- Maintaining and preserving a copy or list of all such returns for 3 years after the close of the return period.[170]

In addition to the above requirements and associated penalties, a preparer who "endorses or otherwise negotiates" a federal tax refund check payable to another taxpayer shall pay a $500 penalty for each check, unless the preparer is depositing the check into the taxpayer's account for the taxpayer's benefit.[171]

Preparers are also subject to criminal sanctions, including:

- The willful attempt to evade or defeat tax;[172]
- The willful making of false statements under penalties of perjury;[173] and
- The willful aiding, assisting, counseling, or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent with respect to a material matter.[174]

[167] IRC § 6695(a); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6107(a).

[168] IRC § 6695(b); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000.

[169] IRC § 6695(c); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6109(a)(4).

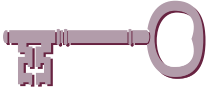
[170] IRC § 6695(d); the preparer is subject to a $50 penalty for each failure, subject to a reasonable cause exception, and an annual maximum penalty of $25,000. *See also* IRC § 6107(b).

[171] IRC § 6695(f). The penalties under IRC §§ 6694 and 6695 are applicable in addition to any other penalties applicable to the situation. These penalties are assessed without regard to the deficiency procedures under IRC § 6212.

[172] IRC § 7201.

[173] IRC § 7206(1).

[174] IRC § 7206(2). In 1996, the IRS Criminal Investigation Division launched the Return Preparer Program (RPP). "The program was developed to enhance compliance in the return-preparer community by engaging in enforcement actions and/or asserting appropriate civil remedies against unscrupulous or incompetent return preparers." http://treas.gov/irs/ci/tax_fraud/docreturnpreparer.htm. Criminal Investigation reports that for the four fiscal years from October 1, 1998 through September 30, 2001, the Return Preparer Program resulted in 468 investigations, 303 prosecution recommendations, 291 indictments or informations, 283 convictions, and an incarceration rate of 92.9 percent.



A preparer who knowingly or recklessly discloses any information provided to him in connection with the preparation of a return, or who uses that information for any non-preparation related purpose, shall be guilty of a misdemeanor.[175]

Under Internal Revenue Code section 7407(a), the IRS has the authority to bring a civil action in the appropriate federal district court to seek an injunction to prohibit certain specified actions of income tax return preparers. Preparers who engage in practices that would subject the preparer to penalties under IRC §§ 6694 and 6695, who misrepresent their education or experience as an income tax preparer or their eligibility to practice before the IRS, who engage in fraud or deceptive conduct, or who guarantee the payment of a tax refund or the allowance of a tax credit may be enjoined from engaging in such practices under IRC § 7407(b). Where the court determines that a preparer has continuously or repeatedly engaged in one of the above specified practices, the court may also enjoin the preparer from acting as an income tax return preparer. IRC § 7407(b).

State Law Regulation of Tax Return Preparers

Both California and Oregon regulate persons who prepare federal and state tax returns. In California, the regulatory program is administered by the California Tax Education Council (CTEC).[176] A tax preparer is required to post a $5,000 bond, complete an initial requirement of 60 hours of basic individual tax law education within the previous 18 months, and a continuing education requirement of 20 hours per year, including 12 hours of federal taxation.[177] The Council's website permits taxpayers to enter a preparer's name to determine the preparer's registration status – i.e., registered, delinquent, or expired registration.

The California Tax Preparers Act[178] imposes certain duties upon tax preparers, including the obligation to *not* ask the taxpayer to sign a tax return which contains blank spaces that will be completed after it is signed.[179] County superior courts may enjoin tax preparers who are in violation of the Act from various conduct, including preparing taxes.[180] A violation of the Act is punishable by a civil penalty of $1,000 and/or up to one year imprisonment.[181] Further, any person can bring a civil action against a return preparer

[175] IRC § 7216(a). The preparer may be subject to a fine of up to $1,000 and/or up to 1 year imprisonment. The preparer who discloses such information in response to a court order or as required by some other Code provision is not subject to criminal sanctions. IRC § 7216(b)(1).

[176] The California Tax Education Council (CTEC), a public and private entity, began its official duties on July 1, 1997. It assumed the responsibility for the Tax Preparer Program, formerly administered by the California Department of Consumer Affairs.

[177] Tax Preparers Act, Chapter 14, California Business and Professions Code, § 22255.

[178] The Tax Preparers Act, originally passed in 1997, was reauthorized, effective January 1, 2002, and will be reviewed before its expiration on July 1, 2008.

[179] Col. Bus. & Prof. Code § 22253(b).

[180] Col. Bus. & Prof. Code § 22256(a).

[181] Col. Bus. & Prof. Code § 22256(b).

who has violated the Act. A successful plaintiff can recover specific enforcement and/or a penalty of $1,000, in addition to reasonable attorneys' fees and costs.[182]

The Act defines a tax return preparer as a person who assists or prepares tax returns (both federal and state) for another for a fee, or who assumes final responsibility for such work, or who holds himself or herself out as offering those services.[183] Tax return preparers can be a business entity, including a corporation.[184] Various persons are exempt from the Act's requirements, including accountants licensed by the California State Board of Accountancy, members of the State Bar of California, and enrolled agents.[185]

Upon satisfactory completion of the education and registration requirements, the preparer receives a certificate of completion, an identification card, and a window sticker identifying the preparer as a tax return preparer certified by CTEC. Each CTEC Registered Tax Preparer is assigned a unique registration number.

The Oregon State Board of Tax Practitioners regulates any person who prepares personal income tax returns for a fee or who holds himself or herself out as doing so.[186] Only CPAs, public accountants licensed by the Oregon Board of Accountancy, and members of the Oregon State Bar are exempt from the licensing requirement. Enrolled agents must be licensed if they are preparing, assisting, or advising in the preparation of individual income tax returns.

Oregon provides two types of licenses – the Tax Preparer and the Tax Consultant. A Tax Preparer must work under the supervision of a licensed Tax Consultant, a CPA, a public accountant, or an attorney. The Tax Preparer must be 18 years of age, be a high school graduate or have completed the GED, complete 80 hours of basic income tax law education, and pass the Board administered Tax Preparer Examination.

Upon completing 780 hours of tax preparation work in two of the last five years, a Tax Preparer can take the Tax Consultant exam. The Tax Consultant can prepare personal income tax returns in Oregon for a fee as a self-employed or independent practitioner.[187] Both Tax Preparers and Tax Consultants must annually provide the Board with evidence of 30 hours of continuing education in tax law.[188]

The Oregon Tax Preparer's examination tracks the federal Form 1040 line-by-line, with Oregon adjustments. The Tax Consultant exam covers additional issues, including net

[182] Col. Bus. & Prof. Code § 22257(a) and (b).

[183] Col. Bus. & Prof. Code § 22251(a)(1)(A).

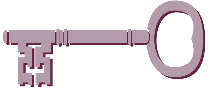
[184] Col. Bus. & Prof. Code § 22251(a)(1)(B).

[185] Col. Bus. & Prof. Code § 22258(a),(b),(e).

[186] See OR. Admin. R. 800-25-0020.

[187] An enrolled agent can become a Tax Consultant by passing the portion of the Tax Consultant exam applicable to Oregon tax law. OR. Admin. R. 800-020-0015, (5) (2002).

[188] OR. Admin. R. 800-015-010 (1) (2002).



operating losses, Investment Tax Credit recapture, passive activities and rentals, and business income and deductions.

Violations of the Board's requirements are punishable by fines up to $5,000 for each violation. The Board may consider each business day a person continues in violation following notification by the Board to be a separate violation.[189] Failure to respond to a Board's request for information is subject to a $1,000 penalty.

The State of North Carolina recently increased the penalties for paid tax preparers who file a fraudulent return. The new law provides that a preparer who files returns that avoid $100,000 or more in taxes will be subject to a maximum sentence of 210 months, an increase from the prior law's maximum term of 24 months.[190]

REASONS FOR CHANGE

The tax return represents a taxpayer's entry point into the federal tax system. Errors on returns, however inadvertent and unintentional, can have serious consequences for taxpayers, in terms of money owed, time spent resolving the problem, and related adjustments in future years.

The tax return preparer plays a pivotal role in the tax administration system. Currently, about 54 percent of all individual taxpayers who file tax returns are paying a tax preparer to determine their tax obligation.[191]

The Federal Return Preparer is an important gatekeeper for the federal tax system. The preparer explains the taxpayer's responsibilities (filing, recordkeeping) as well as the taxpayer's rights. The preparer also advises his or her client, by identifying issues where guidance is unclear, and assessing the risks associated with a possible reporting position.

The tax system is increasingly viewed as an efficient vehicle to deliver social benefits to targeted populations – including those who are unlikely to be well-versed in the complexities of the tax law.[192] Each year, Congress enacts laws and the IRS develops procedures that hinge on specific documentation requirements. A well-educated and professional return preparer can prevent inadvertent errors that undermine the vitality of these programs and consume IRS compliance resources to a disproportionate degree.

Despite the due diligence requirements and penalty regime described above, stories abound in the press and in the tax practitioner and professional community about

[189] OR. Admin. R. 800-030-0025 (1) (2002).

[190] 2002 NC Sess. Laws 106 (Sept. 2002). See Daily Tax Report, No. 168, August 29, 2002, p. H-1.

[191] There were 130.1 million individual income tax returns filed in tax year 2000. Of those, 70,726,315 million or 54.3% were submitted by a tax preparer. Statistics of Income, Spring Bulletin, 2002. This number reflects preparers who sign the returns; anecdotal evidence suggests the number is much larger, since some paid preparers do not sign the returns.

[192] The Earned Income Tax Credit is only one example of such social policy delivered through the Internal Revenue Code. See, for example, the HOPE and Lifetime Learning Credits, Dependent Care Credit, Low Income Housing Credit.

unqualified or unscrupulous preparers. From used car dealers filing taxes so taxpayers can use their refunds as down payments toward automobiles, to preparers in check-cashing storefronts charging pay-day loan rates for refund loans and disappearing without a trace after April 15th, to preparers in migrant or immigrant communities getting a percentage fee of any (incorrect) refund – each of these preparation outlets provide a product, at a high cost to taxpayers who do not always have strong bargaining positions or additional preparation options. The high profit margin on tax return-related products, including refund anticipation loans, attracts legitimate and illegitimate preparers alike. To date, the IRS has not launched an effective enforcement initiative against the illegitimate preparers.

In recent years, most efforts at regulating return preparers have focused on and around the Service's need to achieve a satisfactory level of electronic return filing. Although the Taxpayer Advocate Service are fully cognizant of the critical importance electronic filing plays in the future of the U.S. tax system, the qualifications of return preparers should be addressed as a discrete issue, independent of the need to achieve near-universal electronic filing.

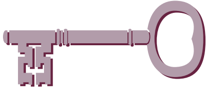
Taxpayers choose a tax preparer because they don't understand the requirements of the tax law well enough to prepare the tax return themselves. Focus group respondents indicate that taxpayers are motivated to use tax preparers for several reasons, including: fear, tax law complexity, changing life situations (birth, marriage, retirement, etc.), overall time and effort requirements, and to obtain rapid refunds.[193]

A 2001 IRS study identified approximately 85,000 commercial firms listed on the Dun & Bradstreet database under three categories – tax preparation firms, accounting firms, and certified public accountants. IRS 1999 filing season data through July 3, 1999, showed 1.2 million paid tax return preparers.[194] Approximately 779,000 of these preparers filed between zero and 9 returns. These preparers far outnumber any other category of preparer. Because it is very unlikely that this category of preparer is employed full-time in tax preparation, it is also unlikely that these preparers are rigorously schooled in tax law.

There is no consistent data regarding the number and types of errors on returns, tracked by type of return preparer. We do know from a 1999 tax year Earned Income Tax Credit (EITC) sample that the more education and training in tax law, and the more oversight, a preparer has, the lower the overclaim rate on the returns these preparers file on behalf of clients. Thus, based on a sample of EITC returns, CPAs and attorneys had a 20.4 percent overclaim rate; enrolled agents and preparers who worked at H&R Block or Jackson Hewett had a 26.0 percent overclaim rate; and unenrolled preparers (other paid return

[193] May – June 2001 Focus Groups held in Tampa, FL and Indianapolis, IN by a research team comprised of representatives from Taxpayer Advocate Service, Tax Forms & Publications, Multimedia Publishing, and Research Group 3.

[194] This number does not include preparers who were paid but did not sign the tax return they prepared. Internal Revenue Service, Task 124: Market Research for e-file Options: Tax Preparer Research & Analysis of Available Data (March 2001).



preparers) had a 34.3 percent overclaim rate. Table 2.5.1 set out the 1999 EITC overclaim rates based on this sample by type of third party preparer.[195]

TABLE 2.5.1

TYPE OF PREPARATION	PERCENT OF RETURNS	AVERAGE EITC CLAIM	AVERAGE EITC OVERCLAIM	OVERCLAIM RATE	MARGIN OF ERROR
CPA/Attorney	5.0%	$1,279.22	$260.45	20.4%	8.43%
EA/HR/JH	26.4%	$1,917.67	$499.08	26.0%	5.47%
Other Professional	32.4%	$1,755.53	$603.00	34.3%	3.80%

Analysis of data detailing complexity and accuracy factors reveals there are errors on returns signed by tax preparers as well as self prepared returns. Nearly 26 percent of the returns filed with math errors in 2000 (1999 tax year) were computed and signed by tax preparers.[196] Furthermore, for every type of Form 1040 filed in 2000 (TY99), a larger portion of taxpayers claiming EITC used paid preparers than those who did not claim EITC.[197] Since the EITC is targeted to low income taxpayers who frequently have limited literacy skills (both in terms of computers or language), this suggests that those who are least likely to possess the skills needed to determine the qualifications of a tax preparer, rely on preparers more than the general population.

The largest number of EITC over-claims is associated with taxpayers claiming a child who was not the taxpayer's qualifying child.[198] Recent reports of $8.5 to $9.9 billion of erroneous Earned Income Tax Credits paid in 1999[199] indicate that tax preparer errors contribute to this revenue loss.

Regulating tax preparers could significantly improve the accuracy of tax returns. As noted above, Oregon established a state-licensing program for tax preparers in the early 1970's. When comparing the numbers of returns that contain errors as a proportion of the total returns filed for the state of Oregon, there is compelling support for registering tax preparers. The error rate of returns filed from tax preparers in Oregon is from 30 to 60 percent lower than those states of similar size which do not require tax preparer licensing.[200]

Proposals to regulate federal return preparers have surfaced in different venues over the years.

[195] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns. (2/28/02). This data was derived from taxpayer answers to the examiners' question about how the return was prepared.

[196] More than 65% of taxpayers who claimed EITC used a paid preparer as compared with about 53% of those who did not claim EITC (but used a preparer). CRIS Model 2001 IMF TY99 data. (4/3/02).

[197] CRIS Model 2001 IMF TY99 data. (4/9/02).

[198] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns. (2/28/02).

[199] *Id.*

[200] CRIS Model 2001 IMF TY99 data. (3/22/02).

- In 1995, the Ethics in Business subgroup of the Commissioner's Advisory Group proposed a program to identify, regulate and improve the expertise and professionalism of all individuals engaged in the preparation of Federal tax returns for a fee. A final decision was not rendered.[201]
- In 1997 the National Commission on Restructuring the IRS recommended that "all paid preparers be subject to regulation under Circular 230." The Commission concluded, "Uniform requirements will increase professionalism, encourage continuing education, improve ethics and better enable the IRS to prevent unscrupulous tax preparers from operating."[202] Their recommendation was not adopted by Congress in the subsequently enacted IRS Restructuring and Reform Act of 1998.
- On April 30, 2001, Senator Bingaman introduced the Low Income Taxpayer Protection Act of 2001, which was referred to the Committee on Finance. The Bill provides for the regulation of income tax return preparers and refund anticipation loan providers. Regulations include registration, rules of conduct, and reasonable fees and interest rates charged to taxpayers made by refund anticipation loan providers. A penalty is provided for each incident of non-compliance.[203]

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate seeks to strengthen the professionalism of those who prepare tax returns for compensation through a registration framework that provides for testing, certification, continuing education, and consumer education. Tax preparers who become certified would be required to prominently display their proof of certification. Publicizing of this requirement would put taxpayers on notice of the simple fact that you should only pay someone to prepare your return if they are registered with and certified by the IRS. Taxpayers would be able to choose a tax preparer with confidence because they could easily determine which preparers are certified.

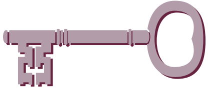
Individuals covered by this proposal provide a vital service to the public. This program is not intended to limit or reduce the number of available tax return preparers.[204] This program is intended to improve the expertise and professionalism of all individuals engaged in the preparation of federal tax returns for compensation. Improvements that increase the professionalism of the tax preparer community will also increase the confidence of the public they serve.

[201] Minutes of the Commissioner's Advisory Group, January 18, 1995.

[202] A Vision for the New IRS, National Commission on Restructuring the Internal Revenue Service, G.5 (June 25, 1997).

[203] S. 182, Low Income Taxpayer Protection Act of 2001, 107th Cong. (2001).

[204] Many unenrolled return preparers already satisfy the proposed continuing education requirements, through attendance at the annual Tax Forums and other tax courses offered by professional organizations.



Registration and Certification

The registration process would begin with an application and fee that would cover certain administrative costs of the program. Each applicant would be required to obtain certification based on the complexity of the returns the applicant wishes to prepare. The suggested tiers would be categorized by the complexity of returns:

- Tier 1 Individual returns including Forms 1040, 1040A, 1040EZ with schedules and deductions, EITC and other family-status credits, Schedule F (farm income), Schedule E (rental income), Schedule D (capital gains) and simple Schedule Cs (sole proprietorship income).
- Tier 2 everything in Tier 1 plus small business and S-Corp returns; Employment tax returns including 941, 940, 1099 and W-2.

Applicants would be required to pass a test with minimum standards for tax preparation before receiving certification. IRS would set the standards for the competencies that need to be tested in each tier and make the certification determination. The test administration could be contracted out and those contract fees covered by a test fee paid by the applicant. The successful applicant would be issued a certificate that contains a certification number, and expiration date. The certificate would be prominently displayed for public viewing. The tax preparer's certification number would be a required entry on each tax return. Taxpayers would see the certificate and know that the preparer they chose is certified to prepare their tax return.

Education

There are extensive educational opportunities for individuals who prepare tax returns. Attorneys, certified public accountants and enrolled agents must meet continuing professional education requirements to retain professional licensure. A similar continuing education requirement expectation is essential for each tax preparer registered in each tier. In addition, each time there is a significant tax law change, an annual update certification requirement would ensure the preparer's competence in that area of the tax laws. Refresher courses and test preparation courses readily available to tax professionals could be expanded to meet these needs. Tax Forums and CPE courses sponsored by trade associations, business and accounting schools, and other membership groups can be alternative sources of continuing education.

Oversight and Fines

Individuals who prepare and submit a tax return and fail to disclose their certification would be subject to a scale of progressive deterrents ranging from educational notices and warnings to fines. The taxpayer would also be notified if the preparer of his return did not

fulfill the minimum requirements for certification within a specified probationary timeframe. These taxpayer communications would complement the deterrent actions by putting both parties on notice, and enable taxpayers to enforce the law by taking their business elsewhere.

A tax preparer who fails to provide his or her certification number would indicate:

- he may have the certification number and neglected to include it either by oversight or choice, or
- he may have let his certification expire or it was revoked, or
- he may never have had certification because he did not take or pass the test or were not aware of the requirement.

Further safeguards could be provided on the tax form so that taxpayers can indicate that they paid someone to prepare the tax returns that they are signing. The proposed fine for not complying should be significant for each incident of noncompliance and compounded when repeated.

Consumer Education and Publicity

Public knowledge and support of this program is key to its success. Because of this, IRS needs specific authority and funding to launch an extensive public awareness campaign. A marketing campaign that provides information about the registration process for tax preparers would provide taxpayers with the consumer information they need to make an informed decision. It would be a simple message, and would not require an assessment of the competence of a tax preparer by a taxpayer poorly equipped to do so. Taxpayers could go to the IRS website to check on the certification status of their intended return preparer.

The campaign message would be clear: look for the certificate before you consider paying anyone to prepare your tax return. Providing consumers with clear standards about what to look for (the certification) so that they could easily determine who is qualified to prepare tax returns would enable taxpayers to "vote with their feet."

Impact Statement

It is difficult to estimate the total number of tax preparation professionals practicing in the United States that would be impacted by this recommendation because there are no national licensing or registration requirements. Using data gathered from public and commercial sources we estimate that there are between 700,000 and 1.2 million individuals[205] who prepare income tax returns. Based on the number of participants in the IRS Tax Professional Program for TY2001 (a program established to send tax materials to tax

[205] CRIS Model 2001 IMF TY 99 data. Internal Revenue Service Research Task 124.

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

preparers), individuals who did not designate themselves as an attorney, certified public accountant, or enrolled agent constitute nearly 50 percent of the participants.[206] Using 50 percent as a reasonable assumption, we estimate that between 300,000 and 600,000 tax preparers would be affected by this proposal.

Primary cost would be born by those who profit from the profession: the tax preparers. Like their more regulated counterparts, they would pay for their own continuing professional education, testing and certificate of competency fees. Taxpayers would know to look for certificates posted in the office reception areas, so that market pressures would encourage participation and compliance. However, IRS could not implement this program without additional resources, especially in the start-up phase.

Initial funding to establish the program is key to its success. This would include funding for developing certification standards, testing instruments, and licensing test administration organizations. Funding to bring tax preparers into compliance, especially through the transition period, is critical. IRS would need to advertise (through paid placements) the importance of looking for the certificate to the general public. Finally, a continued enforcement presence would be needed to ensure that there are consequences for those who set out to evade certification requirements and continue to prepare returns without meeting basic competency standards.

We acknowledge that this registration, education, and certification proposal may result in some tax return preparers dropping out of the system. It is also likely that some preparers will go "underground," that is, they will no longer sign their name to the returns they prepare. The consumer education and public information campaign plays an important role in this regard. First, taxpayers will be alert and on notice that they should not pay for return preparation unless the preparer is certified. Second, with the advent of a certification program, an underground preparer cannot claim ignorance of the requirements. (We acknowledge that any certification system should build in a reasonable cause exception.) We believe that the benefits to the public of a registration system far outweigh the loss of these return preparers.

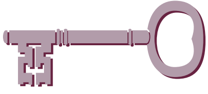
A licensing program – one with enough resources to provide real consequences for tax preparers who contribute to non-compliance, whether through ignorance or deliberate act – has the potential to achieve significant improvements in taxpayer compliance at a much lower cost than extending audit coverage to the affected population. While we believe that a stronger audit presence is also needed, the additional measure of licensing tax preparers would be a significant step forward in tax compliance.

[206] Tax Professional Program Database, Multimedia Publishing Division, Computer Assisted Publishing System. (4/2/02).

6 CHILDREN'S INCOME

DID YOU KNOW?

- The special rules pertaining to tax on investment income of a child under age 14 (the "Kiddie Tax") do not apply if neither of the parents is alive at the end of the tax year.
- A child under 14 who is subject to the Kiddie Tax often must use the information on the return of the parent with the greater taxable income to compute the child's tax. If a child cannot obtain that information directly from the parent, the child (or the child's legal representative) must request the necessary information from the Internal Revenue Service (IRS).
- The Kiddie Tax rules even apply to a child who lives with someone other than a parent.
- If a parent makes an election to include a child's income on his or her tax return, the parent's investment income will be higher, which may allow the parent to claim a larger investment interest deduction under Internal Revenue Code section 163.
- A parent's election to include the income of a child on the parent's tax return can accelerate the phase-out of itemized deductions due to adjusted gross income (AGI) limitations. It can also decrease the parent's deduction for medical expenses, casualty and theft losses, and miscellaneous deductions due to phase-out limitations. However, a child's itemized deductions are not allowable on the parent's return.
- If a parent elects to include a child's income on his or her return, the parent's Earned Income Tax Credit, Child and Dependent Care Credit, and Child Tax Credit may be reduced.
- The election to report a child's income on the parent's income tax return can only be made if no estimated or withholding tax has been paid in the child's name.
- A child whose tax is computed on Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500) may also owe Alternative Minimum Tax (AMT).
- If an adjustment is made to the tax return of either a child's parent or sibling after the returns have been filed, the child's return may also require adjustment.



PROBLEM

Dependent children often receive gifts from relatives and friends that generate investment income. For example, a child may receive U.S. savings bonds, cash, or shares of stock at birth, upon religious milestones such as a Baptism, confirmation, or Bar Mitzvah, or through periodic gifts from a parent. Dependent children, even relatively young children, also may earn income for the performance of services such as babysitting.

The rules governing the taxation of the income of dependent children impose significant compliance burdens in two respects. First, any investment income of a child under the age of 14 that exceeds $1500 must be reported in accordance with the so-called "Kiddie Tax" rules set out in Internal Revenue Code section 1(g). The Kiddie Tax rules are complex. In part, these rules (1) require parents to decide whether to file a separate return in the child's name or to include the child's income on the parent's own return (the tax consequences often differ); (2) require the child of separated parents who are still considered married to obtain tax information from the parent who has the greater taxable income; (3) require the parent of multiple children under age 14 who each have investment income in excess of $1500 and who each file a separate return to perform a series of interrelated computations involving the tax return of the parent and each of the children to compute the tax liability of each child; and (4) subject a child and/or the parent in certain circumstances to the Alternative Minimum Tax (AMT). Each of these complexities arises because the child's tax liability is not independently determined but rather must be computed in conjunction with the applicable parent's tax return.

Second, a dependent child will be subject to tax if his or her income exceeds the applicable standard deduction.[207] The standard deduction for dependents is set at a low level (as low as $750 in 2002), which often requires children with nominal amounts of income to file tax returns. Further, the standard deduction for dependents with modest amounts of both earned income and investment income must be determined through a computation – it is not a specified amount.

Based on recent data, these complex rules affect approximately one million taxpayers annually.[208] There are two ways that the tax on a child's income can be reported and paid. In all cases, the child may file his or her own tax return and calculate the tax on Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500). In

[207] For purposes of this discussion, we assume that a dependent child will claim a standard deduction. In the unusual case in which a child itemizes his or her deductions, the standard deduction rules discussed in this section do not apply. Moreover, because individuals who may be claimed as dependents on the return of another taxpayer (typically a parent) may not themselves claim a personal exemption, the standard deduction for a dependent child is the same as the amount of income that is exempt from tax (except where deductions are itemized).

[208] Statistics of Income Report No. 44591, *Statistics of Returns Posted in 2001* (based on data from the Individual Master File).

some cases, a parent may elect to include the child's income on the parent's return by filing Form 8814 (Parent's Election To Report Child's Interest and Dividends). For tax year 2000, 621,960 Forms 8615 were filed and 503,444 Forms 8814 were attached to a parent's tax return.[209]

EXAMPLE

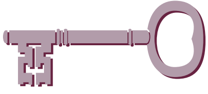
Mother and Father are separated, but they are considered married at the end of the tax year. They will file separate tax returns. They have three children, each with investment income in excess of $1,500 and no earned income. The children are currently living with Mother, but Father has the greater income.

To file their tax returns, the children must obtain Father's tax information because they must use his return to compute their tax liability on the portion of their income that exceeds $1,500. Father is reluctant to provide his financial information because he is concerned that his wife will use it against him in a divorce proceeding. If he refuses to provide the information, the children probably will be unable to file timely returns. Instead, they will have to file requests with the IRS to obtain the information, file their tax returns based on a reasonable estimate of their tax liability, and then file amended tax returns after they receive Father's tax information from the IRS.

If Father provides the information and wishes to minimize the family's combined tax liability, he must decide whether to allow his children to file their own returns or, alternatively, to make an election to include their income on his return. This can be a time-consuming decision because making the election to include their income on his return may increase or decrease the family's combined tax liability, and it is often necessary for a taxpayer to complete all forms under all alternatives to determine the most tax-efficient option.

Finally, the tax liabilities of Father and each child are interrelated. The income of each child must be computed. Then the "net unearned income" of each child must be added on the father's tax return to compute an "allocable parental tax." Finally, the "allocable parental tax" must be allocated to each child in proportion to the child's share of the aggregate net unearned income of all of the children. If the tax liability of Father or any child is later adjusted on an audit, the tax liability of the other children will also be adjusted and underpayment interest will be charged on any additional amounts due.

[209] *Id.*



RECOMMENDATIONS

- Repeal the rules under Internal Revenue Code section 1(g) that govern the taxation of investment income of children under age 14 and thereby sever the link between the computation of the child's tax liability and the parent's tax return. Instead, tax such children on their investment income at either (a) the tax rates applicable to estates and trusts[210] or (b) the child's own income tax rate up to a specified threshold, with investment income above that threshold taxed at a higher tax rate.
- Amend Internal Revenue Code section 63(c) to make the standard deduction for dependent children equal to the standard deduction for a single taxpayer.[211] A dependent child with total income (earned or unearned) of more than this amount would be required to file a tax return.

[210] IRC § 1(e).

[211] In the event that Congress determines the revenue loss resulting from this proposal is excessive, we offer two alternative simplification proposals in the Explanation of Recommendations section below.

PRESENT LAW

Kiddie Tax

Internal Revenue Code section 1(g) and Temp. Treas. Reg. § 1.1(i)[212] provide special rules for the taxation of investment income of children under the age of 14 (the Kiddie Tax rules).[213] In general, the investment income of a child is subject to tax under a three-tiered system:[214]

- The first tier is the amount of the child's investment income that equals or falls below the child's minimum standard deduction as set forth in IRC § 63(c)(5)(A).[215] This amount is not subject to tax. The minimum standard deduction in 2002 is $750.
- The second tier is the greater of (1) the minimum standard deduction as set forth in IRC § 63(c)(5)(A) or (2) if the child itemizes deductions, the amount of deductions directly connected with the production of investment income.[216] This amount is subject to tax at the child's tax rate. For a child who does not itemize deductions, this amount in 2002 is $750. Thus, investment income between $751 and $1500 would be taxed at the child's tax rate.
- The third tier consists of all income that exceeds the second-tier amount and is referred to as "net unearned income."[217] Net unearned income is taxed at the top marginal tax rate of the applicable parent (or parents, in the case of a joint income tax return),[218] and the amount of tax computed under this third tier at the parent's rate is referred to as the "allocable parental tax".[219]

> *Example:* A child under the age of 14 has investment income of $3,000 in 2002. She has no earned income and does not itemize deductions. Her parents file a joint return and face a top marginal tax rate of 35 percent. The child's first $750 of income is not subject to tax. The child's next $750 of income is taxed at her marginal rate of 10 percent. The child's remaining $1,500 of income is "net unearned income" and is taxed at her parents' top marginal rate of 35 percent. Therefore, the child's tax liability will be $600 (*i.e.*, ($750 x 10%) + ($1,500 x 35%)).

The allocable parental tax is equal to the excess of (1) the amount of the parent's tax liability computed as if the parent's income included the net unearned income of all children of the parent to whom the Kiddie Tax rules apply over (2) the amount of the

[212] The temporary regulations were issued prior to 1990, when the statutory rules appeared at IRC § 1(i). The temporary regulations have not been redesignated.

[213] The Kiddie Tax rules do not apply if both of the child's parents are deceased. IRC § 1(g)(2)(B). The Kiddie Tax rules apply to Social Security and pension benefits received by a child. Temp. Treas. Reg. § 1.1(i)-1T, Q&A 9.

[214] IRC § 1(g)(1) provides that the tax liability will be equal to the greater of the amount computed under the Kiddie Tax rules or the amount computed without regard to the Kiddie Tax rules. In the vast majority of cases, the amount computed under the Kiddie Tax rules will be greater.

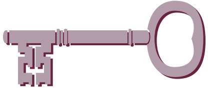
[215] IRC § 1(g)(4)(A)(ii)(I).

[216] IRC § 1(g)(4)(A)(ii)(II).

[217] IRC § 1(g)(4).

[218] IRC § 1(g)(3)(A).

[219] IRC § 1(g)(3).



parent's tax liability computed without regard to the net unearned income of the children.[220] If a parent has multiple children to whom the Kiddie Tax rules apply, the allocable parental tax is computed by combining the net unearned income of all of the parent's children and then is allocated to each child in proportion to that child's share of the aggregate net unearned income of all such children of the parent.[221]

If the parents of a child are married and file joint income tax returns, the allocable parental tax is computed using the joint return. If the parents are considered married (even if separated) but file separate returns, the allocable parental tax is computed using the return of the parent with the greater taxable income.[222] If the parents are considered unmarried (including parents who were never married and parents who are divorced), the allocable parental tax is computed using the return of the custodial parent.[223] When a child cannot obtain the required information about his or her parent's tax return, the child (or the child's legal representative) can request the information from the IRS.[224] The request must contain the following: (1) a statement that the child is attempting to comply with the Kiddie Tax rules and has attempted unsuccessfully to obtain the information from the parent; (2) proof that the child is under 14 years of age; (3) evidence that the child has more than $1,500 of unearned income; and (4) the name, address, social security number (if known), and filing status (if known) of the parent. If the child's legal representative makes the request, a power of attorney must be included.[225] If the child cannot obtain the required parental information before the filing deadline, the child may file a timely return using reasonable estimates and then file an amended return after the parent's tax information is obtained.[226]

In general, a tax return must be filed in the name of a child who has a tax liability.[227] The return must include a Form 1040, Form 1040A, or Form 1040NR along with a Form 8615 (Tax for Children Under Age 14 With Investment Income of More Than $1,500). Form 8615 is an 18-line form that must be completed in conjunction with the return of the applicable parent so that tax on the portion of the child's income that constitutes net unearned income may be computed on the basis of the applicable parent's tax rate.

Under certain circumstances, a parent may make an election to include the child's income on the parent's return.[228] If this election is made, the parent must attach to his or her return a Form 8814 (Parents' Election To Report Child's Interest and Dividends), and the child is not required to file a separate return. The parental election may be made only

[220] IRC § 1(g)(3)(A).

[221] IRC § 1(g)(3)(B).

[222] IRC § 1(g)(5)(B).

[223] IRC § 1(g)(5(A).

[224] Temp. Treas. Reg. § 1.1(i)-1T, Q&A 22 (citing IRC § 6103(e)(1)(A)).

[225] *Id.; see* IRS Publication 929, *Tax Rules for Children and Dependents*, at 11 (2002).

[226] *Id.*

[227] IRC § 6012.

[228] IRC § 1(g)(7).

if (1) the child's gross income consists solely of interest and dividends, (2) the child's gross income is more than the amount of the minimum standard deduction but less than ten times the amount of the minimum standard deduction (*i.e.*, more than $750 and less than $7,500 in 2002), and (3) no amount has been withheld and no estimated tax payments have been made in the child's name.

A family's aggregate tax liability may differ depending on whether the parental election is made. If the child files a separate return, the child's net unearned income is added to the parent's income for purposes of computing the child's tax, but the parent files his or her return without including the child's income. By contrast, a parent who makes the election must report the child's income on his or her return, resulting in greater taxable income to the parent. The parental election can alter the family's combined tax liability. On the one hand, a parent making the election must treat the child's investment income as the parent's own investment income, which may allow the parent to claim a larger investment interest deduction pursuant to IRC § 163. On the other hand, the higher adjusted gross income reported by the parent increases the dollar threshold that must be exceeded to deduct miscellaneous itemized deductions under IRC § 67 and medical expenses under IRC § 213 and may cause the parent to lose additional tax benefits because of the phase-out of personal exemptions under IRC § 151(d) and the limitation on itemized deductions under IRC § 68.[229] In addition, any itemized deductions to which the child is otherwise entitled are forfeited if the parental election is made.[230]

The Kiddie Tax rules also affect the possible application of the alternative minimum tax (AMT). If a child under the age of 14 files his or her own return, the child's AMT exemption amount is limited to the child's earned income plus $5,350 in 2002.[231] By contrast, single filers are entitled to an exemption of $35,750 in 2002.[232] If the parental election is made, any interest which is an item of tax preference of the child under IRC § 57(a)(5) shall be treated as an item of tax preference of the parent instead, potentially exposing the parent to AMT liability or increasing the parent's AMT liability.[233] An AMT tax liability of a child is most likely to arise if the child receives tax-exempt interest from a private activity bond.

Standard Deduction

The standard deduction of a dependent child varies depending on whether the child's income consists exclusively of earned income, exclusively of unearned income, or a combination of earned and unearned income. If the child's income consists exclusively of earned income, the standard deduction will eliminate any income tax liability of the child

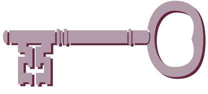
[229] For a description of the effects of the parental election, see IRS Publication 929, *Tax Rules for Children and Dependents*, at 7-8 (2002).

[230] *See* IRC § 1(g)(7)(B).

[231] IRC § 59(j)(1).

[232] IRC § 55(d)(1)(B).

[233] IRC § 1(g)(7)(B)(iii).



to the extent that his or her adjusted gross income does not exceed $4,700 in 2002 (i.e., the amount of the standard deduction for single filers). If the child's income consists exclusively of unearned income, the standard deduction will eliminate any income tax liability of the child only to the extent that his or her adjusted gross income does not exceed $750 in 2002. If the child's income consists of a combination of earned and unearned income, the standard deduction in 2002 is the lesser of (1) $4,700 or (2) the greater of (a) $750 or (b) the child's earned income plus $250.[234]

REASONS FOR CHANGE

Kiddie Tax

The Kiddie Tax rules were enacted as part of the Tax Reform Act of 1986 to discourage parents from shifting income-producing assets to their children in order to take advantage of a child's tax rate.[235] Prior to the 1986 Act, there was no provision in the Code requiring that a portion of a child's income be taxed at the parent's tax rate if higher than the child's rate.

The Kiddie Tax rules are unnecessarily complex because of the interrelationship between the child's tax return and the parent's tax return. The National Taxpayer Advocate believes that the relationship between the returns of the child and parent should be severed. Consider the following:

- *Determination of Applicable Paren*t. If a child's parents are considered married but file separate tax returns, the tax liability of the child must be computed by using information from the return of the parent with the greater taxable income. If both parents have roughly equivalent sources of income, the applicable parent can be difficult to determine. This is especially true if the parents, although still considered married, are separated and going through a divorce proceeding. It is likely that each parent would try to avoid disclosing financial information to the other. If the parents are considered unmarried, the tax liability of the child must be computed by using information from the return of the custodial parent. In some cases, it may be difficult to determine which is the custodial parent.
- *Need to Obtain Applicable Parent's Tax Return Information*. Apart from determining which parent is the applicable parent for purposes of computing the child's tax liability, the tax return information of that parent must be obtained. In cases where a child's parents are divorced or separated, the child may have difficulty obtaining tax information from the applicable parent, particularly where the applicable parent is living apart from the child and where the applicable parent cannot practically provide tax information to the child without also providing the information to an estranged or former spouse. Although the law provides procedures for the

[234] The basic standard deduction is set forth in IRC § 63(c)(2). The limitation on the standard deduction for certain dependents is set forth in IRC § 63(c)(5). All amounts cited in this paragraph are indexed annually to account for the effects of inflation. IRC § 63(c)(4).

[235] *See* S. Rep. No. 99-313, at 862 (1986).

child to request the information directly from the IRS, the request takes time to prepare and the child very likely will be required to file a return on the basis of estimates and then to file an amended return after the tax information of the applicable parent is obtained. Tax considerations aside, it is also worth considering the desirability of requiring a parent to share tax information with an estranged or former spouse even where the parent is not required under any other provision of law to do so.

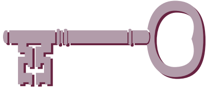
- *Determination Whether to Make Election to Include Child's Income on Parent's Return.* An election to include the child's income on the parent's return may result in the same combined tax liability, a lower combined tax liability, or a greater combined tax liability. To determine the best option, it is often necessary for a taxpayer to complete all forms under all options. The forms are complicated, and the task of completing all forms and comparing the results is time-consuming. To complicate matters further, a parent with multiple children may elect to include on his or her return the income of some children and not others.[236]
- *Additional Complexity in the Case of Multiple Children.* The allocable parental tax is computed by combining the net unearned income of all of the parent's children and then is allocated to each child in proportion to that child's share of the aggregate net unearned income of all of the children. Therefore, a family with multiple children must (1) compute the income of each child, (2) add the net unearned income amounts to the applicable parent's return to compute the allocable parental tax, and (3) allocate the allocable parental tax to each child in proportion to the child's share of the aggregate net unearned income of all of the children. Not only are these computations intricate, but if one member of the family is delayed in computing his or her taxable income, all other members of the family are precluded from filing an accurate tax return.
- *Ripple Effect of Subsequent Adjustments.* If a parent's taxable income is used to compute the taxable income of a child and the taxable income of the parent is later adjusted, the child's tax liability must be recomputed using the parent's taxable income as adjusted.[237] Moreover, if multiple children use the same parent's taxable income to compute their respective shares of the allocable parental tax and a subsequent adjustment is made to the net unearned income of any of the children, the allocable parental tax of all of the children must be recomputed to reflect the adjustment.[238] If the tax liability of a child is increased in either of these situations, his or her additional tax liability is treated as an underpayment of tax, and as such, interest is imposed at the underpayment rate as provided in IRC § 6601.[239]

[236] *See* IRS Publication 929, *Tax Rules for Children and Dependents*, at 7 (2002).

[237] Temp. Treas. Reg. § 1.1(i)-1T, Q&A 17.

[238] Temp. Treas. Reg. § 1.1(i)-1T, Q&A 18.

[239] Temp. Treas. Reg. § 1.1(i)-1T, Q&A 19.



All of the foregoing problems could be avoided if the child's tax liability were determined independently of the parent's tax liability.

Standard Deduction

The standard deduction applicable to dependent children causes taxpayer compliance burdens for two reasons.[240] First, it subjects individuals with relatively small amounts of income to tax liability. A dependent child with as little investment income as $751 – or with earned income of $500 and investment income above $250 – is subject to tax.[241] Compared with other taxpayers, this is a very low threshold. For example, a non-dependent single filer will not owe tax in 2002 unless his or her income exceeds $7,700 (*i.e.*, the standard deduction of $4,700 plus a personal exemption of $3,000). A married couple without dependents will not owe tax in 2002 unless the couple's income exceeds $13,850 (*i.e.*, a standard deduction of $7,850 plus two personal exemptions of $3,000 each). A married couple with three children would not owe tax in 2002 unless its income exceeded $22,850 (*i.e.*, $13,850 plus three dependency exemptions of $3,000 each). By setting the bar for dependent children as low as $751, current law subjects hundreds of thousands of children with relatively small amounts of income to tax liability and to tax reporting obligations.[242] And because of the complex Kiddie tax rules, the parents of these children face onerous compliance burdens.

Second, the amount of the standard deduction for dependent children in many cases must be computed – it is not a specified amount. For the 2002 tax year, the standard deduction is set at $7,850 for married couples filing a joint return, at $3,925 for married couples filing separate returns, at $6,900 for head-of-household filers, and at $4,700 for single filers. By contrast, the standard deduction for a dependent child is the lesser of (1) $4,700 or (2) the greater of (a) $750 or (b) the child's earned income plus $250. Thus, the standard deduction for a child could be as low as $750, as high as $4,700, or any number in between. Requiring the parent or legal guardian of a child with both earned income and unearned income to compute the standard deduction each year adds an additional layer of complexity that is not imposed on any other category of taxpayers.

[240] For simplicity, this discussion refers to the limited standard deduction described in IRC § 63(c)(5) as applying to dependent children. However, it should be noted that the provision applies to all individuals who may be claimed as dependents on the tax return of another taxpayer – not only to dependent children.

[241] An individual who may be claimed as a dependent on the return of another taxpayer is not entitled to claim a personal exemption for himself or herself. Therefore, a dependent child has a tax liability if income exceeds the standard deduction without regard to exemptions (except if the child itemizes deductions).

[242] One commentator observed that the combined effect of the provisions in the Tax Reform Act of 1986 limiting the standard deduction and eliminating the personal exemption with respect to dependents created "a significant increase in complexity." He added: "The amended rules meant that hundreds of thousands of children with only modest amounts of assets were now required to file tax forms. (To add to the complexity, some income was to be taxed at the child's rate and some at the parent's rate, while those with only moderate amounts of nontaxable wage income needed to file to report a few dollars of interest from a small checking or saving account.) There is little doubt that after 1986 a significant portion of children and their parents violated this section of the tax code, often without knowing it. Here then was a classic case of the political system simply giving too little weight to the issue of administration and simplification." C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* 158-159 (1992).

EXPLANATION OF RECOMMENDATIONS

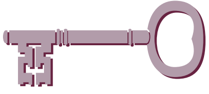
The National Taxpayer Advocate recommends that Congress repeal the Kiddie Tax rules under Internal Revenue Code section 1(g) in light of the complexity that results from the mandated interaction between the tax return of a parent and the tax returns of his or her children. If Congress remains concerned about the shifting of income-producing assets from parents to children, it should instead consider taxing children on their investment income at either (a) the tax rates applicable to estates and trusts[243] or (b) the child's own income tax rate up to a specified threshold, with investment income above that threshold taxed at a higher tax rate, perhaps the maximum rate applicable to individuals. This proposal would sever the link between a child's income and the top marginal tax rate of the child's parent, yet could be tailored to be revenue neutral.

The National Taxpayer Advocate further recommends that Internal Revenue Code section 63(c) be amended to make the standard deduction for dependent children equal to the standard deduction for single filers. Under current law, the standard deduction for dependent children is effectively equal to the standard deduction for single filers with respect to *earned* income but is as low as $750 with respect to *unearned* income. For 2002, the standard deduction for a single filer is $4,700. As discussed above, the current standard deduction creates compliance burdens for two reasons. First, the low minimum standard deduction amount of $750 imposes a filing requirement on many taxpayers with relatively small amounts of income. Second, the fact that the standard deduction amount may differ depending on whether the child has earned income or unearned income – and often must be computed when a child has both earned and unearned income – adds additional complexity. Setting the standard deduction for dependents at the same level as the standard deduction for single filers – and making no distinction between earned and unearned income – would eliminate both of these compliance burdens.

Although (1) exempting individuals with small amounts of income from the return-filing requirement and (2) eliminating the disparate treatment of earned and unearned income would further the goal of simplicity, Congress may determine that the revenue effects of this proposal are too high or that the incentive to shift income-producing assets to children would be too great. If so, two alternative approaches could be considered.

One alternative would be to increase the minimum standard deduction somewhat above $750. How much higher would reflect a policy judgment that balances the revenue effects of the increase in the minimum standard deduction against the number of children with low incomes who would be relieved of income tax obligations. The advantage of this approach is that it would remove individuals with low incomes from the tax rolls. The disadvantage is that the distinction between earned and unearned income would remain.

243 IRC § 1(e).



A second alternative would be to eliminate the disparate treatment between earned and unearned income and to set the minimum standard deduction for dependents somewhere between its current minimum of $750 and the single filer amount of $4,700. The advantage of treating earned and unearned income equally is simplicity. The disadvantage of setting the standard deduction for earned income below $4,700 is that dependents whose income consists entirely of wages would face a tax increase and would be taxed more than other taxpayers with wage income. We have reservations about this alternative on equity grounds.

In sum, we strongly recommend that the Kiddie Tax rules be repealed to eliminate the myriad problems that arise from the link between the tax returns of child and parent. Any revenue loss could be made up by taxing children on their investment income at the trusts-and-estates tax rate or at a higher individual tax rate, perhaps the maximum individual rate. We further recommend that Congress consider making revisions to the standard deduction rules applicable to dependents to reduce the number of dependents with small amounts of income who must file tax returns and, if feasible, to eliminate the disparate treatment of earned and unearned income and the complex calculations and decisions arising from this distinction.

CHANGE OF WITHHOLDING PROCEDURE UNDER INTERNAL REVENUE CODE SECTION 3402(I).

PROBLEM

Under present law, taxpayers can increase (but not decrease) withholding by a specified dollar amount. The only mechanism to decrease withholding is to claim additional withholding allowances. Worksheets are needed to convert deductions and credits into withholding allowances. Most taxpayers who want less withholding can figure the amount without having to compute withholding allowances.

EXAMPLE

A single taxpayer with no dependents expects to earn $35,000 in wages during 2002. By September of 2002 she has incurred and paid unexpected medical expenses of $5,000. She estimates that she will have itemized deductions of approximately $7,475, based on the portion of her medical expenses that exceeds 7.5 percent of her adjusted gross income (AGI), along with her mortgage interest, real estate taxes, and charitable contributions. Since the amount of itemized deductions is greater than the standard deduction for a single taxpayer ($4,700) she is entitled to itemize her deductions on Schedule A when she files her 2002 federal income tax return. As a result of itemizing her deductions, the taxpayer expects her tax liability to decrease by approximately $420.

The medical expenses have caused the taxpayer a financial hardship. She is paid twice a month, and will receive eight more paychecks before the end of the year. She would like to be able to decrease her federal income tax withholding (FITW) by $50 per pay period for the remainder of the year, and receive the financial benefit immediately. She spends almost two hours reviewing the relevant instructions and completing Form W-4. However, she finds that she is not entitled to claim an additional withholding allowance because her estimated itemized deductions do not exceed the standard deduction by at least $3,000.

RECOMMENDATAION

Amend Internal Revenue Code section 3402(i)(1) to permit taxpayers to decrease the amount of withholding where the employee requests such changes.

Internal Revenue Code section 3402(i)(1) would read:

> "The Secretary may by regulations provide for increases or decreases in the amount of withholding otherwise required under this section in cases where the employee requests such changes."

COLLECTION DUE PROCESS

PROBLEM

Taxpayers submitting a Collection Due Process (CDP) request from outside the United States do not have additional time to respond. The Internal Revenue Service often grants extra time for those outside the country to file other documents or respond to inquiries where important procedural rights are involved.[244] Taxpayers outside the U.S. experience an additional burden to gather pertinent documents and allow for the processing and delivery of foreign mail. This exhausts a significant portion of their 30-day CDP filing window, which can result in late filing and the loss of their ability to pursue judicial remedy.

EXAMPLE

A taxpayer was mailed a CDP Notice of Determination on March 30, 2001. The notice was sent to an address in Israel. He did not receive the notice until April 24, 2001 because of intervening Jewish holidays (Passover and Holocaust Memorial Day) and slow rural mail delivery. He was also delayed in mailing his petition to the court due to Israeli Memorial Day and Israeli Independence Day. He mailed his petition on April 30, 2001, and the Court received it seven days late on May 7, 2001.[245]

RECOMMENDATION

Amend Internal Revenue Code 6330(a)(3)(b) as necessary subsection (a)(2) to provide the taxpayer outside the United States an additional 30-day period to request a hearing in response to a COP notice.

Amend Internal Revenue Code section 6330(d) to allow an additional 30-day response period to taxpayers appealing a CDP determination from outside the United States.

[244] IRC § 6213(a) grants taxpayers an additional 60 days to respond to a Notice of Deficiency. IRM 5.7.6.3(2) grants taxpayers an additional 30 days to respond to a Proposed Trust Fund Recovery Penalty Assessment Letter. Treas. Reg. 1.6081-5 grants U.S. citizens or residents either living or in military service outside the U.S. or Puerto Rico an additional two months to file a US Individual Income Tax Return.

[245] This example is derived from Sarrell v. Commissioner, 117 T.C. No. 11 (2001); which involved a tax court petition.

DE MINIMIS EXCEPTION TO PASSIVE LOSS AND CREDIT LIMITATIONS

PROBLEM

Losses from passive trade or business activities can only offset income from passive activities – i.e., passive losses cannot offset non-passive income such as wages, portfolio income, or income from an active trade or business. Credits from passive activities generally can only offset the tax attributable to income from passive activities. Disallowed passive losses and credits are carried forward and to the extent not used in subsequent years are allowed in full when the taxpayer disposes of his/her interest in the passive activity.

Taxpayers with relatively small amounts of passive losses and credits must complete a complex calculation and form preparation to determine and claim their allowable losses and credits from passive activities.

EXAMPLE

Taxpayer has invested in a limited partnership that involves passive trade or business activity. For tax year 2001, the taxpayer's share of this limited partnership's net ordinary loss was $585.00. To determine whether the taxpayer can claim that loss in full on his 2001 individual income tax return, the taxpayer must first read through and complete two pages of worksheets for Form 8582, read a 12 page publication, Instructions for Form 8582 Passive Activity Loss Limitations, and complete the Form 8582. It is estimated that record-keeping, learning, preparing and filing this form will require five hours and 14 minutes.

RECOMMENDATION

Amend Internal Revenue Code section 469(a) to provide a *de minimis* exception to the rules limiting the allowance of losses and credits from passive activities. Specifically, provide that the passive loss limitations shall not apply if the sum of the taxpayer's passive activity losses and three times his/her passive activity credits is less than $1,000, indexed for inflation.

ELECTION TO BE TREATED AS AN S CORPORATION

PROBLEM

Internal Revenue Code section 1362(b)(1)(B) requires that the election to be treated as an S-corporation be made on or before the 15th day of the 3rd month of the tax year. If this election is not made by the statutory date, it is deemed made for the succeeding year unless the Secretary determines that there was reasonable cause for the failure to make a timely election.

EXAMPLE

The problem arises when a small business corporation files a Form 1120S (U.S. Income Tax Return for an S-Corporation), and the IRS has no record of an approved 2553 election. The result is as follows:

- The filed Form 1120S is unpostable, and is converted to, and posted as, a Form 1120; then the tax is assessed.
- The flow-through returns related to the Form 1120S may or may not be corrected to reflect the 1120 assessment.
- IRS notifies the small business corporation of its changed status and grants the corporation two options:
  1. if the election was in fact approved by the Service – provide proof of filing and approval notification; or
  2. if there is reasonable cause for late filing – prepare a request for Private Letter Ruling (PLR) from IRS Chief Counsel.

In most cases reasonable cause exists, and the taxpayer eventually is approved for treatment as an S-corporation in the current year. As a result, the entire 1120 set up is then reversed, including any flow through adjustments, and the original 1120S set up is transcribed.

RECOMMENDATION

Amend Internal Revenue Code section 1362(b)(1)(B) to allow a small business corporation to elect to be treated as an S corporation at the time it files its first Form 1120S return.

LEVY ON MUTUAL FUNDS, INCLUDING MONEY MARKET FUNDS

PROBLEM

Existing law permits the seizure and sale of mutual fund or money market shares. The authority of the service to obtain cash from a levy on liquid mutual funds has been challenged. Some brokers argue that their only responsibility is to turn over the shares in response to the levy rather than liquidating the shares and providing funds to the IRS. Provisions in IRC § 6335 (e)(1)(A) allow for reduction in value of the asset due to expenses of sale, resulting in an amount less than the market value of shares seized being applied to the liability. The successful bid will generally be less than market value of the shares, so that the taxpayer does not benefit from the full value of the sale.

EXAMPLE

Taxpayer has a liquid mutual fund in an account with a brokerage firm. The IRS levies this fund, up to the amount of an unpaid tax liability. The brokerage firm maintains that it is only required to turn over the shares to the IRS. The IRS then conducts a sale of the funds, and reduces the sale proceeds by the expenses of sale. Thus, only the net sale proceeds are applied toward the taxpayer's outstanding tax liability.

RECOMMENDATION

Amend Internal Revenue Code section 6332 to include a new paragraph (d) to read:

> Special Rule for agent of mutual funds, including money market funds.
>
> Any agent for a mutual fund including money market funds shall dispose of sufficient shares at market value to satisfy the amount due on such levy up to the market value of share owned by the person against whom the tax is assessed.

INTRODUCTION

Internal Revenue Code section 7803(c)(2)(B)(ii)(X) not only requires the National Taxpayer Advocate to identify the tax issues most often litigated in the federal courts, but requires her to classify the issues by the type of taxpayer involved and to include recommendations, if appropriate, for mitigating disputes of this nature. We recognize that many issues are litigated because of legitimate interpretative and factual disputes of law. However, administrative or legislative change could eliminate or minimize some of the litigation discussed in this section.[1]

The Taxpayer Advocate Service worked with the Office of Chief Counsel to identify the issues most frequently litigated. Our office researched a commercial database for decisions filed for each issue by the United States Tax Court, federal district courts, the United States Court of Federal Claims and the United States bankruptcy courts during the time period June 1, 2001 through May 31, 2002. For this analysis and report, the term "litigated" is defined as a case with a published decision by the court. This does not mean that the taxpayer has exhausted the appeals process. This year we report on 11 issues because the number of cases with a published decision for Joint and Several Liability and Barred Refunds fell within a very narrow range and we feel that both issues merit discussion.

This year's analysis and reporting of the most litigated issues are more comprehensive and detailed than any previous Annual Report to Congress. Each issue includes a general discussion of the relevant law, an analysis of the cases litigated (including discussion of specific significant or representative cases), and a conclusion, which in some instances contains specific recommendations for legislative or administrative change. We have listed each of the cases litigated in tables and have categorized the cases by type of taxpayer. The case listings for each issue also include the taxpayer's name, the specific citation of the case, the court in which it was tried, a brief synopsis of the issue, whether the taxpayer was represented at trial by counsel, and the decision of the court.

TAX LITIGATION IN GENERAL

Taxpayers generally have access to four different tribunals in which to litigate a tax matter – the United States Tax Court, the federal district courts, the United States Court of Federal Claims, and the U.S. bankruptcy courts. Each of these courts has specific jurisdiction over certain types of tax cases.

[1] See, e.g., "Unreported and Underreported Income," and "Relief from Joint and Several Liability" *infra*.

[2] See IRC § 6214.

[3] See, e.g., IRC §§ 7428(a), 7476, 7477, 7478, 7479.

[4] IRC § 6330(d).

[5] IRC § 7442.

The United States Tax Court is generally a "pre-payment" forum and has jurisdiction over deficiency cases,[2] declaratory judgments,[3] lien and levy cases,[4] and other matters that are authorized from time to time by statute.[5] Both the federal district courts and the Court of Federal Claims are "refund fora."[6] They have jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[7] and (2) the taxpayer has filed an administrative claim for refund.[8] The federal district courts are the only forum in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that involve a debtor's open tax years and that were not previously adjudicated before the initiation of a bankruptcy case.[9]

Each of the courts has specific rules regarding procedure and evidence. The Tax Court and U.S. Court of Federal Claims are national courts; the Tax Court holds trial calendars in 62 cities.[10] The federal district and bankruptcy courts, on the other hand, are local courts, sitting in judicial districts throughout the nation.

The taxpayer's choice of judicial forum depends on many factors, including the court's procedures, the burden of proof, and the controlling precedent. As noted above, if the Tax Court has subject matter jurisdiction over the taxpayer's case, he or she can litigate without paying the tax in advance but must file a petition within the prescribed 90 days from the date of receiving a Notice of Deficiency.[11]

Over 95 percent of all tax-related litigation is adjudicated in the Tax Court.[12] Table Intro-A shows the number of docketed cases in inventory in the Tax Court, the Court of Federal Claims, and the district courts as of the end of each of the fiscal years 1991 through 2001. Table Intro-B shows the dollars in dispute for the docketed case inventory in these courts over the same time period.

[6] 28 U.S.C. § 1346(a)(1).

[7] See Flora v. United States, 362 U.S. 145 (1960).

[8] IRC § 7422(a).

[9] See 11 U.S.C. §§ 505(a)(1) and (a)(2)(A).

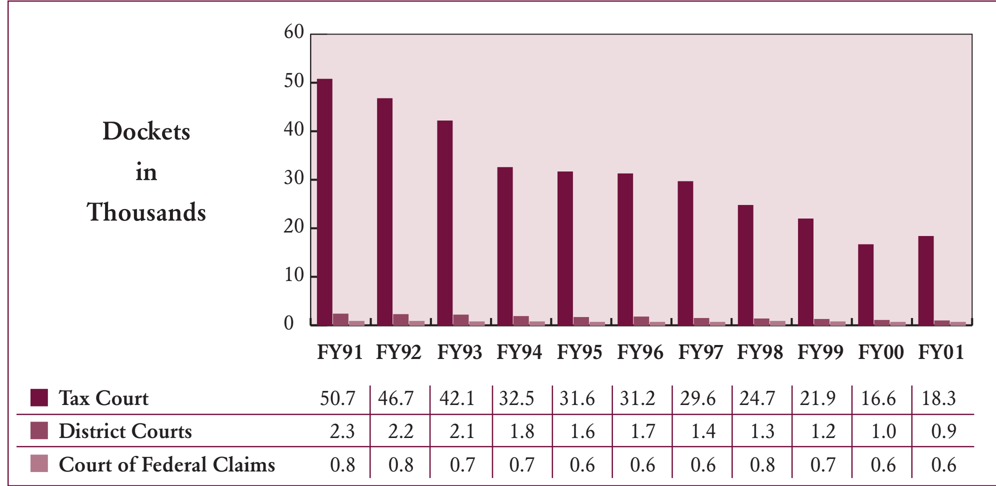
[10] The Tax Court holds trial sessions in 15 additional cities for cases involving up to $50,000 in dispute per tax year.

[11] IRC § 6213(a). A petitioner who is outside the United States at the time the Notice of Deficiency is mailed has 150 days within which to file a petition with the Tax Court.

[12] Judge David Laro, *The Evolution of the Tax Court As An Independent Tribunal*, 1995 U. Ill. L. Rev. 17.

TABLE INTRO-A
DOCKETED INVENTORY - CASES IN DISPUTE

Pending Before Tax Court, District Courts, and Court of Federal Claims

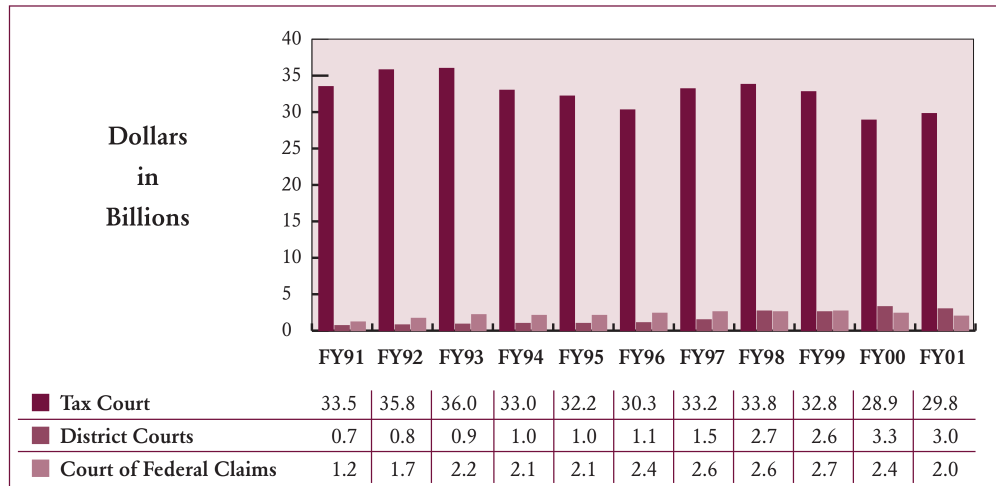


	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Tax Court	50.7	46.7	42.1	32.5	31.6	31.2	29.6	24.7	21.9	16.6	18.3
District Courts	2.3	2.2	2.1	1.8	1.6	1.7	1.4	1.3	1.2	1.0	0.9
Court of Federal Claims	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.8	0.7	0.6	0.6

Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-711 and TL-712

TABLE INTRO-B
DOCKETED INVENTORY - DOLLARS IN DISPUTE

Pending Before Tax Court, District Courts, and Court of Federal Claims

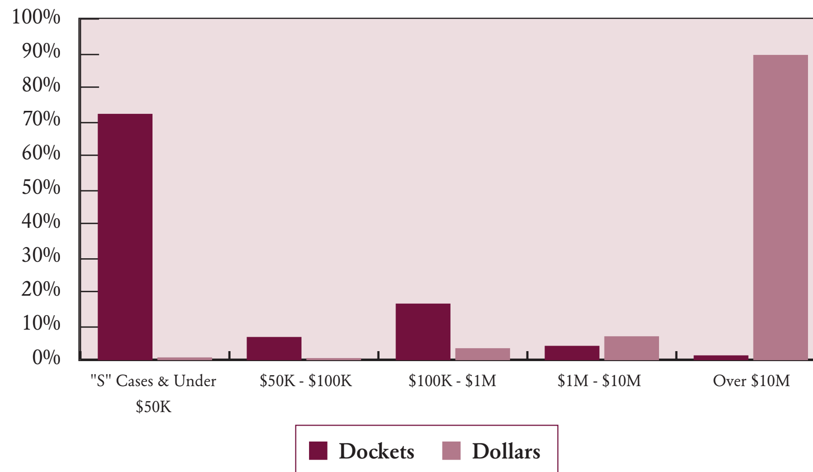


	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Tax Court	33.5	35.8	36.0	33.0	32.2	30.3	33.2	33.8	32.8	28.9	29.8
District Courts	0.7	0.8	0.9	1.0	1.0	1.1	1.5	2.7	2.6	3.3	3.0
Court of Federal Claims	1.2	1.7	2.2	2.1	2.1	2.4	2.6	2.6	2.7	2.4	2.0

Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-711 and TL-712

Table Intro-C shows the percentages of dollars in dispute and total dockets by dollar category in the Tax Court's inventory as of September 30, 2001. It is interesting to note that while "S" cases and other cases involving amounts under $50,000 accounted for only 0.5 percent of the dollars in controversy, they constituted 72 percent of the docketed cases. On the other hand, cases with over $10 million in dispute made up only 1.1 percent of the case docket inventory yet these same cases accounted for 89.3 percent of the entire dollars in dispute.

TABLE INTRO-C
TAX COURT INVENTORY - PERCENTAGE OF DOLLARS IN DISPUTE AND TOTAL DOCKETS BY DOLLAR CATEGORY, AS OF SEPTEMBER 30, 2001



Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-711

Thus, the Tax Court regularly deals with a few cases in which a large tax liability is at issue and many cases in which the amount in controversy is relatively small. This dichotomy has been a constant fact of Tax Court litigation over the last eleven years.[13]

[13] Counsel Automated Tracking System, TL-711.

PRO SE LITIGATION

Early in our analysis of issues, it became apparent that a significant number of taxpayers chose to represent themselves before the court ("*pro se*" representation[14]). All persons have a right to plead their own case before all courts of the United States or to retain counsel.[15] The right to self-representation applies equally to taxpayers who find themselves engaged in disputes with the Internal Revenue Service (IRS).

The Tax Court Rules of Practice and Procedure provide that in the absence of appearance by counsel, an individual may appear on his or her own behalf. A corporation or unincorporated association may be represented by an authorized officer of the corporation or by an authorized member of the association. An estate or trust may be represented by the fiduciary.[16]

In federal courts such as the district courts or the Court of Federal Claims, the provisions of 28 U.S.C. § 1654 apply, with specific rules for each court. In federal district courts, local rules provide for *pro se* representation. In the Court of Federal Claims, Rule 83.1(c)(8) provides that an individual may represent him- or herself or a member of his or her immediate family as a party before the court.

Over the last decade, more than 70 percent of cases filed by taxpayers in the Tax Court were *pro se* cases.[17] One reason for the predominance of *pro se* petitioners in the Tax Court is that a taxpayer does not have to pay the tax at issue in order to litigate. Further, the Tax Court has a simplified procedure for handling small dollar cases.[18]

Overall, it appears that persons who act *pro se* do so for a number of reasons. Some cite mistrust of lawyers or the cost of legal services. Some *pro se* litigants believe that their cases are not very complex. Prior experience with litigation can lead some persons to distrust the entire legal process. "They sometimes assume that their lawyers complicate issues purposefully in order to charge higher fees. They can also misconstrue the judge's duty to remain objective as behavior that is impervious and unsympathetic."[19] Yet a 1991 American Bar Association study of *pro se* litigants found the following:[20]

- Persons with annual incomes of less than $50,000 are more likely to represent themselves.

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[14] "*Pro se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (7th ed. 1999).

[15] Under the provisions of Title 28 U.S.C. § 1654, in all courts of the United States the parties may plead and conduct their own cases personally or by counsel as they are permitted by rules of such courts, to manage and conduct causes therein.

[16] Tax Court Rule 24(b).

[17] IRS Counsel Automated Tracking System, TL 708A, Prepared by: CC:FM:PM:O.

[18] IRC § 7463(b) provides a simplified process for disputes involving $50,000 or less.

[19] Margaret Graham Tebo, *Self-Serve Legal Aid*, ABA Journal, August 2002, at 43.

[20] The *Pro se* Law Center, available at www.pro-selaw.org/pro-selaw/index.asp.

- Approximately 20 percent of self-represented litigants report that they can afford an attorney but do not want one.
- Self-represented persons are more likely to be satisfied with the judicial process than those who are represented by lawyers.
- Almost 75 percent of those who represented themselves in court said they would do so again.

Despite these survey results, Tax Court judges, Counsel field attorneys, and employees and volunteers of Low Income Taxpayer Clinics[21] all report that taxpayers generally obtain better results when they are represented by a professional who is authorized to practice before the Court. These observations are borne out by the following discussion of the most litigated issues. Table Intro-D illustrates the number and percentage of cases where *pro se* and represented taxpayers prevailed in each of the issues considered.

TABLE INTRO-D
***PRO SE* CASES**

MOST LITIGATED ISSUE	PRO SE TAXPAYERS			REPRESENTED TAXPAYERS		
	TOTAL CASES	TAXPAYER PREVAILED	PERCENT	TOTAL CASES	TAXPAYER PREVAILED	PERCENT
Abusive Trusts	24	0	0%	14	0	0%
Barred Refunds	8	0	0%	4	0	0%
Capital Gain/Loss	10	2	20%	21	11	52%
Collection Due Process	67	1	1%	29	2	7%
EITC	36	14	39%	16	7	44%
Fraud Penalty	15	3	20%	15	6	40%
Joint and Several Liability	6	3	50%	8	2	25%
Itemized Deductions	24	4	17%	11	1	9%
Trade & Business Expenses	65	13	20%	30	12	40%
Unreported/ Underreported Income	89	13	15%	47	18	38%
Valuation	5	3	50%	49	5	10%
Total	**349**	**53**	**15%**	**244**	**64**	**26%**

[21] Low Income Taxpayer Clinics provide free or nominal fee representation to low income taxpayers in disputes with the IRS. *See* IRC § 7526.

MOST LITIGATED

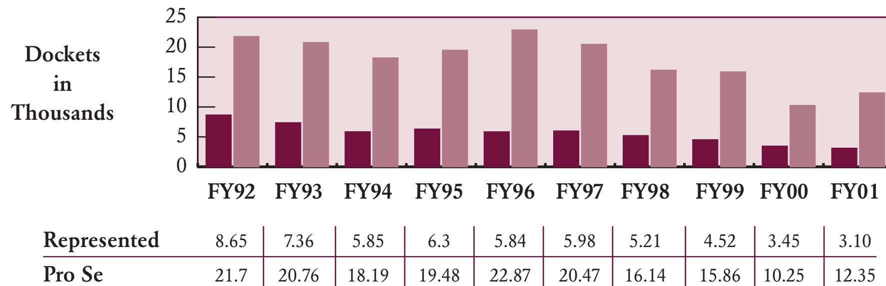
MOST LITIGATED TAX ISSUES

TRENDS AND ANALYSIS

The following charts (Tables Intro-E and Intro-F) indicate the number and percentage of cases in which taxpayers either were represented by counsel or represented themselves over the last ten fiscal years.[22] The increase in *pro se* cases in fiscal year 2001 may be explained by the IRS Reform and Restructuring Act of 1998 (RRA '98).[23] Taxpayers now have access to the courts for collection matters[24] and stand-alone proceedings for relief from joint and several liability.[25] These may be the types of issues that lend themselves to *pro se* representation, particularly where the cost of representation would be greater than the tax liability at issue.

TABLE INTRO-E

CASES PETITIONED TO TAX COURT - PETITIONER: REPRESENTED OR *PRO SE*

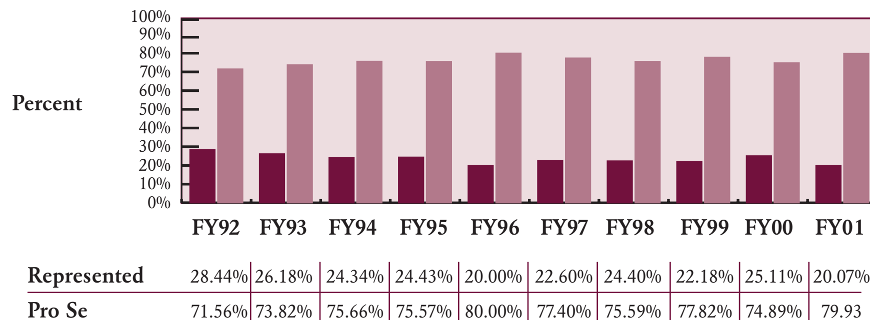


	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Represented	8.65	7.36	5.85	6.3	5.84	5.98	5.21	4.52	3.45	3.10
Pro Se	21.7	20.76	18.19	19.48	22.87	20.47	16.14	15.86	10.25	12.35

Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-708A

TABLE INTRO-F

CASES PETITIONED TO TAX COURT - PETITIONER: REPRESENTED OR *PRO SE*



	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Represented	28.44%	26.18%	24.34%	24.43%	20.00%	22.60%	24.40%	22.18%	25.11%	20.07%
Pro Se	71.56%	73.82%	75.66%	75.57%	80.00%	77.40%	75.59%	77.82%	74.89%	79.93

Does not include cases on appeal and declaratory judgments.
Source: Counsel Automated Tracking System, TL-708A

[22] The IRS fiscal year runs from October 1st through September 30th.

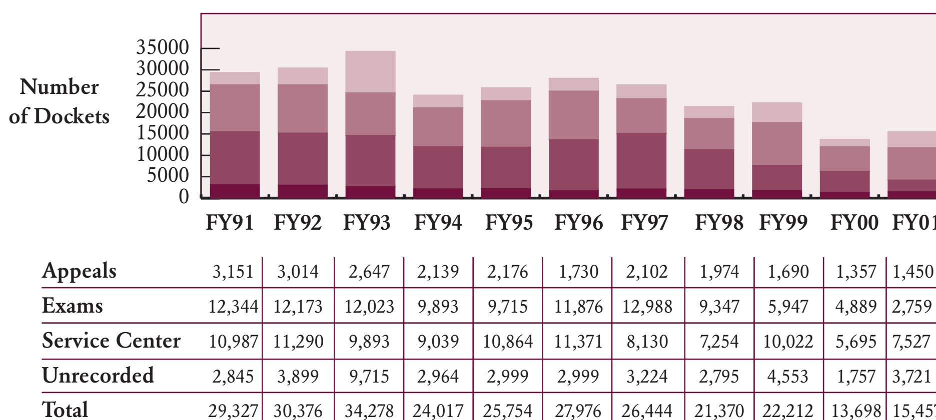
[23] Pub. L. No. 105-206.

[24] Collection Due Process hearings under IRC §§ 6320 and 6330.

[25] IRC § 6015.

Pro se representation occurs at all levels of practice before the Internal Revenue Service. For example, a 2001 IRS customer satisfaction survey report indicates that 77 percent of the Appeals cases heard by IRS are *pro se*.[26] Table Intro-G shows the source of cases petitioned to the Tax Court over an eleven-year period. In recent years, the largest number of Tax Court cases originated from IRS Service Center examinations or collection actions. Service Center (or "campus") activity includes Earned Income Tax Credit examinations, automated underreporter and substitute-for-return programs, and the "innocent spouse" (i.e. joint and several liability) program. These programs involve relatively small amounts of tax in dispute. However, they are also the types of IRS activities in which a taxpayer would be inclined to represent himself or herself because representation is too costly either at the outset or in relation to the amount of tax in dispute.

TABLE INTRO-G
SOURCE OF CASES PETITIONED TO TAX COURT



	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01
Appeals	3,151	3,014	2,647	2,139	2,176	1,730	2,102	1,974	1,690	1,357	1,450
Exams	12,344	12,173	12,023	9,893	9,715	11,876	12,988	9,347	5,947	4,889	2,759
Service Center	10,987	11,290	9,893	9,039	10,864	11,371	8,130	7,254	10,022	5,695	7,527
Unrecorded	2,845	3,899	9,715	2,964	2,999	2,999	3,224	2,795	4,553	1,757	3,721
Total	29,327	30,376	34,278	24,017	25,754	27,976	26,444	21,370	22,212	13,698	15,457

Source: Counsel Automated Tracking System, TL-708B

ANALYSIS OF *PRO SE* LITIGATION

The following table (Table Intro-H) lists the most litigated tax issues for the period June 1, 2001 through May 31, 2002. The number of cases in which taxpayers represented themselves before the court is also noted.

[26] http://www.irs.gov/pub/irs-utl/newappealsinternet.pdf

MOST LITIGATED

MOST LITIGATED TAX ISSUES

TABLE INTRO-H

MOST LITIGATED ISSUE	TOTAL NUMBER OF LITIGATED CASES REVIEWED	PRO SE LITIGATION	PERCENTAGE OF PRO SE CASES
Abusive Trusts	38	24	63%
Barred Refunds	12	8	67%
Capital Gains	31	10	32%
Collection Due Process	96	67	70%
EITC	52	36	69%
Fraud Penalty	30	15	50%
Joint and Several Liability	14	6	43%
Itemized Deductions	35	24	69%
Trade & Business Expenses	95	64	68%
Under/Underreported Income	136	89	65%
Valuation	54	5	9%
Total	**593**	**349**	**59% overall**

Collection Due Process (CDP), Earned Income Tax Credit (EITC), Itemized Deductions, Trade & Business Expenses, Barred Refunds, Under and Unreported Income and Abusive Trusts all show high percentages of *pro se* litigants. Of the 348 *pro se* cases litigated, 83 percent (289 cases) were tried in United States Tax Court.

CONCLUSION

The number of people handling their own legal problems, of any type, has increased dramatically in recent years. Self-representation raises concerns about protecting the rights of those who represent themselves while ensuring that the courts are not excessively burdened by the need to inform and assist *pro se* litigants.[27]

"Meeting the challenge of *pro se* litigation is a long-term effort that includes overcoming barriers, questioning the way of doing things, dealing with the complexities of collaborating with other stakeholders, testing innovative approaches, and working toward special procedures to assist with this increase in litigants."[28]

[27] American Bar Association, *Pro se or Self-representation*, available at http://www.abanet.org.

[28] Kathleen M. Sampson, *Meeting The Pro se Challenge (2002),* available at http://www.ajs.org.

We must acknowledge that most civil tax litigation occurs without a lawyer representing the taxpayer, despite the fact that taxpayers routinely fare better in court when represented by counsel. Courts, the Internal Revenue Service, associations of lawyers, accountants, and enrolled agents, and Congress all have a stake in developing innovative approaches to *pro se* litigants, to make sure that their self-representation does not lead to incorrect results. In this Report, the National Taxpayer Advocate proposes several initiatives to address this issue. She and the Taxpayer Advocate Service encourage all participants in the tax system to rise to the challenge of *pro se* litigation.

LITIGATED ISSUE #1 NONFILER/UNREPORTED AND UNDERREPORTED INCOME

PRESENT LAW

Current law defines gross income as "all income from whatever source derived."[29] Gross income includes (but is not limited to) the following:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

Internal Revenue Code (IRC) sections 71 through 90 address items specifically included in gross income, and IRC sections 101 through 140 address items that are specifically excluded.

If the Internal Revenue Service believes that a taxpayer has unreported or underreported income, the IRS notifies the taxpayer via the audit process or the Automated Underreporter program. Usually these items are easily identifiable amounts of income from taxable sources, including wages, nonemployee compensation, interest, dividends, rents, and pensions. Taxpayers are given the opportunity to agree to the adjustments to their tax, to disagree and appeal the adjustments to the Appeals function, or to resolve their differences with the IRS through the court system.

[29] IRC § 61(a).

ANALYSIS OF LITIGATED CASES

There were 136 cases with income and nonfiler issues litigated in the federal court system between June 1, 2001, and May 31, 2002. TAS analyzed these cases for trends or patterns in an effort to develop recommendations that could help resolve cases before litigation. Table 3.1.4 identifies the cases analyzed.

Of these litigated cases, 23 were strictly nonfiler cases. Another six cases involved taxpayers who filed returns in some years but not in others. In 15 of the 29 cases with nonfiler issues, the taxpayers used frivolous arguments in attempts to evade the payment of income taxes. Another three cases contained issues of fraud. The remaining 11 cases involved unreported or underreported income from nonemployee compensation, business gross receipts, rental income, wage income, capital gains, or constructive dividends. The cases contained a variety of issues, as noted above, with differing sets of facts and circumstances.

The income issues from all of the cases analyzed are categorized in Table 3.1.1 below:

TABLE 3.1.1
UNDERREPORTED INCOME ISSUES

INCOME ISSUES EMERGING FROM ANALYZED CASES	NUMBER OF CASES	PERCENT OF TOTAL
Frivolous Filers/Frivolous Nonfilers	21	15.5%
Indirect Methods of Determining Income by IRS	17	12.6%
Criminal Fraud and Civil Fraud Penalty	14	10.3%
IRA/Retirement Distributions/Social Security Income	9	6.6%
Lawsuit Settlements & Contigent Attorney Fees	8	5.9%
Wage Income	6	4.4%
Unreported/Underreported Gross Receipts	6	4.4%
Gambling Income	5	3.7%
Sham Trusts	5	3.7%
Cancellation of Debt Income	4	2.9%
Lawsuit Settlements (Attorney Fees Not an Issue)	4	2.9%
Constructive Dividend Income	4	2.9%
Capital Gain Income	3	2.2%
Interest Income	3	2.2%
Unemployment Compensation	3	2.2%
Other Miscellaneous Issues	24	17.6%
Total	**136**	**100.0%**

The cases cover a wide range of taxpayers, including individuals, businesses (corporations, partnerships and trusts), and estates. The above table identifies the various categories of income that were determined to be the most significant in each case. However, many cases involved two or more income issues as well as other issues.

Twenty-one of the 136 cases litigated involved frivolous filers and frivolous nonfilers. The cases categorized as "sham trusts" often contained frivolous arguments as well. Tax Court judges have shown little patience for such arguments and often penalize the plaintiffs under IRC section 6673(a)(1). The penalty under this section can be as high as $25,000, in addition to any other penalties that apply in a given case. The court can assert the penalty if the taxpayer does one or more of the following:

- fails to exhaust the available administrative remedies
- raises constitutional issues
- institutes pretrial delays
- litigated the same issues previously
- uses delaying tactics
- takes particular actions that are frivolous or groundless.[30]

The following table indicates the penalties applied under IRC § 6673(a)(1) in the cases litigated for frivolous issues. This illustrates the seriousness with which the Tax Court views what it determines to be frivolous arguments.

TABLE 3.1.2
SANCTIONS AGAINST FRIVOLOUS FILERS & NON-FILERS

TABLE OF SANCTIONS APPLIED

NAME	CITATION	§6673(a)(1) PENALTY AMOUNT
Barmes	T.C. Memo. 2001-155	2,000
Bland-Barclay	T.C. Memo. 2002-20	1,500
Caralan Trust	T.C. Memo. 2001-241	12,500
Carpentier	T.C. Memo. 2002-43	15,000
Combs	T.C. Memo. 2001-264	25,000
Corcoran	T.C. Memo. 2002-18	2,000
Curtis	T.C. Memo. 2001-308	15,000
Funk	T.C. Memo. 2001-291	25,000
Hart	T.C. Memo. 2001-306	15,000
Heisey	T.C. Memo. 2002-41	2,000
Howard	T.C. Memo. 2002-85	7,500
Laidlaw	T.C. Summary Opinion 2001-179	25,000
Madge	T.C. Memo. 2000-370	25,000
Monaghan	T.C. Memo. 2002-16	1,500
Olsen	T.C. Memo. 2001-217	750
Ruocco	T.C. Memo. 2002-91	12,500
Scheckel	T.C. Summary Opinion 2001-84	500
Simanonok	T.C. Memo. 2002-66	5,000
Yacksyzn	T.C. Memo. 2002-99	1,000

[30] IRC § 6673.

In 17 of the 136 cases litigated, the IRS used indirect methods to accurately determine the taxpayer's income. These methods are principally employed when taxpayers keep inadequate books and records that do not clearly reflect their income.[31]

Indirect methods include bank account analysis, source and application of funds, net worth analysis, and cash transaction analysis. For example, in a bank account analysis, all deposits to a taxpayer's various accounts are totaled. The IRS subtracts nontaxable amounts, such as transfers, gifts, redeposits, and reimbursements, and then treats the remainder as the taxpayer's taxable gross income. Indirect methods of determining income are well established and accepted by the courts. In Krist v. Commissioner, a case involving unreported gross receipts, the Court wrote: "Section 6001 imposes a duty on all persons liable for any tax to maintain records. It is well established that where a taxpayer fails to maintain adequate records, the Commissioner may prove the existence and amount of unreported income by any method that will clearly reflect the taxpayer's income."[32]

Fourteen of the cases litigated involved issues of civil or criminal fraud. When a taxpayer is found guilty of criminal fraud, intent to defraud the government by understating income or overstating expenses is typically present. When criminal fraud is tried and proven in the court system, prison sentences or other criminal penalties may be imposed as well as the civil fraud penalty. The burden of proof rests with IRS when asserting the civil fraud penalty. Therefore, the IRS takes a conservative approach when pursuing this penalty.

The remaining litigated cases represent situations in which the taxpayer disagreed with the IRS that the income in question was taxable. These cases involved numerous issues, such as IRA and other retirement distributions, social security income, lawsuit settlements, wage income, unreported or underreported business gross receipts, and other categories of income. See the first table in this section titled "Underreported Income Issues" for a more complete breakdown of the issues.

Pro se plaintiffs are those who forego the option to have counsel represent them in court, and choose to represent themselves. Table 3.1.3 shows the breakdown of *pro se* taxpayers in the cases litigated in this analysis and the outcomes of those cases. *Pro se* litigation is discussed in detail in the Introduction to this section of the report.

[31] IRC § 446(b).

[32] Krist v. Comm'r, T.C. Memo 2001-140, at *13 to *14.

TABLE 3.1.3
PRO SE CASES

MOST LITIGATED ISSUE	TOTAL CASES	PRO SE	NOT PRO SE	DECISION FOR TAXPAYER	DECISION FOR IRS	SPLIT DECISION
Individuals	75	52	23	4	65	6
Businesses	59	37	22	2	36	21
Estates	2	0	2	1	1	0
Total	**136**	**89**	**47**	**7**	**102**	**27**

One significant issue that emerged during this analysis concerns the taxability of attorney fees in cases of nonphysical personal injury. Nonphysical personal injury cases usually involve employment discrimination, race discrimination, sex discrimination, age discrimination, breach of contract, and wrongful termination. Even though only eight cases were litigated in this category, they reveal inconsistent treatment of taxpayers, depending upon where the taxpayer is located and the court in which the case is heard.

If a taxpayer lives in a state under the jurisdiction of the U.S. Court of Appeals for the Fifth, Sixth, or Eleventh Circuits, and wins a settlement in a nonphysical personal injury case, the attorney fee portion of the settlement may be excluded from gross income. However, if the same taxpayer receives a settlement from the same type of lawsuit in a state under the jurisdiction of the U.S. Court of Appeals for the First, Third, Fourth, Seventh, Ninth, Tenth, or Federal Circuits, the attorney fee portion of the settlement must be included in gross income. This means it is possible for the attorney fees and tax burden to consume the majority, or possibly all, of the damages received by the taxpayer.[33] See the legislative recommendation included in the Key Legislative Recommendations section of this report for a more complete analysis of this issue.

CONCLUSION

This analysis identified one issue, the taxability of attorney fees in nonphysical personal injury cases, in which a legislative change could significantly reduce taxpayer burden and promote equity for all taxpayers, regardless of their physical residence. The balance of the litigated cases did not present opportunities to propose legislative or systemic changes. The cases represent a variety of issues with very different sets of facts and circumstances. Many result from honest disagreements with the IRS regarding the taxability of certain kinds of income. Others are the result of taxpayers attempting to delay the inevitable payment of taxes for as long as possible, not necessarily due to frivolous arguments or actions, but because they do not understand the tax law, are not be able to pay the taxes due, have not maintained adequate books and records, or because of other circumstances.

[33] Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, Tax Notes Today, (2001) 126-42.

TABLE 3.1.4
LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Acuncius	T.C. Memo. 2002-21	U.S. Tax Court	Cancellation of debt income	No	Taxpayer
Banaitis	T.C. Memo. 2002-5	U.S. Tax Court	Settlement proceeds, attorney fees	No	IRS
Biehl	118 T.C. 467	U.S. Tax Court	Attorney fee for lawsuit	No	IRS
Bland-Barclay	T.C. Memo. 2002-20	U.S. Tax Court	Wage income	Yes	IRS
Bokman	T.C. Summary Opinion 2001-137	U.S. Tax Court	Sale of residence	Yes	Taxpayer
Bonner	T.C. Summary Opinion 2001-170	U.S. Tax Court	Nonemployee compensation	Yes	IRS
Brickey	289 F.3d 1144	U.S. Court of Appeals 9th Cir.	Illegal income	No	IRS
Broedel	T.C. Memo 2001-135	U.S. Tax Court	Settlement proceeds, loan from retirement fund	Yes	IRS
Bynam	T.C. Memo 2001-142	U.S. Tax Court	Wage income	Yes	IRS
Carpentier	T.C. Memo. 2002-43	U.S. Tax Court	Interest, dividends, rental income	No	IRS
Carver	T.C. Summary Opinion 2001-94	U.S. Tax Court	Gambling winnings	Yes	IRS
Cipriano	T.C. Memo. 2001-157	U.S. Tax Court	Interest income	Yes	IRS
Clayborn	T.C. Summary Opinion 2001-152	U.S. Tax Court	Social Security disability benefits	Yes	IRS
Comey	T.C. Memo. 2001-275	U.S. Tax Court	Income from gain on sale of mutual fund shares, interest, dividends, and capital gains	Yes	IRS
Corcoran	T.C. Memo. 2002-18	U.S. Tax Court	Wage and interest income, unemployment compensation	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Curtis	T.C. Memo. 2001-308	U.S. Tax Court	Wage and rental income	Yes	IRS
Dela Cruz	T.C. Summary Opinion 2001-154	U.S. Tax Court	Social Security disability benefits	Yes	IRS
Dimon	T.C. Memo. 2002-105	U.S. Tax Court	Nonemployee compensation	Yes	IRS
Dirkes	T.C. Memo. 2002-60	U.S. Tax Court	Wage income	Yes	IRS
Ervin	T.C. Memo. 2002-134	U.S. Tax Court	Settlement proceeds, attorney fees	No	Split
Farris	T.C. Summary Opinion 2001-132	U.S. Tax Court	Gambling winnings	Yes	IRS
Favero	T.C. Memo. 2001-219	U.S. Tax Court	Wage income	Yes	IRS
Ferreira	T.C. Summary Opinion 2001-167	U.S. Tax Court	Unemployment compensation	Yes	IRS
Francisco	267 F.3d 303	U.S. Court of Appeals 3d Cir.	Delay damages from settlement	No	IRS
Freeman	T.C. Memo. 2001-254	U.S. Tax Court	Settlement proceeds, attorney fees	No	IRS
Goodchild	T.C. Summary Opinion 2001-102	U.S. Tax Court	Disability benefits	No	IRS
Grace	T.C. Summary Opinion 2002-35	U.S. Tax Court	Workers' compensation benefits	Yes	IRS
Greene	12 Fed. Appx. 606	U.S. Court of Appeals 9th Cir.	Wages and compensation	Yes	IRS
Harris	T.C. Memo. 2001-281	U.S. Tax Court	Unemployment compensation	Yes	IRS
Hart	T.C. Memo. 2001-306	U.S. Tax Court	Wage and interest income, IRA distribution	Yes	IRS
Heisey	T.C. Memo. 2002-41	U.S. Tax Court	Wage income, nonemployee compensation, sale of residence	Yes	IRS
Hendricks	T.C. Memo. 2001-299	U.S. Tax Court	IRA distribution	Yes	IRS
Hernandez	T.C. Summary Opinion 2001-144	U.S. Tax Court	Interest income	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Howard	T.C. Memo. 2002-85	U.S. Tax Court	Wage income	Yes	IRS
Hukkanen-Campbell	274 F.3d 1312	U.S. Court of Appeals 10th Cir.	Settlement proceeds, attorney fees	No	IRS
Huynh	T.C. Summary Opinion 2001-131	U.S. Tax Court	Insurance payments on credit card debt	Yes	IRS
Kenseth	259 F.3d 881	U.S. Court of Appeals 7th Cir.	Settlement proceeds, attorney fees	No	IRS
LeBlanc	T.C. Summary Opinion 2001-92	U.S. Tax Court	Gambling winnings	Yes	IRS
Lehmuth	T.C. Summary Opinion 2001-190	U.S. Tax Court	Settlement proceeds, attorney fees	Yes	Split
Lutz	T.C. Memo. 2002-89	U.S. Tax Court	Gambling winnings	No	Split
Major	T.C. Summary Opinion 2002-36	U.S. Tax Court	Commission income	Yes	IRS
Mangels	T.C. Summary Opinion 2002-40	U.S. Tax Court	Nonemployee compensation, wage and interest income, cancellation of debt income	Yes	IRS
Monaghan	T.C. Memo. 2002-16	U.S. Tax Court	Wage and dividend income, capital gains	Yes	IRS
Norris	T.C. Memo. 2001-152	U.S. Tax Court	Federal Employees Retirement System payments	Yes	IRS
Olsen	T.C. Memo. 2001-217	U.S. Tax Court	Wages and Social Security benefits	Yes	IRS
Parker	13 Fed. Appx. 611	U.S. Court of Appeals 9th Cir.	Sale of residence	No	IRS
Penn	T.C. Memo. 2001-267	U.S. Tax Court	Interest income, social security benefits	Yes	IRS
Price	T.C. Memo. 2001-307	U.S. Tax Court	Wage and other income	Yes	IRS
Quintero	T.C. Summary Opinion 2002-47	U.S. Tax Court	Wage income	No	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Ramey	T.C. Summary Opinion 2001-156	U.S. Tax Court	Settlement proceeds	No	IRS
Reytblatt	T.C. Memo. 2001-209	U.S. Tax Court	Nonemployee compensation, wages, dividend and interest income, income from an annuity	Yes	IRS
Rinehart	T.C. Memo. 2002-71	U.S. Tax Court	Cancellation of debt income	No	Split
Rosario	T.C. Memo. 2002-70	U.S. Tax Court	Guaranteed advance payments	No	Taxpayer
Satrang	T.C. Summary Opinion 2001-140	U.S. Tax Court	Gambling winnings	Yes	IRS
Scheckel	T.C. Summary Opinion 2001-84	U.S. Tax Court	Wages, interest income	Yes	IRS
Shelton	T.C. Summary Opinion 2002-9	U.S. Tax Court	Wage, interest, and rental income	Yes	Split
Simanonok	T.C. Memo. 2002-66	U.S. Tax Court	Military retirement pay, Social Security benefits	Yes	IRS
Smith	T.C. Summary Opinion 2002-33	U.S. Tax Court	Distributions from various employee retirement plans	Yes	IRS
Specking	117 T.C. No. 9	U.S. Tax Court	Wage income	No	IRS
Sykes	T.C. Memo. 2001-169	U.S. Tax Court	Illegal income, cash hoard	Yes	Split
Taken	T.C. Summary Opinion 2001-98	U.S. Tax Court	Wage income, interest income, gambling winnings	Yes	IRS
Tanner	117 T.C. No. 20	U.S. Tax Court	Nonstatutory employee stock option	No	IRS
Timmerman	T.C. Summary Opinion 2002-51	U.S. Tax Court	Distribution from a profit-sharing plan	Yes	IRS
Tinsman	12 Fed. Appx. 431	U.S. Court of Appeals 8th Cir.	IRA distribution, wage income	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Torre	T.C. Memo. 2001-218	U.S. Tax Court	Dividend income	Yes	IRS
Tritz	T.C. Summary Opinion 2001-76	U.S. Tax Court	Income from severance package	Yes	IRS
Tsakopoulos	T.C. Memo. 2002-8	U.S. Tax Court	Cancellation of debt income	No	Taxpayer
Vega	T.C. Summary Opinion 2002-14	U.S. Tax Court	Retirement plan distribution, interest income	Yes	IRS
Webster	T.C. Summary Opinion 2002-43	U.S. Tax Court	Nonemployee compensation, wages, prizes and awards, interest income, IRA distribution	Yes	IRS
Weir	T.C. Memo. 2001-184	U.S. Tax Court	Pension income	No	IRS
Whitehead	T.C. Memo. 2001-317	U.S. Tax Court	Constructive dividends, fringe benefits	No	IRS
Whittaker	T.C. Memo. 2001-224	U.S. Tax Court	Annuity payments from retirement plan	Yes	IRS
Wolgamott	T.C. Memo. 2001-188	U.S. Tax Court	Deferred compensation, unemployment compensation	Yes	IRS
Yacksyzn	T.C. Memo. 2002-99	U.S. Tax Court	Wage income and distributions from various employee retirement plans	Yes	IRS
Zidar	T.C. Memo. 2001-200	U.S. Tax Court	Capital gains from redemption of corporate stock	No	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bacon	88 A.F.T.R. 2d 6396	U.S. Court of Appeals 3d Cir.	Unreported income from corporations	No	IRS
Barmes	T.C. Memo. 2001-155	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Barnard	T.C. Memo. 2001-242	U.S. Tax Court	Schedule C and corporate gross receipts	No	Split
Beck	T.C. Memo. 2001-270	U.S. Tax Court	Constructive dividends	Yes	Split
Bisceglia	T.C. Memo. 2002-22	U.S. Tax Court	Schedule C gross receipts	No	Split
Brodsky	T.C. Memo. 2001-240	U.S. Tax Court	Unreported income	No	Split
Cannon	T.C. Memo. 2001-292	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Caracci	118 T.C. No. 25	U.S. Tax Court	Corporate asset transfers	No	Split
Caralan Trust	T.C. Memo. 2001-241	U.S. Tax Court	Underreported gross income	No	Split
Chama	T.C. Memo. 2001-253	U.S. Tax Court	Distributive share of partnership income.	No	IRS
Chappel	T.C. Memo. 2001-146	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Clark	T.C. Memo. 2001-205	U.S. Tax Court	Schedule C gross receipts, rental income	Yes	IRS
Cohen	T.C. Memo. 2001-249	U.S. Tax Court	Schedule C gross receipts, capital gains	Yes	IRS
Combs	T.C. Memo. 2001-264	U.S. Tax Court	Income diverted to trusts	Yes	IRS
Cordes	T.C. Memo. 2002-124	U.S. Tax Court	Constructive dividends, interest income	No	Split
Coyle/ Regal Mobile Home Sales, Inc.	T.C. Summary Opinion 2002-42	U.S. Tax Court	Gross receipts from sales, commission income, rental/ installment sale income	No	Split
Dang	T.C. Memo. 2002-117	U.S. Tax Court	Gross receipts from Schedule C and partnership	No	Taxpayer
DelVecchio	T.C. Memo. 2001-130	U.S. Tax Court	Schedule C gross receipts, capital gains	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Eddie Cordes, Inc.	T.C. Memo. 2002-125	U.S. Tax Court	Constructive dividends, interest income	No	Split
Framatome Connectors USA, Inc.	118 T.C. No. 3	U.S. Tax Court	Constructive dividends	No	IRS
Funk	T.C. Memo. 2001-291	U.S. Tax Court	Income diverted to trusts	Yes	IRS
Furniss	T.C. Memo. 2001-137	U.S. Tax Court	Commission, wage, and pension income, dividend and interest income, unemployment compensation	Yes	IRS
Gale	T.C. Memo. 2002-54	U.S. Tax Court	Settlement proceeds, attorney fees	Yes	IRS
Glenn	T.C. Summary Opinion 2001-83	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Hadri	T.C. Memo. 2002-77	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Ihlenfeldt	T.C. Memo. 2001-259	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Ishler/20th Century Marketing, Inc.	T.C. Memo. 2002-79	U.S. Tax Court	Constructive dividends, distributive share of S corporation income, commission income	No	IRS
Jones	268 B.R. 865	U.S. Bankruptcy Court, Tampa	Settlement proceeds	No	IRS
Kang/Ngo	T.C. Summary Opinion 2001-97	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Kaufman	T.C. Memo. 2001-161	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Key	T.C. Memo. 2001-166	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Knelman	33 Fed. Appx. 346	U.S. Court of Appeals 9th Cir.	Schedule C gross receipts	Yes	IRS
Krist	T.C. Memo. 2001-140	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Laidlaw	T.C. Summary Opinion 2001-179	U.S. Tax Court	Commission income	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Lobe	T.C. Memo. 2001-204	U.S. Tax Court	Business gross receipts, wages, interest income, nonemployee compensation	Yes	IRS
Madge	23 Fed. Appx. 604	U.S. Court of Appeals 8th Cir.	Business gross receipts	Yes	IRS
Motaghayer	T.C. Summary Opinion 2001-109	U.S. Tax Court	Income from S corporation	Yes	Split
Mueller	T.C. Memo. 2001-178	U.S. Tax Court	Embezzlement income, liquidating dividend, capital gains	Yes	IRS
O'Connell	T.C. Memo. 2001-158	U.S. Tax Court	Corporate distributions	Yes	IRS
Owens	T.C. Memo. 2001-143	U.S. Tax Court	Schedule C gross receipts, insurance proceeds	Yes	IRS
Owens	T.C. Memo. 2001-314	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Pappas	T.C. Memo. 2002-127	U.S. Tax Court	Unreported income from various sources	Yes	Split
Park	T.C. Memo. 2002-50	U.S. Tax Court	Gift income, Schedule C gross receipts	No	Split
Pham	T.C. Memo. 2002-101	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Possas	T.C. Summary Opinion 2002-28	U.S. Tax Court	Schedule C gross receipts	Yes	IRS
Residential Management Services Trust/Carey	T.C. Memo. 2001-297	U.S. Tax Court	Income diverted to a trust, Schedule C gross receipts	Yes	IRS
Ruocco	T.C. Memo. 2002-91	U.S. Tax Court	Schedule C gross receipts	Yes	Split
Sams	T.C. Memo. 2001-293	U.S. Tax Court	Constructive dividends, rental income, corporate gross receipts	No	Split
Smarthealth, Inc.	T.C. Memo. 2001-145	U.S. Tax Court	Customer overpayments	No	Taxpayer
Swain	118 T.C. No. 22	U.S. Tax Court	Income diverted to a trust	Yes	IRS

TABLE 3.1.4 — LITIGATED CASES: UNREPORTED/UNDERREPORTED INCOME *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Textron, Inc.	117 T.C. No. 7	U.S. Tax Court	Subpart F income	No	Split
Tietig	T.C. Memo. 2001-190	U.S. Tax Court	Sale of lots, capital gains, interest income, partnership and S corporation income	Yes	Split
Velasco	T.C. Memo. 2001-252	U.S. Tax Court	Commission income	No	IRS
Wapnick	T.C. Memo. 2002-45	U.S. Tax Court	Unreported income from accounting fees, check cashing, capital gains, interest income	Yes	IRS
Welch	T.C. Memo. 2002-84	U.S. Tax Court	Schedule C gross receipts	No	IRS
Westpac Pacific Foods, Save Mart	T.C. Memo. 2001-175	U.S. Tax Court	Upfront payments received in consideration of entering various purchasing contracts	No	IRS
Wu	T.C. Memo. 2002-68	U.S. Tax Court	Unreported income from computer sales diverted from S corporation	Yes	Split
Zack	291 F.3d 407	U.S. Court of Appeals 6th Cir.	Constructive dividends	No	IRS
Zhadanov	T.C. Memo. 2002-104	U.S. Tax Court	Constructive dividends, Social Security benefits	Yes	Split
Estate/Gift Taxpayers					
Estate of Burris	T.C. Memo. 2001-210	U.S. Tax Court	Life insurance proceeds	No	Taxpayer
Estate of Johnson	T.C. Memo 2001-182	U.S. Tax Court	Schedule C gross receipts, asset transfers, capital gains, Social Security benefits, gambling income	No	IRS

LITIGATED
ISSUE #2

COLLECTION DUE PROCESS (CDP)

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien[34] filed by the IRS or a proposed levy action.[35] The IRS Restructuring and Reform Act of 1998 established the Collection Due Process (CDP) hearing to ensure that lien and/or proposed levy actions are both warranted and procedurally correct.[36]

The IRS mails a certified notice to the taxpayer, giving him or her the opportunity to request a CDP hearing.[37] The taxpayer must return a signed, written request for a hearing within 30 days of the date of notice.[38] Unless the IRS has reason to believe collection of the tax is in jeopardy, the Service will stop levy action during the 30-day period.[39] When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the Appeals Officer will conduct one hearing.[40]

If the taxpayer's appeal is filed on time, the IRS will suspend collection action throughout the process. Internal Revenue Code Section 6330(e)(1) requires the collection statute of limitations to be suspended until the date the appeals determination is final or the taxpayer withdraws the request for a hearing.[41]

The taxpayer may raise one or more of the following issues relating to the unpaid tax:

- Appropriateness of collection actions;
- Collection alternatives such as installment agreement, offer-in-compromise, posting a bond or substitution of other assets;
- Appropriate spousal defenses; and
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.[42]

[34] IRC § 6320.

[35] IRC § 6330.

[36] Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206, Section 3401.

[37] IRC § 6320(a)(2)(C) and IRC § 6330(a)(2)(C). The notice regarding a lien filing is sent after the lien is filed; it is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action; it is required to be sent not less than 30 days before the day of the first levy.

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

[39] IRC § 6330(e)(1).

[40] IRC § 6320(b)(4).

[41] IRC § 6330(e)(1).

[42] IRC § 6330(c)(2).

The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding.[43]

CDP hearings are informal and can be conducted face-to-face, by telephone or by correspondence.[44] The hearing is to be held by an impartial officer from the Appeals unit of the IRS.[45] Within 30 days of the Appeals determination, the taxpayer may petition the appropriate court.[46] The Notice of Determination, which sets forth Appeals' findings and decisions, provides instructions for litigation, including the court of jurisdiction.[47]

The legislative history of the IRS Restructuring and Reform Act of 1998 addresses in detail the standard of review that the Court is to apply in reviewing the Commissioner's administrative determinations. Where the validity of the tax liability was properly at issue in the CDP hearing, the amount of the tax liability will in such cases be reviewed by the appropriate court on a *de novo* basis.[48] [49] Where the validity of the underlying tax liability is not properly at issue, the court will review the Commissioner's administrative determination for abuse of discretion.[50]

ANALYSIS OF LITIGATED CASES

Ninety-six CDP cases were litigated in the federal court system from June 1, 2001 through May 31, 2002. Table 3.2.1 provides a detailed listing of litigated CDP cases. Seventy-seven taxpayers raised issues originating from individual returns, 18 taxpayers raised business tax issues, and one estate case was heard.

The outcomes of these CDP cases are as follows:

- Fifty-one decisions were rendered in favor of IRS,

43 IRC § 6330(c)(4).

44 Treas. Regs. 301.6330-1(d)(2), Q&A-D7

45 IRC §§ 6330(b)(1) and 6330(b)(3).

46 IRC § 6330(d)(1).

47 IRM 8.7.2.3.9(5) states the Tax Court has jurisdiction of CDP cases where the underlying tax liability is the type of liability that is subject to the deficiency procedures (e.g., income, gift, and estate taxes). IRM 8.7.2.3.9(6) states the U.S. District Courts have jurisdiction over CDP cases not within the jurisdiction of the Tax Court, that is, those where the underlying tax liability is not the type of liability subject to the deficiency procedures (e.g., Trust Fund Recovery Penalty, employment taxes, and excise taxes other than those under IRC Chapters 41, 42, 43, and 44).

48 Internal Revenue Service Restructuring and Reform Act of 1998, House Report 105-599, 105th Congress, 1998.

49 "*De novo*" is defined as anew; afresh; a second time. Black's Law Dictionary (6th ed.1990).

50 Abuse of discretion is synonymous with a failure to exercise a sound, reasonable, and legal discretion. It is a strict legal term indicating that appellate court is of opinion that there was commission of an error of law by the trial court. Black's Law Dictionary (6th ed. 1990).

- Thirty-five cases were dismissed,
- Three cases were decided in favor of the taxpayer,
- Three cases resulted in split decisions, and
- Four cases were sent back to IRS Appeals for a hearing.

In one fairly typical case where the IRS prevailed, a taxpayer argued that the IRS Appeals Officer failed to compromise or accept expenses claimed in arriving at a payment schedule. The court found that the Appeals Officer's calculations and disallowance of claimed expenses were reasonable, and that IRS could proceed with its proposed collection action.[51]

In 14 of the 35 cases that were dismissed, the courts found taxpayers failed to state a claim upon which relief could be granted:

- In one case, the taxpayer claimed IRS had "acted improperly in refusing to entertain a settlement…of its proposed tax levy," but provided no specific item of law or regulation in support of this position.[52]
- In another case, the court ruled that the taxpayer failed to raise a spousal defense or challenge to the Commissioner's proposed levy by offering a less intrusive means of collecting the tax. Instead, the court held the taxpayer's complaint contained nothing but frivolous and groundless arguments relating to the Uniform Commercial Code. The taxpayer was deemed to have conceded all issues that were not raised during the CDP hearing or in the court petition.[53]

Six dismissed cases involved late filing:

- One taxpayer claimed it was not clear whether the filing period was counted in calendar days or business days. The court concluded that a timely filed petition must be filed within 30 calendar days and dismissed the case because the taxpayer's petition was filed beyond the filing requirement.[54]
- Another taxpayer claimed his notice of determination after a CDP hearing was delayed because of legal holidays and slow rural mail delivery in a foreign country. The court dismissed the case, noting that the law does not give additional time to file a petition even if the taxpayer is in another country.[55]

[51] Schulman v. Commissioner, T.C. Memo. 2002-129.

[52] Asbury v. Internal Revenue Service, 2002-1 U.S.T.C. 50,117.

[53] Tipp v. Commissioner, T.C. Memo. 2001-272.

[54] Guerrier Jr. v. Commissioner, T.C. Memo. 2002-3.

[55] Sarrell v. Commissioner, 117 T.C. No. 11 (2001). Unlike the notice of deficiency under IRC § 6213(a), the taxpayer in a CDP hearing is not granted extra time to respond when he or she is out of the U.S. at the time of mailing the notice of determination.

The courts decided there was a lack of jurisdiction in thirteen cases:

- The United States Court of Appeals for the Tenth Circuit upheld the District Court's ruling in one particular case. The District Court dismissed this case for lack of jurisdiction because the Tax Court had jurisdiction over the underlying liability at issue, and therefore had exclusive jurisdiction over the appeal of the levy determination.[56]

The courts dismissed two cases because the taxpayers did not comply with court orders:

- The court ordered the taxpayer in one case to obtain legal counsel within 30 days, then dismissed the case because the taxpayer failed to respond or comply with the order.[57]

The courts decided in the taxpayer's favor in three cases:

- A taxpayer was notified that a telephonic hearing was scheduled for January 10, 2001. The Appeals Officer returned a message from the taxpayer (requesting a face-to-face hearing) on January 4, 2001, and informed the taxpayer that the January 4th call would constitute his CDP hearing. The court ruled that an unscheduled telephone call does not constitute a hearing.[58]
- A taxpayer requested a CDP hearing because of the IRS' intent to levy. The IRS filed a motion to dismiss the taxpayer's petition seeking a review of determination to levy, claiming the court lacked jurisdiction because the lien was filed prior to the effective date of RRA '98, even though the notice of intent to levy was issued after this date. The court dismissed the IRS' motion and held that the taxpayer was entitled to a due process hearing because the lien and levy constitute two separate collection actions.[59]

Split decisions occurred in three cases. In two of them, the IRS prevailed on the CDP issue, but the taxpayers prevailed when IRS requested they be penalized for bringing frivolous or groundless actions. The courts concluded the penalties were not appropriate.[60]

Four cases were sent back to Appeals for a CDP hearing. In one case, IRS could not prove the taxpayer had received a notice of proposed liability. Thus, the court gave the taxpayer an opportunity to challenge the merits of the underlying tax liability.[61]

[56] Glass v. Internal Revenue Service, 21 Fed. Appx. 870 (2001).

[57] Safe-Watch 24 Security Inc. v. Internal Revenue Service, 2002 U.S. Dist LEXIS 2981.

[58] Montijo v. United States, 2002 US Dist. LEXIS 9602.

[59] Parker v. Commissioner, 117 T.C. 63 (2001).

[60] Service Engineering Trust v. Commissioner, T.C. Memo. 2001-181, McMahan v. Commissioner, T.C. Memo. 2001-191.

[61] Herycyk v. United States, 89 A.F.T.R. 2d 1584 (2001).

Analysis of the litigated cases identified several procedural issues:

- A taxpayer was denied a hearing due to a heavy workload at the IRS. The court remanded the case back to Appeals for a hearing.[62]
- IRS filed a motion for a summary judgment for improper service. The court ruled that improper service does not require that the case be dismissed.[63]
- The court ruled Form 12153 (Request for a Collection Due Process Hearing) is not necessary for the IRS to provide a CDP hearing and the request may be submitted on any document.[64]
- Although in one case, the majority of the court ruled in favor of IRS, six judges dissented regarding the issue of "what constitutes a hearing." The taxpayers contended they were not afforded a face-to-face hearing and their hearing was conducted by correspondence. The dissenting judges felt that the court should have addressed this issue and stated that it was the intent of Congress that a face-to-face hearing would occur.[65]
- The taxpayer claimed that he was not provided verification of the validity of the assessments. The Appeals Officer did not provide the taxpayer with a copy of the transcript prior to the hearing. The majority of the court ruled in favor of the IRS and determined that the requirements under IRC § 6330(c)(1) were met. Two judges dissented and found the IRS failed to provide the taxpayer with proof of assessments and did not allow the taxpayer to discuss the validity of the assessments.[66]
- A revenue agent instead of an Appeals Officer held a CDP hearing, contrary to the requirements of the regulations. Despite the error, the taxpayer did not raise this issue in his petition. As a result, the court declined to consider this issue on the grounds that any allegations of error must be set forth in the petition.[67]

Seventy percent of the litigated CDP cases were *pro se*. Of the ten taxpayers who won their cases, received split decisions, or had their cases sent back to Appeals for a CDP hearing, counsel represented seven.

[62] Ahee v. United States, 89 A.F.T.R. 2d 1247 (2001).

[63] Brantley v. District Director, 2002-1 U.S.T.C. 50,251.

[64] Brantley v. District Director, 2002-1 U.S.T.C. 50,251.

[65] Lunsford v. Commissioner, 117 T.C. 183 (2001).

[66] Nestor v. Commissioner, 118 T.C. 162 (2002).

[67] Strickland v. Commissioner, T.C. Memo. 2001-312.

CONCLUSION

The CDP provisions of the IRS Restructuring and Reform Act of 1998 have had a major impact on taxpayers, their representatives, the IRS, and the federal courts. As all the participants continue to chart their way through this process, problems will arise which may require administrative or legislative modifications.

One such problem frequently raised by the IRS is abuse of the CDP process by taxpayers who submit frivolous arguments and documents. This analysis of litigated cases did uncover evidence of such abuse, as noted in cases where the courts identified the arguments as frivolous, upheld the assertion of frivolous return penalties, and/or imposed sanctions. To address this problem, pending legislation proposes to increase the frivolous submission penalty from $500 to $5,000, and allow the IRS to return those submissions without further consideration.[68]

While there is a need to remedy the problem, this solution raises some concerns:

- Who will be empowered to determine whether submissions are frivolous?
- Will there be an independent review of these determinations?
- Will submissions that raise both significant procedural issues as well as frivolous grounds survive this process?
- Will the IRS be diligent in correcting a “frivolous” designation erroneously placed on the database?

The examination of litigated cases revealed that the courts have ruled on significant procedural issues, even in cases where the taxpayer has raised frivolous arguments.[69] Two significant examples of these rulings are (1) that a CDP request can be submitted on any document,[70] and (2) an unscheduled telephone call does not constitute a hearing.[71]

The court also ruled in another case that filing a notice of tax lien constitutes a collection action.[72] This raises the question of whether the IRS should modify its current practice of filing liens when collection actions are prohibited (e.g., filing a Notice of Federal Tax Lien after an offer-in-compromise has been submitted).

[68] Tax Relief Guarantee Act of 2002, H.R. 586, Section 217.

[69] Fifty-one of the litigated cases raised frivolous arguments; four of these cases resulted in the courts ruling on procedural issues.

[70] Brantley v. District Director, 2002-1 U.S.T.C. 50,251.

[71] Montijo v. United States, 2002 U.S. Dist. LEXIS 9602.

[72] Parker v. Commissioner, 117 T.C. 63 (2001).

The issue of *pro se* representation illustrates the benefit of taxpayers having counsel. Those who hire outside representation succeed more often than those who do not. Increased participation by *pro bono* counsel and Low Income Taxpayer Clinics should raise the level of representation in court, thereby improving the taxpayer's position.

The Office of the Taxpayer Advocate will continue to study CDP issues as an on-going advocacy project. We will continue to review litigated cases to identify trends, and to assist in improving this vital arena for taxpayer rights. Our focus and concerns are:

- What should constitute a CDP hearing?
- Is the CDP process being abused? If so, is IRS overcorrecting for that abuse?
- When taxpayers need a hearing, can they obtain one? Or are they sometimes persuaded to settle prematurely, without complete resolution of the case?

TABLE 3.2.1
LITIGATED CASES: COLLECTION DUE PROCESS

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Issues Other Than Business Issues) *Note: If sufficient information to identify the issue was not available in the court case, it was placed in this category.*					
Strickland	T.C. Memo. 2001-312	Tax Court	Levy	Yes	IRS
Smith	T.C. Memo. 2002-59	Tax Court	Levy	Yes	IRS
Mann	T.C. Memo. 2002-48	Tax Court	Levy	No	IRS
Kuglin	T.C. Memo. 2002-51	Tax Court	Lien and Levy	No	IRS
Duffield	T.C. Memo. 2002-53	Tax Court	Levy	No	IRS
Guerrier Jr.	T.C. Memo. 2002-3	Tax Court	Levy	Yes	Dismissed
Gunderson	T.C. Memo. 2002-26	Tax Court	Lien and Levy	Yes	IRS
Aguirre	117 T.C. 324 (2001)	Tax Court	Lien and Levy	Yes	IRS
Ahee	89 A.F.T.R. 2d 1247 (2001)	District Court for Nev.	Levy	Yes	Sent back to Appeals
Asbury	2002-1 U.S.T.C. 50,117	Western District of Pa.	Lien	No	Dismissed
Bartschi	2001-2 U.S.T.C. 50,672	District Court for Az.	Levy	Yes	Dismissed
Brantley	2002-1 U.S.T.C. 50,251	Middle District of Fla.	Lien	Yes	Dismissed
Coleman	T.C. Memo. 2002-132	Tax Court for Nev.	Levy	Yes	IRS

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Danner	208 F. Supp. 2d. 1166 (2002)	Eastern District of Wash.	Levy	Yes	Dismissed
Frain	2002-2 U.S.T.C. 50,553	District Court for NJ	Levy	No	IRS
Geller	2001-2 U.S.T.C. 50,703	Southern District of Ohio	Levy	Yes	Dismissed
Glass	21 Fed. Appx. 870 (2001)	10th Circuit	Levy	Yes	Dismissed
Hoffman	209 F. Supp. 2d. 1089 (2002)	Western District of Wash.	Levy	Yes	Dismissed
Holliday	T.C. Memo. 2002-67	Tax Court	Lien and Levy	Yes	IRS
Johnson	89 A.F.T.R. 2d. 2018 (2001)	Northern District of Utah	Levy	Yes	Dismissed
Kelly	209 F. Supp. 2d. 981 (2002)	Eastern District of Mo.	Levy	Yes	IRS
Kintzler	2001-2 U.S.T.C. 50,696	District Court	Levy	Yes	Dismissed
Klawonn	T.C. Memo. 2002-27	Tax Court	Levy	Yes	IRS
MacLeod	2001-2 U.S.T.C. 50,699	Southern District of Ca.	Levy	Yes	Dismissed
Magana	118 T.C. No. 30	Tax Court	Lien and Levy	No	IRS
Newman	T.C. Memo. 2002-135	Tax Court	Lien and Levy	Yes	IRS
Reinhart	2002 U.S. Dist. Lexis 13741	Eastern District of Ca.	Levy	Yes	IRS
Remole	2002-1 U.S.T.C. 50,224	Central District of Illinois	Levy	No	IRS
Rennie	2001 U.S. Dist. LEXIS 18954	Eastern District of Ca.	Levy	Yes	Sent back to Appeals
Sarrell	117 T.C. No. 11 (2001)	Tax Court	Lien and Levy	Yes	Dismissed
Schulman	T.C. Memo. 2002-129	Tax Court	Levy	Yes	IRS
Roberts	118 T.C. 365 (2002)	Tax Court	Levy	Yes	IRS
Hurford	T.C. Memo. 2002-94	Tax Court	Lien and Levy	Yes	IRS
Nicklaus	117 T.C. No. 10 (2001)	Tax Court	Lien	Yes	IRS
Tolotti	T.C. Memo. 2002-86	Tax Court	Lien	Yes	IRS
Boyd	117 T.C. No. 12 (2001)	Tax Court	Levy	Yes	IRS
Chase	T.C. Memo. 2002-93	Tax Court	Levy	Yes	IRS

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Downing	118 T.C. 22 (2002)	Tax Court	Levy	Yes	IRS
Harris	T.C. Memo. 2002-75	Tax Court	Levy	Yes	IRS
Hart	2001-2 U.S.T.C. 50,641	3RD Cir.	Levy	Yes	Dismissed
Howard	T.C. Memo. 2002-81	Tax Court	Levy	Yes	IRS
Jackson	T.C. Memo. 2002-100	Tax Court	Levy	No	Dismissed
Johnson	117 T.C. 202 (2001)	Tax Court	Levy	Yes	Dismissed
Joye	T.C. Memo. 2002-14	Tax Court	Levy	Yes	IRS
Kaeckell	T.C. Memo. 2002-114	Tax Court	Levy	Yes	IRS
Lindsey	T.C. Memo. 2002-87	Tax Court	Levy	Yes	IRS
Lunsford	117 T.C. 159 (2001)	Tax Court	Levy	No	IRS
Lunsford	117 T.C. 183 (2001)	Tax Court	Levy	No	IRS
Nestor	118 T.C. 162 (2002)	Tax Court	Levy	Yes	IRS
Ogden	T.C. Memo. 2002-15	Tax Court	Levy	Yes	Dismissed
Vossbrinck	T.C. Memo. 2002-96	Tax Court	Levy	Yes	IRS
Weishan	T.C. Memo. 2002-88	Tax Court	Levy	Yes	IRS
Whitfield	T.C. Summary Opinion 2002-38	Tax Court	Levy	Yes	IRS
Williams	T.C. Memo. 2002-111	Tax Court	Levy	Yes	IRS
Yacksyzn	T.C. Memo. 2002-99	Tax Court	Levy	Yes	IRS
Barker	T.C. Memo. 2002-13	Tax Court	Levy	Yes	IRS
Parker	117 T.C. 63 (2001)	Tax Court	Lien and Levy	No	Taxpayer
Adams	2002-1 U.S.T.C. 50,295	District Court for Nev.	Lien and Levy	Yes	Dismissed
McNeil	2002-1 U.S.T.C. 50,415	Western District of Mich.	Levy	Yes	Dismissed
Tornichio	2002-1 U.S.T.C. 50,411	Northern District of Ohio	Levy	Yes	Dismissed
McIntosh	2002-1 U.S.T.C. 50,204	Southern District of Ohio	Levy	Yes	Dismissed
Stanifird	2001-2 U.S.T.C. 50,492	District Court for Az.	Levy	Yes	IRS
Hickey	2002-1 U.S.T.C. 50,294	District Court for Nev.	Levy	Yes	Dismissed
Montijo	2002 US Dist. Lexis 9602	District Court for Nev.	Lien	Yes	Taxpayer

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Van Gaasbeck	2002-1 U.S.T.C. 50,309	District Court for Nev.	Levy	Yes	Dismissed
Walz	2002-1 U.S.T.C. 50,377	District Court for Minn.	Levy	Yes	Dismissed
Hart	2002-1 U.S.T.C. 50,460	Northern District of Ohio	Levy	Yes	Dismissed
Baxter	T.C. Memo. 2001-300	Tax Court	Lien and Levy	Yes	Dismissed
Lindsay	T.C. Memo. 2001-285	Tax Court	Lien	Yes	IRS
Lopez	T.C. Memo. 2001-228	Tax Court	Lien and Levy	Yes	Dismissed
McMahan	T.C. Memo. 2001-191	Tax Court	Levy	No	Split
Obersteller	T.C. Memo. 2002-106	Tax Court	Lien and Levy	Yes	IRS
Tipp	T.C. Memo. 2001-272	Tax Court	Lien and Levy	Yes	Dismissed
Tkac	T.C. Summary Opinion 2001-175	Tax Court	Lien and Levy	Yes	Dismissed
Watson	T.C. Memo. 2001-213	Tax Court	Lien and Levy	Yes	IRS
Moore	T.C. Memo. 2001-305	Tax Court	Lien and Levy	No	IRS

Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Dogwood Forest Rest Home Inc.	181 F. Supp. 2d. 554 (2001)	Middle District of N.C.	Levy	No	IRS
Evergreen Resources Inc.	2002-1 U.S.T.C. 50,422	Eastern District of Ca.	Lien and Levy	No	Dismissed
Jon H. Berkey,	PC 2001-2 U.S.T.C. 50,708	Eastern District of Mich.	Levy	No	IRS
Barnhill	T.C. Memo. 2002-116	Tax Court	Levy	Yes	IRS
Herycyk	89 A.F.T.R. 2d 1584 (2001)	Northern District of Ohio	Lien and Levy	No	Sent back to Appeals
Pikover	2001-2 U.S.T.C. 50,702	Central District of Ca.	Lien	No	IRS
Bonfante	2002-1 U.S.T.C. 50,266	Southern District of Ohio	Levy	No	Dismissed
Thomson	2001-2 U.S.T.C. 50,614	Southern District of Fla.	Lien	No	Dismissed
The Inner Office Inc.	89 A.F.T.R. 2d 1311 (2002)	Northern District of Tx.	Levy	No	Dismissed

TABLE 3.2.1 — LITIGATED CASES: COLLECTION DUE PROCESS *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
CPS Elect. Ltd	200 F. Supp. 2d 120 (2002)	Northern District of N.Y.	Lien and Levy	No	IRS
Driver Logistics Service	197 F. Supp. 2d 1346 (2002)	Middle District of Fla.	Levy	No	Split
Lee	2002-1 U.S.T.C. 50,365	Middle District of Tenn.	Lien and Levy	Yes	Dismissed
Compucel Service Corporation	2002-1 U.S.T.C. 50,284	District Court for Md.	Levy	No	IRS
Dami	2002-1 U.S.T.C. 50,433	Western District of Pa.	Lien and Levy	No	IRS
Logical Marketing Inc	2002 US Dist. LEXIS 7516	Northern District of Ca.	Levy	No	Sent back to Appeals
Safe-Watch 24 Security Inc	2002 US Dist. LEXIS 2981	Northern District of Ga.	Lien and Levy	Yes	Dismissed
Sillavan	2002-1 U.S.T.C. 50,236	Northern District of Ala.	Levy	No	Dismissed
Wald	2002-1 U.S.T.C. 50,278	Southern District of Fla.	Levy	Yes	Dismissed
Service Engineering Trust	T.C. Memo. 2001-181	Tax Court	Lien and Levy	No	Split

Estate/Gift Taxpayers

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Estate of Doster	T.C.Memo. 2002-2	Tax Court	Lien and Levy	No	IRS

LITIGATED ISSUE #3 TRADE OR BUSINESS EXPENSES

PRESENT LAW

Internal Revenue Code section 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.[73]

These expenses include:

- Reasonable allowance for salaries or other compensation for personal services actually rendered;
- Travel expenses while away from home in the pursuit of a trade or business; and
- Rentals or other payments for use of property in a trade or business.[74]

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and non-deductible expenses incurred in carrying on a trade or business (e.g. fines and penalties; state legislators' travel expenses away from home; and special rules for health insurance costs of self-employed individuals).[75]

Deductions for ordinary and necessary expenses incurred in carrying on a trade or business are closely related to a larger group of statutory provisions[76] that allow taxpayers to deduct business and profit-oriented expenditures at some time during the life of the enterprise – when the cost is paid or incurred, over an asset's useful life, when it is sold, or when the business venture is terminated.[77] Internal Revenue Code section 162 is one of the Code's most basic provisions, but it becomes considerably more complex when applied in conjunction with other sections. In effect, some code sections specifically limit or disallow deductions permitted under section 162's broad grant.

Rules regarding the practical application of IRC § 162 have evolved largely from the vast body of case law and administrative guidance (e.g., rulings and revenue procedures) that have developed over the years. The IRS, Congress and courts continue to pose questions and provide legal guidelines about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report reveal this process is ongoing. When a taxpayer seeks a redetermination of tax liability because the IRS has disallowed trade or business expenses, the courts must often address a series of questions before issuing decisions, including those discussed below.

[73] IRC § 446. The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting.

[74] IRC § 162 (a)(1), (2), and (3).

[75] IRC § 162(f), (h), and (l).

[76] Itemized Deductions for Individuals and Corporations (e.g., IRC § 165 losses, IRC § 167 depreciation, and IRC § 183 activities not engaged in for profit) and inventories (IRC § 471, cost of goods sold).

[77] Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates And Gift*s ¶ 20.1.1 (3rd ed. 1999)

What constitutes a trade or business as referenced in IRC § 162?

"Trade or Business" is one of the most widely used terms in the Internal Revenue Code, but no definition appears in the Code or in any Treasury Regulation.[78] In *Commissioner v. Groetzinger*, Justice Blackmun wrote "…the Code has never contained a definition of the words 'trade or business' for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged."[79] The definition of "trade or business" comes from the so-called common law of federal income tax, concepts developed or defined by court decisions.[80]

In 1987, the IRS challenged the decision of the United States Courts of Appeals for the Seventh Circuit, which affirmed the Tax Court's ruling that the taxpayer, a full-time gambler, was engaged in a trade or business as defined by IRC § 162(a) and § 62(1).[81] In the case at issue, *Commissioner v. Groetzinger*, the Supreme Court held "…that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify." In the end, the Supreme Court admitted adherence to the general position of the Court's holding in *Higgins v. Commissioner*, that whether a taxpayer is engaged in a trade or business depends on the fact of each case.[82]

In reaching its decision in *Groetzinger*, the Supreme Court examined a number of significant cases and noted the cases produced results but no clear guidance in deciding what is a trade or business.[83] Justice Blackmun wrote, "The issue in this case has 'been around' for a long time and, as indicated above, has not met with consistent treatment in the Tax Court itself or in the Federal Courts of Appeals."[84]

What is an ordinary and necessary expense?

Ordinary and necessary business expenses are current business expenses that are paid or incurred during the taxable year and are fully deductible, as opposed to unreasonable expenses and capital expenditures. A current business expense must be both ordinary and

[78] F. Ladson Boyle, *What is a Trade or Business*, 39 Tax Law. 737 (1986). The term "trade or business" appeared in at least 492 subsections of the Code and 664 provisions of the regulations.

[79] 480 U.S. 23, 27 (1987).

[80] Carol Duane Olson, *Toward A Neutral Definition of "Trade or Business" In The Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

[81] As defined by the Internal Revenue Code of 1954 as it existed in 1987, the tax year at issue.

[82] 312 U.S. 212 (1941).

[83] E.g., Flint v. Stone Tracy Co. 220 U.S. 107 (1911); Deputy v. DuPont, 308 U.S. 488 (1940); Higgins v. Commissioner, 312 U.S. 212 (1941).

[84] 480 U.S. 23, 32-33 (1987).

necessary in relation to the taxpayer's trade or business.[85] In *Welch v. Helvering*,[86] Justice Cardozo emphasized the difference between "ordinary" and "necessary" and the need to satisfy both in order to achieve the deduction. In *Deputy v. du Pont*, the Supreme Court held that an expense is considered ordinary if it is customary or usual and is of common occurrence in the taxpayer's business.[87] An expense is considered necessary if it is appropriate and helpful for the development of taxpayer's business.

In addition to being ordinary and necessary, the courts have held that the amount of the expense must be reasonable. In *Commissioner v. Lincoln Electric Co.*, the Court of Appeals for the Sixth Circuit held "…the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."[88] Specific statutory language provides that salaries or other compensation for personal services actually rendered must be reasonable, and travel expenses incurred while away from home in pursuit of trade or business must not be lavish or extravagant.[89]

Is the expense a currently deductible expense or capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in carrying on a trade or business.[90] Examples of currently deductible expenses are management expenses, labor, supplies, incidental repairs, operating expenses of automobiles used in trade or business and traveling expenses while away from home solely in pursuit of trade or business.[91]

A capital expenditure is the amount paid for a new building or for permanent improvements that increase value or lengthen useful life, subject to certain exceptions.[92] As such, no deductions are allowed for cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.[93] Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property. Determining whether expenditures are deductible under IRC § 162(a) or must be capitalized under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach in applying principles of capitalization and deductibility.

[85] IRC § 162 (a).

[86] 290 U.S. 111 (1933); *see also* Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345 (1971).

[87] 308 U.S. 488, 495 (1940); *see also* Commissioner v. Tellier, 383 U.S. 687, 698 (1966).

[88] 176 F.2d 815, 817 (6th Cir. 1949).

[89] IRC § 162(a)(1) and (2).

[90] IRC § 162(a).

[91] *See* Treas. Reg. § 1.162-1 for a more complete list.

[92] IRC § 263.

[93] IRC § 263(a); Treas. Reg.§ 1.263 (a)-2.

In *Commissioner v. Lincoln Savings and Loan Association*, the IRS sought review of a decision of the United States Court of Appeals for the Ninth Circuit holding that the taxpayer's statutorily mandated payment to the Federal Savings and Loan Insurance Corporation (FSLIC) was a deductible capital expenditure and ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954. The Supreme Court held the payment served to create a separate and distinct additional asset for the taxpayer. Thus, the payment was capital in nature and not an ordinary and necessary expense.[94]

In *INDOPCO Inc., v. Commissioner*, the taxpayer sought review of a decision of the United States Court of Appeals for the Third Circuit, which affirmed the United States Tax Court's holding that certain legal and professional expenses incurred by the taxpayer as part of a friendly takeover by another corporation were capital expenditures and not currently deductible business expenses under IRC § 162(a). The Supreme Court affirmed the lower courts' decision that the takeover resulted in long-term, future benefits for the taxpayer. It rejected the taxpayer's argument that because the expenses did not create a separate and distinct additional asset they could not be capitalized under section 263 of the Code.[95] In response to the taxpayer's argument, the Court clarified its holding in *Lincoln*, "*Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that 'serves to create or enhance…a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under IRC § 263."[96]

Can the taxpayer substantiate that the expense was paid or incurred during the taxable year?

Present law requires a taxpayer to maintain books and records that substantiate income, deductions and credits.[97] A taxpayer must keep adequate records to substantiate deductions claimed as trade or business expenses.[98] If a taxpayer is unable to substantiate deductions by documentary evidence (e.g. invoice, paid bill, or canceled check) but can establish that he had some deductible business expenditures, the *Cohan Rule* may apply.

The *Cohan* rule is a rule of "indulgence" that was established by the United States Court of Appeals for the Second Circuit in its decision in Cohan v. Commissioner.[99] The Court of Appeals held "…the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to

[94] 403 U.S. 345 (1971).

[95] 503 U.S. 79 (1992).

[96] 503 U.S. 79, 86-87 (1992).

[97] IRC § 6001; Treas. Reg. § 1.446-1(a)(4).

[98] IRC § 6001; Treas. Reg. § 1.6001-1(a), (e).

[99] 11 BTA 743 (1928), aff'd and rev'd, 39 F.2d 540, 543-544 (2d Cir. 1930).

allow nothing at all appears to us inconsistent with saying that something was spent."[100] A taxpayer can argue entitlement to deduct business expenses under the *Cohan* rule but if he is unable to establish a reasonable basis for the expense, the Court is not compelled to follow the rule.

In *Williams v. Commissioner*, the United States Court of Appeals for the Fifth Circuit held "For the basic requirement is that there be sufficient evidence to satisfy the trier that at least the amount allowed in the estimate was in fact spent or incurred for the stated purpose. Until the trier has that assurance from the record, relief to the taxpayer would be unguided largesse."[101]

In the event that the IRS has applied the *Cohan* rule in determining a deficiency amount, the taxpayer bears the burden of proving entitlement to a larger deduction. The courts have stated on numerous occasions that trade and business deductions are a matter of legislative grace and a taxpayer bears the burden of proving entitlement to any deduction claimed.[102]

In certain instances, Congress has required specific and exact substantiation of expenses. For example, IRC § 274(d) requires strict substantiation of expenses for travel, meals and entertainment, and gifts, with respect to any listed property as defined in IRC § 280F(d)(4). Listed property includes any passenger automobile or other means of transportation.[103] A taxpayer is required to substantiate a claimed IRC § 274(d) expense by adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, and place and business purpose of the expense. Even if such an expense would otherwise be deductible, the deduction may still be denied if there is insufficient substantiation to support it.[104]

Who has the burden of proof in a substantiation case?

When the Commissioner of Internal Revenue issues a notice of proposed deficiency to a taxpayer, it is presumed to be correct, and the burden is on the taxpayer to show that the proposed determination is incorrect. However, under certain circumstances, the burden of proof shifts to the Commissioner.[105]

Internal Revenue Code section 7491, Burden of Proof, was enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998).[106] Under the provi-

[100] 39 F. 2d 540, 544 (2d Cir. 1930).

[101] 245 F.2d 559 (5th Cir. 1957).

[102] INDOPCO, Inc. v. Commissioner, 503 U.S.79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

[103] IRC § 280F(d)(4)(A)(i) & (ii).

[104] Treas. Reg. § 1.274-5T.

[105] IRC § 6663, Civil fraud is an exception to the Commissioner's presumed correctness. The burden of proof has to be carried by clear and convincing evidence. See IRC § 7454 and United States Tax Court Rule 142(a).

[106] Pub. L. No. 105-206, § 3001(a) & (c)(1) (1998), 112 Stat. 685, 726, 727.

sions of IRC § 7491(a)(1), if, in any court proceeding, a taxpayer introduces credible evidence with respect to his tax liability the burden may shift to the Commissioner of Internal Revenue.[107] To shift the burden to the Commissioner, a taxpayer must meet these three requirements:[108]

1. Taxpayer must comply with all substantiation and record keeping requirements in accordance with the applicable Internal Revenue Code section.
2. Taxpayer must cooperate with requests for witnesses, documents, meetings and interviews.
3. Finally, if the taxpayer is a partnership, corporation or trust, that taxpayer must meet the net worth requirements (less than $7 million) of IRC § 7430(c)(4)(A)(ii).

ANALYSIS OF LITIGATED CASES

Trade or Business Expenses is listed as one of the top ten issues identified by the IRS in audits[109] for the fiscal years 1998, 1999 and 2000, and one of the top ten Appeals issues in Coordinated Examination Program (CEP) audits by dollar amounts and number of cases.[110] Prior editions of the National Taxpayer Advocate's Annual Report to Congress have identified Trade or Business Expenses as one of the issues most litigated by taxpayers.

Ninety-five cases involving trade or business expense issues were identified and selected for review for this year's report.[111] Deduction of allowable expenses under IRC § 162(a) and subject to the strict substantiation of IRC § 274(d) is the top litigated issue for individual taxpayers, especially *pro se* taxpayers.[112] The top litigated issues for business taxpayers are deduction of current expenses under IRC § 162(a) versus capitalizing expenditures under IRC § 263(a) and deduction of expenses for reasonable allowance for salaries or other compensation for personal services actually rendered (IRC § 162(a)(1)).

[107] IRC § 7491(a)(1) applies to court proceedings in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

[108] IRC § 7491(a)(2)(A) & (a)(2)(B), & (a)(2)(C).

[109] Joint Committee Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; GAO-01 301R Information on Federal Tax System C-115 (April 2001). Identifies audit sources as Coordinated Examination Program (CEP) audits, non-CEP audits, district office audits and service center audits for individuals, corporate, fiduciary, estate, and other returns.

[110] Joint Committee Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; GAO-01 301R Information on Federal Tax System C-115 TO C-125 (April 2001).

[111] Individual taxpayers include sole proprietor and the self-employed. Business taxpayers include corporations, trust and partnerships.

[112] Parties who represent themselves in a court proceeding without the assistance of a lawyer are called Pro se. The right to self-representation comes from the Latin words: "Pro se" which means "For oneself; on one's own behalf; without a lawyer." Black's Law Dictionary (7th ed. 1999), at 1236-1237.

TABLE 3.3.1
TRADE OR BUSINESS EXPENSE ISSUES LITIGATED

ISSUE AND NUMBER OF CASES	TAXPAYER		
	INDIVIDUAL	BUSINESS	ESTATE
Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d) (30 cases)	30		
Carrying on a trade or business and entitled to deductions (12 cases)	11	1	
Current expenses ordinary and necessary in trade or business (10 cases)	10		
Deduction of expense and Substantiation and application of the *Cohan* Rule (10 cases)	9		1
IRC § 162(a) and other applicable IRC sections (9 cases)	8	1	
Deduction and substantiation of Traveling expenses while away from home in pursuit of trade or business (3 cases)	3		
Current Deductible Business Expense v. Capital Expenditure IRC § 162(a) v. § 263(a) (8 cases)	2	6	
Deduction of punitive fine or penalties disallowed per IRC § 162(f) (2 cases)	1	1	
Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1) (6 cases)		6	
Deduction of expense treated as compensation per IRC § 162(a)(1) and limitations of IRC § 274(a) (3 cases)		3	
Refund Suit for employment taxes related to Claimed Business Expenses (1 case)		1	
Deduction of rent or other payments for property in use of trade or business IRC § 162(a)(3) (1 case)		1	
Total	**74**	**20**	**1**

Eighty-seven percent of the cases were filed in United States Tax Court. The courts ruled in favor of the IRS in 70 of the 95 cases, with the appeals courts deciding in favor of the IRS in seven out of nine cases. Individual taxpayers were not successful as a category of litigants. The courts decided in favor of two individual taxpayers and issued split decisions in 13 cases.

TABLE 3.3.2
COURT DECISIONS

TYPE OF TAXPAYER	IRS	TAXPAYER	SPLIT
Individual	59	2	13
Business	10	9	1
Estate	1	0	0
Total	**70**	**11**	**14**

Individual Taxpayers

This group of individual taxpayers presented little or no evidence to support their claimed deductions, did not give credible testimony, and often lacked knowledge of tax law. In most cases, the taxpayer appeared ignorant of the strict substantiation requirements for business and trade expenses, and that without substantial proof, the courts could not overcome the strictures of IRC § 274(d).

In *Xuncax v. Commissioner*, the Tax Court wrote:

> "First, the record is entirely devoid of anything which could corroborate the self-serving averments that cash payments were in fact made during the year at issue. Second, even if we were willing to accept that cash had been remitted, the record provides no basis for a reasonable estimate of the deductible amount. The oral testimony contains no numerical information whatsoever, as to either the number or the amount of payments, and the written statement is both ambiguous and so blatantly conjectural as to be almost useless for estimation purposes."[113]

The number of adverse decisions in individual taxpayer cases raised the following questions:

- Why is deduction of trade or business expenses one of the ten most litigated tax issues in federal court?
- More specifically, why is the trade or business expense deduction in accordance with IRC § 162 and § 274(d) one of the ten most litigated issues by *pro se* taxpayers, despite the strict substantiation requirements set forth by law?

[113] Xuncax v. Commissioner, T.C. Memo 2001-226, * 15-16.

A detailed analysis of 30 of the original 95 cases was conducted to identify factors, if not answers, to these questions. *Pro se* taxpayers filed 28 of the 30 petitions in the Tax Court cases. The court ruled in favor of one *pro se* taxpayer, issued split decisions in eight cases and ruled against twenty-one *pro se* taxpayers. Fourteen cases were filed under regular procedures and sixteen were filed under the small tax case procedures.[114] Overall, the Tax Court accommodated *pro se* taxpayers, especially those who filed their cases under small tax case procedure. The small tax case procedures are heard and decided by special trial judges, do not require briefs or oral arguments, and operate informally. However, a major drawback, especially for *pro se* taxpayers, is that the court's decision in small tax cases cannot be appealed.

Individual taxpayers routinely claimed expenses for cars and transportation without possessing understanding or knowledge of the substantiation requirements under IRC § 274(d). Many of these litigants, *pro se* taxpayers, could not meet that burden.[115]

In *Newhouse v. Commissioner*, the Court noted: "When petitioner was questioned about the existence of substantiation for his business expenses, specifically the automobile expenses, he replied: 'I have found it to be not financially worthwhile to complete detailed logs of things.' He added that 'I don't have any detailed records with me at this time.'"[116]

In some cases, the Tax Court did not allow *pro se* taxpayers trade or business deductions in excess of those allowed by the Commissioner, absent documentation. In *Franklin v. Commissioner*, the Tax Court wrote:

> At trial petitioner presented no documentary evidence to support his claims for deductions in excess of the amounts allowed by respondent. Petitioner argued that he had records to substantiate amounts that would exceed those allowed by respondent; however, his records were 'scattered' in several places, and, with sufficient time he could produce the records that would establish his entitlement to additional deductions.[117]

In cases where taxpayers provided the IRS with a factual basis to estimate eligible expenses under the *Cohan* rule after the Tax Court petition was filed, the court allowed a reasonable estimation.

[114] See Tax Court Rule 170, Small Tax Case Procedures.

[115] In Arhontes v. Commissioner, T.C. Summary Opinion 2002-10, the Tax Court in finding for IRS noted that "Evidence fell short."

[116] Newhouse v. Commissioner, T.C. Summary Opinion 2002-18, * 10-11.

[117] T.C. Summary Opinion 2002-13, * 5.

In *Furnish v. Commissioner*, a favorable ruling for the individual taxpayer, the Tax Court wrote: "…the record establishes that the petitioner fully cooperated with the IRS from the audit level through the trial stage. Furthermore, having observed petitioner's appearance and demeanor at trial, we find him honest, forthright and credible."[118] The Court found the taxpayer's testimony credible and estimated his deductible expense for labor cost, office expense, utilities and car and truck expenses for the three years at issue.[119]

In another case with a favorable ruling for the taxpayer, the burden of proof shifted to the IRS on the issue of deduction of business expense for advertising. The Tax Court allowed the taxpayers the full amount of the deduction claimed on their income tax return.[121]

In cases where the taxpayers came to court prepared, brought adequate information and documentation to support their deductions, and offered credible testimony the Tax Court allowed deductions to the extent possible.[121]

An individual taxpayer representing him or herself in federal tax matters is not a new trend. In the last ten years, *pro se* taxpayers filed 75 percent of the petitions filed in the United States Tax Court.[122] *Pro se* taxpayers represent a growing customer base of the IRS Office of Appeals. The IRS Office of Appeals' mission is to resolve tax controversies, without litigation, on a fair and impartial basis for both the government and the taxpayer.[123] During a presentation at an IRS Nationwide Tax Forum in 2002, Appeals acknowledged that 77 percent of its customer base now consists of *pro se* taxpayers.[124] "IRS as a whole and Appeals specifically, need to do a better job of explaining the Appeals process and taxpayer rights. IRS will need to tailor our communications with taxpayers to ensure that the needs of individual taxpayers will be met."[125]

[118] T.C. Memo 2001-286, * 10-11.

[119] T.C. Memo 2001-286, * 12.

[120] Possas v. Commissioner, T.C. Summary Opinion, 2002-28.

[121] See, e.g., Krist v. Commissioner; T.C. Summary Opinion 2001-140; Lemos v. Commissioner, T.C. Summary Opinion 2002-29; Webb v. Commissioner, T.C. Summary Opinion 2001-172.

[122] IRS Chief Counsel Automated Tracking System, TL 708A, Prepared by CC:FM:PM:O.

[123] IRM 8.1.3.2 Appeals Mission (May 19, 1998).

[124] The 2002 Nationwide Tax Forums are the Service's major outreach activity to the tax practitioner community. Appeals participated, and in response to the requests from the participants provided copies of their presentations, available at http://www.irs.gov/pub/irs-utl/newappealsinternet.pdf.

[125] 2001 TNT 27-9; *IRS Releases Strategic Plan for Fiscal Years 2000-2005*. (IRS Strategic Plan fiscal year 2000-2005 (February 7, 2001) (doc 2001-3873).

Business taxpayers were more successful than individuals when litigating trade or business expense issues.[126] Two significant decisions were issued:

- In *Sutherland Lumber-Southwest, Inc. v. Commissioner*,[127] the IRS disallowed all deductions claimed by a corporation for expenses incurred in allowing its officers to use corporate aircraft for vacations. The Tax Court rejected the IRS' argument that the corporation's deduction, under IRC § 162, was limited to the amount claimed as compensation by the officers rather than the actual cost of providing vacation flights. The Eighth Circuit Court of Appeals affirmed the Tax Court decision.

  The Tax Court followed the eighth circuit court's ruling in two subsequent cases.[128] On February 11, 2002, IRS Chief Counsel issued an Action on Decision (AOD) recommending acquiescence in cases with the same set of facts.[129]
- In *U.S. Freightways Corp v. Commissioner*, the IRS determined that the corporate taxpayer improperly deducted its vehicle fleet operating expenses. The Tax Court agreed with the IRS and ruled that the corporation was required to capitalize these expenses. The Court of Appeals for the Seventh Circuit reversed the Tax Court's findings. The Seventh Circuit weighed all of the arguments and determined that the fleet operating expenses at issue were fixed one-year items and the benefits expired within that set year.[130] The Court of Appeals for the Seventh Circuit recognized a "one-year rule" for purposes of allowing a deduction for prepaid license fees and insurance premiums. The expenses were allowed as ordinary and necessary expenses deductible under IRC § 162 (a).[131]

In January 2002, the IRS issued an advance notice of proposed rulemaking seeking public comments on rules that would clarify the application of Internal Revenue Code section 263(a) for expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits.[132] "The IRS and the Treasury Department are concerned that the current level of uncertainty and confusion is neither fair to taxpayers nor consistent with sound and efficient tax administration."[133]

[126] Twenty cases filed by business taxpayers were reviewed as part of the larger group of 95 cases. The court ruled in favor of the IRS in ten cases, in favor of the taxpayer in nine cases and issued a split decision in one case.

[127] 255 F.3d 495 (8th Cir. 2001).

[128] Midland Fin. Co. v. Commissioner, T.C. Memo 2001-203; Nat'l Bancorp of Alaska, Inc. v. Commissioner, T.C. Memo 2001-202.

[129] 2002 AOD LEXIS 1, CC-2002-02 (Chief Counsel Action on Decision).

[130] 270 F.3d 1137 (7th Cir. 2001).

[131] "The case was remanded to the Tax Court for the limited purpose of considering the Commissioner's argument that the taxpayer's method of accounting did not clearly reflect income. 270 F .3d 1137,1147 (7th Cir. 2001).

[132] 67 Fed. Reg. 3461 (Jan. 24, 2002).

[133] 67 Fed Reg. 3461-3462 (Jan. 24, 2002).

Tax litigation filed by business taxpayers crossed industry lines[134] and attracted attention and in some cases support from stakeholders.[135] Deduction of trade or business expense issues litigated by businesses included:

- Reasonable compensation,[136]
- Trade or business expense versus capital expenditures,[137]
- Expenses deducted for amounts treated as compensation and/or fringe benefits to employees,[138] and
- Deduction of amounts paid to redeem common stock held in the employee stock ownership trust (ESOT) underlying the Employee Stock Ownership Plan (ESOP).[139]

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[134] Businesses litigating trade or business expense deduction issues between June 1, 2001 and May 31, 2002 included major airlines, financial institutions, automobile makers, trucking companies and service companies.

[135] In the case of U.S. Freightways v. Commissioner, 270 F. 3d 1137 (2001), the National Federation of Independent Business (NFIB) Legal Foundation joined the American Trucking Association Inc., in filing an amicus brief.

[136] IRC § 162(a)(1); International Capital Holding Corp. v. Commissioner, T.C. Memo 2001-262.

[137] IRC § 162 and IRC § 263; See Wilson v. CIR, T.C. Memo 2002-61.

[138] IRC § 162 (a); IRC § 274 (a)(1); IRC § 274 (e)(2); Treas. Reg. § 1.61-21; Midland Financial Corp. v. Commissioner, T.C. Memo 2001-203.

[139] IRC § 311(a); IRC § 317 (b); Chrysler Corporation v. Commissioner, T.C. Memo 2001-244.

CONCLUSION

Advocating legislative changes to substantiation requirements for trade or business expense deductions does not appear to be the most effective method of reducing litigation over trade or business expenses.

A look at the legislative history of IRC §§ 162 and 274(d) reveals the efforts by past presidents, Congress and the Treasury to curb abuse relating to improper deductions for meals and entertainment.[140] The most controversial effort occurred in 1984, when Congress changed the record keeping requirements for expenditures subject to section 274(d), and established tax preparer and negligence penalties.[141]

The laws regarding substantiation of business expenses, particularly under IRC § 274(d) with respect to entertainment and transportation, are well established. This case analysis indicates that individuals, especially *pro se* taxpayers, with trade or business expenses will benefit from the IRS taking a proactive approach through education, outreach, and partnering with stakeholders.

[140] In 1961, Treasury reported to Congress that widespread abuse was developing in the use of expense accounts. President Kennedy recommended disallowing business entertainment deductions, curtailing deductions for business travels and business gifts and limiting the amount of deduction for business meals. See Revenue Act of 1962, S. Rep. No. 87-1881 (1962) reprinted at 1962-3 C.B. 707. These proposals were intended to prevent personal and extravagant expenses from being borne by the federal government (i.e. by other taxpayers). Instead, Congress enacted legislation that included strict substantiation requirements. In 1978, President Carter proposed a similar plan, calling for disallowance of all business entertainment deductions and restricting deductions of business meal expenses. Congress rejected this plan, deciding instead to limit deductions of expenses for entertainment facilities. In 1984, Treasury released its plan, proposing a complete denial of all deductions for entertainment expenses. See Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuse and Restore Some Progressivity Into The Tax Code*, 41 Cath. U.L. Rev. 581 (1992).

[141] The Tax Reform Act of 1984, (Pub. L. No. 98-369, Sec. 179(b)(2)) made three distinct of changes to IRC § 274(d). It required taxpayers to keep contemporaneous records; it eliminated the ability of taxpayers to offer written and oral testimony in lieu of records, and it added other forms of transportation to the list of property subject to the requirements of IRC § 274(d). In an attempt to improve compliance, Congress enacted two controversial retroactive changes to prior law. First, it made paid income tax preparers responsible for advising taxpayers of the substantiation requirements of IRC § 274(d) and to get written confirmation from the taxpayers that they met the requirements. The second change related to the negligence penalty; it would now be applied to any portion of an underpayment attributable to failure to comply with the record keeping requirements.

TABLE 3.3.3
LITIGATED CASES: TRADE OR BUSINESS EXPENSES

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers	*Note: If sufficient information to identify the issue was not available in the court case, it was placed in this category.*				
Allison	T.C. Summary Opinion 2001-161	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Arhontes	T.C. Summary Opinion 2002-10	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Awadallah	T.C. Summary Opinion 2001-93	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Beck	T.C. Memo. 2001-198	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Bedoy	T.C. Summary Opinion 2001-120	Tax Court	Current expenses ordinary and necessary to trade or business	No	IRS
Beecroft	T.C. Summary Opinion 2001-166	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Bjornstad	T.C. Memo. 2002-47	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	Split
Bland-Barclay	T.C. Memo. 2002-20	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Blodgett	T.C. Memo. 2001-147	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Boyd	T.C. Memo. 2002-46	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	No	Split
Brayshaw	T.C. Summary Opinion 2002-22	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Bright	T.C. Summary Opinion 2001-164	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Burton	T.C. Summary Opinion 2002-19	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Bush	T.C. Memo. 2002-33	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Calimer	T.C. Summary Opinion 2001-75	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	IRS
Campbell	28 Fed. Appx. 613 (2002)	8th Circuit	Current expenses ordinary and necessary to trade or business	No	IRS
Chapell	T.C. Memo. 2001-146	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Clark	T.C. Memo. 2002-32	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Cotta	T.C. Summary Opinion 2001-133	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
De Bane	T.C. Summary Opinion (CCH) 2002-5	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Ecker	T.C. Summary Opinion 2002-44	Tax Court	Current expenses ordinary and necessary to trade or business	No	Split
Emmit	T.C. Memo. 2001-179	Tax Court	Carrying on a trade or business and entitled to deductions	No	IRS
Erbs	T.C. Summary Opinion 2001-85	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Favero	T.C. Memo. 2001-219	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Franklin	T.C. Summary Opinion 2002-13	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Friedmann	T.C. Memo. 2001-207	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Furnish	T.C. Memo. 2001-286	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Taxpayer

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Gage	T.C. Memo. 2002-72	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Gale	T.C. Memo. 2002-54	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Garrett	T.C. Summary Opinion 2001-126	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Glenn	T.C. Summary Opinion 2001-83	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Griffin	T.C. Memo. 2002-6	Tax Court	IRC § 162(a) and other application IRC sections	No	IRS
Hamdan	12 Fed. Appx. 590 (2001)	9th Circuit	Current expenses ordinary and necessary to trade or business	Yes	IRS
Ihlenfeldt	T.C. Memo. 2001-259	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	Split
Kang	T.C. Summary Opinion 2001-97	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	Split
Kringen	T.C. Summary Opinion 2001-169	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Krist	T.C. Summary Opinion 2001-140	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Kwan	T.C. Memo. 2002-16	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Land	T.C. Summary Opinion 2001-111	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Lemos	T.C. Summary Opinion 2002-29	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Levitt	T.C. Summary Opinion 2001-147	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Levy	T.C. Memo. 2001-136	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Lewis	T.C. Summary Opinion 2002-49	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Llewellyn-Rose	T.C. Summary Opinion 2002-8	Tax Court	Deduction and substantiation of travel expenses while away from home in pursuit of trade or business	Yes	IRS
Lobato	2002-1 U.S.T.C. 50,332 (2002)	Northern District of Oklahoma	IRC § 162(a) and other application IRC sections	No	IRS
Mayo	T.C. Summary Opinion 2001-146	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
McKelvey	T.C. Memo. 2002-63	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
McMullen	T.C. Summary Opinion 2001-87	Tax Court	Carrying on a trade or business and entitled to deductions	Yes	IRS
Mejanartowicz	T.C. Summary Opinion 2001-150	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Mosier	T.C. Summary Opinion 2001-104	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Newhouse	T.C. Summary Opinion 2002-18	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Olsen	T.C. Memo. 2002-42	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Osborne	T.C. Memo. 2002-11	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Owens	T.C. Memo. 2001-143	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Pappas	T.C. Memo. 2002-127	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Possas	T.C. Summary Opinion 2002-28	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	Taxpayer

MOST LITIGATED

MOST LITIGATED TAX ISSUES

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Poyda	T.C. Summary Opinion 2001-91	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Richards	T.C. Summary Opinion 2002-3	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Romer	T.C. Memo. 2001-168	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Seawright	117 T.C. 294 (2001)	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	Yes	Split
Simpson	23 Fed. Appx. 425 (2001)	6th Circuit	Deduction of expense, substantiation, and application of Cohan Rule	Yes	IRS
Sullivan	T.C. Memo 2002-131	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Sweet	2001 T. C. Summary LEXIS 293	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	No	IRS
Tokh	25 Fed. Appx. 440 (2001)	7th Circuit	Deduction of expense, substantiation and application of Cohan Rule	Yes	IRS
Triplett	T.C. Memo. 2001-230	Tax Court	Deduction of punitive fine or penalties disallowed under IRC § 162(f)	Yes	IRS
Trudel	T.C. Summary Opinion 2002-39	Tax Court	IRC § 162(a) and other application IRC sections	Yes	IRS
Tsakopoulos	T.C. Memo. 2002-8	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Vaksman	T.C. Memo. 2001-165	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Verma	T.C. Memo. 2001-132	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d))	Yes	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Webb	T.C. Summary Opinion 2001-172	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	Split
Wilson	T.C. Memo. 2001-301 Opinion 2001-172	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	No	IRS
Wilson	T.C. Memo. 2002-61	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	Yes	IRS
Xuncax	T.C. Memo. 2001-226	Tax Court	Deductions allowable per IRC § 162(a) and subject to substantiation under IRC § 274(d)	Yes	IRS
Zanath	T.C. Summary Opinion 2001-118	Tax Court	Current expenses ordinary and necessary to trade or business	Yes	IRS
Business Taxpayers (Corporation, Partnership, Trust Issues)					
B&D Found-ations, Inc	T.C. Memo. 2001-262	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	IRS
Beech Trucking Co., Inc.	118 T.C. 428 (2002)	Tax Court	IRC § 162(a) and other application IRC sections	No	IRS
Caralan Trust	T.C. Memo. 2001-241	Tax Court	Carrying on a trade or business and entitled to deductions	No	IRS
Chrysler Corporation	T.C. Memo. 2001-244	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Damron Auto Parts, Inc.	T.C. Memo. 2001-197	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
Florida Progressive Corporation	264 F.3d 1313 (2001)	11th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Haffner's Service Stations Inc.	T.C. Memo. 2002-38	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	IRS
Hunt & Sons Inc.	T.C. Memo. 2002-65	Tax Court	IRC § 162(a)(3) Deduction of rent or other payment for use of property in trade or business	No	Split
Illinois Tool Works Inc.	117 T.C. No. 4 (2001)	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
International Capital Holding Corp.	T.C. Memo. 2002-109	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
Midland Financial Co.	T.C. Memo. 2001-203	Tax Court	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
National Bancorp of Alaska, Inc.	T.C. Memo. 2001-202	Tax Court	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
Plastic Engineering & Technical Services	T.C. Memo. 2001-324	Tax Court	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
Sutherland Lumber-Southwest Inc.	255 F.3d 495 (2001)	8th Circuit	Deduction of expense treated as compensation per IRC § 162(a)(1) and IRC § 274 (a)(1) and (e)(2)	No	Taxpayer
Talley Industries Inc.	18 Fed. Appx. 661 (2001)	9th Circuit	Deduction of punitive fine or penalties disallowed under IRC § 162(f)	No	IRS

TABLE 3.3.3 — LITIGATED CASES: TRADE OR BUSINESS EXPENSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
UAL Corporation	117 T.C. No. 2 (2001)	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
United Airlines Inc.	51 Fed. Cl. 722 (2001)	Ct. Fed. Claims	Refund of Employment taxes related to payment of employee travel expenses	No	Taxpayer
United Dairy Farmers Inc.	267 F. 3d 510 (2001)	6th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	IRS
U.S. Freightways Corp.	270 F. 3d 1137 (2001)	7th Circuit	Current deductible business expense v. capital expenditure (IRC § 162(a) v. IRC § 263(a))	No	Taxpayer
Wagner Construction Inc.	T.C. Memo. 2001-160	Tax Court	Allowance of deduction claimed as expense for reasonable compensation per IRC § 162(a)(1)	No	Taxpayer
Estate/Gift Taxpayers					
Estate of Gaffner	T.C. Memo. 2001-239	Tax Court	Deduction of expense, substantiation, and application of Cohan Rule	No	IRS

LITIGATED ISSUE #4 VALUATION

PRESENT LAW

The Internal Revenue Code of 1986 includes more than 200 provisions that require valuation of property or rights to property in order to assess the correct tax liability. A few of these sections and related rulings are:

- **Internal Revenue Code section 2031(a)**: The fair market value (FMV) of a decedent's gross estate shall be determined by including, to the extent provided, the value at the time of death of all property, real or personal, tangible or intangible, wherever situated.
- **Internal Revenue Code section 2512(a)**: The fair market value (FMV) of the property at the date of a gift shall be considered the amount of the gift.
- **Internal Revenue Code section 2701**: Special valuation rules and restrictions apply in the case of transfers of interests in corporations or partnerships.
- **Revenue Ruling 81-253**: No minority shareholder discount is allowed with respect to transfers of shares of stock between family members based upon a composite of the family members' interest at the time of the transfer.
- **Revenue Ruling 59-60 as modified by Revenue Ruling 65-193**: Specific methods are provided for valuing shares of capital stock of closely held corporations for estate tax purposes. These methods may also be applied to corporate stocks on which market quotations are unavailable or scarce.

The IRS has outlined its approach, methods and factors for valuing shares of stock for closely held corporations as well as corporate stocks.[142] Corporate stocks are defined as the capital or principal funds raised by a corporation through subscribers' contributions or the sale of shares.[143] A closely held corporation is defined as a business of which 20 percent or more shares are owned by one individual or as a corporation with 45 or fewer shareholders.[144] Issues regarding both stock valuation and closely held partnerships are regularly litigated in the federal court system.

Determining fair market value has long been essential in administering both the income tax and estate tax laws. The IRS established the Engineering and Valuation Program to meet this need. The concepts of cost basis, fair market value and depreciation of assets created an immediate need for specialists in the natural resources and utilities fields. By the end of the 1920s, the IRS employed 45 Engineer Specialists. As demand for their services grew, more Engineers and Valuation Specialists joined the IRS workforce. The Engineering and Valuation Program is today part of the Field Specialist Group under the

[142] Rev. Rul. 59-60, 1959-1 C.B. 237 as modified by Rev. Rul. 65-193, 1965-2 C.B. 370.

[143] Black's Law Dictionary 1428 (7th ed. 1999).

[144] IRC § 6166(b)(1).

Large and Mid-Size Business (LMSB) Operating Division. The primary function of this program is to provide specialized services to the IRS Examination, Collection, Criminal Investigation, Appeals, and Counsel employees.

Valuation specialists receive referrals from the IRS operating divisions to assist with the valuation of property, corporate stocks, closely held corporations, art, intangibles, and other items. In many cases, the amount of tax liability depends on technical considerations, engineering issues, or asset valuations.

ANALYSIS OF LITIGATED CASES

Valuation represents approximately one percent of IRS Chief Counsel's open tax cases for litigation. Between June 1, 2001 and May 31, 2002, 54 valuation cases were litigated within the federal court system. A detailed listing of the cases can be found on Table 3.4.2. The cases tried are categorized as follows:

TABLE 3.4.1
TYPES OF VALUATION CASES

TYPE OF VALUATION	TOTAL CASES	ESTATE AND GIFT TAX	INDIVIDUAL INCOME	CORPORATE INCOME
Stock valuation (mostly closely held)	10	8	1	1
Value of partnership/real estate interests	13	13		
Sales/leaseback/leases/rentals	4		1	3
Worthless stocks/bad debts/losses	5		1	4
Excessive compensation	3			3
Sham transactions	6		4	2
Charitable contributions	4		4	
Lottery winnings/annuity tables	2	2		
Other cases	7		3	3
Total	**54**	**23**	**14**	**17**

Twenty-three of the 54 delegated cases involved estate and gift tax returns. The two most common issues for this category of cases were closely held stock and partnership/real estate interests. Of these 23 cases, 10 were rulings by the United States Court of Appeals, 12 were Tax Court decisions, and one was a United States Court of Federal Claims case.

The applicability and determination of the value of minority discounts and lack of marketability discounts were prevalent issues in these cases. These discounts are associated with determination of the fair market value of property for federal estate and gift tax purposes. The outcome of the litigated cases generally favors taxpayers in that the proposed notice of deficiency is usually adjusted.

The cases reviewed involved closely held corporations or partnership interests where market quotations were not available and where in-depth analysis was necessary to determine whether the value should be adjusted for marketability, minority interest or other factors. The analysis of the litigated cases for business taxpayers in Table 3.4.2 indicates that many of the cases contained the following factors that led to litigation:

- Inconsistencies in statistical data.
- Lack of supporting documents to collaborate or substantiate the analysis and conclusion that discounts are applicable, and the amount of the discount to be applied.
- Expert witnesses for both the taxpayer and the IRS who did not address or provide proper support for analysis relating to discount factors.

According to an IRS Counsel report dated April 18, 2002, 29 valuation cases were settled prior to litigation. These included 18 cases settled by Appeals, seven by Counsel, and four that were dismissed for lack of jurisdiction. All settled cases in this category dealt with stock or real property valuation. IRS Counsel litigated 14 valuation cases from June 1, 2001 through May 31, 2002. Most of the valuation issues in these cases also involved closely held stock and valuation of property or real estate.

Of the 54 sample cases litigated, only four contained issues of charitable contributions. Since this is such a small part of the sample, it would appear that most issues regarding gifts of assets are resolved during the audit or appeals process.

CONCLUSION

There are many different methodologies for determining the fair market value (FMV) of property. The United States Tax Court has observed:

> Disputes over valuation fill our dockets, and for good reason. We approximate that 243 sections of the Code require fair market value estimates in order to assess tax liability, and that 15 million tax returns are filed each year on which taxpayers report an event involving a valuation-related issue. It is no mystery, therefore, why valuation cases are ubiquitous.
>
> Today, valuation is a highly sophisticated process. We cannot realistically expect that litigants will, will be able to, or will want to, settle, rather than litigate, their valuation controversies if the law relating to valuation is vague or unclear.
>
> We must provide guidance on the manner in which we resolve valuation issues so as to provide a road map by which the Commissioner, taxpayers, and valuation practitioners can comprehend the rules applicable thereto and use these rules to

> resolve their differences. Clearly articulated rules will also assist appellate courts in their review of our decisions in the event of an appeal.[145]

The LMSB Operating Division has recognized the need for additional guidance in this area. LMSB has begun to address the inconsistencies and vagueness by creating the Valuation Policy Council, which is reviewing policies and procedures regarding the valuation and engineering program. The Council has developed a charter, held meetings and established a review team to study the internal workings of valuation. The team made several recommendations to improve the valuation process and developed guidelines that are required for business valuation as of October 2002. The team's recommendations are explained in Publication 3579 and are listed below:

- Establish an IRS Valuation Policy Council;
- Establish an Issue/Industry Specialist position for valuation issues;
- Develop guidelines for valuing real property interests;
- Update Revenue Ruling 59-60;
- Develop guidelines for valuing personal property;
- Require taxpayers to substantiate their valuation opinions;
- Produce a vehicle to provide guidance to taxpayers on valuations for all federal tax purposes; and
- Recommend that Counsel consider revising the estate and gift regulations to update and remove obsolete material.

The Valuation Policy Council will partner with other operating divisions to implement more clearly defined business valuation standards for all examiners and valuation specialists within IRS. Training to help define these new standards began in October 2002. The IRS is also developing guidelines concerning real and personal property valuations.

LMSB is working with the Small Business/Self-Employed Operating Division (SB/SE) to revise Form 8283 (Non-cash Charitable Contributions). The IRS is considering whether to establish an appraisal program so that Appeals settlements will benefit from valuation expertise. This will allow valuation specialists to put their knowledge toward a uniform, consistent approach.

LMSB has taken a leadership role in responding to recurring litigation in the valuation area. Its work includes developing a strategy for pre-filing activities, providing guidance and education to taxpayers, and establishing policy with the input of our external and internal stakeholders.[146] These initiatives could help to reduce the number of valuation cases litigated.

[145] Estate of Auker v. Commissioner, TC Memo. 1998-185.

[146] Internal Revenue Service Publication 3579 (02-2000), *Valuation Policy & Procedures.*

TABLE 3.4.2
LITIGATED CASES: VALUATION

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Income Tax (Issues Other Than Business Issues)					
Arbini	T.C. Memo 2001-141	Tax Court	Charitable contribution/ FMV	No	IRS
Berry	T.C. Memo 2001-311	Tax Court	Sham transactions/ valuation overstatement	No	IRS
Cameron	2002 Tax Ct Summary Lexis 4	Tax Court	Value of charitable contributions	Yes	Split
Caracci	T.C. Memo 2002-25	Tax Court	TP participation in asset transfer	No	IRS
Carroll	22 Fed. Appx. 52 (2001)	2nd Cir.	Sham transaction/ valuation overstatement	No	IRS
Espinosa	24 Fed. Appx. 825 (2001)	9th Cir.	Transferee liability / TP insolvent or solvent at time of transfer	No	IRS
Gow	19 Fed. Appx. 90 (2001)	4th Cir.	Sham transactions / Valuation of stock	No	IRS
Yeager	T.C. Memo 2002-9	Tax Court	Section 183 Horse Breeding Expectation assets may appreciate in value	No	Taxpayer
Schmidt	T.C. Summary Opinion 2002-23	Tax Court	Casualty loss Earthquake repairs	Yes	IRS
Seawright	117 T.C. 294	Tax Court	Inventory valuation	Yes	Split
Thornsjo	T.C. Memo 2001-129	Tax Court	Sham transaction/ valuation overstatement	No	IRS
Tate	118 T.C. 354	Tax Court	Charitable contribution and stock	No	IRS
Wetizman	T.C. Memo 2001-215	Tax Court	Sham transaction / Valuation overstatement	Yes	IRS
Whitehead	T.C. Memo 2001-317	Tax Court	FMV employee leased vehicles	No	IRS
Landrum	T.C. Summary Opinion 2001-112	Tax Court	Charitable contributions /FMV	No	IRS

TABLE 3.4.2 — LITIGATED CASES: VALUATION *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Business Income (Schedule C, Corporation, Partnership, Trust Issues)					
Andantech L.L.C.	T.C. Memo 2002-97	Tax Court	Sale/Leaseback of computer equipment	No	IRS
B & D Foundations Inc.	T.C. Memo 2001-262	Tax Court	Excessive compensation sole shareholder	No	IRS
Bemidji Distributing Co, Inc.	T.C. Memo 2001-260	Tax Court	Value of covenant not to compete	No	Split
Boca Investerings Partnership	167 F. Supp. 2d 298 (2001)	District Court for DC	Sham transactions	No	Taxpayer
DHL Corp	285 F.3d 1210 (2002)	9th Cir.	Valuation misstatements and sale of international trademark	No	Split
Eddie Cordes, Inc.	T.C. Memo 2001-265	Tax Court	Valuation of transferred assets	No	IRS
Flint Industries	T.C. Memo 2001-276	Tax Court	Worthless stock / Bad debt deduction	No	Split
FMC Corp	T.C. Memo 2001-298	Tax Court	Theft losses/stock redemption valuation	No	IRS
Haffner's Service Station Inc	T.C. Memo 2002-38	Tax Court	Excessive compensation in reference officers bonuses	No	Split
Hunt & Sons, Inc.	T.C. Memo 2002-65	Tax Court	Excessive FMV Rental of Land/Sales leaseback issues	No	Split
Minnesota Lawyers Mutual Ins.	285 F.3d 1086 (2002)	8th Cir.	Insurance company unpaid losses /Estimates unreasonable	No	IRS
Nicole Rose Corp.	117 T.C. 328	Tax Court	Interest in business leases	No	IRS
Physicians Ins Co.	T.C. Memo 2001-304	Tax Court	Insurance company unpaid losses/Actuary Estimates	No	Split
Saba Partnership	273 F.3d 1135 (2001)	DC Cir	Sham transactions/ Installment sales lacked substance	No	Taxpayer

TABLE 3.4.2 — LITIGATED CASES: VALUATION *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
South Tulsa Pathology Lab	118 T.C. 84	Tax Court	Stock valuation/ reorganization/spin-off	No	IRS
Wagner Construction Co	T.C. Memo 2001-160	Tax Court	Excessive compensation/ sole shareholder	No	Split
Estate and Gift Tax					
Adams	88 A.F.T.R. 2d 6057 (2001)	Northern District of Texas	Valuation of assignee partnership interest	No	Taxpayer
Adams	T.C. Memo 2002-80	Tax Court	Reduction of FMV stock interests	Yes	Split
Armstrong	277 F.3d 490 (2002)	4th Cir.	Under valuation of stock when gift tax paid	No	IRS
Baird	T.C. Memo 2001-258	Tax Court	Estates interests in timberland	No	Split
Cook	T.C. Memo 2001-170	Tax Court	Lottery winning value based on annuity tables	No	IRS
Costanza	T.C. Memo 2001-128	Tax Court	Transfer of real property where taxable gifts no sale	No	IRS
Edwards	T.C. Memo 2001-229	Tax Court	Interest in ranch land includible in gross estate/ oral options restrict sale of use	No	IRS
Fontana	118 T.C. 318	Tax Court	Stock aggregated increasing valuation	No	IRS
Godley	286 F.3d. 210 (2002)	4th Cir	Valuation of partnership Interests	No	IRS
Barlett	186 F. Supp. 2d 875 (2002)	Central District of Illinois	Transferee gift tax	No	IRS
Harper	T.C. Memo 2002-121	Tax Court	Limited partnership Interests	No	Split
Heck	T.C. Memo 2002-34	Tax Court	Valuation stocks closely held companies	No	Split
Helis	52 Fed. Cl. 745 (2002)	Court of Federal Claims	Partnership interests overvalued	No	Split

TABLE 3.4.2 — LITIGATED CASES: VALUATION *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Jameson	267 F.3d 366 (2001)	5th Cir.	Valuing the assets of the estate	No	Vacated and remanded
Rogers	281 F.3d 1108 (2002)	10th Cir.	Bad debt deductions/ loans to shareholders/ stock redemption	No	IRS
Dailey	T.C. Memo 2002-263	Tax Court	Valuation of family ltd. Partnership interests retained and gifted	No	Taxpayer
Mitchell	T.C. Memo 2002-98	Tax Court	Valuation of stock. burden of proof	No	Remand of valuation
Schwan	T.C Memo 2001-174	Tax Court	Stock closely held	No	Split
Shackleford	262 F.3d 1028 (2001)	9th Cir.	Lottery winnings/ annuity valuation	No	IRS
Trompeter	279 F.3d 767 (2001)	9th Cir.	Under reported value of estate / valuation of stock	No	Vacated and remanded
Trotter	T.C. Memo 2001-250	Tax Court	Value of real estate	No	IRS
True	T.C. Memo 2001-167	Tax Court	Closely held business interest buy sell agreements	No	IRS
Shepherd	283 F.3d 1258 (2002)	11th Cir.	Leased timberland gifted to family partnership/ minority shares	No	IRS

LITIGATED ISSUE #5 EARNED INCOME TAX CREDIT (EITC)

PRESENT LAW

In 2002, the federal Earned Income Tax Credit (EITC) is expected to provide more than $30 billion in refundable credits to low income working families.[147] The credit represents one of the nation's largest anti-poverty programs, moving an average of five million Americans above the poverty line each year.[148]

Congress enacted the EITC in 1975[149] with the goal of relieving the working poor from Social Security taxes[150] and creating a greater work incentive for low income families.[151] Working taxpayers with "earned income"[152] can qualify for the credit in one of two ways, either with a "qualifying child"[153] or by "income-only."[154] For tax year 2001, the amount of EITC that could be claimed with a qualifying child or children ranged from $9 to $4008. The refundable credit ranged from $2 to $364 for taxpayers qualifying under the "income-only" rules.[155]

[147] W&I Earned Income Tax Credit Program Office, EITC Reports – Submission Processing, August 2002.

[148] Center on Urban & Metropolitan Policy, The Brookings Institution and The Progressive Policy Institute, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of EITC*, May 2002, p. 1.

[149] Tax Reduction Act of 1975; Public Law 94-12; (H.R. 2166); Title II Sec 204, Reductions in Individual Income Taxes, March 29,1975. During this period in history, the United States economy experienced its sharpest decline since the 1930's. As the economic situation deteriorated, unemployment rates rose – from 5.2 percent in January 1974 to 8.2 percent in February 1975, which was the highest rate since 1941. S. Rep. No. 94-36 (1975)

[150] S. Rep. No. 94-36 (1975). The Earned Income Tax Credit was to provide relief to workers with dependent children who pay little or no income taxes but were subject to the social security payroll tax on their earnings. Because it would increase their after-tax earnings, the credit, in effect, was anticipated to provide an added bonus or incentive for low income people to work, and therefore, of importance in inducing individuals with families receiving Federal assistance to support themselves. It was also expected to be effective in stimulating the economy because the low-income people were expected to spend a large fraction of their increased disposable incomes. Id., at *9-10.

[151] H.R. Rep. No. 94-19 (1975). "The Tax Reduction Act of 1975 takes prompt and effective action to check the drastic downward slide in our economy and to restore economic growth and move us closer to full employment," at *2-3.

[152] IRC § 32(c)(2).

[153] IRC § 32(c)(3).

[154] IRC § 32(c)(1)(A)(ii).

[155] IRS Publication 596, *Earned Income Credit (EIC) 2001*, Earned Income Credit Table.

General EITC Eligibility

For a taxpayer to claim the EITC, the following requirements must be met:

- The taxpayer must provide his or her taxpayer identification number (TIN)[156]; if married, the TIN of the spouse is also required.[157] If qualifying children[158] are involved, the taxpayer must provide the name, age and TIN of each child.[159]
- If married (as determined under IRC § 7703), the taxpayer must file a joint return for the taxable year.[160]
- The taxpayer must be a U.S. citizen or resident alien.[161] The term "eligible individual" does not include any nonresident alien, unless that person is treated as a resident of the United States for the taxable year[162] and does not include any individual claiming benefits of IRC § 911 (citizens or residents living abroad) for the taxable year.[163]
- The taxpayer must have earned income.[164] Taxable earned income includes wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year, plus net earnings from self-employment.[165]
- The taxpayer must meet income thresholds, which vary according to how the credit is claimed.[166] For tax year 2001, the earned income could not exceed:
  - $ 32,121 if the taxpayer claimed more than one qualifying child,
  - $ 28,281 if the taxpayer claimed one qualifying child, or
  - $ 10,710 if the taxpayer met "income only" qualifications.

[156] IRC § 32(c)(1)(F)(i). There are several types of taxpayer identification numbers including Social Security Numbers (SSN), IRS Individual Taxpayer Identification Numbers (ITIN), IRS Adoption Taxpayer Numbers (ATIN) and Employer Identification Numbers (EIN). Treas. Reg. § 301.6109-1.

[157] IRC § 32(c)(1)(F)(ii).

[158] IRC § 32(c)(3)(D).

[159] IRC § 32(m). For purposes of the EITC, a TIN means a SSN issued to an individual by the Social Security Administration.

[160] IRC § 32(d).

[161] IRC § 32(c)(1)(E).

[162] IRC § 6013(g) & (h).

[163] IRC § 32(c)(1)(D).

[164] IRC § 32(c)(2)(A).

[165] The Economic Growth and Tax Relief Reconciliation Act of 2001; Pub. L. No. 107-16, Title III, § 303 changed the definition of earned income to include wages, salaries, tips and other employee compensation, but only if such amounts are includible in gross income for the taxable year. Previous rules required taxpayers to include taxable and non-taxable earned income in determining EITC eligibility. Non-taxable earned income included such things as salary deferrals, salary reductions, and excludable employer-provided benefits. It also replaced modified adjusted gross income with adjusted gross income. These rules are effective beginning in 2002. Prior rules still apply to cases from previous years.

[166] IRC § 32(a)(2).

- The taxpayer's investment income must not exceed a specified amount.[167] For tax year 2001, investment income was capped at $2,450. Investment income for most taxpayers is the total of taxable interest, tax-exempt interest, dividend income, and capital gain net income.
- The taxpayer claiming the credit must not be the qualifying child of another taxpayer.[168]

Additional Requirements for Taxpayers with Qualifying Child or Children

Additional requirements apply to taxpayers claiming the EITC with one or more qualifying children:

- Qualifying children must meet a relationship test.[169] In general, an individual meets the relationship test if the qualifying child or children are:
  - a son or daughter, stepson or stepdaughter, or a descendent of any such individual, or
  - a brother or sister, stepbrother or stepsister, or a descendant of any such individual whom the taxpayer cares for as his or her own child, or
  - an eligible foster child (i.e., an individual not described above who is placed with the taxpayer by an authorized placement agency and whom the taxpayer cares for as his or her own child).
- Qualifying children must meet a "residency requirement."[170] A qualifying child or children must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Beginning in tax year 2002, the residency test for a foster child or children has become more than one half of such taxable year instead of the entire year.[171]
- Qualifying children must meet certain age requirements.[172] A qualifying child must be under the age of 19 at the end of the tax year, a student who has not reached the age of 24 at the end of the tax year,[173] or a child who is permanently and totally disabled[174] at any time during the tax year regardless of age.

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[167] IRC § 32(i).

[168] IRC § 32(c)(1)(B).

[169] IRC § 32(c)(3)(B).

[170] IRC § 32(c)(3)(A)(ii).

[171] In prior years, the residency requirement for foster children was for the entire year, which still applies to older cases. This change was enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Title III, § 303.

[172] IRC § 32(c)(3)(C).

[173] IRC § 151(c)(4).

[174] IRC § 22(e)(3).

- If an individual (or individuals) may be claimed and is claimed as a qualifying child by two or more taxpayers, the individual (or individuals) shall be treated as the qualifying child of the taxpayer who is:
  - a parent of the individual, or if the parents do not apply, the taxpayer with the highest adjusted gross income.
  - If the parents claiming the credit with respect to the qualifying child do not file a joint return, the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time, or the parent with the highest adjusted gross income if the child resides with both parents for the same amount of time.[175]

Additional Requirements for Taxpayers Claiming EITC on "Income Only" Basis

The following are additional requirements for taxpayers claiming "income-only" EITC:

- The taxpayer must meet a residency test that requires the taxpayer's principal place of abode to be in the United States for more than one-half of the taxable year.[176]
- The taxpayer must meet an age requirement. The taxpayer, or if married, either the taxpayer or the spouse must be at least 25 years of age but less than 65 years of age before the close of the tax year.[177]
- The taxpayer cannot be a dependent (under IRC § 151) of another taxpayer in the same calendar year.[178]

ANALYSIS OF LITIGATED CASES

Fifty-two cases involving EITC issues were litigated in the federal court system during the period June 1, 2001 through May 31, 2002. A detailed listing of these cases is found in Table 3.5.6. The table categorizes the cases by the type of taxpayer.

The 52 EITC cases are broken down into the following six categories: legislative, procedural and substantive, minor or computational, new evidence, correspondence, or systemic.

[175] IRC § 32(c)(1)(C). Starting in 2002, if an individual may be claimed, and is claimed, as a qualifying child by two or more taxpayers for the same year, the taxpayer who is the parent of the qualifying child trumps all other individuals for eligibility. If both individuals are parents, the parent with whom the child resided for the longest period of time is the eligible individual. If the child resided with both parents for the same amount of time, then the parent with the highest adjusted gross income becomes the eligible individual. Previously, the individual with the highest modified adjusted gross income for the taxable year was the eligible individual with respect to claiming the EITC. The prior year rules apply to older cases.

[176] IRC § 32(c)(1)(A)(ii)(I).

[177] IRC § 32(c)(1)(A)(ii)(II).

[178] IRC § 32(c)(1)(A)(ii)(III).

TABLE 3.5.1
CATEGORIES OF EITC CASES

LEGISLATIVE	PROCEDURAL AND SUBSTANTIVE	MINOR OR COMPUTATION	NEW EVIDENCE	CORRESPONDENCE	SYSTEMIC
3	24	22	2	1	0
6%	46%	42%	4%	2%	0

The categories are defined as follows:

Legislative-based issues
- Unresolved problems that require legislation to resolve and were previously addressed in the National Taxpayer Advocate's Annual Report to Congress.
- Unresolved problems that require other legislation to resolve.
- Resolved problems addressed by legislation enacted after the case was litigated.

Procedural and substantive-based issues
- IRS failed to administer existing tax laws, procedures or requirements correctly; or
- Taxpayers failed to correctly comply with existing tax laws, procedures or requirements.

Minor or computation-based issues
- EITC is affected as a result of adjustments to income, deductions or expenses.
- EITC is a secondary issue and not the primary reason litigation was initiated and may or may not be affected by the decision of the court.

New evidence-based issues
- The taxpayer or a third party provided new or additional information not previously considered by or provided to the IRS.

Correspondence-based issues
- IRS generated unclear correspondence to a taxpayer, and the taxpayer is unable to determine what is required to verify the claim.
- A taxpayer's correspondence to the IRS failed to substantiate the taxpayer's claim to the satisfaction of the IRS.
- The taxpayer failed to respond to the IRS.
- IRS failed to consider correspondence provided by the taxpayer during the examination or audit process.

Systemic-based issues
- An IRS system failed to perform correctly or an IRS process failed to achieve the expected results.[179]

[179] None of the 52 cases involved systemic-based litigation.

ANALYSIS OF ISSUES

Legislative Based Issues

Congress has passed legislation or the National Taxpayer Advocate has made recommendations for all three of the litigated cases in the legislative category.

- There were two cases litigated that involved adjusted gross income (AGI) issues with other individuals living in the home.[180] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) clarified the tiebreaker rule in situations where two or more individuals may claim the same qualifying child.[181]
- The remaining case involved a taxpayer who claimed his daughter for all tax purposes, including EITC.[182] He based his decision on a divorce decree that granted him the right to claim a dependency exemption deduction for his daughter. This case, and many others, illustrates the confusion surrounding the differing definitions of who qualifies as a child for purposes of the dependency exemption, child care credit, filing status and EITC. It serves as an example of the need for a uniform definition of a qualifying child as proposed by the National Taxpayer Advocate, the Joint Committee on Taxation,[183] Congress,[184] and the Department of the Treasury.[185]

Procedural and Substantive Based Issues

The 24 cases within the procedural and substantive category account for the largest number of cases tried. The procedural and substantive issues break down as follows:

- Thirteen cases involved taxpayers who did not or were not able to provide proof of relationship, residency, and/or meeting foster child guidelines (e.g., "cared for as the taxpayer's own child").[186]

[180] Obriot v. Commissioner, T.C. Summary Opinion 2001-86 and Obriot v. Commissioner, T.C. Summary Opinion 2001-162.

[181] IRC § 32(c)(1)(C).

[182] Rabold v. Commissioner, T.C. Summary 2001-119.

[183] Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986; Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, JSC-3-01, April 2001, p. 35.

[184] Tax Simplification Act of 2002, H.R. 5166, 107th Cong. (2002).

[185] Department of the Treasury, *Proposal for Uniform Definition of a Qualifying Child*, April 2002.

[186] Argomaniz v. Commissioner, T.C. Summary Opinion 2001-117; Barajas v. Commissioner, T.C. Summary Opinion 2002-59; Briggsdaniels v. Commissioner, T.C. Memo. 2001-321; Carlisle v. Commissioner, T.C. Summary Opinion 2002-11; Jeter v. Commissioner, T.C. Memo. 2001-223; Mares v. Commissioner, T.C. Memo. 2001-216; Mayeux v. Commissioner, T.C. Summary Opinion 2001-121; Paramore v. Commissioner, T.C. Summary Opinion 2001-113; Poole v. Commissioner, T.C. Summary Opinion 2001-163; Reed v. Commissioner, T.C. Summary Opinion 2001-89; Rivera v. Commissioner, T.C. Summary Opinion 2001-124; Taylor v. Commissioner, T.C. Summary Opinion 2002-25 and Wilkerson v. Commissioner, T.C. Summary Opinion 2002-37.

- One taxpayer's case was dismissed for failure to comply with court orders to produce documentation in support of her claim.[187]
- Several taxpayers filed returns claiming Head of Household Filing Status, and courts found that they were ineligible (i.e., married or single filing status).[188]
- One case was dismissed for failure to state a claim because the taxpayer was a prison inmate who as a statutory matter did not have earned income and therefore did not qualify for the EITC.[189]
- One taxpayer's unearned rental income exceeded the allowable maximum for disqualified income.[190]
- A taxpayer's claim for reimbursement of administrative and litigation costs was denied after family status issues were conceded.[191]
- A court ruled that an IRA withdrawal was includible in Modified Adjusted Gross income.[192] (Applies under the former and current AGI for EITC purposes.)

Minor or Computation Based Issues

Of the 22 cases in this category, 10 dealt with business deductions and expenses.[193] These cases generally do not involve any substantive determination or holding by the court with regard to the Earned Income Tax Credit. The disposition of the cases and any resulting adjustments to the taxpayer's income may also result in an adjustment to or a denial of any earned income tax credit claimed by the taxpayer. These EITC issues are treated largely as computational matters by the parties and the courts and are not further addressed in the courts' opinions.

Six cases were bankruptcy based, either as initial litigation or as the appeal of a bankruptcy case.[194] These cases did not involve the IRS, and eligibility for or applicability of

[187] Brown v. Internal Revenue Service, 88 A.F.T.R. 2d 7331 (M.D. Ala. 2001).

[188] Allen v. Commissioner, T.C. Summary Opinon 2001-116; Benitez v. Commissioner, T.C. Summary Opinion 2002-12; Chappell v. Commissioner, T.C. Memo. 2001-146; Kang v. Commissioner, T.C. Summary Opinion 2001-97; Ramirez-Ota v. Commissioner, T.C. Summary Opinion 2002-27 and Washington v. Commissioner, T.C. Summary Opinion 2002-31.

[189] Wilson v. Commissioner, T.C. Memo. 2001-139; IRC § 32(c)(2)(B)(iv).

[190] Holbrook v. Commissioner, T.C. Summary Opinion 2001-135.

[191] Huynh v. Commissioner, T.C. Memo. 2002-110.

[192] Phillips v. Commissioner, T.C. Summary Opinion 2002-2; 2002 T.C. Summary LEXIS 3.

[193] Allison v. Commissioner, T.C. Summary Opinion 2001-161; Residential Management Services Trust v. Commissioner, T.C. Memo. 2001-297; Coyle v. Commissioner, T.C. Summary Opinion 2002-42; Esposito v. Commissioner, T.C. Memo. 2001-131; Furnish v. Commissioner, T.C. Memo. 2001-286; Glenn v. Commissioner, T.C. Summary Opinion 2001-83; Land v. Commissioner, T.C. Summary Opinion 2001-111; Poyda v. Commissioner, T.C. Summary Opinion 2001-91; Sweet v. Commissioner, 2001 T.C. Summary Lexis 293 and Xuncax v. Commissioner, T.C. Memo. 2001-226.

[194] In re Allen, 266 BR 713 (Bankr. N.D. Iowa 2001); In re Ekenasi, 271 BR 256 (S.D. W.V. 2002); In re Hammermeister, 270 BR 863 (Bankr. S.D. Ohio 2001); In re Ivory, 269 BR 890 (Bankr. N.D. Ala. 2001); In re Jackson, 2001 Bankr. LEXIS 1125 (Bankr. M.D. Ga. 2001); In re Wessels, 271 BR 313 (W.D. Wis. 2002).

the EITC was not being litigated. In some cases, the debtor's income was at issue in dischargeability or exempt property claimed. Thus, the court often noted deductions and credits including the EITC identified on the debtor's federal tax return.

- Three cases involved the discharge of student loans. They were identified for the review because the taxpayer's income tax return was part of the court case and contained an EITC claim.
- Two cases involved exempt property claims related to federal tax refunds, including EITC amounts.
- The remaining case involved discharge of a mortgage obligation. The tax return, which included EITC, was an incidental part of the case.

There were three Court of Appeals cases. In two instances, taxpayers appealed sentences after being convicted of making and/or aiding and assisting in the filing of false income tax returns claiming EITC.[195] The other Court of Appeals case[196] involved a class action lawsuit dealing with refund anticipation loans in which a member of the class claimed EITC.[197]

In one of the remaining three cases, the taxpayer did not claim the EITC but did pay his mother a wage from his business in order to allow her to have earned income and thus be eligible to claim the EITC.[198] In another case, an increase in income cut the EITC.[199] The final case involved income-only EITC eligibility and the taxability of gross income annuity payments received from the retirement plan of a deceased spouse.[200]

New Evidence Based Issues

In the first of two cases where new evidence was presented to the court, the taxpayer and a former spouse were issued statutory notices of deficiency because they both claimed their children for EITC purposes. [201] The former spouse failed to challenge the parallel deficiency notices by filing a timely action in United States Tax Court. The IRS considered his default as evidence in favor of the taxpayer. The Commissioner conceded that the taxpayer was entitled to the EITC. The litigation related to the taxpayer's right to recover attorney fees and costs under IRC § 7430.

[195] United States v. Leonard 289 F.3d 984 (7th Cir. 2002); United States v. Price, 89 A.F.T.R. 2d 2544 (10th Cir. 2002).

[196] Reynolds v. Beneficial National Bank, 288 F.2d 277 (7th Cir. 2002).

[197] A refund anticipation loan is a loan made to a taxpayer based upon an expected refund. This loan is a contract between a taxpayer and lender. The IRS is not involved in this contract.

[198] Awadallah v. Commissioner, T.C. Summary Opinion 2001-93.

[199] Quintero v. Commissioner, T.C. Summary Opinion 2002-47.

[200] Whittaker v. Commissioner, T.C. Memo. 2001-224.

[201] Sherbo v. Commissioner, 255 F.3d 650 (8th Cir. 2001).

The second case involved the 1997 and 1998 tax years of a taxpayer and wife who separated in 1995. Based on the wife's testimony, the taxpayer was allowed EITC and the head-of-household filing status on his 1997 income tax return.[202]

Correspondence Based Issues

The sole correspondence-based case dealt with possible errors identified by the IRS on the taxpayer's income tax return.[203] The taxpayer contended that he and his wife made several attempts to correct certain discrepancies by visiting an IRS office, writing correspondence, and conducting telephone conversations. The court stated that "the essence of the petitioner's difficulties appear to stem from his perceived inability to obtain accurate and relevant information from the IRS. Petitioner now turns to the court for assistance, although it is unclear what specific relief he seeks."[204] In his original complaint, the taxpayer asked for a more favorable determination regarding his indebtedness. However, he failed to identify specific determinations of the IRS that he challenged or to clarify the relief he was seeking. The court dismissed the case for lack of jurisdiction and failure to state a claim.

Court Decisions and Representation

The analysis of the 52 litigated cases identified the decision rendered by the court in each case as well as the type of taxpayer representation.

Table 3.5.2 below outlines the decisions of the court.

TABLE 3.5.2
COURT DECISIONS

COURT DECISION SUMMARY [205]				
LITIGATION BASED CATEGORY	FOR IRS/U.S.	FOR TAXPAYER	SPLIT DECISION	DISMISSED
Legislative (3)	1		2	
Procedural and Substantive (24)	15	3	5	1[206]
Minor or Computational (22)	11	4	7	
New Evidence (2)			2	
Correspondence (1)	1			
Total Review (52)	**28[207] (54%)**	**7 (13%)**	**16 (31%)**	**1 (2%)**

[202] Corona v. Commissioner, T.C. Summary Opinion 2001-181. EITC and the head-of-household filing status were disallowed for 1998.

[203] Stubblefield v. Commissioner, 2002-1 USTC ¶ 50,382 (S.D. Texas 2002).

[204] Stubblefield v. Commissioner, 2002-1 USTC ¶ 50,382 (S.S. Texas 2002), at 2.

[205] The determinations in this table reflect the entirety of the courts' decisions – not just the EITC issue.

[206] Brown v. Internal Revenue Service, 88 A.F.T.R. 2d 7331 (M.D. Ala. 2001). In the dismissed case, the court stated that the taxpayer engaged in a clear pattern of willful contempt, evidenced by her repeated failure to comply with the orders of the court. The court dismissed the case without prejudice as the least severe sanction that will remedy plaintiff's inaction in the case. The taxpayer failed to provide any evidence to support her claim to either the IRS or the Court.

[207] In five of the cases, the respondent was other than the IRS.

In 69 percent or 36 of the cases tried, the taxpayers represented themselves. The remaining 31 percent or 16 cases were litigated by attorneys. The court decisions by representation were as follows:

TABLE 3.5.3
COURT DECISIONS BY REPRESENTATION

COURT DECISIONS BY REPRESENTATION					
PRO SE - 36			ATTORNEY REPRESENTATION – 16		
For IRS/ Government	21	58%	For IRS/Government	7	44%
For TP	2	6%	For TP	5	31%
Split Decision	12	33%	Split Decision	4	25%
Dismissed	1	3%	Dismissed	0	0
Totals	**36**	**100%**		**16**	**100%**

The majority of cases involved non-business or individual taxpayers, who represented themselves (*pro se*) in 65 percent of cases tried. The remaining Schedule C (Profit or Loss From Business (Sole Proprietorship)) taxpayers elected to represent themselves 80 percent of the time. See Table 3.5.6 for a detailed listing of the cases by type of taxpayer, individual or business.

ANALYSIS OF SETTLED CASES

During the period April 19, 2001 through April 18, 2002, either the Office of Chief Counsel or Office of Appeals settled 635 cases with EITC issues after the cases were docketed but before they were litigated.[208] Of the 635 cases identified, 139 case summaries were selected for review.[209] The findings are:

- Ninety-two percent (128) had the potential to be resolved earlier in the process.[210]
- Eighty-six percent (119) included dependency-exemption issues.
- Eighty-one percent (113) involved lack of documentation as the basis of disagreement.
- Eleven percent, or 12 of the 113 lack of documentation cases, included foster child issues.

[208] Case Cross Reference By Unique Issue Listing Report 04/19/2001 to 04/18/2002. The Office of Chief Counsel developed its Unique Issue Listing (UIL) system to track the types of cases where taxpayers petitioned the Tax Court.

[209] A random sample of cases from the UIL was selected for review. Originally, there were 159 settled cases selected. Sixteen files could not be located and four did not involve the EITC as an issue. Case summaries were provided instead of the actual case files to avoid disclosure concerns.

[210] One hundred and four of the case summaries received from the Office of Appeals included a category identified as “maybe” as an answer to “could the case have been resolved earlier in the process?” The “maybe” and “yes” answers were combined as having the potential for earlier resolution.

- Seventy-one percent (98) dealt with filing status issues. Ninety-three percent or 91 of the 98 cases, involved Head of Household (HOH) filing status.
- Four percent (6) dealt with Schedule C (Profit or Loss From a Business [Sole Proprietorship]) issues.

Table 3.5.4 below identifies the outcome of the settled cases.

TABLE 3.5.4
SETTLED CASES

SETTLED CASE RESOLUTION SUMMARY		
FOR IRS	FOR TAXPAYER	SPLIT DECISION
19 (14%)	81 (58%)	39 (28%)

OBSERVATIONS

Every individual taxpayer must determine his or her filing status when filing a federal income tax return (i.e., single, head-of-household, married filing jointly, or married filing separately) and the number of personal and dependency exemptions to which they are entitled. Additionally, millions of taxpayers must determine EITC eligibility to take advantage of the refundable credit available to low income working families.[211]

The complexity of the tax law, with its multiple definitions of a child and numerous rules and exceptions, causes taxpayers and IRS employees alike to make errors while trying to navigate the process of determining eligibility. In tax year 2000, the IRS held 416,000 taxpayer refunds due to EITC issues.[212] As outlined in the present law section of this report, taxpayers claiming the EITC with a qualifying child must meet 11 requirements to qualify for the credit, while those claiming income-only EITC must meet ten requirements.

[211] In tax year 2001, 19,777,601 taxpayers filed returns claiming the EITC. (EITC Coverage Rate Report, June 24, 2002, W&I EITC Reports and Reference Data: Earned Income Tax Credit Coverage Rate (FY 1996 – 2002)).

[212] Report 1 – Exam Section Service Center Inventory – dated 05-25-01. The total number projected was 470,160. The May report was the last in which W&I and SBSE combined available data.

Often, the errors made while attempting to determine eligibility result in the IRS withholding refunds, generating error notices, and issuing statutory notices of deficiency to taxpayers. These disputes may take months or in some cases more than a year to resolve. As a result, many taxpayers petition the Tax Court to resolve the EITC issue. Approximately 22 percent of the docketed cases for the period from October 1, 2001 through July 31, 2002, consist of EITC, dependency exemption and filing status issues, which represent approximately 12 percent of IRS Counsel's time.[213]

Litigated vs. Settled

Fifty-two cases litigated between June 1, 2001 and May 31, 2002 identified EITC as an issue. From April 19, 2001 to April 18, 2002, the IRS Counsel and Appeals functions settled 635 cases with EITC issues after being docketed and prior to litigation.[214] The number of cases docketed or litigated before being resolved clearly illustrates the burden placed on low income taxpayers trying to qualify for EITC. Eighty-six percent of settled cases resulted in a full or partial settlement for the taxpayer. This raises a concern about why settlements were not reached earlier in the process.

Litigated and settled cases were reviewed for commonalities and variances. The following is a comparison of the findings between the two types of cases reviewed.

- Cases dealing with multiple issues (such as EITC, dependency exemptions and filing status)

  Litigated cases – 90 percent (47 cases out of 52 reviewed)

  Settled Cases – 96 percent (134 cases out of 139 reviewed)

- Cases dealing with documentary issues (such as residency, relationship and foster child guidelines)

  Litigated cases – 25 percent (13 cases out of 52 reviewed)

  Settled cases – 81 percent (113 cases out of 139 reviewed)

There was a significant difference in the outcome of litigated cases and settled cases. Table 3.5.5 below gives a comparison.

[213] IRS Counsel tracking information from October 1, 2001 to July 31, 2002.

[214] Case Cross Reference By Unique Issue Listing Report, 04/19/2001 to 04/18/2002.

TABLE 3.5.5
LITIGATED VS. SETTLED DECISIONS

LITIGATED VERSUS SETTLED DECISION – OUTCOME COMPARISON		
	LITIGATED	SETTLED
For IRS/Government	28 (54%)	19 (14%)
For Taxpayer	7 (13%)	81 (58%)
Split Decision	16 (31%)	39 (28%)
Dismissed	1 (2%)	-
Total Reviewed	**52**	**139**

Our review of the 52 Tax Court cases involving the EITC indicates a variety of reasons why taxpayers petition the court. Fifty-six percent of the litigated cases reviewed contained EITC, Dependency Exemptions, head-of-household filing status or a combination of these factors as a key issue in the case. Twenty-four percent of those cases resulted in a split decision where the taxpayer prevailed on at least one of the family status issues litigated.

Many of these issues have been or will be addressed by recent legislation[215] or through legislative recommendations made in the National Taxpayer Advocate's FY 2001 Annual Report To Congress.[216] Proposed legislation would reduce taxpayer burden, lessen complexity and move toward simplification and fair administration of this intricate portion of the tax code.[217]

Procedural and substantive issues accounted for a large number of disputes. These issues include such items as lack of documentation concerning relationship, including eligible foster child, residency and filing status. The analysis of cases indicates a considerable lack of understanding regarding eligibility issues and presents the IRS with an opportunity to administratively improve the EITC program.

[215] *Economic Growth and Tax Relief Reconciliation Act of 2001*; Pub. L. No. 107-16, Title III, § 303.

[216] In FY 2001, the National Taxpayer Advocate recommended five legislative changes to reduce taxpayer burden and simplify the tax code in the area of family status. The recommendations are: Create a Uniform Definition of a Qualifying Child, Remove Means-Tested Public Assistance and Other Government Benefits in the Computation of Support, Require a "Voluntary" Release of Exemptions by Custodial Parents, Eliminate the Age Restrictions for Taxpayers Claiming Earned Income Tax Credit with No Qualifying Child, and Expand the Definition of Head of Household Filing Status. *National Taxpayer Advocate FY 2001 Annual Report To Congress*, December 31, 2001, p. 76.

[217] Tax Simplification Act of 2002, H.R. 5166, 107th Cong. (2002).

Documentary Evidence

A cross-functional team within the IRS is identifying items and information that would qualify as documentary evidence to support relationship and residency requirements. The National Taxpayer Advocate is represented on this team. Administrative changes to documentary evidence requirements to prove relationship and residency and foster care guidelines should improve the taxpayers' ability to substantiate their claims and resolve issues without petitioning the Tax Court.

Foster Child Guidelines

> In 1997, 1.8 million children lived with relatives, with neither of their parents present in the home, according to the analyses of the 1997 National Survey of America's Families (NSAF). The majority (1.3 million) of these children lived with kin privately without involvement of the child welfare system, while half a million children were removed from their parents by a public agency because of abuse or neglect and placed with kin.[218]

The National Survey of America's Families is evidence of the increase in the number of non-traditional families. In 1999, 1,710,828 million returns claimed foster children as dependents.[219] Understandable guidelines for taxpayers in non-traditional family roles are necessary. There is an opportunity for improvement by providing an understandable definition and clear guidelines for the term "cared for as the taxpayer's own child."

Today, taxpayers arrive at one interpretation of caring for a foster child as one's own child, while the IRS arrives at another. Judges of the Tax Court have also grappled with this issue. None of the litigated cases reviewed can be cited as precedent, but there are clear indications of factors considered by the courts. Some of the factors considered by the Tax Court in determining a parental role include:

- Providing financial assistance. (On its own, the mere fact of contributing financially does not rise to the level of caring for an individual as one's own child).
- Assisting with homework.
- Enforcing discipline.
- Teaching personal hygiene.
- Educating about social issues.

[218] Jennifer Ehrie, Rob Green & Rebecca Clark, *Children Cared for by Relatives: Who Are They and How Are They Faring?* Urban Institute, February 2001, p. 1.

[219] Tax Year 1999, Information Returns Transaction File (IRTF).

For those non-traditional families where the child lives without either parent present, the current restrictive requirement the child be placed by an "authorized placement agency" can yield counter-intuitive and undesireable results. For example, a court order awarding an unrelated person custody of the child may not be considered placement by an authorized placement agency.

The National Taxpayer Advocate supports administrative procedures that will provide clear guidance for EITC eligibility, including the types of factors used in court case determinations. This guidance will assist employees and taxpayers in making accurate determinations about their eligibility for the EITC. These administrative procedures may require changes to regulations, Internal Revenue Manuals, and other published materials.

CONCLUSION

This review demonstrates how complicated it is for taxpayers and IRS employees to determine EITC eligibility. Many findings from the review confirm the problems that the National Taxpayer Advocate's previous recommendations, TAS systemic advocacy initiatives, and pending legislation have attempted to address. There are of course EITC cases that are litigated because of legitimate interpretive and factual disputes. However, this analysis makes clear that all too many low income taxpayers struggle to determine EITC eligibility. Even when their determinations are correct, they may not be able to make their cases under current processes unless they seek judicial intervention.

TABLE 3.5.6
LITIGATED CASES: EARNED INCOME TAX CREDIT

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Other Than Business)					
Allen	266 BR 713 (Bankr. N.D. Iowa 2001)	Bankruptcy Court Northern District of Iowa	Exempting tax refund and EITC from bankruptcy proceedings	NO	Split
Allen	T.C. Summary Opinion 2001-116	Tax Court	Head-of –Household filing status and EITC for three children	YES	Split
Argomaniz	T.C. Summary Opinion 2001-117	Tax Court	Dependency exemption deductions, Head-of-Household filing status, child care credit, child tax credit and EITC for niece and nephew	YES	IRS
Barajas	T.C. Summary Opinion 2002-59	Tax Court	Petitioner's siblings qualifying under eligible foster child requirement	YES	Taxpayer
Benitez	T.C. Summary Opinion 2002-12	Tax Court	Married taxpayer used Head-of-Household filing status, claiming dependency exemption deductions and EITC	YES	IRS
Briggsdaniels	T.C. Memo. 2001-321	Tax Court	Dependency exemption deduction, head-of household filing status and EITC claimed for taxpayer's children living in state foster care	YES	IRS
Brown	88 A.F.T.R. 2d 7331 (M.D. Ala. 2001)	US District Court for the Middle District of Alabama	IRS violated constitutional rights by denying EITC	YES	Dismissed
Carlisle	T.C. Summary Opinion 2002-11	Tax Court	Guardianship of child for dependency exemption deduction and EITC	YES	IRS

MOST LITIGATED TAX ISSUES

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Corona	T.C. Summary Opinion 2001-181	Tax Court	Dependency exemption deductions, Head-of-Household filing status, child tax credit and EITC claimed by both parents	YES	Split
Ekenasi	271 BR 256 (S.D.W.V. 2002)	Bankruptcy Court Southern District of W.V.	Appeal decision of U.S. Bankruptcy discharge for student loan	NO	Upheld discharge of student loan.
Esposito	T.C. Memo. 2001-131	Tax Court	Federal income tax deficiencies and accuracy-related penalties	YES	IRS
Hammer-meister	270 BR 863 (Bankr. S.D. Ohio 2001)	Bankruptcy Court Southern District of Ohio	Dischargeability of a mortgage obligation (imposed by state court divorce decree) under bankruptcy. (Hammermeister v Hammermeister)	NO	Taxpayer (Wife/ Plaintiff)
Huynh	T.C. Memo. 2002-110	Tax Court	Claims for dependency exemption, filing status and EITC. Claims for court costs.	NO	Split
Ivory	269 BR 890 (Bankr. N.D. Ala. 2001)	Bankruptcy Court for the Northern District of Alabama	Discharge of Student Loan	NO	Taxpayer
Jackson	2001 Bankr. LEXIS 1125 (Bankr. M.D. Ga. 2001)	Bankruptcy Court for Middle District of Georgia.	Exempting tax refund and EITC from bankruptcy proceedings	NO	Taxpayer
Jeter	T.C. Memo. 2001-223	Tax Court	Dependency exemption deductions for 2 children and relative, claiming EITC	YES	IRS

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Leonard	289 I. 3d 984 (7th Cir. 2002)	7th Circuit US Appeals	Sentence for guilty plea one count tax fraud	NO	Affirmed sentence
Mares	T.C. Memo. 2001-216	Tax Court	Dependency exemption deductions for siblings and mother, Head-of-household filing status, and EITC	YES	IRS
Mayeux	T.C. Summary Opinion 2001-121	Tax Court	Dependency exemption deduction and qualifying children for EITC	NO	Taxpayer
Obriot	T.C. Summary Opinion 2001-86	Tax Court	EITC with a qualifying child and Head-of-Household filing status	YES	Split
Obriot	T.C. Summary Opinion 2001-162	Tax Court	Dependency exemption deduction for daughter, Head-of-Household filing status, childcare credits and EITC	YES	Split
Paramore	T.C. Summary Opinion 2001-113	Tax Court	Dependency exemption deduction, Head-of-Household filing status, and EITC for son	YES	Split
Phillips	T.C. Summary Opinion 2002-2; 2002 T.C. Summary LEXIS 3	Tax Court	IRA proceeds included in modified adjusted gross income	NO	IRS
Poole	T.C. Summary Opinion 2001-163	Tax Court	Dependency exemption deductions, Head-of-Household filing status, child care credit and EITC for two children	YES	IRS
Quintero	T.C. Summary Opinion 2002-47	Tax Court	Determination of employee vs. self-employed. Income exceeding threshold for claiming EITC	NO	Split

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Rabold	T.C. Summary Opinion 2001-119	Tax Court	Divorce decree provides taxpayer entitled to dependent exemption deduction, also claimed Head-of-Household filing status and EITC	YES	IRS
Ramirez-Ota	T.C. Summary Opinion 2002-27	Tax Court	Head-of-Household filing status and claiming EITC	YES	IRS
Reed	T.C. Summary Opinion 2001-89	Tax Court	Dependency exemption deduction, Head-of-Household filing status and EITC	YES	IRS
Reynolds	288 F. 2d 277 (7th Cir. 2002)	7th Circuit US Appeals	Class action lawsuit concerning Refund Anticipation Loans	NO	Judgement reversed. Case remanded to district court
Rivera	T.C. Summary Opinion 2001-124	Tax Court	Dependency exemption deductions for nephews, Head-of-Household filing status, EITC and addition to tax	YES	IRS
Sherbo	255 F. 3d 650 (8th Cir. 2001)	8th Circuit US Appeals	Discretionary award of litigation cost and attorney's fees	NO	Affirmed for IRS
Taylor	T.C. Summary Opinion 2002-25	Tax Court	Custody of children for dependency exemption deductions, head-of-household filing status and EITC	YES	Taxpayer
Washington	T.C. Summary Opinion 2002-31	Tax Court	Married taxpayer used Head-of-Household filing status, claiming EITC	YES	IRS

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Wessels	271 BR 313 (W.D. Wis. 2002)	US District Court for Western District of Wisconsin	Appeal decision of U.S. Bankruptcy discharge for student loan	NO	Reversed bankruptcy discharge
Whittaker	T.C. Memo. 2001-224	Tax Court	Income annuity payments from deceased spouse's retirement plan included in gross income	YES	IRS
Wilkerson	T.C. Summary Opinion 2002-37	Tax Court	Dependency exemption deduction, head-of household filing status, childcare credit and EITC for someone else's child	YES	IRS
Wilson	T.C. Memo. 2001-139	Tax Court	EITC	YES	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Allison	T.C. Summary Opinion 2001-161	Tax Court	Schedule C expenses	YES	Split
Awadallah	T.C. Summary Opinion 2001-93	Tax Court	Schedule C income and expenses	YES	IRS
Chappell	T.C. Memo. 2001-146	Tax Court	Schedule C income and expenses and Head-of-Household filing status for 1994 and 1995, EITC for 1995	YES	Split
Coyle	T.C. Summary Opinion 2002-42	Tax Court	Liability for deficiency, addition to tax and penalty assessment	NO	Split
Furnish	T.C. Memo. 2001-286	Tax Court	Schedule C deductions, addition to tax and penalties.	YES	Split
Glenn	T.C. Summary Opinion 2001-83	Tax Court	Schedule C income and expenses net operating loss deductions and accuracy-related penalties	YES	Split

TABLE 3.5.6 — LITIGATED CASES: EARNED INCOME TAX CREDIT *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Holbrook	T.C. Summary Opinion 2001-135	Tax Court	Disqualified income and EITC eligibility	YES	IRS
Kang	T.C. Summary Opinion 2001-97	Tax Court	Relationship between petitioners and business expenses	YES	Split
Land	T.C. Summary Opinion 2001-111	Tax Court	Schedule C deductions and expenses	YES	IRS
Poyda	T.C. Summary Opinion 2001-91	Tax Court	Medical and business expenses	YES	Split
Price	89 A.F.T.R. 2d 2544 (10th Cir. 2002)	10th Cir. US Court of Appeals	Sentence for aiding and assisting in filing false tax returns and of making and subscribing a false tax return	NO	Affirmed for USA
Stubblefield	2002 – 1 USTC ¶50,382 (S.D. Texas 2002)	District Court	Taxpayer did not challenge specific determinations of the IRS or clarify the relief being sought	YES	IRS
Sweet	2001 T.C. Summary LEXIS 293	Tax Court	Schedule C income and expenses and EITC eligibility	NO	IRS
Xuncax	T.C. Memo. 2001-226	Tax Court	Schedule C offset gross profits and expense deductions	YES	Split

LITIGATED ISSUE #6 ABUSIVE TRUSTS

PRESENT LAW

Definition

A trust is an entity created to hold assets for the benefit of certain persons or entities, with a trustee managing the trust.[220] A trustee is a person or entity who holds the assets of a trust for the benefit of the beneficiaries and manages the trust and its assets under the terms of the trust stated in the declaration of trust.[221] A beneficiary is a person or entity (such as a charity) that is to receive assets or income from a trust.[222]

A trust is created and governed by state law. In establishing a trust, the grantor (owner of assets) places personal property, real estate, cash, investments, or other assets into the trust to be administered by a trustee (trust company, bank, or individual). The trustee then administers the assets for the beneficiary (the person named in the deed of trust who will receive income or corpus from, or use of the assets).

Federal Taxation of Trusts

For federal income tax purposes, a trust is considered a separate taxable entity. The gross income of a trust is determined in much the same way as that of an individual. A trust must file a federal income tax return, Form 1041 (U.S. Income Tax Return for Estates & Trusts), each year using a separate tax rate schedule.[223] The deductions and credits allowed to individuals are also allowed to trusts. However, special rules govern the computation of certain deductions and the allocation of certain credits and deductions between the trust and the beneficiaries.[224]

The principle of taxing trusts is that all income from whatever source derived (other than exempt income, such as tax-free interest on municipal obligations, etc.) is taxable to the trust entity or to the beneficiary. Regardless of who is taxed, the income retains its character and the taxpayer is allowed the credits, exclusions, capital gains benefits, or other privileges attached to the income.[225] Where no valid trust exists, the income is taxable to the grantor.

[220] Black's Law Dictionary 1513 (7th ed. 1999).

[221] Black's Law Dictionary 1519 (7th ed. 1999).

[222] Black's Law Dictionary 149 (7th ed. 1999).

[223] Treas. Reg. § 1.641(a) – 2.

[224] Treas. Reg, § 1.641(b) – 1.

[225] IRC §§ 643 and 652.

Economic Substance

In cases where the IRS has argued that a trust is abusive and should be disregarded for federal tax purposes, the courts have generally ruled for the IRS if the trust lacks economic substance. In such cases, courts consider the following factors in making this determination:

(1) whether the taxpayer's relationship as grantor to property purportedly transferred into trust differed materially before and after the trust formation;

(2) whether the trust had a bona fide independent trustee;

(3) whether an economic interest in the trust passed to trust beneficiaries other than the grantor; and

(4) whether the taxpayer honored restrictions imposed by the trust or by the law of trusts.[226]

Analysis of Litigated Cases

Thirty-eight trust cases were litigated in the federal court system between June 1, 2001 and May 31, 2002. The cases can be summarized as follows:

TABLE 3.6.1
LITIGATED TRUST CASES

ORIGIN OF LITIGATED CASE	NUMBER OF CASES
Income Tax Examination	23
Collection Action	8
Criminal Investigation	5
Injunction	1
Sanctions Against Attorney	1
Total Cases Litigated	**38**

A more detailed listing of the cases can be found in Table 3.6.3.

In 24 of the litigated cases, taxpayers represented themselves before the court. Twelve taxpayers were represented by attorneys or were lawyers themselves, and in two cases neither the taxpayer nor a representative was present for the proceeding.

Three of the cases that originated with a criminal investigation involved promoters of what the IRS considered an abusive trust scheme or tax shelter. In another case, the court issued an injunction against the promoter of such a scheme.[227]

[226] Markosian v. Commissioner, 73 T.C. 1235 (1980); see also Cim Trust v. Commissioner, T.C. Memo. 2001-172.

[227] United States v. Sweet, 89 A.F.T.R.2d, 2189 (2002).

Defining an abusive trust

An abusive trust, also known as a "sham trust," is created for the purpose of avoiding taxes and lacks economic substance. Trusts are considered abusive if they are established to conceal the true ownership of assets and income or disguise the substance of a financial transaction. In a sham or an abusive trust, the same person often is the grantor, trustee, and beneficiary.[228]

An abusive trust can be classified as either a domestic or a foreign scheme trust. Domestic schemes involve a series of trusts that are formed in the United States, while foreign trust schemes are formed offshore, outside U.S. jurisdiction. Both types may involve multiple layers of trusts, with each trust distributing income to the next layer. These schemes give the appearance of separating responsibility and control from the benefits of ownership, but in reality both are controlled and directed by the same taxpayer, thereby reducing taxable income to nominal amounts.[229] The IRS in Publication 2193 (Too Good to be True Trust) enumerated elements commonly found in abusive trust promotions:

- A promise to reduce or eliminate income and self-employment tax;
- Deductions for personal expenses paid by the trust;
- Depreciation deductions on an owner's personal residence and furnishings;
- High fees for trust packages, to be offset by promised tax benefits;
- Use of backdated documents;
- Unjustified replacement of trustee;
- Lack of an independent trustee;
- Use of post office boxes for trust addresses;
- Use of terms such as *pure trust, constitutional trust, sovereign trust*;
- Use of unincorporated business organizations such as, Common Law Trust Organizations (COLATOS) and Foreign Common Law Trust Organizations (FORCOLATOS).

Outcome of Litigated Cases

The IRS prevailed in whole or part in all 38 cases litigated.[230] In a significant number of cases, the courts examined the economic substance of the trusts and held that the entities were not bona fide trusts.

[228] *See, e.g.,* Fox v. Commissioner, T.C. Memo. 2001-208.

[229] *See, e.g.,* Caralan Trust v. Commissioner, T.C. Memo. 2001-241.

[230] *See,* Audio Invs. v. Robertson, 203 F. Supp. 2d 555 (DSC 2002), a quiet title action in which the IRS was a third party defendant because it had seized and sold the plaintiff's property to the defendant in order to satisfy plaintiff's outstanding tax obligation.

In one case, for example, the proposed deficiency resulted from the IRS' assertion that certain trust arrangements were shams and merely an attempt to avoid or evade income tax.[231] The taxpayer did not attack the correctness of the IRS determination, but instead used a variety of frivolous and immaterial arguments that challenged the IRS' authority to make such a determination. The United States Tax Court granted the IRS' motion for summary judgment with respect to both the deficiency and penalties.

The litigated cases originating from criminal investigations involved appeals of criminal offenses. In United States v. Trupin, the taxpayer had been found guilty of tax evasion and filing a false document with the IRS.[232] The government alleged that the taxpayer transferred assets to numerous corporations, which were in fact owned by the taxpayer's family trusts, solely to evade tax. The prosecution also asserted that the taxpayer filed a false statement of assets, omitting the property transferred. The court held that the jury was entitled to rely upon the economic realities of ownership and title and that the complex mechanisms used by the taxpayer to possess and transfer the assets permitted the inference that the concealment of assets was willful. Accordingly, the court denied the taxpayer's motion for a judgment of acquittal or a new trial.

In a case litigated due to collection action, taxpayers with a tax deficiency transferred their personal and real property to a trust.[233] The court recommended that a judgment be entered against the taxpayers for unpaid taxes, foreclosed on the taxpayers' home and business property, and set aside the proceeds to pay the taxes owed after payment of senior lienholders.

Cases Settled Prior to Litigation

Although some cases reach the courts, a large number are settled prior to litigation. These cases are resolved in the IRS Examination, Appeals, Counsel or Criminal Investigation units. Cases that were not litigated are categorized as follows:

1) Cases settled in IRS Appeals or the Office of Chief Counsel prior to litigation; and
2) Cases resolved by IRS Criminal Investigation or the United States Department of Justice prior to litigation.

Cases Settled in IRS Appeals and the Office of Chief Counsel

Between September 7, 2001 and May 29, 2002, approximately 148 cases involving abusive trusts settled in IRS Appeals and Counsel before litigation, with Appeals settling 114 cases and Counsel handling the remaining 34. The cases included the following issues:

[231] Swain v. Commissioner, 118 T.C. 358 (2002).

[232] U.S. Dist. LEXIS 8041 (S.D.N.Y. June 18, 2001).

[233] United States v. Wight, 2002-1 U.S.T.C. 50,287 (E.D. Cal. 2002).

- Assignment of income
- Grantor trust
- Sham trust
- Trust income attributable to grantors
- Sham assignments of income
- Fiduciary and distributions deductions for abusive trusts
- Abusive trust

Cases Settled by IRS Criminal Investigation and the United States Department of Justice

When IRS Office of Chief Counsel refers a case to the United States Department of Justice (DOJ), the department can either reject the case or accept it and refer it to the United States Attorney's office, which will review the matter and contact the taxpayer. The taxpayer may then concede the case by entering into a plea agreement or contest the issues. If the taxpayer does not enter into a plea agreement, the case will be scheduled for trial.

As of November 20, 2002, IRS Criminal Investigation reported the following:[234]

TABLE 3.6.2
CRIMINAL CASES

FISCAL YEAR 2002 (OCTOBER 1, 2001 THROUGH SEPTEMBER 30, 2002)	NUMBER OF CASES
Criminal Investigations Initiated	108
Prosecution Recommendations	55
Indictments/Informations	44
Convictions	26
Incarceration* Rate	88.2%
Average Months to serve (w/prison)	32
Average Months to serve (all Sent)	28

*Incarceration may include prison time, home confinement, electronic monitoring, or a combination thereof. Fiscal year 2002 runs October 1 2001 through September 30, 2002

All of the above cases were directly related to abusive trusts. Most were not litigated in the traditional sense: they never came to trial or were resolved before trial. A substantial number of the taxpayers entered plea agreements and were subsequently sentenced and fined.

[234] *Summary of Abusive Trust Schemes*, available at http://www.irs.gov.

Trusts have been used as a vehicle to evade taxes for decades.[235] With the advent of the internet, abusive trust promoters can now market schemes to a broader audience. With the exception of the individual income tax return, there are more trust returns filed than any other type.

From 1997 through 2001, Form 1041 filings increased at a rate of 16.85 percent, and the number of estate and trust filings was second only to filings of Form 1040, Individual Income Tax Return.[236]

The IRS estimates that in tax year 2000 alone, there were 570,000 abusive domestic trust returns and offshore schemes. Sixty-five thousand were domestic abusive trust returns.[237] The estimated tax revenue loss is between $20 billion and $40 billion.[238] With the increase of IRS resources targeting abusive trusts, it is certain that more of these cases will reach the courts in the coming years.

While the loss of revenue to the Treasury is substantial, there are also economic and social effects on the taxpayers who become involved in these types of trust schemes. Once a court determines a trust is abusive, the taxpayer faces not only an income tax deficiency, but also interest, penalties and possible criminal sanctions. While many of those involved in trust schemes simply oppose taxes, the group also includes vulnerable individuals who have been duped by skilled promoters. The promoters are also subject to appropriate sanctions and penalties, including criminal prosecution.

The majority of cases involving abusive trust issues are usually settled in the IRS audit or appeals process after the taxpayer obtains help from a tax professional. Taxpayers who pursue litigation often make frivolous and groundless arguments in court.[239] For example, one taxpayer refused to participate in administrative proceedings and failed to comply with court orders on the ground that Federal Income taxes are unconstitutional.[240] As a result, courts will frequently impose sanctions under IRC § 6673 on these litigants.[241]

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[235] Tax Issue Director, Michael Brostek, U.S. General Accounting Office, *Enhanced Efforts to Combat Abusive Tax Schemes – Challenges Remain*, Testimony Before the Committee on Finance, U.S. Senate, GAO-02-618T (2002).

[236] *Small Business Self Employed: Trusts and Estates*, available at http://www.irs.gov.

[237] Tax Issue Director, Michael Brostek, U.S. General Accounting Office, *Enhanced Efforts to Combat Abusive Tax Schemes – Challenges Remain*, Testimony Before the Committee on Finance, U.S. Senate, GAO-02-618T (2002).

[238] Id.

[239] Johnson v. Commissioner, 289 F. 3d 452 (2002); Barmes v. Commissioner, T.C. Memo. 2001-155; Deserio v. Commissioner, T.C. Memo. 2001-154; Matrixinfosys Trust v. Commissioner, T.C. Memo. 2001-133; Sigerseth v. Commissioner, T.C. Memo. 2001-148.

[240] Combs v. Commissioner, T.C. Memo. 2001-264.

[241] IRC § 6673(a)(1) provides that there will be sanctions and costs awarded by the courts. For Tax Court proceedings, there are sanctions and costs up to $25,000 awarded for proceedings instituted primarily for delays, or for frivolous or groundless positions. For proceedings in other courts, where the taxpayer's position is frivolous or groundless the penalty can be imposed up to $10,000; collection of sanctions as well as sanctions and costs awarded by a court of appeals can be assessed and collected in the same manner as a tax.

In *Funk v. Commissioner*, the taxpayer filed a petition alleging that the Commissioner made errors in determining the assessment and deficiency in his case.[242] The taxpayer failed to report over $1,000,000 of income from two trusts, which were found to be shams, thereby making the income taxable under the assignment of income doctrine. The taxpayer alleged that the Commissioner lacked authority to make a 'determination', that the deficiency asserted did not conform with the tax laws, and that the statute of limitations had not been extended. The court rejected the taxpayer's claims, finding that the case was "frivolous and was brought by petitioner primarily for delay." In addition to granting the Commissioner's motion to dismiss the case, the court exercised its discretion to impose and require the taxpayer to pay a $25,000 penalty to the United States.[243]

Expansion of Abusive Tax Schemes

Abusive trusts and other tax schemes are promoted through seminars, advertisements, publications and the internet. The IRS has been fighting such abusive tax schemes for years, but historically the agency reacts only after an upsurge. While the internet has fueled the growth of many new and old schemes, they also spread by word of mouth. As one taxpayer succeeds in avoiding tax by using an abusive trust, the scheme takes hold and grows exponentially.

Abusive trusts are just one of many abusive tax scams promoted to the public. The recent slavery reparations credit scheme illustrates the force with which a scam can take hold. The IRS has periodically seen slavery reparations claims in previous years; the latest resurgence began in late 2000 and false filings accelerated in 2001.

In 2001, the IRS received approximately 80,000 tax returns claiming slavery reparations credits that exceeded $2.7 billion.[244] The largest influx of claims began in 1998 on the heels of an announced settlement of a $1.25 billion case from Swiss banks accused of hoarding cash deposited by Holocaust victims. This settlement prompted discussions in the African American community about what reparations might be due to blacks in America as a result of slavery.[245]

Once this issue came to the forefront, the topic gained recognition in magazine and newspaper articles, talk shows, radio, and discussions in the Congressional Black Caucus. A

[242] Funk v. Commissioner, T.C. Memo. 2001-291.

[243] The courts have determined that resources are wasted when taxpayers' arguments are frivolous and without merit. *Norton v. Commissioner*, T.C. Memo. 2002-137. Norton also demonstrated that the court will exercise its discretion under IRC § 6673(a)(1) and require taxpayers to pay penalties of not more than $25,000 per case.

[244] IRS News Release No. IR-2001-08,"Slavery Reparation scams surge, IRS urges taxpayers not to file false claims," January 24, 2001.

[245] "Swiss Banks to Make First Payment to Holocaust Survivors," November 20, 1998, available at http://www.cnn.com.

book entitled *The Debt: What America Owes to Blacks* by Randall Robinson helped galvanize the issue.[246] In that book, Mr. Robinson argues that the United States must be prepared to make restitution to African-Americans for 246 years of slavery.

Certain promoters seized the moment and began marketing a sales pitch to African Americans, stating that they could receive up to $500,000 in a reparations credit or refund from the Internal Revenue Service. However, no provision of tax law allows African-Americans to obtain credits or refunds related to slavery reparations.[247]

The slavery reparations scam demonstrates the need for the IRS to consider the following questions in order to identify and minimize future "epidemics" of this nature:

1) What event or environment acted as a catalyst for the emergence or resurgence of the tax avoidance scheme?
2) How was information about this scheme publicized and disseminated?
3) At what point were the tax avoidance schemes first identified as a matter for concern by the press, by tax agencies, or by private organizations?
4) At what point in the promotion of the scheme did it become *acceptable* for taxpayers to participate in the scheme?
5) What proactive initiatives can be taken to address a scheme before it becomes an epidemic?
6) What is the IRS currently doing to recognize and combat future schemes?
7) Is the most appropriate medium being used to educate taxpayers?
8) How does the IRS measure the effectiveness of its outreach efforts and other deterrent strategies?

Recommendations

Like the slavery reparations scam, many abusive trust schemes involve heavily promoted products. The reparations scam demonstrates that these promotions can appear persuasive and attractive to taxpayers who otherwise comply with their tax obligations. The National Taxpayer Advocate is concerned about this trend.

The National Taxpayer Advocate endorses an approach that identifies schemes in their infancy and takes appropriate educational and deterrent actions before the schemes reach epidemic proportions. Recognizing and preventing the next tax scheme from proliferating is an efficient use of limited resources. Criminal convictions of and injunctions against

[246] Randall N. Robinson, *The Debt: What America owes to Blacks*, Dutton/Plume, New York, 2000.

[247] U.S. Department of Justice News Release, "Justice Department Sues to Enjoin Return Preparers Implicated in Slavery Reparations Tax Scam," March 6, 2002.

promoters of tax schemes are essential deterrents, but often occur years after the schemes have taken root.

IRS educational programs should not only inform the public generally but also should identify those taxpayers most likely to be affected and adopt a fresh approach to reaching that audience. The traditional education, outreach and communication methods alone, including publications, news releases and contacts with practitioner groups, are not necessarily the most effective. The IRS needs not only to consider a new message but also to partner with messengers who possess the social power to effect a change in perception. Using the slavery reparation scheme as an example, national and local leaders in the African-American community could have been informed and consulted during the *infancy* of the scheme. Their influence could have prevented the scam from reaching the epidemic stage. As a supplement to its traditional compliance initiatives, the IRS should consult marketing experts with knowledge of psychology and sociology to assist in understanding and tracking the development and acceptance of ideas.

Finally, the National Taxpayer Advocate supports IRS's efforts to reenergize its compliance program. IRS has identified and publicized key areas of non-compliance, including abusive trusts, and will focus enforcement resources on these key areas during the coming year. While a comprehensive approach is needed to reduce the number of tax avoidance schemes such as abusive trusts, concentrating resources in a few key areas could have a significant impact.

TABLE 3.6.3
LITIGATED CASES: ABUSIVE TRUST

BUSINESS TAXPAYERS (SCHEDULE C, CORPORATION, PARTNERSHIP, TRUST ISSUES					
NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Andantech, L.L.C.	T.C. Memo. 2002-97	Tax Court	Sale & leaseback	No	IRS
Audio Investments Trust	203 F. Supp. 2d 555 (2002)	District Court for South Carolina	Sale was legal	Yes	IRS (third party)
Barmes	T.C. Memo. 2001-155	Tax Court	Assessment/ Sanctions upheld	Yes	IRS
Caralan Trust	T.C. Memo. 2001-241	Tax Court	Assessment sustained	No	IRS
Cim Trust	T.C. Memo. 2001-172	Tax Court	Assessment sustained	Yes	IRS
Combs	T.C. Memo. 2001-264	Tax Court	Assessment sustained	Yes	IRS
Comey	T.C. Memo. 2001-275	Tax Court	Assessment sustained	Yes	IRS
Criss	T.C. Memo. 2002–62	Tax Court	Assessment sustained	Yes	IRS
Deserio	T.C. Memo. 2001-154	Tax Court	Assessment sustained	Yes	IRS
Fennel Trust	T.C. Memo. 2001-316	Tax Court	Assessment sustained	Yes	IRS
Fox	T.C. Memo. 2001-208	Tax Court	Assessment sustained	Yes	IRS
Funk	T.C. Memo. 2001-291	Tax Court	Assessment sustained	Yes	IRS
Herbst Asset Mgmt. Trust	T.C. Memo. 2002-73	Tax Court	Assessment sustained, lack of jurisdiction	No (no show)	IRS
Johnson	289 F. 3d 452 (2002)	7th Circuit	Sanctions on attorney	No	IRS
Matrixinfosys Trust	T.C. Memo. 2001-133	Tax Court	Assessment sustained	Yes	IRS
Norton	T.C. Memo. 2002-137	Tax Court	Assessment sustained	No	IRS
Pelham	T.C. Memo. 2001-173	Tax Court	Assessment sustained	Yes	IRS
Residential Mgmt. Servs. Trust	T.C. Memo. 2001-297	Tax Court	Assessment sustained	No	IRS
Richards Asset Mgmt. Trust	T.C. Memo. 2002-74	Tax Court	Assessment sustained	No (No show)	IRS
Ruocco	T.C. Memo. 2002-91	Tax Court	Assessment sustained	Yes	IRS

TABLE 3.6.3 — LITIGATED CASES: ABUSIVE TRUST *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Service Engineering Trust	T.C. Memo. 2001-181	Tax Court	Assessment sustained	No	IRS
Sigerseth	T.C. Memo. 2001-148	Tax Court	Assessment sustained	Yes	IRS
Snyder	T.C. Memo. 2001-255	Tax Court	Assessment sustained	Yes	IRS
Swain	118 T.C. No. 22 (2002)	Tax Court	Assessment sustained	Yes	IRS
Tarragon Trust	T.C. Memo. 2001-315	Tax Court	Assessment sustained	No	IRS
Bell	89 A.F.T.R. 2d 1486 (2002)	Eastern District of California	Tax Sale	Yes	IRS
Bollin	264 F. 3d 391 (2001)	4th Circuit	Conviction upheld	No	IRS
Brock	88 A.F.T.R. 2d 7068 (2001)	Eastern District of California	Tax lien enforcement	Yes	IRS
Chappell	15 Fed. Appx. 484 (2001)	9th Circuit	Conviction upheld	No	IRS
Engels	2001-2 U.S.T.C 50,723 (2001)	District Court of Iowa	Liens valid	No	IRS
Evseroff	2001-2 U.S.T.C. 50,783 (2001)	Eastern District of New York	Foreclosure	No	IRS
Rempel	202 F. Supp. 2d 1051 (2001)	District Court for Alaska	Foreclosure	Yes	IRS
Stewart	19 Fed. Appx. 46 (2001)	4th Circuit	Bail	Yes	IRS
Sweet	89 A.F.T.R. 2d 2189 (2002)	Middle District of Florida	Injunction	Yes	IRS
Trupin	2001 U.S. Dist. Lexis 8041 (2001)	Southern District of New York	Tax Evasion	No	IRS
Wight	2002-1 U.S.T.C. 50,287 (2002)	Eastern District of California	Foreclosure	Yes	IRS
Lundberg	32 Fed. Appx. 795 (2001)	9th Circuit	Conviction upheld	Yes	IRS
Powell	31 Fed. Appx. 424 (2002)	9th Circuit	Collection	Yes	IRS

LITIGATED ISSUE #7 ITEMIZED DEDUCTIONS

PRESENT LAW

The amount of individual federal income tax due is determined by first computing taxable income as defined by Internal Revenue Code section 63.[248] Taxpayers may subtract either a standard deduction or certain itemized deductions from gross income to arrive at taxable income. The basic deduction amount depends on the taxpayer's filing status.[249] An additional standard deduction amount is available to taxpayers who are age 65 or older, blind or both.[250] Standard deductions are adjusted annually for inflation using the Consumer Price Index.[251]

Itemized deductions are specified "personal" and "other" expenses allowed as deductions in arriving at taxable income. Personal expenses include interest payments, such as mortgage interest and points;[252] nonfederal taxes, including state and local income taxes, and real estate and personal property taxes;[253] gifts to charity;[254] medical expenses;[255] and casualty and theft losses.[256] Other deductible expenses include certain payments related to production or collection of income, including expenses related to the management of property held for the production of income.[257]

ANALYSIS OF LITIGATED CASES

In recent years, approximately 30 percent of individual taxpayers have itemized their deductions while the rest claimed the standard deduction.[258] Thirty-five cases involving itemized deductions were litigated in the federal court system from June 1, 2001 through May 31, 2002. A detailed listing of the cases is found on Table 3.7.2. The listing categorizes each case tried according to the type of taxpayer involved. The table also identifies the specific itemized deduction; tells whether an attorney represented the taxpayer or the taxpayer represented him or herself before the court *pro se*; and gives the decision of the court.

[248] IRC § 63, Taxable Income Defined.

[249] IRC § 63(c)(2).

[250] IRC § 63(c)(3).

[251] IRC § 63(c)(4).

[252] IRC § 163.

[253] IRC § 164.

[254] IRC § 170.

[255] IRC § 213.

[256] IRC §§ 165(f) & 165(h).

[257] IRC § 162.

[258] U.S. General Accounting Office, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, GAO-02-509, Washington, D.C. March 2002.

The specific itemized deductions that were litigated most often are:

TABLE 3.7.1
ITEMIZED DEDUCTION CASES

ITEMIZED DEDUCTIONS	NUMBER OF CASES	PERCENTAGE OF CASES
Employee Business Expenses	15	42.9
Charitable Contributions	6	17.1
Taxes and/or Interest	5	14.3
Miscellaneous Deductions	4	11.4
All Others	5	14.3
Total	**35**	**100**

All 35 cases were litigated in the United States Tax Court. The Court ruled in favor of the IRS in 30 of the cases tried. Nearly 50 percent of the cases reviewed were tried in just three states: 21.6 percent in California; 13.5 percent in Florida; and 10.8 percent in Texas. Each of these states has four or more locations where a trial can be held. Four cases were appealed and upheld; in two of these cases, the taxpayer had legal representation. Taxpayers represented themselves (*pro se*) in 69 percent of the 35 cases litigated, but the courts ruled in favor of *pro se* taxpayers in only four cases.

A common factor in many cases was the court's finding that taxpayers failed to substantiate the deductions taken and their records did not demonstrate ordinary business care and prudence.[259] The court ruled in 20 cases (57 percent) that the taxpayer failed to substantiate the itemized deductions claimed.

The itemized deductions most frequently litigated involved unreimbursed employee business expenses. Fifteen of the 35 cases litigated were due to employee business expense issues. Twelve of these cases were *pro se*. Two cases, one of which was *pro se*, were decided in favor of the taxpayer. This particular *pro se* taxpayer was allowed to deduct the expense of printed flyers as an employee business expense.[260] The respondent did not question this expense until the morning of the trial, even though the examiner had allowed the expense as an itemized deduction during the audit. The court held the expense was allowable absent the respondent's ability to prove otherwise.

[259] Ihlenfeldt v. Commissioner; T. C. Memo, 2001-259; Landrum v. Commissioner; T.C. Summary Opinion 2001-112; and Tokh v. Commissioner 25 Fed. Appx. 440 (7th Cir 2001).

[260] Possas v. Commissioner, T.C. Summary Opinion, 2002-28.

The following are two examples of taxpayer claims that the court disallowed:

- A deduction for work expenses claimed by a common law employee on a Schedule C business return.[261]
- Travel expenses were disallowed and the court held that the taxpayer failed to prove that he incurred claimed travel expenses "away from home", and that he had failed to substantiate the expenses.[262]

In each case, the claim was denied due to lack of substantiation, or because the expenses were not considered ordinary and necessary business expenses. It could not be determined if the taxpayers simply did not keep sufficient records of their expenses or were unaware of what expenses are not reimbursed by employers and are deductible for employees.

CONCLUSION

The IRS produces the following educational material for small businesses, which includes publications and CD-ROMs:

- Publication 3693 (Introduction to Federal Taxes for Small Business/Self/Employed)
- Publication 3207 (Small Business Resource Guide)
- Publication 3700 (A Virtual Small Business Workshop CD ROM)

The products contain information that is marketed specifically to taxpayers with employee business expenses. The publications cover vehicle expenses, business use of the home and record keeping. Similar products or specific education/outreach programs for employees with unreimbursed business expenses would provide additional resources to assist in preparing their tax returns.

Charitable contributions are an itemized deduction issue that is frequently litigated. Substantiation of these contributions depends on record keeping by the taxpayer as well as the charitable organization. The IRS is addressing the issue of substantiation of charitable contributions. The report of the latest public meeting by the IRS Advisory Committee on Tax Exempt and Government Entities (ACT) outlines an extensive outreach plan for this program.[263] ACT plans to improve the IRS website and publications that address record keeping requirements for the individuals and reporting requirements for organizations. Publication 1771 (Charitable Contributions – Substantiation and

[261] Nicholas v. Commissioner, T.C. Summary Opinion, 2001-106.

[262] Wilson v. Commissioner, T.C. Memo, 2001-301.

[263] Advisory Committee on Tax Exempt and Government Entities Public Meeting, Washington, DC. June 21, 2002.

Disclosure Requirements), published in March 2002, is an excellent example of ACT's efforts.[264]

A recent General Accounting Office (GAO) report estimates that 70 percent (86 million) of returns filed claimed the standard deduction in tax year 1998.[265] Of those taxpayers, 948,000 could have reduced their taxes by itemizing their mortgage interest, mortgage points, and state and local income tax payments that exceeded the standard deduction. The GAO further estimates that if charitable contributions, real estate taxes, and personal property taxes are included, as many as 2.2 million people could have lowered their taxes by itemizing. The report did not attempt to determine the reasons why taxpayers claimed the standard deduction when they might have paid less tax by itemizing.

Of the 35 cases reviewed, only five taxpayers provided the necessary documentation to support their claims in court. The case histories identify lack of documentation and preparation as reasons the courts ruled against the taxpayers. Better tax preparation can be achieved through contemporaneous record keeping and community resources. The IRS has various outreach programs, such as Tax Counseling for the Elderly (TCE) and Volunteer Income Assistance (VITA) available to help taxpayers during the filing season. By following the detailed record keeping process suggested in Publication 1771, taxpayers may be able to avoid litigation and resolve controversies with the IRS during the Appeals process. Low income taxpayers who seek judicial resolution of their dispute may receive assistance from the Low Income Taxpayer Clinics, which may provide *pro bono* representation to those who are eligible.

[264] IRS Publication 1771, (Rev. March 2002).

[265] U. S. General Accounting Office, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, Report to House Majority Leader, House of Representatives (March 2002).

TABLE 3.7.2
LITIGATED CASES: ITEMIZED DEDUCTIONS

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Arthur	T. C. Summary Opinion 2001-166	Tax Court	Charitable contributions, Employee business expenses	Yes	IRS
Barclay	T. C. Memo 2002-20	Tax Court	All itemized deductions	Yes	IRS
Blodgett	T. C. Memo 2001-147	Tax Court	Employee business expenses	Yes	IRS
Burton	T. C. Summary Opinion 2001-155	Tax Court	Not for profit	Yes	TP
Cameron	T. C. Summary Opinion 2002-4	Tax Court	Charitable contributions	Yes	IRS
Carver	T. C. Summary Opinion 2001-94	Tax Court	Losses	Yes	IRS
Cruz	T. C. Summary Opinion 2001-154	Tax Court	Attorney fees	Yes	TP
Dixon	15 Fed. Appx. 469 (2001)	9th Cir.	Employee business expenses	Yes	IRS
Ecker	T. C. Summary Opinion 2002-44	Tax Court	Employee business expenses	No	TP
Elliott	T. C. Memo 2001-164	Tax Court	Employee business expenses	No	IRS
Emerson	T. C. Memo 2001-186	Tax Court	Employee business expenses	Yes	IRS
Griffin	T. C. Memo 2002-6	Tax Court	Taxes paid Employee business expenses	No	IRS
Hackley	T. C. Summary Opinion 2002-19	Tax Court	Interest expenses Taxes paid	Yes	IRS
Harrell	T. C. Summary Opinion 2001-80	Tax Court	Charitable contributions Medical expenses Taxes paid	Yes	IRS
Higbee	116 T.C. No. 28	Tax Court	Charitable contribution	Yes	IRS
Ihlenfeldt	T. C. Memo 2001-259	Tax Court	Employee business expenses	Yes	TP
Landrum	T. C. Summary Opinion 2001-112	Tax Court	Not for profit	No	IRS

TABLE 3.7.2 — LITIGATED CASES: ITEMIZED DEDUCTIONS *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Lemos	T. C. Summary Opinion 2002-29	Tax Court	Employee business expenses	Yes	IRS
Levitt	T. C. Summary Opinion 2001-147	Tax Court	Employee business expenses	Yes	IRS
Mayo	T. C. Summary Opinion 2001-146	Tax Court	Medical expenses	Yes	IRS
Mellon Bank	265 F.3d 1275 (2001)	Federal Cir.	Miscellaneous deductions – advice	No	IRS
Minneman	T. C. Summary Opinion 2001-122	Tax Court	Losses	Yes	IRS
Morcos	T. C. Summary Opinion 2001-114	Tax Court	Employee business expenses Business use of the home	No	IRS
Mosier	T. C. Summary Opinion 2001-104	Tax Court	Employee business expenses	Yes	IRS
Newhouse	T. C. Summary Opinion 2002-18	Tax Court	Employee business expenses	Yes	IRS
Nicholas	T. C. Summary Opinion 2001-106	Tax Court	Employee business expenses	No	IRS
Nordbrock	T. C. Memo 2002-112	Tax Court	Interest expenses	Yes	IRS
O'Connell	T. C. Memo 2001-158	Tax Court	Bad debts Not for profit	Yes	IRS
Possas	T. C. Summary Opinion 2002-28	Tax Court	Employee business expenses	Yes	TP
Strange	270 F.3d 786 (2001)	9th Cir.	Taxes paid	No	IRS
Todd	118 T.C. No. 19	Tax Court	Charitable contributions	No	IRS
Tokh	25 Fed. Appx. 440 (2002)	7th Cir	Charitable contributions Employee business expenses	Yes	IRS
Weil	T. C. Memo 2001-212	Tax Court	Interest expenses	No	IRS
Wilson	T. C. Memo 2001-301	Tax Court	Employee business expenses	No	IRS
Zanath	T. C. Summary Opinion 2001-118	Tax Court	Employee business expenses	Yes	IRS

LITIGATED
ISSUE #8

CAPITAL GAIN AND LOSS

PRESENT LAW

Gains and losses from the sale or exchange of property are generally recognized for income tax purposes.[266] Such gains or losses are classified as either "ordinary" or "capital" in nature. They must further be categorized as either short term or long term.[267] Generally, the sale or exchange of a "capital" asset results in a capital gain or loss[268] and the sale of a "noncapital" asset results in an ordinary gain or loss.[269]

For the most part, all property owned and used for personal or investment purposes is a "capital" asset. The following assets are noncapital in nature: property held for sale to customers; depreciable property used in a trade or business; real property used in a trade or business; copyrights, literary, musical or artistic compositions; a letter or memorandum; accounts or notes receivable; U.S. Government publications; certain commodities derivative financial instruments; hedging transactions; and supplies used in a trade or business.[270]

Historically, the tax rate imposed on capital gains has varied considerably. The Taxpayer Relief Act of 1997 (TRA 97) created a reduction in the capital gains tax rate for individuals.[271] Long-term capital gains on the sale of assets held for eighteen months or longer were taxed at a top rate of 28 percent.

The IRS Restructuring and Reform Act of 1998[272] impacted "long-term" assets and "long-term" gains by:

- Shortening the holding period of a long-term capital asset from eighteen to twelve months[273] and taxing the gain from the sale of a "long-term" capital asset at a maximum rate of 20 percent.[274]
- Reducing the tax rate on long-term gains realized by taxpayers in the lowest tax bracket from a 15 percent rate to a 10 percent rate when the asset was held from one to four years[275] and an 8 percent rate if the asset was held for five or more years.[276]

[266] IRC § 61.
[267] IRC § 1222.
[268] IRC § 1201 and IRC § 1211.
[269] IRC § 64 and IRC § 65.
[270] IRC § 1221.
[271] The Taxpayer Relief Act of 1997, Public Law 99-514, Section 311.
[272] Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206, Section 5001.
[273] IRC § 1223.
[274] IRC § 1(h)(1)(C).
[275] IRC § 1(h)(B).
[276] IRC § 1(h)(2)(A).

- Creating a special reduced rate of 18 percent for assets sold after December 31, 2000 if the assets were held for more than five years.[277]

The IRS Restructuring and Reform Act of 1998 also altered the taxation of "short-term" gains.[278] Gains on assets held one year or less are considered "short-term" and are taxed at the same rates as ordinary income.[279]

There are numerous special tax provisions related to capital gains. Many of these provisions are intended to prevent the conversion of ordinary income into capital gains and to limit arbitrage[280] transactions that would take advantage of the difference between tax rates on ordinary income and capital gains.[281]

Because of the complexity in characterizing capital assets, determining the basis of assets and construing the special treatment of certain assets classified as "exceptions," capital gain and loss issues can result in litigation.

ANALYSIS OF LITIGATED CASES

Thirty-one cases with capital gain and loss as a primary issue were tried in the federal courts between June 1, 2001 and May 31, 2002. Table 3.8.1 lists the cases.

The litigated cases primarily involved the following sub-issues:

- Determination of Asset Basis
- Treatment of Bad Debts
- Characterization as Capital or Ordinary
- Miscellaneous "Other"

Eighteen of the cases involved individual taxpayers, 11 cases involved businesses, and two involved estates. Generally, taxpayers chose to use legal representation in federal court proceedings. However, 10 individuals chose to represent themselves *pro se*. The courts ruled for the IRS in 17 cases and for the taxpayer in six cases. Split decisions occurred in eight of the cases tried.

[277] IRC § 1(h)(2)(A).

[278] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Section 5001.

[279] IRC § 1222.

[280] Arbitrage is defined as "[t]he simultaneous buying and selling of identical securities in different markets, with the hope of profiting from the price difference in those markets." *Black's Law Dictionary 99* (7th ed. 1999).

[281] Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy, A Guide for the Perplexed*, Washington D.C., Brookings Institution Press, 1999 p. 9-32.

Determination of Asset Basis

Ten of the 31 capital gain and loss cases analyzed involved the issue of asset basis. Generally, a taxpayer's basis in an asset is the amount paid for or invested in the asset.[282] The basis of property is critical for purposes of computing the taxpayer's gain or loss on the sale, exchange, or disposition of the property. Taxpayers are required to maintain accurate records of all items that affect the basis of property so that accurate computations can be made for tax purposes.[283]

In certain cases, the law requires taxpayers to make adjustments (increases or decreases) to the amount paid for or invested in an asset to compute an "adjusted basis." If a taxpayer pays $200,000 for a house and then makes $50,000 worth of capital improvements, for example, the taxpayer's adjusted basis is likely to be $250,000.[284] Special rules apply when the basis of an asset is an amount other than the original cost, requiring the fair market value of an asset to be used for income tax calculations.[285] Because of these complexities of tax law, the correct determination of basis is a frequently litigated capital gain and loss issue.

The ten cases that included basis issues fall into three categories: substantiation, allocation, and computation. The following are two examples of litigated cases involving a basis issue in which **substantiation** was a factor:

- The taxpayer challenged a determination by the IRS that he underreported capital gains from the redemption of corporate stock. The taxpayer owned, with his brother, a concrete repair business. After a dispute with his brother, the taxpayer received cash and forgiveness of a non-business debt to the corporation in return for relinquishing his stock in the business. The court held that the entire amount realized from the exchange of stock was a capital gain because the taxpayer failed to establish any basis in the stock.[286]
- The taxpayers failed to substantiate the costs of improvements to a condominium. Moreover, IRC § 1016(a)(2) required a decrease in their condominium basis to reflect depreciation for two tax years. The court found for the IRS due to the fact that the taxpayers failed to show that they had not understated their long-term capital gain on the sale of the property.[287]

[282] IRC § 1012.

[283] IRC §§ 1001 and 6001.

[284] IRC § 1016.

[285] IRC § 1014.

[286] Zidar v. Commissioner, T.C. Memo. 2001- 200.

[287] Stoddard v. Commissioner, T.C. Memo. 2002-31.

The following examples indicate the type of basis **allocation** issues that were litigated:

- The taxpayer bought and resold American Depository Receipts (ADR), which are essentially shares of a foreign corporation. The transaction resulted in gross dividend income, a foreign tax credit, and capital losses that the taxpayer claimed on his income tax return.

  The Tax Court upheld the IRS determination that the ADR transaction was a sham and should be disregarded for income tax purposes.[288] On appeal, the Ninth Circuit reversed the Tax Court decision. It held that the Tax Court had erred as a matter of law in disallowing the taxpayer's identification of the income, tax credit, and losses associated with the transaction. The appeals court held that (1) the transaction could not be treated as a sham because it had economic substance independent of generating tax benefits and a business purpose involving a reasonable possibility of profit; and (2) because the transaction affected the taxpayer's economic and nontax business interests, it would not be disregarded because it was motivated by tax considerations.

- The controlling issue in another case was whether any of the cost basis in the land purchased by the landowners' partnership could be allocated to water rights that were not legally vested at the time of the land purchase. The Tax Court held that the landowners acquired the water rights in a "separate transaction" that occurred after the original land purchase, and that the cost basis of the rights was therefore zero.

  The Ninth Circuit held that while the water rights were not vested at the time the partnership purchased the land, the purchase was made with a realistic expectation that water rights would eventually attach to the land. Thus, the landowners could apportion some of their cost basis in the land to the later sale of water rights appurtenant to that land.[289]

The following is an example of a litigated case involving **computation** of basis issues:

- The IRS assessed an income tax deficiency against a taxpayer after determining that the taxpayer had a capital gain rather than a loss on a sale of rental property, among other issues. The taxpayer did not provide a calculation of basis in the property or records showing depreciation. The taxpayer submitted a schedule of purported capital improvements but admitted that the total amount listed on the schedule erroneously doubled the amount of the items. A decision was entered in favor of IRS.[290]

[288] Compaq v. Commissioner, 277 F.3d 778 (9th Cir. 2001), rev'g 113 T.C. 214 (1999). Compaq was a significant case also involving other prominent tax issues.

[289] Gladden v. Commissioner: 112 T.C. 209 (1999), *rev'd*, 262 F.3d 851(9th Cir 2001). Because the Tax Court ruled against the landowners on summary judgment, the record was undeveloped as to what portion of the cost of the land may have been a premium paid for the water rights later acquired by the partnership, or whether it was impracticable or impossible to determine what that premium may have been. Therefore, the Tax Court's decision was reversed and the case was remanded for further proceedings.

[290] Lewis v. Commissioner: T.C. Summary Opinion 2001-142.

Treatment of Bad Debts

Tax law provisions relating to the treatment of non-business bad debts as short-term capital losses, and the interpretations of "bona-fide" and "wholly worthless" debts are very complex and can be factually difficult. Thus, taxpayers end up in litigation over these issues.

Eight of the 31 capital gain and loss cases reviewed contained disputes involving bad debts. Bad debt obligations are allowable under IRC § 166. This section of the Code describes two distinct categories of bad debts – business and non-business.

Internal Revenue Code section 166 states that a debt must be genuine to be deductible. A debt is genuine, or bona-fide, if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed sum of money. A business bad debt is generally a debt that was created or acquired in connection with a taxpayer's trade or business.[291] Business bad debts generally received the most favorable tax treatment because they are deductible from income as ordinary losses without limitations when they become "partially" or "wholly" worthless.

Non-business bad debts are debts that were not received in the ordinary course of operating a trade or business. To be deductible, a non-business bad debt must be proven to be "wholly" worthless. There must be evidence of the non-business debt's worthlessness, including the value of collateral and the financial condition of the debtor.[292] Non-business bad debts are deductible as "short-term" capital losses and are subject to the loss limitations under IRC § 1211.

To deduct non-business bad debts, taxpayers must be able to provide substantiation that clearly states basis in the loss, total worthlessness of the loss, and their method of accounting. Cash basis taxpayers can generally deduct a bad debt only when there has been an actual cash loss or the amount deducted was included in income.[293] Taxpayers using the accrual method of accounting generally use a specific charge-off method to deduct business bad debt.

The following case summaries provide a flavor of the issues that arose in the seven bad debt cases that we reviewed:

- A taxpayer advanced money to a corporation of which he was general manager and a shareholder. The taxpayer took business bad debt losses (ordinary losses) that he said resulted from the money advances (loans) he had made to the corporation. The taxpayer stated he made these loans so he could collect a salary and the company could continue to operate. The court ruled that the "debts" for which

[291] IRC § 166.

[292] Id.

[293] IRC § 166(d).

the taxpayer claimed a business bad debt deduction were not bona fide debts. The court deemed the payments as contributions of capital.[294]

- A taxpayer contended that he should be allowed to claim a non-business bad debt deduction on a personal loan. The taxpayer did not pursue payment of debt for nine years, at which time he claimed a bad debt loss. The court sustained the IRS's disallowance of the deduction because the taxpayer failed to establish that the loan was a bona fide debt or that the debt had become worthless in the year claimed.[295]
- A taxpayer advanced funds to three sister companies over a period of years. The advances continued, even though the likelihood of repayment was diminishing. When the sister companies went out of business, the taxpayer took a business bad debt and treated it as an ordinary loss. The court found that the payments to the sister corporations were contributions to capital rather than loans. A decision was entered for the IRS.[296]
- A taxpayer who had guaranteed a corporate loan claimed a bad debt deduction for amounts seized by a bank. The taxpayer argued that he was entitled to a business bad debt deduction for the amounts seized as the guarantee was to protect his salary as a corporate officer. The court ruled for the IRS, concluding that the bad debt deduction was a non-business bad debt, which allowed the taxpayer only a short-term capital loss.[297]

Characterization as Capital or Ordinary

Three of the 31 cases litigated included the issue of characterization, which was raised in conjunction with other capital gain and loss issues. Characterization is the identification and classification of an asset for tax purposes. Assets can be classified as capital assets subject to the capital gains and tax provisions of IRC § 1221 or as non-capital assets subject to the ordinary gains and loss provisions of IRC § 61 and IRC § 64.

The characterization of income or losses as either capital or ordinary and the further characterization of capital gains or losses as either short-term or long-term are essentially for income tax reporting purposes. The law further requires the additional identification of long-term capital gains and losses into long-term gains and losses that qualify for the 28 percent rate.[298] Net capital gains must also be subclassified as those that qualify for five-year gains.

[294] Warning v. United States, 2001-2 U.S.T.C. 50,729 (N.D. Okla. 2001).

[295] Webb v. Commissioner, T.C. Summary Opinion 2001-172.

[296] Cerand & Company, Inc. v. Commissioner, T.C. Memo. 2001-271.

[297] O'Connell v. Commissioner, T.C. Memo. 2001-158.

[298] IRC § 1(h).

There are additional "special tax provisions" for certain assets.[299] These provisions add to the complexity of determining the correct tax treatment on the sale or exchange of an asset as either a capital gain or loss or an ordinary gain or loss.

An example of one of the cases litigated due to a characterization issue is as follows:

- The taxpayer, a farming business, claimed ordinary losses on transactions in hog futures related to hedging transactions. The Tax Court upheld the IRS position that the losses were capital and not ordinary because the taxpayer was not engaged in the hog business.[300]

Miscellaneous "Other"

Ten of the 31 cases analyzed were categorized as involving other issues that could not be primarily classified as relating to basis, characterization, or bad debt. These issues were raised in conjunction with other capital gain and loss issues. Below are some of the courts' holdings regarding the cases that included other issues:[301]

- The taxpayer reported a long-term capital loss from the sale of real property on his 1996 tax return. In 1993, the taxpayer conveyed the property to another person as a repayment of debt. The taxpayer contended that, in 1993, he received an option to repurchase the property that he conveyed. In 1996, the taxpayer relinquished his option to repurchase the property. An option contract or agreement was never prepared, but the taxpayer did execute a promissory note to the new owner. The taxpayer produced no evidence to show any payments of principal or interest to the new owner as required by the note. The Tax Court concluded that there was no sale or exchange of the property in 1996.
- The taxpayers were general partners in a partnership that owned shares in a fisheries corporation and was in the process of selling its stock in the corporation. During this time, the corporation had settled an insurance claim and distributed proceeds directly to the taxpayers. The disputed issue was whether the settlement distributions received by the taxpayers as partners were ordinary income as opposed to capital gain. The Tax Court concluded that the distributions were not proceeds from the sale of corporate shares. The form of the transaction was a distribution of the insurance proceeds from the corporation to the taxpayers, followed by a sale of the corporation's stock. The court upheld the IRS finding that these distributions were ordinary income to the taxpayers.

[299] IRC § 1(h)(2)(A).

[300] Pine Creek Farms. Ltd. v. Commissioner, T.C. Memo. 2001-176.

[301] Hale v. Commissioner, T.C. Summary Opinion 2001-99, *see also* Steel v Commissioner, T.C. Memo 2002-113.

CONCLUSION

As discussed in the analysis section, the complexity of the tax law and its many provisions regarding capital gains and losses has created interpretation differences between the IRS and taxpayers. These differences can result in litigation.

Ten of the cases tried, or 32 percent, involved basis issues. The majority of the basis issues were fact specific and dealt with the interpretation of technical and complex matters of tax law. The IRS is currently exploring the use of publicly available software that will help determine the cost basis for securities transactions.[302] Such technology can reduce taxpayer burden by streamlining documentation of cost basis calculations during audits and can create a reliable standard for taxpayers, preparers, and the IRS.

The analysis of each case litigated did not identify underlying trends or similarities that would allow for specific recommendations. However, additional taxpayer education would be beneficial to provide a better understanding regarding capital gains and losses. The IRS currently utilizes revenue agents and estate and gift attorneys each filing season for a program in which they answer specific technical tax law questions of taxpayers and preparers. This program, known as R-Mail, includes the issue of capital gain and loss and has been successful in answering questions on a timely basis.[303] IRS Chief Counsel currently uses private letter ruling procedures for highly technical issues.

The National Taxpayer Advocate encourages the IRS to continue its efforts to reduce taxpayer burden regarding capital gain and loss issues, and supports all education and assistance efforts that are currently in place. Our office is particularly interested in the computer software that the IRS is testing regarding the computation of basis. It appears this initiative would not only significantly reduce taxpayer burden in preparing tax returns, but would also impact the number of audits, administrative appeals, and litigated cases that result in a disagreement between taxpayers and the IRS regarding basis issues.

[302] National Customer Research Study, Internal Revenue Service, Research Analysis and Statistics, Washington, D.C. (Sept. 3, 2002).

[303] IRS R-Mail Report for Filing Season 2002.

MOST LITIGATED

MOST LITIGATED TAX ISSUES

TABLE 3.8.1
LITIGATED CASES: CAPITAL GAINS AND LOSSES

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Yankwich	T.C. Memo. 2002-37	Tax Court	Other	No	Split
Stoddard	T.C. Memo. 2002-31	Tax Court	Basis (computation)	No	IRS
Webb	T.C. Summary Opinion 2001-172	Tax Court	Bad Debt	Yes	IRS Rule 155
Flint	T.C. Memo. 2001-276	Tax Court	Bad Debt	No	Split
Cohen	T.C. Memo. 2001-249	Tax Court	Basis (substantiation)	Yes	IRS Rule 155
Barnard	T.C. Memo. 2001-242	Tax Court	Basis (computation)	No	Split
Brodsky	T.C. Memo. 2001-240	Tax Court	Basis (substantiation)	No	IRS Rule 155
Lewis	T.C. Summary Opinion 2001-142	Tax Court	Basis (computation)	Yes	IRS Rule 155
Torre	T.C. Memo. 2001-218	Tax Court	Other	Yes	IRS
Zidar	T.C. Memo. 2001-200	Tax Court	Basis (substantiation)	No	IRS
Tietig	T.C. Memo. 2001-190	Tax Court	Basis (substantiation, computation)	Yes	IRS
O'Connell	T.C. Memo. 2001-158	Tax Court	Bad Debt	Yes	IRS Rule 155
Hale	T.C. Summary Opinion 2001-99	Tax Court	Other	Yes	IRS Rule 155
Pappas	T.C. Memo. 2002-127	Tax Court	Other	Yes	Split
Levy	T.C. Memo. 2001-136	Tax Court	Bad Debt	Yes	Split
Esposito	T.C. Memo. 2001-131	Tax Court	Other	Yes	IRS

TABLE 3.8.1 — LITIGATED CASES: CAPITAL GAINS AND LOSSES *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Lobato	2002-1 U.S.T.C ¶ 50, 332 (N.D. Okla. 2002)	USDC	Bad Debt	No	Taxpayer
Baker	118 T.C. No. 28(2002)	Tax Court	Characterization	No	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bemidji	T.C. Memo. 2001-260	Tax Court	Characterization	No	Split
Brazoria Co Stewart Food	T.C. Memo. 2001-220	Tax Court	Bad Debt	No	IRS
Pine Creek Farms	T.C. Memo. 2001-176	Tax Court	Characterization	No	IRS
Alarecare Home Health	T.C. Memo. 2001-149	Tax Court	Other	No	Split
Compaq	277 F.3d 778(9th Cir. 2001)	Court of Appeals	Basis (allocation)	No	Petitioner
Warning	2001-2 U.S.T.C. ¶ 50, 729 (N.D. Okla 2001)	USDC	Bad Debt	No	Granted for D/IRS
Gladden	262 F.3d 851 (9th Cir. 2001)	Court of Appeals	Basis(allocation)	No	Reversed and Remanded/ TP
Cerand	254 F.3d 258 (D.C. Circuit 2001)	Court of Appeals	Bad Debt	No	Granted and Remanded/ TP
IES Industries	253 F.3d 350 (8th Cir. 2001)	Court of Appeals	Basis(allocation)	No	Affirmed/ TP
Steel	T.C. Memo. 2002-113	Tax Court	Other	No	IRS
Illinois Tool	117 T.C. No.4 (2001)	Tax court	Other	No	IRS Rule 155
Estate/Gift Taxpayers					
Estate of Keith Gurr	T.C. Summary Opinion 2002-7	Tax Court	Other	No	IRS
Estate of Branson	264 F.3d 904 (9th Cir 2001)	Court of Appeals	Other	No	Affirmed/ TP

LITIGATED ISSUE #9 CIVIL FRAUD PENALTY

PRESENT LAW

In general, penalties support the Internal Revenue Service mission by enhancing voluntary compliance. Penalties enhance compliance by (1) helping taxpayers understand that compliant conduct is appropriate and noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer.[304]

Under Internal Revenue Code section 6663, a civil fraud penalty may be imposed on taxpayers who engage in intentional wrongdoing for the specific purpose of evading tax believed to be owed.[305] The civil fraud penalty is distinct from criminal fraud sanctions. Whereas the criminal penalty is largely intended to be punitive, the civil fraud penalty is remedial in nature, designed primarily to safeguard revenue and reimburse the IRS for the heavy expense of investigations and for losses resulting from fraud.[306]

The civil penalty is an addition to tax that formerly was set forth in Internal Revenue Code section 6653(b). The Tax Reform Act of 1986 modified IRC § 6653(b) by increasing the fraud penalty rate from 50 percent to 75 percent, effective for tax returns due (determined without regard to extensions) after December 31, 1986.[307] The law narrowed the scope of the fraud penalty so that it applies only to the amount of the underpayment attributable to fraud.[308] The Omnibus Budget Reconciliation Act of 1989 (OBRA 89) redesignated IRC § 6653(b) as IRC § 6663 (effective for returns due after December 31, 1989).[309]

Internal Revenue Code section 6663 is imposed when any part of an underpayment of tax is due to fraud. The law provides for the 75 percent penalty on the portion of the underpayment attributable to fraud.[310] As an initial matter, the entire underpayment is considered attributable to fraud. However, if the taxpayer establishes (by a preponderance of evidence) that a portion of the underpayment is not due to fraud, that portion will not be subject to the 75 percent penalty.[311] A special rule applies to joint returns, where the civil fraud penalty does not apply to a spouse unless part of the underpayment is the result of fraud perpetrated by that spouse.[312]

[304] IRS Policy Statement P-1-18 (4/27/92).

[305] Mitchell v. Commissioner, 118 F.2d 308, 310 (5th Cir. 1941).

[306] Helvering v. Mitchell, 303 U.S. 391, 401, 82 L.Ed. 917, 58 S. Ct. 630 (1938).

[307] Tax Reform Act of 1986, Public Law 99-514, Section 1503(a).

[308] S. Rep. No. 99-313, at 64 (1986).

[309] The Omnibus Budget Reconciliation Act, Public Law 101-239, Section 7721(c)(1).

[310] IRC § 6663(a).

[311] IRC § 6663(b).

[312] IRC § 6663(c).

OBRA 89 modified the failure to file penalty in cases where a tax return is not filed because of fraud.[313] This penalty is an addition to tax of 15 percent for each month or fraction of month, with the total not to exceed 75 percent.[314]

A finding of fraud rests upon the taxpayer's intent. The IRS must show by clear and convincing evidence that the taxpayer knew that his or her conduct was in bad faith or was believed to be in bad faith.[315] Fraud may be established by drawing reasonable inferences from the taxpayer's entire course of conduct.[316] The courts have developed several nonexclusive indicators of fraudulent behavior, which are sometimes referred to as "badges of fraud."[317] These are indirect evidence of fraud, considered in the context of all surrounding circumstances.[318]

Courts have held that the badges of fraud include the following elements:

- Understatement of income
- Keeping inadequate records
- Failure to file tax returns
- Implausible or inconsistent explanations of behavior
- Concealment of income or assets
- Failure to cooperate with tax authorities
- Filing false documents
- Dealing in cash
- Engaging in illegal activity
- Failing to make estimated payments[319]

The IRS procedures for asserting the civil fraud penalty are described in the Internal Revenue Manual (IRM).[320] Auditors are trained to identify the badges of fraud and to develop civil and criminal referrals. The referrals are reviewed to ensure quality and are approved by management and the Fraud Referral Specialist of the Small Business and Self-Employed Division (SB/SE). The Criminal Investigation Division (CI) may receive referrals to determine whether a criminal inquiry is warranted. If CI declines to pursue a case, the auditor may still develop the civil fraud elements.

[313] The Omnibus Budget Reconciliation Act, Public Law 101-239, § 7741(a).

[314] IRC § 6651(f).

[315] IRC § 7454(a); U.S. Tax Ct. Rule 142(b).

[316] Korecky v. Commissioner, 781 F.2d 1566 (11th Cir. 1986).

[317] Bradford v. Commissioner, 796 F.2d 303, 307 (9th Cir. 1986).

[318] King's Court Mobile Home Park, Inc. v. Commissioner, 98 T.C. 511, 516 (1992).

[319] Yang-Wu v. Commissioner, T.C. Memo. 2002-68; see also Bradford v. Commissioner, supra note 317.

[320] IRM 20.1.5.12.

ANALYSIS OF LITIGATED CASES

Civil fraud was at issue in 30 decisions litigated in the federal courts between June 1, 2001 and May 31, 2002. A detailed listing of the cases is found in table 3.9.1.

Taxpayers represented themselves before the court in 15 of the 30 cases, while attorneys represented the remaining 15. One of these *pro se* taxpayers prevailed when litigating the civil fraud penalty and split decisions were entered in two other *pro se* cases. The courts decided in favor of three taxpayers who were represented by counsel and issued split decisions in four other cases.

The fraud penalty was the primary issue in nine cases and was a collateral issue in the 21 others. Unreported income was the underlying issue in 17 of those 21 cases. Business deductions, net operating loss, the diesel fuel credit and valuation of an estate were the primary issues in the other four cases.

Of the nine cases where the fraud penalty was the primary issue, the courts sustained the IRS position in five cases and the taxpayers prevailed in three. The remaining two cases resulted in split decisions. Taxpayers offered several reasons for contesting the civil fraud penalty. The positions of the three taxpayers who prevailed were as follows:

- The taxpayer was grieving over the death of his spouse and was unable to focus on keeping adequate books and records.[321]
- The taxpayers made honest mistakes and did not realize that their activities could be construed as fraudulent.[322]
- The taxpayer had no knowledge of fraudulent activity on the part of a company in which the taxpayer was a shareholder.[323]

The taxpayers' positions in the split decisions were:

- The taxpayer claimed reliance on her accountant's advice, which the court accepted for two out of three years before the court.[324]
- The taxpayer claimed that funds in his possession were not his income, but were corporate assets. As a result, there was no understatement to which the fraud penalty would attach. The taxpayer prevailed on his individual return, but the IRS was upheld on the corporate return.[325]

[321] Beck v. Commissioner, T.C. Memo. 2001-270.

[322] Terrell Equip. Co., Inc. v. Commissioner, T.C. Memo. 2002-58.

[323] Estate of Feinsmith v. Commissioner, T.C. Memo. 2001-194.

[324] Estate of Campana v. Commissioner, T.C. Summary Opinion 2001-159.

[325] Zhadanov v. Commissioner, T.C. Memo. 2002-104.

Taxpayers made various arguments in four of the nine cases where the civil fraud penalty was sustained.

- One case was based on frivolous arguments where the taxpayer was contending his income from his business was not "gross income" under the tax code, that he was denied due process, and the sanction was inappropriate.[326]
- Another taxpayer relied on the "Cheek" defense, asserting that his failure to file was caused by a good-faith misunderstanding of the tax code.[327]
- The taxpayer in another case argued that the IRS did not prove fraud by clear and convincing evidence and that the Tax Court was "biased and prejudiced against him."[328]
- The taxpayer claimed that income reported on Forms 1099 was overstated but did not specifically identify which forms reflected an overstatement and did not indicate any specific amounts of alleged overstatements.[329]

Of the 21 cases where the civil fraud penalty was the secondary issue, 17 taxpayers contested the penalty by challenging the underlying understatement of income or the method of determining the income. Overall, the courts sustained the penalty in 17 of the 21 cases.

CONCLUSION

We do not recommend any changes in legislation or IRS administrative procedures for asserting the civil fraud penalty. In the cases under review, the IRS' decision to assess the penalty was based on circumstantial evidence or admission of guilt. The circumstantial evidence was established by associating the badges of fraud with the underlying issue that resulted in an understatement of tax. The reasons taxpayers litigated this issue were based on several contentions that challenged the badges of fraud, the issue causing the understatement of tax, or the legislative intent of applying the penalty. The IRS was usually sustained where taxpayers made frivolous arguments, provided implausible or inconsistent explanations of their behavior, engaged in illegal activities, failed to cooperate with taxing authorities, or kept inadequate books or records. Overall, the civil fraud penalty is asserted through the exercise of judgment and discretion. Because the burden of proof rests with the IRS, the IRS has appropriately taken a conservative posture when seeking to impose this penalty.

[326] Madge v. Commissioner, T.C. Memo. 2000-370, *aff'd,* 23 Fed. Appx. 604 (8th Cir. 2001), *cert. denied*, 154 L. Ed. 2d 36, 123 S.Ct. 113 (2002).

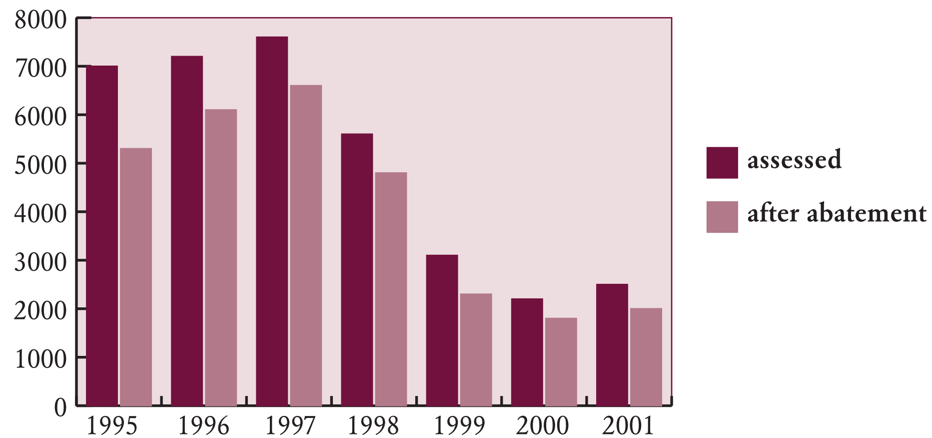
[327] Lopez v. Commissioner, T.C. Memo. 2001-211. *See* Cheek v. United States, 498 U.S. 192 (1991).

[328] House v. Commissioner, T.C. Memo. 2000-22, *aff'd,* 24 Fed. Appx. 608 (7th Cir. 2001), *cert. denied*, 153 L.Ed.2d 840, 122 S.Ct. 2666 (2002).

[329] Levine v. Commissioner, T.C. Memo. 2002-12.

The number and amount of civil fraud penalties assessed before and after abatement is recorded in the IRS Data Book, Publication 55b. The following graph demonstrates a decline in the number of penalties assessed after 1997:

THE NUMBER OF CIVIL FRAUD PENALTIES (CFP) ASSESSED BEFORE AND AFTER ABATEMENT FROM FISCAL YEARS 1995 TO 2001.[330]



The graph represents the number of civil fraud penalties assessed for all types of tax returns. The number of CFPs assessed rose until 1998, then began to decline. The reasons for this trend have not been analyzed. However, during this period the IRS has taken steps to strengthen the Fraud Penalty Program and improve the quality of fraud referrals.

It has not been determined whether the reduction in civil fraud penalties assessed is directly related to RRA98, which changed the enforcement of civil tax laws. However, after the law took effect, IRS resources shifted to customer service functions and fewer audits were conducted. The IRS has taken steps to reinvigorate the fraud program. The administrative process is established to ensure that the IRS effectively adheres to its policy and applies the civil fraud penalty in accordance with legislative intent.

[330] IRS Data Book, Publication 55b, (1995, Table 15)(1996, Table 15)(1997, Table 15)(1998, Table 28)(1999, Table 29)(2000, Table 26)(2001, Table 26).

TABLE 3.9.1
LITIGATED CASES: FRAUD PENALTY

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Lopez	T.C. Memo. 2001-211	U.S. Tax Court	Fraud Penalty	No	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Bacon	88 A.F.T.R. 2d 6396 (3rd Cir. 2001)	U.S. Court of Appeals	Unreported income/ Fraud Penalty	No	IRS
Barnard	T.C. Memo. 2001-242	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Beck, E	T.C. Memo. 2001-270	U.S. Tax Court	Fraud Penalty	Yes	Taxpayer
Bisceglia	T.C. Memo. 2002-22	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Brodsky	T.C. Memo. 2001-240	U.S. Tax Court	Unreported income/ Fraud Penalty	No	Split
Clark	T.C. Memo. 2001-205	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Console	T.C. Memo. 2001-232	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Cordes	T.C. Memo. 2001-125	U.S. Tax Court	Unreported Income/ Fraud Penalty	No	IRS
Coyle	T.C. Summary Opinion 2002-42	U.S. Tax Court	Unreported Income/ Fraud Penalty	No	Split
Delvecchio	T.C. Memo. 2001-130	U.S. Tax Court	Net Operating Loss/ Fraud Penalty	No	IRS
Fagan	T.C. Memo. 2001-222	U.S. Tax Court	Unreported income/ Fraud Penalty	No	IRS
Hadri	T.C. Memo. 2002-77	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
House	2001 U.S. App. 26887 (7th Cir. 2001)	U.S Court of Appeals	Fraud Penalty	Yes	IRS
Ishler	T.C. Memo. 2002-79	U.S. Tax Court	Unreported income/ Fraud Penalty	No	IRS
Levine	T.C. Memo. 2002-12	U.S. Tax Court	Fraud Penalty	No	IRS
Madge	88 A.F.T.R 2d 6804 (8th Cir. 2001)	U.S. Court of Appeals	Fraud Penalty	Yes	IRS

TABLE 3.9.1 — LITIGATED CASES: FRAUD PENALTY *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Marsh	89 A.F.T.R 2d 725 (9th Cir. 2002)	U.S. Court of Appeals	Unreported Income/ Fraud Penalty	Yes	IRS
Owens	T.C. Memo. 2001-314	U.S. Tax Court	Unreported Income/ Fraud Penalty	Yes	IRS
Pappas	T.C. Memo. 2002-127	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Romer	T.C. Memo. 2001-168	U.S. Tax Court	Business Deductions/ Fraud Penalty	Yes	IRS
Terrell Equipment Co	T.C. Memo. 2002-58	U.S. Tax Court	Fraud Penalty	No	Taxpayer
Western Company of North America	52 Fed. Cl. 51	Federal Claims Court	Diesel Fuel Credit/ Fraud Penalty	No	IRS
Yang-Wu	T.C. Memo. 2002-68	U.S. Tax Court	Unreported Income/ Fraud Penalty	Yes	IRS
Zamzam	89 A.F.T.R. 2d 512 (4th Cir 2002)	U.S. Court of Appeals	Unreported Income/ Fraud Penalty	Yes	IRS
Zhadoavov, et al	T.C. Memo. 2002-104	U.S. Tax Court	Fraud Penalty	Yes	Split
Estate/Gift Taxpayers					
Estate of Campana	T.C. Summary Opinion 2001-159	U.S. Tax Court	Fraud Penalty	Yes	Split
Estate of Feinsmith	T.C. Memo. 2001-194	U.S. Tax Court	Fraud Penalty	No	Taxpayer
Estate of Johnson	T.C. Memo. 2001-182	U.S. Tax Court	Unreported income/ Fraud Penalty	Yes	IRS
Estate of Trompeter	279 F.3d 767 (9th Cir. 2002)	U.S. Court of Appeals	Underreported taxable estate/Fraud Penalty	No	Taxpayer

LITIGATED ISSUE #10 JOINT AND SEVERAL LIABILITY

PRESENT LAW

Taxpayers who are married at the end of the tax year can file their returns either jointly or separately. Many married taxpayers choose to file jointly because of the tax benefits that result from this status.

When couples file a joint return, they are jointly and severally liable for the tax and any interest or penalty due on that return even if they later divorce. This is true even if a divorce decree states that only one spouse will be responsible for any balances due on previously filed joint returns. Joint and several liabilities can result in one spouse paying the entire tax liability, even if the other spouse earned all the income.

The Internal Revenue Service Restructuring and Reform Act of 1998[331] (RRA '98) repealed the prior law that provided relief from joint and several liabilities.[332] The new law created three alternatives for taxpayers who have filed a joint return and are seeking relief from all or a portion of joint liability. The types of relief from joint and several liabilities are:

- "Traditional" relief,[333]
- Separation of liability,[334] and
- Equitable relief.[335]

The new law regarding joint and several liability relief is effective for unpaid balances as of July 22, 1998, and for liabilities arising after that date. Taxpayers must request relief no later than two years after the first IRS collection activity.[336]

"Traditional" Relief

A taxpayer can be relieved of liability for tax, interest and penalties if his or her spouse omitted income, or overstated deductions, exemptions, credits or basis on the couple's tax return. If relief is granted, the tax, interest and penalties that qualify for relief can be collected only from the other spouse. However, the electing spouse remains jointly and individually responsible for any tax, interest and penalties that do not qualify for relief, and the IRS can collect these amounts from either spouse. The taxpayer must meet all of the following conditions to qualify for "traditional innocent spouse" relief:

[331] The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

[332] RRA '98 repealed IRC § 6013(e) and replaced it with IRC § 6015.

[333] IRC § 6015(b).

[334] IRC § 6015(c).

[335] IRC § 6015(f).

[336] IRC § 6015(b)(1)(E); IRC § 6015(c)(3)(B); Rev. Proc. 2000-15, 2000-5 I.R.B. 447.

- File a joint return that understates tax due to erroneous items of the other spouse;[337]
- Establish that at the time both taxpayers signed the joint return the electing spouse did not know, and had no reason to know, that there was an understatement of tax; and
- Demonstrate that, after taking into account all the facts and circumstances, it would be unfair to hold the electing spouse liable for the understatement.

A taxpayer granted traditional relief from joint and several liabilities may receive a refund of an overpayment. Although the normal statutory limitation period applies to this refund,[338] the IRS requires that the amount of tax be paid on or after July 22, 1998.[339]

Separation of Liability

A taxpayer may seek a separate liability election for deficiencies arising from a joint return. To qualify, the taxpayer must have filed a joint return and meet either of the following requirements:

- Be no longer married to, or be legally separated from the spouse with whom he or she filed the joint return for which he or she is requesting relief (widows and widowers are considered to be no longer married); or
- Not be a member of the same household as the spouse with whom he or she filed the joint return at any time during the 12-month period ending on the date relief is requested.

Even if the taxpayer meets the above requirements, separation of liability will not be granted if:

- The IRS proves that the taxpayer and spouse transferred assets as part of a fraudulent scheme;
- The IRS proves that at the time the taxpayer signed the joint return, the taxpayer had actual knowledge of items giving rise to the deficiency that were allocable to the spouse;
- The spouse (or former spouse) transferred property to the taxpayer to avoid tax or the payment of tax.

[337] Generally, an understatement of tax is the difference between the total amount of tax that should have been shown on the return and the amount of tax that was actually shown on the return. Erroneous items include unreported income received by the other spouse, or an incorrect deduction, credit, or basis claimed by the other spouse.

[338] IRC §§ 6511(a) and (b).

[339] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Sec. 3201(g)(1), 112 Stat. 685, 740 (1998).

Taxpayers cannot receive a refund of an overpayment if separate liability relief is granted.[340]

Equitable Relief

Taxpayers who do not qualify for traditional or separate liability relief may still be relieved of liability for paying tax, interest, and penalties under the equitable relief provision. Taxpayers must meet all of the following conditions to qualify for equitable relief:

- The taxpayer does not qualify for traditional or separate liability relief;
- The taxpayer and spouse did not transfer assets to one another as a part of a fraudulent scheme;
- The spouse did not transfer assets to the taxpayer to avoid tax or the payment of tax;
- The taxpayer did not file the return with intent to commit fraud; and
- The taxpayer establishes that, taking into account all the facts and circumstances, it would be inequitable to hold him or her liable for the understatement or underpayment.[341]

The IRS will consider all facts and circumstances to determine whether it is inequitable to hold the taxpayer responsible for understatement or underpayment of tax.[342]

The IRS' position is that a taxpayer is eligible to receive a refund under IRC § 6015(f) for the following payments:

- Amounts paid on or after July 22, 1998 and on or before April 15, 1999, and
- Installment payments made after July 22, 1998 pursuant to an installment agreement with the Service, where the individual is not in default, and where the payments are made after relief is requested.[343]

Community Property Laws

Community property laws of the state where the taxpayer lives determine what is community versus separate income and property. This determination affects the income that a married individual is required to report on his or her separate return. If a husband and wife live in a community property state and file separately, each is required to report his or her share of the community property income and all of his or her separate income.

Community property laws usually require couples to allocate community property income and expenses equally. Community property is all property acquired during a

[340] IRC § 6015(g)(3) specifically excludes the issuance of a refund under the "separate liability."

[341] An underpayment is the amount of tax properly reported on the return but not paid.

[342] Rev. Proc. 2000-15 provides guidance on how to apply the equitable relief provision.

[343] Rev. Proc. 2000-15, 2000-5 I.R.B. 447.

marriage while the spouses live in a community property state. It includes salaries, wages, pay for services, and income from real estate that is treated as community property under the laws of the state where the property is located.

In the event there are items that create an understatement of tax, married taxpayers who file separate returns in community property states may seek and be granted relief of liability under IRC § 66(c). Under regulations prescribed by the Secretary, an item of community income shall be included in the gross income of the other spouse if an individual:

- Filed a separate return for the tax year,
- Did not include an item of community income in gross income on the separate return,
- Establishes that he or she did not know of, and had no reason to know of, such item of community income; and
- Under all facts and circumstances, demonstrates that it would be inequitable to include the item of community property income in his or her gross income.[344]

If an individual does not qualify for relief under IRC§ 66(c), relief under IRC § 6015(f) may be considered.

Tax Court Review

If a request for relief is partially or fully disallowed, the taxpayer may petition the Tax Court within 90 days of the mailing date of the determination letter denying relief. The requesting spouse may also petition the court if the IRS does not make a determination within six months of the time the request is filed.[345]

ANALYSIS OF LITIGATED CASES

There were 14 joint and several liability relief cases litigated between June 1, 2001 and May 31, 2002. Of the 14 cases, 11 were litigated in Tax Court, one in the U.S. Court of Appeals (5th Circuit), one in the United States Court of Federal Claims and one in the Bankruptcy Court for the Northern District of West Virginia. Six of the 14 cases were litigated *pro se*, or without benefit of legal counsel. A detailed listing of the cases litigated is found on Table 3.10.2 of this report.

[344] IRC § 66(c), Spouses relieved of liability in certain other cases.

[345] IRC § 6015(e).

The cases we reviewed break down as follows:

TABLE 3.10.1
JOINT AND SEVERAL LIABILITY LITIGATED CASES

DECIDED IN FAVOR OF		TYPE OF TAXPAYER		TYPE OF CASE		TYPE OF UNDERSTATEMENT	
IRS	8	Individual	3	Understatement	11	Omitted Income	4
Taxpayer	5	Schedule C, Partnership or Trust	9	Underpayment	2	Erroneous Deductions	5
Pending	1	Estate and Gifts	2	Understatement and Underpayment	1	Both Income and Deductions	2
	14		14		14		11

The following is an analysis of some of the significant court decisions:

Cheshire v. Commissioner

The United States Tax Court, in a divided opinion, held in *Cheshire v. Commissioner*[346] that the knowledge requirement of IRC § 6015(c)(3)(C) is met if the IRS proves the requesting spouse had knowledge of the underlying transaction that produced the omitted income and created the deficiency. A dissenting opinion argued that the term "item giving rise to a deficiency" in IRC § 6015(c)(3)(c) is ambiguous, so the statute could mean knowledge of the transaction or activity or it could mean knowledge that an entry on a tax return was incorrect. The court found that the wife had "an actual and clear awareness of the omitted income," which in this case was a retirement distribution. The court found that the wife was aware of the distribution and the fact that it was deposited in a joint account. Thus, the election to allocate liability under IRC § 6015(c) was denied.

The United States Court of Appeals for the Fifth Circuit upheld the Tax Court's decision.[347] The requesting spouse did not qualify for relief under IRC § 6015(b) because she was aware of all of the facts regarding the underlying transaction that resulted in the understatement of tax on the return. This awareness was sufficient in this case regardless of the case's classification as involving an omission of income or an erroneous deduction. The requesting spouse was similarly not entitled to relief under IRC § 6015(c). In making its decision, the Court of Appeals defined "item" to mean an item of income, deduction

[346] 115 T.C.183 (2000), *aff'd.* 282 F.3d 326 (5th Cir. 2002).

[347] Cheshire v. Commissioner, (5th Cir.) 282 F.3d 326 (2002).

or credit, rather than the *incorrect tax reporting* of an item of income, deduction or credit. The Court of Appeals also determined that the Tax Court did not abuse its discretion in denying relief under IRC § 6015(f).

Rowe v. Commissioner

Prior to litigation in the *Rowe*[348] case, the Commissioner granted complete relief to the requesting spouse under IRC § 6015(c) for IRA distributions and farming activity losses attributable to the non-requesting spouse. The IRS also granted partial relief under IRC § 6015(c) for half of the unreported capital gains from jointly held property, an overstated mortgage interest deduction, and overstated charitable contributions that were found to be allocable to the non-requesting spouse. The only items remaining were half of the capital gains, mortgage interest, and charitable contributions and several minor items of income attributable to the requesting spouse. The IRS denied the taxpayer relief for these items under IRC § 6015(b) and under IRC § 6015(f). The Commissioner argued that, considering all facts and circumstances, the determination that petitioner was not entitled to equitable relief was consistent with published guidance.

The Tax Court found that the Commissioner abused his discretion in denying the taxpayer's claim for relief under IRC § 6015(f) for the allocated half of the capital gains, mortgage interest and charitable contributions. The court held that on the basis of all the facts and circumstances, compelling reasons existed for the respondent to grant the petitioner equitable relief. Liability was not eliminated for other minor items of income attributable to the requesting spouse.[349]

Mora v. Commissioner
Estate of Jonson v. Commissioner

Both cases were understatement cases arising from erroneous deductions. In each case, the return showed significant losses as the result of flow-through losses from partnerships.

In *Mora v. Commissioner*,[350] the requesting spouse filed a petition in response to the denial letter received from the IRS. The taxpayer represented herself *pro se*; the non-requesting spouse intervened in this case.[351] The court determined the requesting spouse did not qualify for relief under IRC § 6015(b). Applying the standard enunciated by the U.S. Court of Appeals for the Ninth Circuit in *Price v. Commissioner*,[352] the Tax Court held that the requesting spouse had reason to know of the understatement because the losses

[348] Rowe v. Commissioner, T.C. Memo. 2001-325.

[349] The decision has not been entered and the appeal period is still open.

[350] 117 T.C. 279 (2001).

[351] Tax Court Rule 325 sets forth the procedures for intervention by non-requesting spouses.

[352] 887 F.2d 959, 962 (9th Cir. 1989).

claimed were too large relative to the couple's income for a person of the requesting spouse's education level to ignore.

However, the court considered and granted relief under IRC § 6015(c). It found that the requesting spouse proved she had no involvement in the decision to invest in the partnership or have the partnership group prepare the couple's tax returns. The requesting spouse also signed no partnership documents. The Court cited *King v. Commissioner*[353] in deciding that the requesting spouse did not have actual knowledge. Specifically, the requesting spouse did not know of the factual basis for the denial of the deductions claimed on the return. The court acknowledged that, while in many limited partnership cases neither spouse would have knowledge of the factual basis for denial of deductions, relief under IRC § 6015(c) would not be available to the spouse to whom the deductions are allocated, regardless of knowledge. Although the court ruled for the requesting spouse on this issue, the amount of relief was limited because of the provisions of IRC § 6015(d)(3)(B) (the tax benefit rule). The requesting spouse had the benefit of a reduced liability on the joint return because of the partnership loss.

In *Estate of Jonson v. Commissioner*,[354] the Tax Court was presented with facts similar to those in *Mora*. The wife died while still married to and living with her husband, the petitioner. The husband, as personal representative, filed a claim for relief under IRC § 6015. The court considered relief under IRC § 6015(b), but found that the taxpayer had "reason to know." The deceased wife was educated and involved in the family finances, was aware of the investment and knew of the tax savings and risks. The court then considered relief under IRC § 6015(c), determining that the requesting spouse did not qualify because she was still married to the non-requesting spouse at the time of her death. Finally, the court determined the government did not abuse its discretion in denying equitable relief under IRC § 6015(f), citing several negative factors from IRS published guidance,[355] including consideration of knowledge, significant benefit, and lack of economic hardship.

The key difference in the two cases is the ability to consider relief under IRC § 6015(c). The taxpayer in *Mora* qualified but the petitioner in *Jonson* did not. Marital status was determined at the time of death.[356]

[353] 116 T.C. 198, 203 (2001).

[354] 118 T.C. 106 (2002).

[355] Rev. Proc. 2000-15, 2000-5 I.R.B. 447.

[356] The personal representative on behalf of the estate has appealed this decision.

MORRIS V. COMMISSIONER
BECK V. COMMISSIONER

There were two cases litigated under IRC § 66(c), involving community property jurisdictions. Both of the requesting spouses contended they were entitled to relief because they had not filed joint returns. In *Morris v. Commissioner*[357] the petitioner failed to include any portion of her husband's IRA withdrawals on her separate return. In *Beck v. Commissioner*,[358] the petitioner did not file returns for the periods in question and her spouse included the income on his separate return. Both taxpayers represented themselves *pro se*.

In *Morris*, the Tax Court held that no part of the IRA withdrawal was community income and therefore no portion needed to be reported on the requesting spouse's return. After application of this holding, there remained a small deficiency for the 1996 year. The Court held that the IRS did not abuse its discretion in denying relief under IRC § 66(c) as to this deficiency. In *Beck*, the Court denied relief on the grounds that the requesting spouse had knowledge of the community income, and it would not be inequitable to hold her liable because she benefited from the untaxed income.

The IRS initially contended in *Beck* that the denial of equitable relief under IRC § 66(c) was not subject to judicial review. The Tax Court disagreed. The Court concluded that because IRC § 66(c) was enacted in the same section of legislation as IRC § 6015(f), and the Court had previously decided it had jurisdiction to review the Commissioner's determination for an abuse of discretion under that section, the Court similarly had jurisdiction to review the Commissioner's determination under IRC § 66(c) for an abuse of discretion.[359]

In *Morris*, the taxpayer had filed separate tax returns for the years at issue because she harbored doubts about her spouse's honesty in reporting his tax liability. The IRS determined that he had received several pension distributions and business income that had not been reported. The IRS applied community property principles to determine the parties' share of income, additional tax and deductions. The court, following *Bunney v. Commissioner*,[360] held that the distributee or payee of an IRA distribution is the participant or beneficiary who is entitled to receive the distribution under the plan. The court further concluded that Louisiana community property law did not require a different result. The main erroneous items, the IRA distributions, were not community income and did not need to be included on the separate return.

[357] T.C. Memo. 2002-17.

[358] T.C. Memo. 2001-198.

[359] *See* Butler v. Commissioner, 114 T.C. 276, 287-292. (2000); *see also* Fernandez v. Commissioner, 114 T.C. 324, 328-332 (2000) (Tax Court has authority in "stand alone" petition filed pursuant to IRC § 6015(e)(1)(A) to review denial of relief under section 6015(f).)

[360] 114 T.C. 259 (2000).

The remaining adjustments related to the business income of the petitioner's husband and it was the petitioner's share of that community income that gave rise to a deficiency. The Court found that the taxpayer knew her husband was engaged in business and did not keep reliable records; it appeared she benefited from that income; the remaining deficiency was estimated to be only $200 and the petitioner did not demonstrate that paying that tax would not create an economic hardship. The Court concluded that the Commissioner did not abuse his discretion in denying relief under IRC § 66(c).

FLORES V. UNITED STATES

In *Flores v. United States*,[361] the 1988 joint return reflected a balance due that was not fully paid when the return was filed. The IRS seized the Flores' community property, including their home, sold it and applied the proceeds to the joint liability. The taxpayer filed a timely claim for refund, requesting relief from joint and several liability. The IRS denied the claim and the taxpayer filed a complaint in the United States Court of Federal Claims.

The Court of Federal Claims held the taxpayer was entitled to relief under IRC § 6015(f) for the entire 1988 liability even though only a portion of it was unpaid as of July 22, 1998, the date of enactment of IRC § 6015.

In *Flores*, the Court decided that the phrase "remained unpaid" meant that if any amount of the liability for a year was unpaid, the entire liability for that year "remained unpaid" and was available to be refunded. The amounts to be refunded in this case were the proceeds from the seizure and sale of the petitioner's home. The government is not appealing the decision, but is not acquiescing in the decision. The Tax Court has not yet addressed this issue.

EWING V. COMMISSIONER

In *Ewing v. Commissioner*,[362] the decision of the Tax Court related to the IRS' motion to dismiss the case for lack of jurisdiction. The motion argued that the petition was not timely filed because it was filed 99 days after the IRS mailed the notice of determination, which was beyond the 90-day limit set forth in IRC § 6015(e)(1)(A)(ii). However, the court found the notice of determination was not mailed to the taxpayer's last known address; thus the petition was not filed later than the close of the 90th day after the date the Commissioner mailed the notice of determination to the last known address. The delay caused by the improperly addressed notice was prejudicial to the taxpayer's ability to timely file her petition. The court denied the motion to dismiss.

[361] 51 Fed. Cl. 49 (2001).

[362] 118 T.C. 31 (2002).

During the hearing on the motion, the court raised the issue of whether it lacked jurisdiction under IRC § 6015(e) to review the denial of equitable relief where no deficiency had been assessed. The court, in agreement with both parties' position, held that the absence of a deficiency does not deprive the Tax Court of jurisdiction over a petitioner's claim for equitable relief pursuant to IRC § 6015(f). This opinion basically holds that the Tax Court has jurisdiction over all IRC § 6015 cases, assuming a petition has been timely filed.

The court has not yet addressed the taxpayer's request for relief under IRC § 6015(f). The taxpayer and her husband filed a joint tax return for 1995 and reported tax due but did not pay the full amount. A trial on this issue is scheduled for early in 2003.

CONCLUSION

Our analysis of litigated cases brings into focus several issues that require additional guidance or legislative clarification.

Refunds Available When Taxpayers are Granted Equitable Relief Under IRC § 6015(f)

The provisions of IRC § 6015(g) specifically authorize refunds. The IRS has interpreted the phrase "unpaid tax or any deficiency" in IRC § 6015(f) to mean that refunds were not intended under this subsection. However, the language of IRC § 6015(g) and the allowance of equitable relief under IRC § 6015(f) appear to be sufficiently broad to permit the IRS to grant refunds to taxpayers warranting equitable relief. The IRS' published guidance provides that a requesting spouse is eligible to receive refunds under IRC § 6015(f) for:

1) Amounts paid on or after July 22, 1998, and on or before April 15, 1999; and
2) Installment payments, made after July 22, 1998, pursuant to an installment agreement entered into with the IRS and with respect to which an individual is not in default, that are made after the claim for relief is requested.[363]

This IRS guidance can prevent taxpayers who qualify for equitable relief from joint and several liabilities from receiving such relief. Particularly in those cases where the tax was not paid with the original return, a taxpayer may first learn of the liability when the IRS tries to collect it. To deny a refund of that collected amount to a taxpayer who otherwise qualifies for equitable relief can be in itself inequitable.

For married individuals in community property states, IRC § 66 provides for the allocation of income to the individual earning that income. This section also provides for relief from the effect of community property state laws on the federal tax liability of a spouse when, under the facts and circumstances, it would be inequitable to include the item of

[363] Rev. Proc. 2000-15, 2000-5 I.R.B 447.

community income in the individual's gross income. Therefore, credits and refunds are also restricted in applying IRC § 66(c) equitable relief.

The National Taxpayer Advocate's 2001 Annual Report to Congress discusses this subject in greater detail.[364] The report recommends that the language of IRC § 6015(g) be modified to expand the scope of refunds under IRC § 6015(f) to include those refunds available to the taxpayer under the refund limitation rules described in IRC §§ 6511(a) and (b). Thus, a taxpayer qualifying for equitable relief under IRC § 6015(f) should be entitled to the same refunds as a taxpayer qualifying for "traditional" relief under IRC § 6015(b).

The rights of non-requesting spouses

Currently, the non-requesting spouse (NRS) has two opportunities to participate in the determination of whether the NRS is entitled to relief under IRC § 6015. The IRS notifies the NRS of the requesting spouse's claim for relief and provides the NRS with the opportunity to take part in the administrative review process.[365] IRS includes a questionnaire with its letter to the NRS.[366] The NRS is not required to respond to the questionnaire. However, if the spouse does respond, the examiner will consider the answers in making a decision to grant or deny relief. If the requesting spouse petitions the Tax Court, the NRS is given an opportunity to intervene.[367]

The final regulation under IRC § 6015 provides that the Secretary must notify the NRS of the preliminary and final determination.[368] The regulations do not prohibit the NRS from appealing the IRC § 6015 determinations. Therefore, the NRS will now have a third opportunity to participate. IRS will now notify the NRS of its preliminary decision at the same time that it notifies the requesting spouse. The NRS will have the right to request an Appeals hearing to protest the determination to grant partial or full relief within 30 days of the notification letter. If the determination is a full denial, IRS will inform the NRS that he or she will be contacted if the requesting spouse protests the decision.

IRS is currently developing guidance and administrative procedures to implement these appeal rights. An explanation will be incorporated in letters sent to the requesting and non-requesting spouses. A Taxpayer Advocate Service employee is participating in this initiative.

[364] National Taxpayer Advocate's FY 2001 Annual Report to Congress, Publication 2104 (Revision 12-2001), pages 155 – 158.

[365] IRC § 6015(h)(2).

[366] Form 12508, Innocent Spouse Information Request.

[367] Tax Court Rule 325.

[368] Treasury Regulation § 6015-1, Joint and Several Liability (effective July 18, 2002).

Equitable Relief Factors

The National Taxpayer Advocate's 2001 Annual Report to Congress recommended that Internal Revenue Code § 6015(f) be revised to describe the factors to be used in making the determination to grant equitable relief.[369] Our recommendation that no one factor alone should be sufficient to warrant IRC § 6015(f) relief, and that knowledge, actual or constructive, should not automatically be given more weight than other factors is still applicable.

[369] *National Taxpayer Advocate's FY 2001 Annual Report to Congress*, Publication 2104 (Revision 12-2001) pages 147 – 150.

TABLE 3.10.2
LITIGATED CASES, JOINT & SEVERAL LIABILITY

NAME	CITATION	COURT	ISSUE(S)	*PRO SE*	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Cheshire	282 F.3d 326 (2002)	5th Circuit	Retirement Distributions	No	IRS
Flores	51 Fed. Cl. 49 (2001)	Court of Federal Claims	Claim for refund	No	Taxpayer
Ewing	118 T.C. 31	Tax Court	Underpayment of Tax	No	Case still pending
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Morris	T.C. Memo. 2002-17	Tax Court	Community Property income	Yes	IRS
Smith	T.C. Memo. 2001-313	Tax Court	Unknown – Returns and Deficiency Notice were not available at time of trial	No	IRS
Beck	T.C. Memo. 2001-198	Tax Court	Community Property Income	Yes	IRS
Mueller	T.C. Memo. 2001-178	Tax Court	Items omitted from gross income	Yes	IRS
Mora	117 T.C. 279	Tax Court	Partnership losses	Yes	Taxpayer
Ishizaki	T.C. Memo. 2001-318	Tax Court	Unreported Income	No	IRS
Shafman	267 B.R. 709 (2001)	Bankruptcy Court for the Northern District of W. VA.	Understatement of Income	No	Taxpayer
Gillispie	T.C. Summary Opinion 2002-34	Tax Court	Income from business	Yes	Taxpayer
Rowe	T.C. Memo. 2001-325	Tax Court	Unreported Income/ Disallowance of Deductions	Yes	Taxpayer
Estate/Gift Taxpayers					
Estate of Gurr	T.C. Summary Opinion 2002-7	Tax Court	Capital Gains and Losses	No	IRS
Estate of Johnson	118 T.C. 106	Tax Court	Disallowance of losses related to a limited partnership	No	IRS

MOST LITIGATED TAX ISSUES

LITIGATED ISSUE #11 BARRED REFUNDS

PRESENT LAW

Currently, a claim for refund or credit for an overpayment of tax must be filed within the later of two periods: three years after the filing date of the return to which the overpayment relates, or two years after the tax was paid.[370] If a taxpayer does not file a return, any claim must be filed within two years after the tax is paid.[371] If the taxpayer and the Internal Revenue Service (IRS) agree to extend the time for assessment, the period for filing a refund claim is extended for the same period, plus six months.[372]

If no claim is filed within the prescribed period, the IRS is barred from issuing a refund or credit to the taxpayer, regardless of the merits of the claim.[373] The United States Supreme Court has ruled that the statute of limitations cannot be suspended for equitable reasons.[374]

The two-year and three-year periods for filing claims do not run during any period in which the individual is financially disabled.[375] This situation occurs when the individual is unable to manage his or her financial affairs because of a medically determinable, physical or mental impairment that is expected to result in death, or has lasted or can be expected to last for a continuous period of not less than 12 months. The IRS may require proof of the impairment.[376] An individual is not considered financially disabled during any period when his or her spouse or any other person is authorized to act on behalf of the individual in financial matters.[377] This subsection of the Internal Revenue Code was enacted in 1998.

ANALYSIS OF LITIGATED CASES

A sample of 12 cases, involving claims for refund of an overpayment of tax, which were litigated in the federal court system between June 1, 2001, and May 31, 2002, was analyzed for this section of the report. Table 3.11.1 lists the specific case citations. Eight of the twelve cases were litigated *pro se*, that is, the taxpayers represented themselves before the court. Only four taxpayers had attorneys or other representation.

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370 IRC § 6511(a).

371 Id.

372 IRC § 6511(c)(1).

373 IRC § 6511(b)(1). Long v. United States, 130 Ct. Cl. 806 (1955); Oropallo v. United States, 994 F.2d 25 (1st Cir. 1993), cert. denied, 510 U.S. 1050 (1994); Rinaldi v. Commissioner, 30 Fed. Cl. 164 (1993).

374 United States v. Brockamp, 519 U. S. 347 (1997), but see discussion re IRC § 6511(h)(1) following.

375 IRC § 6511(h)(1), enacted after the Supreme Court's decision in Brockamp (footnote 374).

376 IRC § 6511(h)(2)(A). See Rev. Proc. 99-21 for the specific information required for an individual to request that the limitations period for claiming a tax credit or refund be suspended due to financial disability.

377 IRC § 6511(h)(2)(B).

The following categories of issues were found within the cases litigated due to barred refunds:

- Deposit vs. Payment of Tax
- Formal vs. Informal Claim
- Equitable Relief
- Miscellaneous Issues

Deposit v. Payment of Tax

A taxpayer can make a "deposit" with the IRS before a deficiency has been assessed or while challenging a deficiency in Tax Court. The deposit will prevent interest and penalties from accruing on any deficiency that is ultimately found. Unlike a payment, a deposit is not subject to a claim for credit or refund as an overpayment. The taxpayer may request return of all or part of the deposit at any time before the IRS is entitled to assess the tax. That amount will be returned to the taxpayer without interest, unless the IRS determines that assessment or collection of the tax due would be in jeopardy, or that the amount should be applied against any other liability.[378]

Upon completion of an examination, if a taxpayer who has made a deposit waives restrictions on assessment and collection of the deficiency or otherwise agrees to the full amount of the deficiency, an assessment will be made and any deposit will be applied against the assessed liability as a payment of tax. No notice of deficiency will be mailed in such a case. Thus, the taxpayer will not have the right to petition the Tax Court for redetermination of the deficiency.[379]

The United States Supreme Court has addressed the issue of deposits versus payments, ruling that the individual circumstances of each case must be evaluated.[380] The circumstances include the timing of the remittance, the intent of the taxpayer when making it, and how the IRS treated the remittance upon receipt.[381]

In one of the cases analyzed, the taxpayer argued that his remittances constituted deposits and not payments of tax.[382] However, after reviewing all the facts and circumstances in the case, the court determined that the remittances were payments of tax and not deposits.

[378] Rev. Proc. 84-58.

[379] Id.

[380] Rosenman v. United States, 323 U.S. 658 (1945).

[381] Fier v. United States, 89 A.F.T.R.2d 1649 (2002), at *15; Dantzler v. United States, 183 F.3d 1247, at **7.

[382] Fier v. United States, 89 A.F.T.R.2d 1649 (2002), at *13.

FORMAL V. INFORMAL CLAIM

An individual must file a *formal claim* for refund or credit on Form 1040X, Amended U.S. Individual Income Tax Return, or on Form 843, Claim for Refund and Request for Abatement, within the prescribed statute of limitations.[383] A separate claim must be filed for each year for which the taxpayer is requesting a refund.

An *informal claim* is not filed on Form 1040X and may be a letter or other document, but must contain enough information to be recognized and treated by the IRS as a valid claim.[384] In all three litigated cases involving informal claims that were analyzed for this section, the taxpayers failed to meet the requirements for a valid informal claim.

In one case, the court summarized the law concerning informal claims as follows:

> It has long been recognized that a writing which does not qualify as a formal refund claim nevertheless may toll the period of limitations applicable to refunds if;
>
> (1) the writing is delivered to the IRS before the expiration of the applicable period of limitations,
>
> (2) the writing in conjunction with its surrounding circumstances adequately notifies the IRS that the taxpayer is claiming a refund and the basis therefore, and
>
> (3) either the IRS waives the defect by considering the refund claim on its merits or the taxpayer subsequently perfects the informal refund claim by filing a formal claim before the IRS rejects the informal refund claim. [385]

Equitable Relief

One of the cases litigated in the "equitable relief" category involves a taxpayer who sought a refund of self-employment taxes she paid for the years 1986 to 1995 because her employer led her to believe that she was an independent contractor, making her responsible for paying her employment taxes directly to the IRS.[386] On May 3, 1999, the IRS issued a determination letter ruling that she was an employee for federal tax purposes and that her employer was responsible for paying the employer's share of her social security taxes. Prior to receiving this letter on January 22, 1999, the taxpayer filed a protective claim for refund of the taxes she had erroneously paid. The IRS subsequently refunded the 1995 taxes but disallowed her claims for the years 1986 through 1994 because the claims were not filed within the prescribed period.[387]

[383] IRC § 6511(a).

[384] Jackson v. Commissioner, T.C. Memo. 2002-44, at *11 to *12.

[385] Id.

[386] Knis v. United States, 86 A.F.T.R.2d 7157 (2000), *aff'd* 10 Fed. Appx. 942 (2001).

[387] IRC § 6511(a).

The taxpayer appealed the disallowance to the United States Court of Federal Claims.[388] Her appeal was based on the argument that the statute of limitations should not bar her claim because she was unaware until 1999 that her employer was responsible for paying her social security taxes. In essence, her claim was that the statute of limitations should be suspended for equitable reasons. In denying her claim, the Court cited the United States Supreme Court holding that IRC § 6511 contains no equitable exceptions that would permit a suspension.[389] The taxpayer then appealed to the Court of Appeals for the Federal Circuit, which affirmed the lower court's ruling.[390]

Miscellaneous

Seven barred refund cases fell into the miscellaneous category. They contained a variety of facts and circumstances put forth by taxpayers for their failure to file timely claims.[391] No detailed analysis of these cases was conducted due to the varying issues.

CONCLUSION

The barred refund cases litigated between June 1, 2001, and May 31, 2002, do not present a principal underlying issue. In most instances, the issues appear to be factual in nature and do not suggest that legislation is required to address the perceived problems. In one instance, however, a legislative change may be warranted.

In *Knis v. United States*, the taxpayer erroneously paid self-employment taxes because her employer treated her as an independent contractor.[392] She was denied refunds of one-half of her social security taxes, even though she was unaware that she had been harmed until she received the IRS determination letter. This inequitable result can be alleviated by an amendment to IRC § 6511 to suspend the running of the final determination of employment classification, either in an administrative proceeding, or in a Tax Court proceeding involving determinations of employee status under Section 530 of the Revenue Act of 1978.

[388] Knis v. United States, 86 A.F.T.R.2d 7157 (2000).

[389] United States v. Brockamp, 519 U. S. 347 (1997), at *348.

[390] Knis v. United States, 10 Fed. Appx. 942 (2001).

[391] Burr v. Commissioner, T.C. Memo. 2002-69; Demes v. United States, 52 Fed. Cl. 365; Elder v. I.R.S., 2002-1 U.S.T.C. 50,357; McBride v. United States, 146 F. Supp. 2d 1105; Van Sant v. United States, 2002-1 U.S.T.C. 50,175; Chrysler Corp. v. Commissioner, 116 T.C. 465; R.S. Good Trucking, Inc. v. United States, 2002-1 U.S.T.C. 50,101.

[392] Knis v. United States, 86 A.F.T.R.2d 7157 (2000); 10 Fed. Appx. 942 (2001). See detailed discussion of cases in the Equitable Relief section above.

TABLE 3.11.1
LITIGATED CASES: BARRED REFUND

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business Issues)					
Burr	T. C. Memo. 2002-69	U.S. Tax Court	Whether overpayment shown on 1994 delinquent return was barred as a credit against 1995 and 1996 tax liabilities	Yes	IRS
Demes	52 Fed. Cl. 365	U.S. Court of Federal Claims	Claim for refund of 1989 tax filed in 1998. Refund claim based on bad debt loss carryback	Yes	IRS
Elder	2002-1 U.S.T.C. 50,357	U. S. District Court for the Western District of Virginia, Lynchburg	Claim for refund filed in 2000 of 1985 tax paid in 1987	Yes	IRS
Fier	2002-1 U.S.T.C 50,355	U. S. District Court for the Southern District of New York	Whether funds remitted to IRS in 1988 and 1989 for the 1981 tax year constituted deposits rather than payments		IRS
Jackson	T.C. Memo. 2002-44	U. S. Tax Court	Whether refund of overpayments made in 1993 and 1994 was barred and whether taxpayer's letter to IRS constituted an informal claim	Yes	IRS
Knis	10 Fed. Appx. 942	U.S. Court of Appeals for the Federal Circuit	Claim for refund of self-employment taxes erroneously paid	Yes	IRS

TABLE 3.11.1 — LITIGATED CASES: BARRED REFUND *(cont.)*

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
McBride	146 F. Supp. 2d 1105	U.S. District Court for the Northern District of California	Claim for refund filed in 1998 seeking a refund of taxes, penalties, and interest paid in 1984 and 1988 for tax years 1979 and 1981	No	IRS
Miller	15 Fed. Appx. 875	U.S. Court of Appeals for the Federal Circuit	Informal demand for refund filed in 1997 for refund of taxes withheld from wages for tax years 1977 through 1987 and 1989. Suit based on constitutional arguments	Yes	IRS
Van Sant	2002-1 U.S.T.C. 50,175	U. S. District Court for the District of Columbia	Claim for refund filed in 1993 for tax withheld from retroactive compensation received in 1986	Yes	IRS
Wertz	51 Fed. Cl. 443	U. S. Court of Federal Claims	Informal claim for refund filed in 1998 for tax withheld in 1993	Yes	IRS
Business Taxpayers (Schedule C, Corporation, Partnership, Trust Issues)					
Chrysler Corporation	116 T.C. 465	U. S. Tax Court	Claim for refund filed in 1995 of 1985 tax arising from application of carryover of foreign tax credits from 1980, 1981, and 1982	No	IRS
R.S. Good Trucking, Inc.	2002-1 U.S.T.C. 50,101	U. S. Court of Federal Claims	Claim for refund of employment taxes paid on truck drivers based on the safe harbor provisions of Section 530 of the Revenue Act of 1978	No	IRS

MOST LITIGATED TAX ISSUES

INTRODUCTION

The Taxpayer Advocate Service operates independently within the IRS to help taxpayers resolve problems with the Service, and to address the systemic issues that cause these disputes. In fiscal year (FY) 2001, we strengthened our structure and organization. TAS evolved further in fiscal year 2002, emphasizing our independence, impartiality, and confidentiality – in other words, what it means to be an advocate.

Congress gave TAS two equal, complementary roles: resolving specific tax disputes, and identifying and modifying the programs and procedures that cause them. We have initiated plans to address problems quickly and efficiently through the development of new strategies and initiatives including:

- Implementing the redesigned Taxpayer Advocacy Panels;
- Reviewing and acting upon results of customer satisfaction survey data provided by the Gallup organization;
- Analyzing and improving our case and systemic advocacy processes;
- Developing a training strategy to enhance the technical skills of TAS employees; and
- Designing targeted outreach campaigns to reach taxpayers who may be unaware of our services – or hesitant to avail themselves of assistance.

While developing these new initiatives, we continued our efforts to resolve problem cases affecting both individual and business taxpayers. TAS received approximately 227,000 new cases in FY 2002, compared to approximately 270,000 cases in FY 2001. The decline in receipts may have been caused by several factors, including:

- Improvements to IRS processes (e.g., Earned Income Tax Credit -Revenue Protection Strategy audits);
- Freezes in case activity resulting from the events of September 11, 2001; and
- IRS operating divisions either not recognizing hardship cases or resolving more of them on their own (overall referrals from the divisions were down approximately 38,000 from FY 2001).

Finally, and by no means last, we continue to partner with the IRS on a wide range of teams and task forces geared to overall improvements for all taxpayers. Noteworthy projects include the Service Level Agreements, National Research Program (NRP), offers-in-compromise, and the Earned Income Tax Credit.

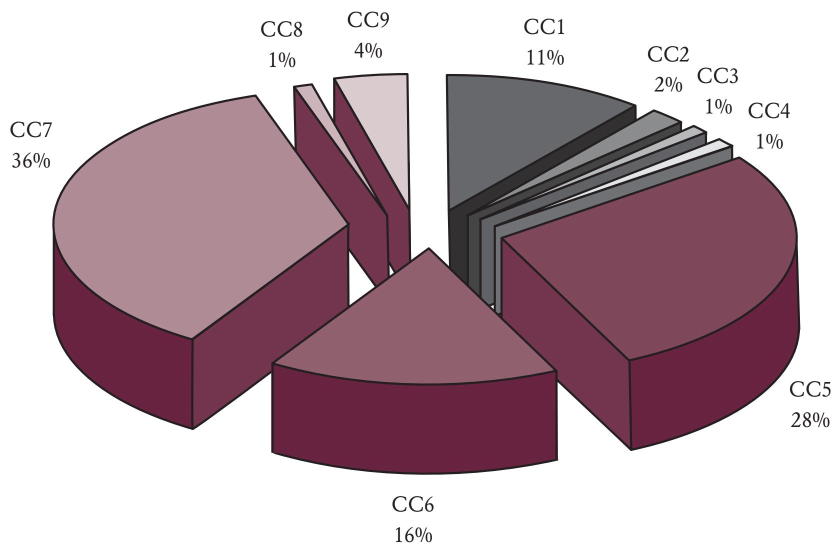
CASE ADVOCACY

Receipts

Most taxpayers contact the Taxpayer Advocate Service because of systemic or procedural hardships with the Internal Revenue Service (including delays) as defined by Internal Revenue Code section 7811(a)(2)(B). Only 15.4 percent of receipts met our criteria for hardship cases as defined by Internal Revenue Code sections 7811(a)(2)(A), (C), and (D) (which are more commonly referred to as economic or financial hardship criteria).

The Taxpayer Advocate Service (TAS) in fiscal year 2002 received 227,373 new cases from taxpayers, practitioners, the IRS Operating Divisions and congressional offices. Table 4.1 illustrates receipts by TAS Criteria Code (CC):

TABLE 4.1
FY 2002 RECEIPTS BY TAS CRITERIA CODE



FINANCIAL OR ECONOMIC HARDSHIP
CC 1: TP suffering or about to suffer a significant hardship (IRC/7811(a)(1)(A)
CC 2: TP facing threat of adverse action (IRC/7811(a)(2)(A)
CC 3: TP will incur significant costs if relief is not granted (IRC/7811(a)(2)(C)
CC 4: TP will suffer irreparable injury, or long term adverse impact (IRC/7811(a)(2)(D)
SYSTEMIC OR PROCEDURAL HARDSHIP
CC 5: TP experienced a delay of more than 30 days to resolve tax account problem (IRC/7811(a)(2)(B)
CC 6: TP has not received a response by the date promised
CC 7: A system(s) or procedure(s) has either failed to operate as intended or failed to resolve the TP's problem
CC 8: Congressional duplicate of any criteria or non-criteria case already in the Taxpayer Advocate Service
CC9: Any case not meeting TAS criteria, but kept in the TAS office to be worked

As in previous years, refund issues comprised a significant source of Taxpayer Advocate Service casework. This includes cases resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001. TAS began tracking these cases in August of 2001, and received 2,539 of them in FY 2002. These taxpayers came to us because they could not understand the notices they received, questioned the amounts of their refunds, could not reach IRS representatives on the toll-free customer service line, or had questions about the new tax law provision. We also received complaints from taxpayers who were eligible for the advanced refund but did not receive it because the IRS was barred from issuing this refund after December 31, 2001. This date, established by the 2001 legislation, left no opportunity to refund monies to taxpayers even in situations where IRS processing difficulties contributed to delays.

Throughout FY 2002, we experienced a significant increase in cases involving levies. We received 8,571 new levy cases during this period compared to 4,199 just one year before, an increase of 105 percent (4,372 cases). While we continue to evaluate these cases, we believe some of the increase is a result of continued implementation of the Federal Payment Levy Program.[1]

We also took in a considerably larger volume of cases involving criminal investigation freezes, which rose from 3,755 in FY 2001 to 5,500 in FY 2002. Many of these taxpayers asked TAS to help with refunds that were frozen while the IRS Criminal Investigation Division completed its probes into possible earned income tax credit fraud, preparer fraud, and similar issues.

The Taxpayer Advocate Service uses the Taxpayer Advocate Management Information System (TAMIS) to track cases. Table 4.2 details the ten most common issues received in TAS this fiscal year. These ten issues accounted for approximately 63 percent of TAS receipts in FY 2002.

[1] IRC § 6331(h).

TABLE 4.2
TEN MOST COMMON ISSUES IN TAS IN FY 2002

DESCRIPTION OF ISSUE	COUNT
Processing claims/amended returns	32,300
Revenue Protection-EITC (refunds frozen pending IRS determination to examine the return.)	26,135
Refund inquiry	20,428
Initial Processing of IMF returns	14,024
Other Penalties	11,260
Problems with payments/credits	8,613
Levies	8,571
Lost/stolen refunds includes entire check tracing process	7,729
Underreporter process-includes both open & closed cases	7,250
Total	**143,425**

Closures

The Taxpayer Advocate Service closed over 244,000 taxpayer cases this past fiscal year, 234,327 of which originated as Applications for a Taxpayer Assistance Order or ATAOs (IRS Form 911 or an acceptable substitute) either in FY 2002 or in prior years. The remaining closures included duplicate congressional inquiries or cases that did not meet TAS criteria. We provided relief in 69 percent of cases that we received as ATAOs. Table 4.3 details the Application for Taxpayer Assistance Order cases that closed in FY 2002.

TABLE 4.3
APPLICATION FOR TAXPAYER ASSISTANCE ORDER CASE DISPOSITION

APPLICATION FOR TAXPAYER ASSISTANCE ORDER (ATAO) DISPOSITION	NUMBER OF CASES	PERCENT OF TOTAL
Relief Granted - Including Taxpayer Assistance Orders	161,611	69.0 %
No Relief Granted - Advocate does not deem relief appropriate.	40,815	17.4 %
No Relief Granted - No response from taxpayer.	16,915	7.2 %
No Relief Granted - Hardship not validated or documentation/verification that the Advocate deems necessary not provided by taxpayer.	4,355	1.9 %
No Relief Granted - Advocate determined relief appropriate, but current law prevents granting relief.	1,716	0.7 %
Advocate Relief Not Required - Relief provided by Operations prior to receipt of ATAO or relief determination.	7,166	3.1 %
Advocate Relief Not Required - Taxpayer rescinds ATAO, no longer requires Advocate relief.	1,452	0.6 %
Advocate Relief Not Required - Taxpayer hardship did not involve in any way the administration of internal revenue laws.	297	0.1 %
Total	**234,327**	**100.0 %**

Taxpayer Assistance Orders

In general, Internal Revenue Code section 7811 authorizes Local Taxpayer Advocates to issue a Taxpayer Assistance Order (TAO) when a taxpayer is suffering or about to suffer a significant hardship as a result of the IRS' administration of tax laws. We issue Direct TAOs to direct an IRS unit to take an action that is specifically authorized by IRC § 7811(b). We issue Review TAOs to require an IRS unit to expedite consideration of a taxpayer's case, review and reconsider its own determination, or review the determination at a higher level in that unit.

During FY 2002, TAS issued 12 TAOs on the following types of cases:

Earned Income Tax Credit (4), Amended Returns (1), Liens (1), Levies (3), Refunds (2), and Interest Abatement (1).

Four of these TAOs were Direct TAOs and eight were Review TAOs. IRS personnel took the requested action(s) in nine of these cases. The IRS appealed one TAO and the National Taxpayer Advocate (NTA) rescinded the order. Another TAO was rescinded at

the Area Advocate level because it was issued prematurely. The IRS verbally appealed another TAO, but provided relief to the taxpayer after securing additional information.

Internal Revenue Code section 7811(b) provides that the terms of the Taxpayer Assistance Order may require the Secretary to take an action within a specified timeframe. The IRS took the requested action(s) or appealed the TAO within the requested timeframes on all but two of the 12 TAOs issued. While the requested timeframes for action or appeal were reasonable for the actions requested on these two TAOs, the IRS responded within six calendar days after the specified timeframe.

We issued three TAOs during FY 2002 where the requested actions were not appropriate subjects of a TAO under IRC § 7811(b). The IRS Operating Division took the requested actions immediately on two of these cases. The third was appealed, but the IRS subsequently complied.

Congressional Casework

The Taxpayer Advocate Service responds to all tax account related inquiries sent to the IRS by members of Congress, even when these inquiries do not constitute significant hardships under IRC § 7811(a)(2). The Taxpayer Advocate Service responded to over 20,000 congressional inquiries during FY 2002. Of these inquiries, 18,366 met the significant hardship criteria defined in IRC § 7811(a)(2). Table 4.4 highlights the case disposition of these hardship inquiries. The remaining congressional inquiries either did not meet hardship criteria or were identified as a case with multiple inquiries on the same taxpayer and issue.

TABLE 4.4
CONGRESSIONAL CASEWORK

CONGRESSIONAL CASE DISPOSITIONS	NUMBER OF CASES	PERCENT OF TOTAL
Relief Granted	11,126	31.2 %
No Relief Granted - Advocate does not deem relief appropriate.	5,728	60.6 %
No Relief Granted - Advocate determined relief appropriate, but current law prevents granting relief.	321	6.5 %
Advocate Relief Not Required - Relief provided by Operations prior to receipt of ATAO or relief determination.	1,191	1.7 %
Total	**18,366**	**100.0 %**

The issues raised most frequently by taxpayers seeking congressional intervention in FY 2002 included: refund issues, abatement of penalties, request for tax law interpretations, offers in compromise, processing of claims and amended returns, processing of original individual returns, problems with payments and credits, collection notices, levies, and the underreporter (information reporting) process.

Senate Finance Committee

While the Senate Finance Committee continues to receive Internal Revenue Service related inquiries, the quantity has significantly declined. In fiscal year 2002, the Committee referred 17 new cases to the Taxpayer Advocate Service, down from 68 in fiscal year 2001.

The most frequent issues raised by taxpayers seeking assistance from the Senate Finance Committee in FY 2002 included: offers-in-compromise, abatement of penalties, and taxpayers unable to pay their liabilities. In fiscal year 2002, we closed 28 Senate Finance Committee cases. Table 4.5 depicts the disposition of these cases:

TABLE 4.5
SENATE FINANCE COMMITTEE CASE CLOSURES

CASE DISPOSITION	NUMBER OF CASES	PERCENT
Relief provided (Partial or Full)	15	53.6 %
Relief not appropriate	12	42.9 %
Law prevented relief	1	3.5 %
Total	**28**	**100.0 %**

Small Business Regulatory Enforcement Fairness Act (SBREFA) Cases

The Small Business Regulatory Enforcement Fairness Act of 1996 established a process for small businesses to register complaints with the Small Business Administration and Agriculture Regulatory Ombudsman (more commonly referred to as the SBA Ombudsman), or with a Regional Small Business Regulatory Fairness Board, about enforcement-related activities taken by federal agencies.

When a small business taxpayer writes to the SBA Ombudsman, the ombudsman's office reviews the correspondence and writes a letter to the federal agency involved, asking some very specific questions about the actions taken with regard to the small business. Correspondence from the Ombudsman to the IRS is sent to the Small Business/Self-Employed Division's Taxpayer Education and Communication (SB/SE TEC) Office. That office then forwards this correspondence to TAS to investigate the issues surrounding the taxpayer's complaint and to respond to the SBA Ombudsman's questions.

This past fiscal year, TAS received 10 new SBREFA cases. Prior to receiving these cases, TAS had not received a SBREFA inquiry since November 1999. Some of the issues presented in these cases include:

- Federal Tax Deposit Penalties
- Notices of Federal Tax Lien
- Electronic Federal Tax Payment System (EFTPS)
- Rental Income and Expenses

SYSTEMIC ADVOCACY

Receipts

The Taxpayer Advocate Service's Office of Systemic Advocacy has dramatically improved the means of receiving advocacy submissions and transforming them into viable projects. Systemic Advocacy has consolidated the workload, streamlined the flow of information, and eliminated multiple reviews. The inventory of advocacy issues and projects has been centralized and issues prioritized using new methodology and criteria. The Taxpayer Advocate Service considers each potential project under the following standards:

- Impact on taxpayer rights
- Reduction of taxpayer burden
- Ease of administration
- Fairness

Processing

The Systemic Advocacy Management System (SAMS) is a web-based system that is scheduled to become operational in 2003. It will assess, rank and store advocacy submissions, as well as deliver them directly from their originators to headquarters. SAMS will extend beyond the Taxpayer Advocate Service, allowing all IRS employees to submit, research, and track advocacy issues. Interested parties outside the IRS, including businesses, individuals, academic and research institutions, and professional organizations may also submit issues by simply completing a form on the IRS website (**http://www.irs.gov**) and emailing it to **Systemic.Advocacy@irs.gov**.

The new system provides a natural linkage to the Taxpayer Advocacy Panel (formerly the Citizen Advocacy Panel). SAMS will facilitate support for and coordination with the panel and will provide TAS with additional resources and information.

Earned Income Tax Credit

The Taxpayer Advocate Service worked with the IRS to improve processes and procedures related to the Earned Income Tax Credit (EITC). The National Taxpayer Advocate served on the Executive Steering Committee for the Joint Treasury/IRS EITC Task Force. A TAS representative served as a member of the Task Force. The Task Force's two primary goals were to reduce erroneous EITC payments and maintain participation in the EITC program. TAS is now working with teams that are designing an implementation strategy for Task Force proposals.

In addition to the EITC Steering Committee and Task Force, TAS is monitoring math error notice processing and initiatives as well as working with the Wage and Investment Operating Division on day-to-day issues related to EITC. Despite the efforts of TAS and the IRS, taxpayers who claim EITC experience many problems. The National Taxpayer Advocate details seven discrete problems with EITC in the Most Serious Problems section of this report.

Automated Collection System

The Taxpayer Advocate Service is a member of the Wage & Investment Operating Division (W&I) Automated Collection System (ACS) Internal Revenue Manual (IRM) Rewrite Team. The purpose of the team is to rewrite IRM 5.19, Liability Collection, and incorporate parts of W & I IRM 21, Accounts Management, to provide procedural guidance. TAS' participation ensures that the team addresses taxpayer rights (including the Appeals process), taxpayer burden issues, and the priority of and procedures for processing TAS cases. Problems that taxpayers experience with ACS are presented in more detail in the Most Serious Problems section of the report.

Offers-in-Compromise

The Office of the Taxpayer Advocate has coordinated with the Small Business/Self-Employed (SB/SE) Operating Division to redesign the processing of offers-in-compromise (OIC). During FY 2002, the National Taxpayer Advocate and TAS representatives visited the two Centralized OIC sites located in Memphis and Brookhaven. TAS worked with SB/SE to refine procedures and ensure the procedures supported IRS Policy Statement P-5-100, which describes the program's purpose, operational goals, and requirements. The Taxpayer Advocate Service is monitoring the changes to the process, ensuring that taxpayers' rights are protected, and that their ability to have a dialogue with the decision maker is preserved. We have also been involved in refining the qualifications for Effective Tax Administration (ETA) Offers. Problems with processing offers-in-compromise and IRS actions to address the problems are discussed in detail in the Most Serious Problems sections of this report.

Taxpayer Advocacy Panels

During fiscal year 2002, the Taxpayer Advocate Service worked with the Department of Treasury and the IRS to redesign the existing Citizen Advocacy Panels. The new Taxpayer Advocacy Panel (TAP) will provide nationwide coverage and "listening opportunities" for taxpayers in all 50 states.

The TAP is aligned with the Office of the National Taxpayer Advocate and will work with TAS and the IRS Functions and Operating Divisions to identify strategic initiatives that need or will benefit from citizen comment. The IRS Functions and Divisions will turn to the TAP for comments and suggestions about IRS strategic initiatives or key program changes that impact taxpayers. The TAP will also identify and capture grass-roots level issues and elevate them to the IRS.

Taxpayer Advocacy Panel members are volunteers, each of whom serves in one of seven geographic areas that are aligned with TAS areas. In addition, TAP members serve on Issue Committees that have responsibility to act on or consider issues of strategic importance to the tax administration system. Each issue committee is empowered to work directly with the IRS program owner to provide observations or recommendations on the issue before them, monitor the status and progress on the issue, and identify concerns in design and implementation of the issue.

The National Taxpayer Advocate believes that the structure and responsibilities of the Taxpayer Advocacy Panel increase opportunities for U.S. taxpayers to communicate with IRS.

Disaster Relief

The Taxpayer Advocate Service supported the IRS in addressing tax issues and questions raised by the September 11, 2001 terrorist attacks. The Taxpayer Advocate Service also supported the Killed in Terrorist Action program, which provided a means to provide immediate tax assistance to families of those who were killed in the attacks.

As of the end of fiscal year 2002, 214 taxpayers who were directly affected by the September 11 attacks had contacted the Taxpayer Advocate Service for assistance. Twenty-eight percent of the taxpayers were experiencing a financial or economic hardship. This compares to approximately 15 percent for all TAS cases. These taxpayer issues included: expedited refund request, claims/amended returns, and penalty abatement requests.

TAS remains committed to IRS disaster relief efforts. We serve on the Disaster Relief Council and worked with the Council to develop a new IRS Disaster and Emergency Relief manual.

Collection Contract Support Project

During the past year, the Taxpayer Advocate Service has been active in evaluating the Small Business/Self-Employed operating division (SB/SE) modernization proposal to collect delinquent debts through private collection agencies. We will continue to look at:

- Legislative initiatives recommending that the IRS use private collection agencies to collect federal tax liabilities.
- Private collection agencies' ability to safeguard taxpayer rights through training and oversight. Taxpayers and their representatives have experienced difficulty, depending on the terms of the contractor's compensation, when trying to resolve cases through methods other than collection. Under certain contractual arrangements, if a taxpayer raises a question regarding the underlying liability, the agency may resist or refuse outright to send the case back to the IRS for review and consideration.
- The IRS' analysis of its ability to work and monitor the referrals anticipated from such a project. The success of using contractors to collect federal tax debt is dependent upon IRS' ability to ensure taxpayer rights protections are in place and monitored, provide guidance, training, and oversight of contractors, and develop a system to refer appropriate cases. We have no clear view of the magnitude of referrals that could be generated by such an initiative and the strain this would place on already limited resources.
- Safeguards for unrepresented low income taxpayers to prevent them entering into unreasonable collection arrangements.

While SB/SE has the primary responsibility for this effort, the Office of the Taxpayer Advocate has partnered with SB/SE to develop potential legislative initiatives. TAS has focused on preserving taxpayer rights and developing processes that afford taxpayers the same procedural and statutory protections in dealing with private contractors that they currently have in their dealings with the IRS. TAS will continue to monitor the implementation phase, as well as work individual cases referred from collection agencies, if the "contracting out" provisions are enacted.

National Research Project

In early fiscal year 2003, the IRS launched the National Research Project (NRP), a research program designed to develop more accurate audit selection criteria. This program replaces the Tax Compliance Measurement Program (TCMP), which consisted of line-by-line audits of individual and business taxpayers.

One component of this program involves Earned Income Tax Credit (EITC) examinations. Taxpayers will be randomly selected to undergo an examination for this issue. The results of this study will drive, to a certain extent, the return selection strategy for EITC examinations for years to come.

The National Taxpayer Advocate believes that taxpayers obtain much more favorable results when they have representation in these audits. Thus, TAS worked with the NRP team to ensure that each NRP contact letter for an EITC examination will include a "stuffer," on which is listed a short message about the availability of free or nominal fee representation for low income taxpayers in these audits. These stuffers include the name, city, state, and telephone number of every Low Income Taxpayer Clinic receiving funding under IRC § 7526; and a reference to other types of organizations that may provide similar *pro bono* assistance.

Federal Payment Levy Program

During FY 2002, we made strides to open the lines of communication between IRS Operating Divisions as a result of systemic or procedural problems involving Federal Payment Levy Program (FPLP) levies. We have made efforts this year to work more closely with the Operating Division to provide TAS perspective on guidance and clarification of FPLP policies and procedures.

Business Advocacy

A strong Business Advocacy organization is crucial to the overall success of the Taxpayer Advocate Service. Its mission is to collaborate with IRS and external stakeholders to identify and resolve problems. These may pertain to processes, systems, statutes, policies, or communication. Nearly half of all TAS cases involve business taxpayers, ranging from self-employed taxpayers to large international corporations.

Business Advocacy accomplishments include:

- influencing changes to proposed regulations;
- working with the Small Business Administration to identify small business concerns with the IRS;
- partnering in taskforces that improve processes; and
- recommending changes to business taxpayer correspondence.

Other Collaborative Efforts

The Taxpayer Advocate Service partners with IRS functions to ensure that barriers to taxpayers' understanding of and compliance with tax law are eliminated. TAS is also vigilant in protecting taxpayer rights that might be impacted by procedural changes. Some of the Office of Systemic Advocacy's current projects include:

- Membership on SB/SE's Burden Reduction Council, which evaluates and approves methods of simplifying forms and publications.
- Wage and Investment (W&I) – focusing on administration of all aspects of Earned Income Tax Credit;
- Large & Mid-Sized Business (LMSB) – addressing the area of incorrect penalty assessment;
- Tax Exempt /Governmental Entities (TE/GE) – assessing the Impact of regulations on retirement plan payers;
- Appeals – analyzing the results of collection due process; and
- Chief Counsel – evaluating taxability of certain categories of trucks/tractors.

CRITERIA USED TO RANK MOST SERIOUS PROBLEMS

RANKING CRITERIA FOR MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

MOST SERIOUS PROBLEM	IMPACT ON T/P'S RIGHTS	TOTAL NUMBER OF T/PS AFFECTED	VISIBILITY / SENSITIVITY / INTEREST				BARRIERS TO TAX LAW COMPLIANCE (COST, TIME, BURDEN)	REVENUE IMPACT OF NON-COMPLIANCE	TAMIS INVENTORY DATA
			NTA	STAKE-HOLDERS	CONGRESS	EXTERNAL INDICATORS			
Navigating the IRS	◆	◆	◆	◆	◆	◆	◆	◆	
Offer-in-compromise	◆	◆	◆	◆	◆	◆	◆		◆
Math Error Authority	◆	◆	◆	◆	◆		◆	◆	
Information Reporting	◆	◆	◆	◆	◆		◆	◆	◆
Processing Claims for Refund	◆		◆	◆	◆	◆	◆		◆
EITC – Substantiating Eligibility	◆		◆	◆	◆		◆		◆
EITC – Exam/Audit Procedures	◆		◆	◆	◆		◆		◆
EITC - Lack of Response in Audits			◆	◆	◆		◆		◆
EITC – Paid Return Preparers			◆		◆		◆		
EITC - Length of Audits	◆		◆	◆	◆		◆		◆

(continued on next page)

MOST SERIOUS PROBLEM	IMPACT ON T/P'S RIGHTS	TOTAL NUMBER OF T/PS AFFECTED	VISIBILITY / SENSITIVITY / INTEREST				BARRIERS TO TAX LAW COMPLIANCE (COST, TIME, BURDEN)	REVENUE IMPACT OF NON-COMPLIANCE	TAMIS INVENTORY DATA
			NTA	STAKE-HOLDERS	CONGRESS	EXTERNAL INDICATORS			
EITC - Recertification			◆	◆	◆		◆		◆
EITC - Language Barriers			◆		◆		◆		
Access to Free Tax Return Preparation	◆	◆	◆	◆	◆		◆	◆	
Access to ACS	◆		◆	◆	◆	◆	◆		
Collection Due Process	◆		◆	◆		◆			◆
Federal Tax Deposits		◆	◆	◆	◆		◆	◆	◆
Toll-Free Accuracy		◆	◆	◆	◆		◆		◆
Toll-Free Access		◆	◆	◆	◆	◆	◆		
Refund Inquiries		◆	◆	◆	◆				◆
Obtaining EINs			◆	◆		◆	◆		
Delays Receiving Documents			◆		◆		◆	◆	◆
Misapplied Payments		◆	◆				◆		

TAMIS LIST OF TAXPAYER PROBLEMS

TOP 25 TAXPAYER ISSUES FOR FISCAL YEAR 2002 SORTED BY VOLUME ON TAXPAYER ADVOCATE MANAGEMENT INFORMATION SYSTEM (TAMIS)

MI-CODE	DESCRIPTION	TOTAL	PERCENTAGE
330	Initial processing of claims or amended returns	32,249	14.2
471	Examination due to Revenue Protection Strategy (RPS)	26,451	11.7
020	Expedite refund request or request for refund status	20,165	8.9
310	Initial processing of original paper or electronic IMF return	13,944	6.2
511	Request involving adjustment or abatement other than FTD penalties	11,243	5.0
210	Problems with payments/credits made to IRS other than EFTPS/FTD/ES payments. Includes excess collection issues.	8,598	3.8
741	Levy issues	8,545	3.8
010	Lost or stolen refunds	7,691	3.4
430	Underreporter process	7,263	3.2
620	Audit Reconsideration	7,067	3.1
610	Examination of tax return in progress prior to assessment on AIMS	6,204	2.7
474	Open Criminal Investigation Freezes	5,509	2.4
790	Other-no other MI code applies	5,108	2.3
771	Offers in compromise issues	4,435	2.0
420	Request for forms, publications. Copies of returns and transcripts	3,478	1.5
230	Problems with FTD, EFTPS & ES payments or credits	3,350	1.5
413	SS4 Application & Entity changes not covered by MI code 410, 411 or 412	3,185	1.4
742	Lien issues	3,156	1.4
760	Substitute for return assessment (SFR) and IRC 6020b assessments	3,022	1.3
730	Notices issued prior to ACS or Collection Field Operation and no other MI Code appropriate	3,013	1.3
340	Initial processing of other returns or documents	2,786	1.2
740	Inability to make balance due payments (can't pay, TC 530, etc.)	2,649	1.2
460	Offsets made to tax liabilities or federal or state agencies	2,645	1.2
320	Initial processing of original paper or electronic BMF return	2,631	1.2
470	EIC issues other than Revenue Protection Strategy (RPS)	2,550	1.1
	Grand Total	**226,707**	**100.0**
	Includes TAMIS receipts from 10/01/2001 to 09/30/2002 excluding reopens.		

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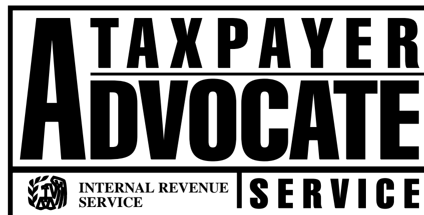
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