

### INTRODUCTION

Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code requires the National Taxpayer Advocate to include in her Annual Report to Congress, among other things, legislative recommendations to resolve problems encountered by taxpayers.

In the 108th Congress concluded a year ago, four proposals we recommended were enacted into law – a uniform definition of a child,<sup>1</sup> an “above-the-line” deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,<sup>2</sup> authorization for the IRS to enter into partial-pay installment agreements,<sup>3</sup> and the availability of income averaging for commercial fishermen.<sup>4</sup> In addition, at least a dozen of our recommendations passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003, or the full Senate as part of S. 882, the Tax Administration Good Government Act of 2004.<sup>5</sup>

During the first session of the 109th Congress, the Taxpayer Protection and IRS Accountability Act and the Tax Administration Good Government Act were not reintroduced, and Congress did not focus on tax administration issues in any significant way. The National Taxpayer Advocate encourages the House Ways and Means Committee and the Senate Finance Committee to give renewed attention to tax administration legislation in the coming year. IRS procedures and technological capabilities change over time, and it is important that the law keep up with IRS practices both to enable the IRS to do its job better and to protect taxpayer rights. The legislation that passed each House during the 108th Congress would be a good starting point.

We continue to advocate for the legislative recommendations we have made previously. In this report, we present seven new Key Legislative Recommendations and three new Additional Legislative Recommendations.

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<sup>1</sup> Working Families Tax Relief Act, Pub. L. No. 108-311, § 201 (2004).

<sup>2</sup> American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004).

<sup>3</sup> *Id.* at § 843 (2004).

<sup>4</sup> *Id.* at § 314 (2004).

<sup>5</sup> The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled Federal income tax preparers.

## KEY LEGISLATIVE RECOMMENDATIONS

**Tax Reform Principles.** Two months ago, the President’s Advisory Panel on Federal Tax Reform submitted a report to the Secretary of the Treasury proposing significant revisions to the Internal Revenue Code, and it appears that Congress may give serious consideration to fundamental tax reform in the next year or two. We recommend that Congress give priority emphasis to six core principles as it considers various tax-reform proposals: (1) the tax system should not “entrap” taxpayers; (2) the tax laws should be simple enough so that taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistants can fully and accurately answer taxpayers’ questions; (3) the tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance; (4) the tax laws should provide some choices, but not too many choices; (5) the tax laws should not necessarily avoid refundable credits but, if it includes them, should design them in a way that is administrable; and (6) the tax system should incorporate a periodic review of the tax code – in short, a sanity check.

**Measures to Reduce Noncompliance in the Cash Economy.** The IRS estimates the annual federal tax gap for 2001 was between \$257 billion and \$298 billion. The IRS receives about 130 million income tax returns each year. Thus, every taxpayer is forced to pay an average \$2,000 “surtax” each year to subsidize noncompliance. IRS data show that the highest rate of noncompliance by far is attributable to transactions that are not reported to the IRS on a Form W-2, Form 1099, Schedule K-1, or similar form. These unreported transactions occur largely in the so-called “cash economy.” To reduce the tax burden on compliant taxpayers, we recommend that Congress (1) create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by (a) instituting backup withholding on payments to taxpayers who have demonstrated “substantial noncompliance”; (b) releasing backup withholding on payments to “substantially noncompliant” taxpayers who have demonstrated “substantial compliance” and agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and (c) providing that payors will not be required to institute backup withholding on payments to independent contractors that present payors with a valid IRS “compliance certificate”; (2) require the IRS to promote making estimated tax payments through EFTPS; (3) authorize voluntary withholding agreements between independent contractors and service recipients; and (4) require third-party information reporting for applicable payments to corporations with 50 or fewer shareholders.

**Tax Reform for Families: A Common Sense Approach.** The Internal Revenue Code contains six provisions related to a taxpayer’s family status: the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), the Child and Dependent Care Credit, personal and dependency exemptions, the head-of-household filing status, and the “separated spouse” rules of IRC § 7703(b). Each of these six provisions directly or indirectly

confers a tax benefit on taxpayers who meet the various eligibility requirements, and at least one of these six provisions impacts every U.S. individual taxpayer. To build upon the recently enacted Uniform Definition of Child and to further simplify the family status provisions, we recommend that Congress (1) combine the exemptions, CTC, and part of the EITC and head of household filing status into a refundable Family Credit comprising two components – one for the taxpayer (and his or her spouse) and one for whomever is the “main carer” of a child or children based on a per-child amount; (2) separate the Child and Dependent Care Credits into two credits; (3) eliminate head-of-household filing status; (4) modify the EITC so that it provides a refundable credit to low income workers based solely on the taxpayer’s earned income and is available to workers age 18 and over, regardless of the existence of children in the household; (5) permit married taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the calendar year to be considered “not married” for purposes of filing status; and (6) provide a separate credit for noncustodial parents of qualifying children who pay all child support obligations due for that calendar year.

**Another Marriage Penalty: Taxing the Wrong Spouse.** The federal income tax liabilities of married persons are often imposed on or collected from a spouse who did not earn the income subject to tax, i.e., the “wrong” spouse. Current law provides some relief to a spouse held liable for tax on the other spouse’s income, at least in cases where the first spouse did not know about the income and did not significantly benefit from it. However, the relief rules are sometimes overly narrow, complex, costly for the IRS to administer, and burdensome for taxpayers. Even if relief rules apply so that one spouse is not liable for his or her spouse’s tax, the IRS may be able to collect the liability from the non-liable spouse in community property states. We recommend that Congress amend the law to tax the “right” spouse in the first instance and to prevent the IRS from undermining this rule through its collection efforts. Our recommendation would better align each person’s tax with his or her individual ability to pay, significantly reduce complexity, and minimize the impact of state property and collection laws that subject taxpayers to different amounts of federal income tax solely because they reside in different states.

**Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds.** Many financial institutions through which investors own stocks and mutual funds (“brokers”) do not currently keep track of an investor’s basis in the stocks or mutual funds, and no brokers report basis information to both taxpayers and the IRS on a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*. The absence of information reporting creates serious problems for many taxpayers and the government alike. For taxpayers, tracking basis can be extraordinarily complex and many taxpayers seeking to comply with the law find they simply cannot do so with accuracy, leaving them exposed if audited. From the government’s perspective, the absence of information reporting enables underreporting by taxpayers who deliberately overstate their basis (thereby reducing their gain or even generating a loss), because they know the IRS generally cannot detect errors in basis reporting in the absence of an audit. One recent

estimate puts the revenue loss to the government from such underreporting at \$250 billion over the next 10 years. We recommend that brokers be required to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B. To offset the cost of implementing a tracking system, we note that Congress could provide a one-time tax credit for brokers.

**Tracking Cost Basis as a Result of Estate Tax Repeal.** Under the current estate tax regime, persons acquiring property from a decedent are able to use a “stepped-up” basis equal to the fair market value of the property at the date of the decedent's death (or, if they so elect, on the date six months after the decedent's death). Once the estate tax is repealed in 2010, these taxpayers must use the modified carryover basis, which may require extremely complex calculations to determine the property's adjusted basis in the hands of the decedent just prior to death. Reconstructing adjusted basis in property is difficult enough while taxpayers holding such assets are alive; after death, it can become impossible. Congress should explore ways to lessen this compliance burden.

**Restructuring and Reform of Collection Due Process Provisions.** Collection Due Process (CDP) hearings afford taxpayers the opportunity to obtain meaningful review of IRS collection actions by an impartial IRS Appeals Officer and the courts, either after the initial filing of a Notice of Federal Tax Lien or before an initial levy on a taxpayer's assets. The current statutory CDP rights are both under-inclusive and over-inclusive, denying judicial review of some lien and levy actions while encouraging counterproductive behavior on the part of some taxpayers and the IRS. To enhance taxpayer protections in the tax collection process while ensuring that the IRS's ability to collect the correct amount of tax is not unreasonably impaired, we recommend that Congress (1) require the IRS to issue a separate CDP Right to Hearing notice at the time it undertakes the first levy action with respect to a tax, describing with specificity the levy source and date such levy will occur and providing the taxpayer with the name and contact information of an IRS employee to call about the levy action; (2) consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases; and (3) codify both the IRS Collection Appeals Program (CAP) and the IRS Audit Reconsideration Process and specifically include Audit Reconsideration as an alternative to be considered at CDP hearings.

**ADDITIONAL LEGISLATIVE RECOMMENDATIONS**

**Direct Deposit of Income Tax Refunds.** Under present law, there are no procedures in place for the IRS, the government's Financial Management Service (FMS), and financial institutions to address inadvertent errors by taxpayers relating to direct deposits of tax refund checks. Disputes over the accuracy of a direct deposit refund due to taxpayer or preparer error must currently be resolved between the taxpayer and the financial institution itself, with little assistance from the IRS. The National Taxpayer Advocate recommends that Congress amend the Internal Revenue Code to create a process through which the IRS and financial institutions work together to identify the incorrect recipient of a direct deposit refund and require the return of the improperly deposited funds.

**Social Security Levies.** Current law exempts from IRS levy certain pension and annuity payments (including payments under the Railroad Retirement Act), but it does not exempt retirement, survivors, and disability insurance payments made under the Social Security Act from levy. Levies by the IRS on Social Security benefits can cause particularly severe hardships for low income taxpayers who rely on these payments as their primary or sole source of income. The National Taxpayer Advocate recommends that Congress exempt Social Security payments altogether from IRS levy. In the alternative, the National Taxpayer Advocate recommends that Congress extend the exemption amount applicable to manual levies to automated levies under the Federal Payment Levy Program.

**Debt Collection Techniques on EITC Benefits by the Refund Anticipation Loan Industry.** Refund anticipation loan (RAL) customers may not completely understand the ramifications of the debt offset collection provisions included in standardized RAL contracts. The provisions give the contracting financial institution or bank the authority to offset RAL proceeds to satisfy outstanding delinquencies owed on RALs previously issued by either the contracting bank or a third-party bank. The practice allows banks to effectively seize EITC benefits and transfer the funds to themselves or third-party banks to satisfy these prior delinquencies. The National Taxpayer Advocate recommends that Congress amend IRC § 32 to prohibit banks from exercising their right to set off on EITC benefits, a protection that currently exists for Social Security benefits. At the very least, the law should prohibit banks from transferring any portion of a federal tax refund representing the EITC to a third-party bank.

**STATUS OF THE NATIONAL TAXPAYER ADVOCATE'S LEGISLATIVE  
RECOMMENDATIONS, 109TH CONGRESS**

Recommendation	Bill No.	Sponsor	Date	Current Status
<b>Alternative Minimum Tax</b>				
Repeal the Individual AMT	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Senate Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Index AMT exemption	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	Passed House 12/7/2005; Placed on Senate Legislative Calendar 12/13/2005.
<b>Tax Preparation and Low Income Taxpayer Clinics</b>				
Matching Grants for LITC for Return Preparation	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Senate Finance Committee
Regulation of Income Tax Return Preparers	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Senate Finance Committee
<b>Small Business Issues</b>				
Health Insurance Deduction/Self-Employed Individuals	S 663	Bingaman	3/17/2005	Referred to the Senate Finance Committee
Married Couples as Business Co-owners	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Federal Tax Deposit (FTD) Avoidance Penalty	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Election to be treated as an S Corporation	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee

## 1

## KEY LEGISLATIVE RECOMMENDATION: A TAXPAYER-CENTRIC APPROACH TO TAX REFORM

## PROBLEM

In our 2004 Annual Report to Congress, the National Taxpayer Advocate identified the “Confounding Complexity of the Tax Code” as the most serious problem facing taxpayers. This complexity imposes enormous and unacceptable burdens on taxpayers.

Tax law complexity shows up in many areas. For starters, the Internal Revenue Code itself is approximately 1.5 million words long,<sup>1</sup> with one popular version encompassing 9,540 pages of text, along with five volumes of regulations.<sup>2</sup> Approximately 61 percent of individual taxpayers pay for tax preparation,<sup>3</sup> as do an astounding 68 percent of low income taxpayers who claim the Earned Income Tax Credit (EITC).<sup>4</sup> The IRS estimates the paperwork burden of completing a Form 1040 to be 13.7 hours,<sup>5</sup> and a leading academic estimates the overall compliance burden for individual and business taxpayers to be \$125 billion.<sup>6</sup> Meanwhile, an entire industry has built up around taxes that extends beyond the mere acts of preparing and filing returns. Taxpayers now pay for tax preparation software, for filing electronically, for “audit insurance,” and for Refund Anticipation Loans and Refund Anticipation Checks. Tax refunds are cross-marketed with debit cards for discount stores, furniture rentals, mortgages, and used cars.

The tax law is so complicated that the IRS limits the types of returns it will prepare for taxpayers in its walk-in sites or that it will allow Volunteer Income Tax Assistance (VITA) sites to prepare, even as it directs more and more taxpayers to those sites for assistance. In fact, the IRS designates entire areas of taxpayer questions “out of scope” for its assistants to answer.

Tax rules and regulations are the Number One headache for small business. And at the top of every complexity list is the Alternative Minimum Tax (AMT), which will impact 34.8 million individual taxpayers – fully 34 percent of all individual taxpayers – in

<sup>1</sup> A study published in April 2001 by the Joint Committee on Taxation put the number of words in the Code at approximately 1,395,000. See Staff of the Joint Committee on Taxation, 107th Cong., 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 (vol. I), 4 (Comm. Print 2001). Subsequent tax legislation has expanded the number of words considerably.

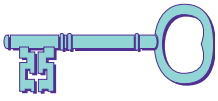
<sup>2</sup> The Complete Internal Revenue Code – All the Income, Estate & Gift, Employment, Excise, Procedure and Administrative Provisions (updated to reflect all tax legislation through December 1, 2004), Research Institute of America, (December 2004); Federal Tax Regulations – Complete text of all final, temporary and proposed Treasury Regulations pertaining to income tax, estate tax, gift tax, employment tax, procedure, administration, and excise taxes, Research Institute of America, (January 2004).

<sup>3</sup> IRS Office of Research, *Taxpayer Usage Study Weekly Report* (August 27, 2004).

<sup>4</sup> Wage and Investment Research, *Tax Year 2004 EITC Numbers* (through June 30, 2005).

<sup>5</sup> Instructions for Form 1040, U.S. Individual Income Tax Return (2005).

<sup>6</sup> Joel Slemrod, *The Costs of Tax Complexity: Presentation to the President’s Advisory Panel on Federal Tax Reform* (March 3, 2005).



2010.<sup>7</sup> Many more will complete the AMT calculations only to learn that they do not owe the tax.

From the perspective of taxpayers, then, the time is clearly ripe for tax reform. Our tax system, as currently structured, makes it too difficult for taxpayers and employers to achieve compliance, and for the IRS to encourage compliance and enforce the laws. Tax reform is no longer a luxury, something to discuss at conferences and on talk shows. It has become a necessity.

**Know your Taxpayer**

The starting point for tax reform should be an acknowledgement that the federal tax system represents a social contract between the federal government and its taxpayers. Taxpayers agree to voluntarily come forward to report their income and pay taxes on that income. In return, the federal government commits to making that process as simple and unburdensome as possible, including providing the necessary assistance and service, while it ensures that all taxpayers pay their fair share of tax.

For this social contract to succeed, the tax system must acknowledge the basic characteristics of its taxpaying population and not impose such complexity that compliance is beyond the comprehension or reach of much of the public. Tables 2.1.1 and 2.1.2 show some of these taxpayer characteristics for Tax Year 2002.

**TABLE 2.1.1, TY 2002 TAXPAYER CHARACTERISTICS**

Median Adjusted Gross Income	\$28,281
Median Wages	\$27,396
Median Schedule C	\$2,980
Median Schedule F	(\$3,436)
<b>Filing Status</b>	
Married/Joint	40%
Married/Separated	2%
Single	44%
Head of Household	14%

<sup>7</sup> Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).



TABLE 2.1.2, TY 2002 TAXPAYER CHARACTERISTICS

	% of Returns	Number/Amount
Median Number of Children	36%	2
Deductions		
Median standard deduction	64%	\$4,700
Median itemized deduction	36%	\$14,450
Retirement Deductions		
Mean IRA	3%	\$2,887
Mean Keogh	1%	\$13,775
Median Refund	80%	\$1,274
Returns Paid in Full	15%	\$803
Unpaid balance due returns	5%	—

Projections about the taxpaying public of 2010 identify some interesting trends. Married couples with children are projected to constitute 22 percent of households, down from 31 percent in 1980.<sup>8</sup> Persons who live alone, with non-relatives, or in a family of non-married relatives will make up 49.6 percent of households, up from 39.1 percent in 1980.<sup>9</sup> Moreover, the foreign-born and immigrant population is projected to be 11.3 percent (34 million) of the U.S. population, up from 10.4 percent (28.4 million) in 2000.<sup>10</sup> In 2000, fifty-one percent of the foreign-born population was from Latin America and 26 percent from Asia. Between 2002 and 2007, the Hispanic population will grow nearly 9 percent while the Asian population is expected to grow 27 percent.<sup>11</sup> By 2010, 21 percent of the population will speak a language other than English in their homes.<sup>12</sup>

People age 55 and older are projected to make up 17 percent of the labor force, compared with 13 percent in 2000.<sup>13</sup> Internet use will be lowest among people who are over 50, receive incomes below \$35,000, have a high school or lower education level, or live in non-family households.<sup>14</sup> These projections are important since they are related to the ability of taxpayers to understand the tax code and comply with tax obligations. They also have consequences for tax reform, if one believes the tax code should reflect the life circumstances of its taxpayers.

<sup>8</sup> W&I Research, *Wage & Investment Taxpayer of the Future* vi (January 2003).

<sup>9</sup> *Id.* at 23.

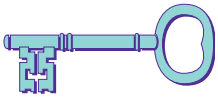
<sup>10</sup> *Id.* at 11.

<sup>11</sup> *Id.* at 12 (citing *American Demographics*).

<sup>12</sup> *Id.* at 14. Other than English, Spanish is the language most commonly spoken in U.S. homes. *Id.*

<sup>13</sup> *Id.* at viii.

<sup>14</sup> *Id.* at viii-ix.



## RECOMMENDATIONS

Based on our experience assisting and advocating for taxpayers, we offer here six general principles that we believe should guide policy makers and legislators as they undertake fundamental tax reform.

### 1. The tax system should not “entrap” taxpayers.

The tax law should not contain arcane and technical “gotchas” such as the AMT, which is unpredictable in its application and penalizes aspects of taxpayers’ lives such as having children or residing in a high-tax state. Complexity such as this breeds disrespect for the tax law and feeds the average taxpayer’s suspicion that the government does not care whether it imposes burden on its taxpayers.

### 2. The Internal Revenue Code should be simple enough so that taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute and report their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers’ questions.

Most individual taxpayers have fairly simple economic lives. Designing a system that treats basic economic transactions in an uncomplicated fashion will ensure that inadvertent errors will be minimal (because taxpayers will understand the rules). Where exceptions to general rules are necessary to maintain fairness, efficiency, or administrability, these exceptions should be designed so as not to add complexity for all taxpayers.

Accomplishing this, of course, is no easy task. The law must reflect the manner in which taxpayers live their lives yet, paradoxically, must deal with the diversity of those lives. In some instances the law must incorporate flexibility into its design.<sup>15</sup> In other instances, the law should establish a single standard so that taxpayers in diverse jurisdictions are treated uniformly.<sup>16</sup>

A well-designed tax system is one that taxpayers can understand and that the majority of taxpayers can participate in without the assistance of third parties, if they so desire. Filing and paying taxes is part of a taxpayer’s dialogue with his or her government. Taxpayer awareness of what income is taxable, what expenses are deductible, what behavior is encouraged by the government, and what share each taxpayer bears of government activity is an important check and balance on government. This sanity check is diluted and even eliminated when complexity drives the majority of taxpayers to turn the job over to professionals.<sup>17</sup>

<sup>15</sup> See, e.g., Key Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*, *infra*.

<sup>16</sup> See, e.g., Key Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*, *infra*.

<sup>17</sup> The act of reporting one’s income and expenses to the government should not be an opportunity for purveyors of ancillary, non-tax related products to sell their goods and services. Moreover, where the participation of third parties is demonstrated to improve compliance, there must be sufficient government oversight of these third parties. See Most Serious Problem: *Regulation of Electronic Return Originators*, *supra*; National Taxpayer Advocate 2004 Annual Report to Congress, 87; National Taxpayer Advocate 2002 Annual Report to Congress, 69; National Taxpayer Advocate 2002 Annual Report to Congress.

A tax law that is so complex that even the tax agency cannot answer questions for fear of giving the wrong answer creates compliance problems for taxpayers and forces the tax agency to undertake examination and collection activity that could be avoided. In enacting tax laws, Congress should consult and work with the IRS to determine whether and how that law can be explained in plain English, in forms and publications, and over the phone. Moreover, policymakers and legislators should routinely ask themselves the following questions: What steps are we requiring taxpayers to take? Does the impacted taxpayer population have the capacity or ability to comply with these requirements? Will that population have to seek the assistance of third parties in complying with the law? Are these requirements imposing an undue burden on taxpayers that will lead to noncompliance, inadvertent or otherwise?

### 3. The tax system should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.

The tax system should identify compliance problem areas and provide the tax administrator with the necessary legal authority and tools to address those areas administratively and in the courts. We know, for example, that income that is not reported to the IRS by a third party provides an opportunity for understating income and therefore tax liability.<sup>18</sup> Thus, income should be subject to information reporting to the maximum extent possible in order to reduce opportunities for noncompliance. This approach would give taxpayers confidence that others are paying their fair share – which is key to building and maintaining public confidence in the fairness of the system – and would enable the government to more easily collect the tax that is due.

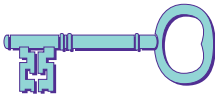
We also know that many taxpayers in small business struggle to pay their daily bills – often spending every dollar that comes into their businesses to keep the businesses afloat. The inability to save, even for legal obligations such as payroll or income taxes, is well-documented. We can reduce this noncompliance by developing procedures that help the small business taxpayer pay over his taxes in a timely fashion, so that he is not tempted to apply funds to other needs. Elsewhere in this report, we discuss some of these procedures, including requiring the monthly payment of estimated taxes, encouraging voluntary withholding agreements between independent contractors and service recipients, authorizing backup withholding on noncompliant independent contractors, and establishing an exemption program for compliant independent contractors.<sup>19</sup>

### 4. The tax law should provide some choices, but not too many choices.

Choice is good – it acknowledges the diversity of human experience – but too many choices are confusing. Do we really need nine different education provisions in the Code or a dozen different retirement saving vehicles? This kind of complexity leads tax-

<sup>18</sup> See Most Serious Problem: *The Cash Economy*, *supra*.

<sup>19</sup> See Most Serious Problem, *The Cash Economy*, *supra*; Key Legislative Recommendation, *Measures to Reduce Noncompliance in the Cash Economy*, *infra*.



payers to believe there is something they are missing out on – did they make the right choice? Taxpayers are left in a state of chronic uncertainty.

**5. Refundable tax credits are not inherently problematic – it’s all in the design.**

There are many reasons why we might want to use a refundable tax credit to deliver a benefit to taxpayers that could also be structured as a direct spending program. For example, if income is a key eligibility requirement, the program may be administered best through the tax code.

With refundable credits, however, we do need to understand the characteristics of any provision’s target population, and we should treat the credit as a separate program within the tax system. That is, we need to think through the elements and the opportunities for noncompliance, and then administer the refundable credit programmatically. There should be a single point of administrative oversight, with authority over education, outreach, and enforcement initiatives, tailored to the program and its recipients.

**6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.**

Congress should impose a mechanism on itself that checks for complexity creep. This mechanism could include a mandated periodic review by the Joint Committee on Taxation of entire segments of the tax laws, on a rolling five-year cycle, so that deadwood provisions are eliminated, archaic requirements are updated, “complexity creep” is identified, and changes in economic and technological conditions are considered.

## 2

## KEY LEGISLATIVE RECOMMENDATION: MEASURES TO REDUCE NONCOMPLIANCE IN THE CASH ECONOMY

## PROBLEM

In the Most Serious Problem section of this Report, the National Taxpayer Advocate lists unreported income attributable to the “cash economy” as one of the most serious problems encountered by taxpayers and the IRS, and cites evidence suggesting that unreported income from the cash economy may be the single largest component of the annual \$257 to \$298 billion net federal tax gap.<sup>1</sup> There is no recognized uniform definition of the cash economy. For purposes of this section of the Annual Report to Congress, we use the term “cash economy” to mean payments for transactions that are not reported to the IRS.<sup>2</sup> The IRS estimates that taxpayers report only a low percentage of income earned from these transactions.<sup>3</sup> Cash economy transactions are difficult to quantify, however, because they are, by definition, unreported. These unreported transactions can easily slip below the IRS’s radar screen and present an almost unlimited opportunity for noncompliance. These noncompliance opportunities appeal not only to those taxpayers who deliberately seek to skirt their tax obligations, but also to those taxpayers who may use unreported transactions as a cash flow cushion or who believe that only reported income is taxable.<sup>4</sup>

In contrast, taxpayers report nearly all income from transactions that are reported to the IRS. Taxpayers report 99 percent of the income subject to withholding and 96 percent of income subject to third-party information reporting.<sup>5</sup> Unfortunately, these compliant taxpayers are left holding the bag for a \$2,000 per return “surtax” to make up the tax gap difference attributable to the noncompliant.<sup>6</sup>

<sup>1</sup> See Most Serious Problem: *The Cash Economy supra*.

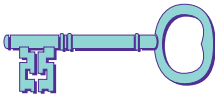
<sup>2</sup> For a similar definition of the cash economy, see Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong., 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as “legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting... your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting”).

<sup>3</sup> Only 68 percent of income not subject to withholding or information reporting is reported to the IRS. This percentage drops to 20 percent for income earned by certain sole proprietors (called “informal suppliers”) who operate “off the books” on a cash basis in areas such as street vending, door-to-door sales or moonlighting in a trade of profession. IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

<sup>4</sup> See Uncollected Taxes: Can We Reduce the \$300 Billion Tax Gap? Hearing Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, United States Senate, 109th Cong. 1st session (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>5</sup> IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

<sup>6</sup> The IRS receives approximately 133 million individual income tax returns each year. IRS Pub. 1136, *Statistics of Income Bulletin, Spring 2005* (Feb. 2004) (Table 22). The lower range of the net tax gap (\$257 billion) divided by the number of individual income tax returns (133 million) is \$1,932 per return. The upper range of the net tax gap (\$298 billion) divided by the number of individual income tax returns (133 million) is \$2,240 per return.



In the Most Serious Problem section of this Report, the National Taxpayer Advocate makes several administrative recommendations that, if implemented, would curb non-compliance in the cash economy. Administrative recommendations alone, however, are not sufficient. Because tax withholding, reporting, and payment requirements are statutory, legislative action is also needed to reduce the tax gap with respect to the cash economy.

The National Taxpayer Advocate offers the following legislative recommendations that, if enacted, would promote compliance and reduce noncompliance in the cash economy.

#### GENERAL RECOMMENDATIONS

1. Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by:
  - ◆ Instituting backup withholding on payments to taxpayers who have demonstrated “Substantial Noncompliance”;
  - ◆ Releasing backup withholding on payments to Substantially Noncompliant taxpayers who have demonstrated “Substantial Compliance,” and who agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and
  - ◆ Providing that payors will not be required to institute backup withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS “Compliance Certificate.”
2. Amend IRC § 6302(h) to require the IRS to promote making estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.
3. Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).
4. Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(a)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code), with 50 or fewer shareholders.

**RECOMMENDATION ONE**

Create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by (1) instituting backup withholding on payments to taxpayers that have demonstrated “Substantial Noncompliance”; (2) releasing backup withholding on payments to Substantially Noncompliant taxpayers that have demonstrated “Substantial Compliance,” and who agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and (3) providing that payors will not be required to institute backup withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS “Compliance Certificate.”

**ILLUSTRATION OF PROPOSAL**

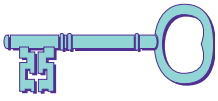
Taxpayer is an independent contractor who performs various construction related services. Taxpayer currently operates in the cash economy and does not file returns or pay taxes. The IRS discovers Taxpayer through its Information Returns Processing (IRP) Nonfiler program. The IRS has no record of Taxpayer ever filing a federal tax return or paying taxes and therefore determines that Taxpayer is “Substantially Noncompliant” as defined by regulation. The IRS contacts the businesses that made payments to Taxpayer (as listed on the IRP documents) and tells them to institute backup withholding, under IRC § 3406, on future payments to Taxpayer. The IRS also records Taxpayer’s name and Taxpayer Identification Number (TIN) on the electronic TIN matching program database.<sup>7</sup> When a business planning to pay Taxpayer for services submits Taxpayer’s TIN for verification through the electronic matching program, the IRS will return a “match indicator” indicating that backup withholding is required on payments to Taxpayer.

When Taxpayer is discovered through the IRP, the IRS issues Taxpayer a notice, via certified mail, explaining that future payments to Taxpayer are subject to backup withholding because he has been Substantially Noncompliant in prior tax years. The notice also tells Taxpayer that the IRS will release backup withholding if Taxpayer (1) becomes compliant by filing returns and paying back taxes (even if through an installment agreement or Offer in Compromise), (2) agrees to use the IRS Electronic Funds Transfer Payment System (EFTPS) to pay future estimated taxes, and (3) provides the IRS with a one-year EFTPS estimated tax payment schedule.

The IRS also sends a notice to all businesses that have been required to institute backup withholding on payees that (1) are subject to backup withholding under the current provisions of IRC § 3406 (i.e., missing TIN, incorrect TIN, or TIN/name mismatch)<sup>8</sup> or (2) are subject to backup withholding under the proposed Substantially Noncompliant provisions of IRC § 3406. This notice explains that backup withholding on payments

<sup>7</sup> For a detailed discussion of the IRS electronic TIN matching program, see Most Serious Problem, Backup Withholding, *supra*.

<sup>8</sup> See backup withholding present law discussion, *infra*.



to additional payees can be avoided if the payees present the payor with an IRS issued “Compliance Certificate.” Payees can obtain a compliance certificate from the IRS by demonstrating compliance (i.e., filing and paying) for a period of two consecutive years.

### SPECIFIC RECOMENDATIONS

To implement this three-pronged approach, Congress should:

Amend IRC § 3406 to:

- ◆ Require backup withholding on payments to certain taxpayers that are determined “Substantially Noncompliant” with federal tax laws, as defined in regulations prescribed by the Secretary of the Treasury (Secretary).
- ◆ Release backup withholding on Substantially Noncompliant taxpayers that (1) demonstrate “Substantial Compliance,” as defined in regulations prescribed by the Secretary, (2) agree to make future estimated tax payments through the IRS Electronic Funds Transfer Payments System (EFTPS), and (3) provide the IRS with a one-year EFTPS estimated tax payment schedule.
- ◆ Authorize the Secretary to prescribe regulations that set forth industry or industry segment compliance standards. If the IRS, using these standards, determines that a substantial number of independent contractors operating in an industry or industry segment are Substantially Noncompliant, then payors in such industry or industry segment shall institute backup withholding on payments made, in the course of a trade or business, to independent contractors.
- ◆ Authorize the Secretary to prescribe regulations that create a federal tax “Compliance Certificate” for certain taxpayers conducting business as independent contractors, and set forth the requirements for obtaining a Compliance Certificate from the IRS. These requirements could include such measures as prior filing and payment activity, valid TIN use, and agreeing to use EFTPS for future estimated tax payments.
- ◆ Provide that backup withholding is not required for payments made to any payee that presents the payor with a valid “Compliance Certificate.”

### PRESENT LAW

#### Backup Withholding

IRC § 3406(a)(1) requires a payor making any reportable payment to withhold 28 percent<sup>9</sup> of such payment if (1) the payee fails to furnish his TIN to the payor in the manner required,<sup>10</sup> (2) the Secretary notifies the payor that the TIN furnished by the

<sup>9</sup> IRC § 3406(a)(1) requires the payor to deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under IRC § 1(c), which is 28 percent for tax year 2005.

<sup>10</sup> A payor may use Form W-9, *Request for Taxpayer Identification Number and Certification*, to obtain a payee’s name, TIN and entity type.



payee is incorrect, (3) the Secretary notifies the payor to start withholding on interest and dividend payments because the payee did not report income on all of his interest or dividend income in prior years, or (4) the payee did not certify, when required, that he is not subject to backup withholding on interest and dividends.<sup>11</sup>

Payors falling into the first two categories are subject to backup withholding under the IRS's "B" backup withholding program. Under the B withholding program, the IRS notifies payors who file information returns with incorrect TINs. A payor receiving a notice must then determine, for each payee who has provided an invalid TIN (or no TIN at all), how many times within three calendar years the IRS has notified the payor that the payee's TIN was invalid and respond accordingly:

- First Notice:** Request a valid TIN from the payee, using Form W-9, *Request for Taxpayer Identification Number and Certification*. If the payee does not respond to this request, begin backup withholding until the payee returns the Form W-9.
- Second Notice:** Validate the payee's TIN with the IRS or Social Security Administration (SSA). The payor may begin backup withholding upon receiving a second notice, but *must* begin backup withholding if the IRS or SSA does not validate the payee's TIN within 30 business days.
- No TIN:** Payors who receive no TIN from a payee must begin immediate backup withholding. No IRS notice is required.<sup>12</sup>

IRC § 6723 imposes a \$50 penalty when a payee fails to provide a payor with a correct Form W-9 (up to a maximum of \$100,000 per year).

In 2004, the IRS introduced an electronic TIN matching program allowing authorized payors<sup>13</sup> of income subject to backup withholding to match Form 1099 payee information against IRS records over the internet before filing information returns. The TIN matching program returns a "match indicator" for each submitted name/TIN combination. A payor will receive the match indicators in "real time" for submissions of 25 name/TIN combinations or less. Match indicators for larger submissions are returned within 24 hours.<sup>14</sup>

### Information Reporting

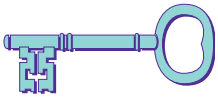
IRC § 6041A(a) requires a service-recipient to report payments of \$600 or more made

<sup>11</sup> For a detailed discussion of backup withholding, see, Most Serious Problem, Backup Withholding, *supra*.

<sup>12</sup> IRC § 3406(a)(1)(A).

<sup>13</sup> An authorized payor is one that has filed information returns with the IRS in at least one of the two past tax years.

<sup>14</sup> For a more detailed discussion of the electronic TIN matching program see Most Serious Problem: *Backup Withholding, supra*.



in the course of a trade or business to a person for services performed. These payments are generally reported on IRS Form 1099-MISC, Miscellaneous Income. IRC § 6721(a) imposes a \$50 per return penalty on Service-recipients that fail to file required Forms 1099-MISC (up to a maximum of \$250,000 per calendar year).

### REASONS FOR CHANGE

One component of the cash economy is unreported payments to independent contractors for services. Unreported payments to independent contractors include:

- ◆ Deliberate “under the table” cash payments.
- ◆ Payments that are reported with an invalid TIN or a payee/TIN mismatch.
- ◆ Payments subject to information reporting, that are not reported.<sup>15</sup>

Current withholding and information reporting provisions do not adequately capture income from transactions in the cash economy. Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. The IRS can catch some of these “off the books” payments to independent contractors through its Information Returns Processing (IRP) program or through direct audits; but when neither payor nor payee reports a payment, there is generally little evidence that a payment was made at all.<sup>16</sup> Even payors wishing to comply with their information reporting obligations may be reporting payments to independent contractors that have supplied invalid TINs. Under existing provisions, these payors may not know that a payee’s TIN is invalid until several payments have been made and the payee has moved on to other jobs.<sup>17</sup>

Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is \$50. And this charge will only be imposed if the IRS actually catches a Form 1099-MISC or W-9 discrepancy.

### Explanation of Recommendation

In her 2003 Annual Report to Congress, the National Taxpayer Advocate addressed the problem of noncompliance by certain independent contractors and suggested that Congress consider a withholding scheme on payments to independent contractors as a starting point for discussions on ways to address the tax gap.<sup>18</sup> After discussing this proposal with many interested stakeholders, we determined that universal withholding

<sup>15</sup> Unreported payments to independent contractors for services also include payments of less than \$600 per year, payments that are not made in the course of a payor’s trade or business, and payments made to certain corporations. IRC § 6041A.

<sup>16</sup> See Most Serious Problem: *The Cash Economy*, *supra*.

<sup>17</sup> See Most Serious Problem: *Limited Scope of Backup Withholding Program*, *supra*.

<sup>18</sup> See National Taxpayer Advocate, 2003 Annual Report to Congress v, 20, 256.

on independent contractors would prove too burdensome<sup>19</sup> and have developed this alternate approach.

This proposal (hereinafter, “Recommendation One”) differs from a universal withholding scheme in three significant respects. First, the burden would be shouldered primarily by taxpayers who have demonstrated an unwillingness to comply with their tax obligations. Second, administrative burdens on payors would be substantially less than under a universal withholding regime. Third, the proposal provides a way for payors to avoid administrative burdens entirely. Overall, Recommendation One uses market forces to drive compliance in the cash economy.

Under Recommendation One, backup withholding would only be instituted on payments to independent contractors that have demonstrated “Substantial Noncompliance,” as defined by regulation, or who work in an industry or industry segment where there are significant numbers of Substantially Noncompliant independent contractors. Recommendation One would have little or no effect on compliant independent contractors.

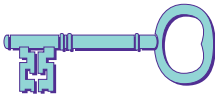
Congress would direct the Secretary to prescribe regulations that set forth the standards for Substantial Noncompliance for purposes of the new backup withholding provisions. One possible measure of Substantial Noncompliance could be failing to file federal income tax returns or pay federal taxes for the two consecutive years immediately preceding the determination year.

Recommendation One also provides redemption for those taxpayers classified as Substantially Noncompliant. Independent contractors who demonstrate Substantial Compliance (as defined by regulation), agree to make estimated tax payments through the convenient EFTPS, and schedule regular EFTPS estimated tax payments for one year in advance, will be released from backup withholding. The IRS would then monitor these “repentant” taxpayers to make sure they were making timely EFTPS payments. If the IRS discovered that a taxpayer had missed an agreed upon EFTPS payment, the IRS would (1) immediately notify the taxpayer of the missed payment, (2) allow the taxpayer a brief window to make the payment, and (3) require regularly scheduled EFTPS estimated tax payments for a second year.

As with Substantial Noncompliance, regulations would set forth the standards for Substantial Compliance for purposes of the new backup withholding provisions. Possible measures of substantial compliance could include filing federal tax returns and paying applicable federal taxes for the two consecutive tax years immediately preceding the determination year, and using a valid TIN.

Another advantage of Recommendation One is that it would place most of the administrative compliance burdens on the independent contractor payee rather than on the business payor. Under Recommendation One, the Secretary would prescribe regula-

<sup>19</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 484.



## RECOMMENDATIONS

SECTION  
TWO

tions creating a federal tax Compliance Certificate that an independent contractor could obtain from the IRS by providing a valid name and TIN, and by having a prior history of tax compliance.<sup>20</sup> Notwithstanding any other provision of Recommendation One, if an independent contractor presents a payor with a valid Compliance Certificate, backup withholding would not be instituted.

The Compliance Certificate is also the mechanism that provides the most attractive feature of Recommendation One: market driven compliance. Businesses do not want to be burdened by backup withholding on payments to independent contractors. Under current law, however, a service-recipient may not know that it is making payments to an independent contractor subject to backup withholding until the IRS notifies the service-recipient that there is a name/TIN mismatch.<sup>21</sup> When a payor receives such a notice from the IRS, it can incur the administrative expense to implement backup withholding, tell the independent contractor to look for work elsewhere, or ignore the backup withholding requirements and continue to pay the independent contractor on a gross basis in violation of IRC § 3406(a). None of these options are ideal for either party.

Recommendation One allows the payor to avoid these problems altogether. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the Service-Recipient knows there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service-recipient immediately knows that backup withholding on payments to this independent contractor is possible, if not likely. Moreover, if the service-recipient operates in an industry or industry segment where the IRS has determined that a significant number of Substantially Noncompliant independent contractors are operating, backup withholding will be mandatory on payments to independent contractors who do not present a valid Compliance Certificate.

Under Recommendation One, market forces will act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a payor to avoid a backup withholding situation is to hire only independent contractors that present a valid Compliance Certificate. It follows that independent contractors who want to work will obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor must be tax compliant. Tax compliance would become a condition of conducting business.

The Compliance Certificate element of Recommendation One is a similar, though simpler, version of the United Kingdom's "Construction Industry Scheme" (CIS). The CIS is administered by the United Kingdom's administrative tax agency, Her

<sup>20</sup> Independent contractors starting a new business could obtain a Compliance Certificate by providing a valid name and TIN, and agreeing to make future estimated tax payments using EFTPS.

<sup>21</sup> Service-recipients can check TIN validity earlier using the electronic TIN matching program. However, from October 16, 2003 to October 17, 2005, only 3,181 payors used this program. See Most Serious Problem: *Backup Withholding*, *supra*.

Majesty's Revenue & Customs (HMRC). The CIS applies only to the construction industry. Under the CIS, businesses operating in the construction industry are known as "contractors" and "subcontractors." Subcontractors perform work for and are paid by contractors. Thus, it is possible to be both a contractor and a subcontractor in the CIS. Subcontractors can obtain either a "Registration Card" or a "Tax Certificate" from HMRC. Subcontractors can receive a Registration Card simply by registering with HMRC. In order to obtain a Tax Certificate, however, the subcontractor must meet several criteria that demonstrate the subcontractor's past and current tax compliance. A subcontractor must have a valid Registration Card in order to receive any payments from a contractor. Contractors are to withhold 18 percent of payments to subcontractors with Registration Cards and pay the amount withheld to HMRC on behalf of the subcontractor. Subcontractors with valid Tax Certificates, however, are paid on a gross basis.<sup>22</sup>

#### RECOMMENDATION TWO

Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.

#### EXAMPLE OF PROBLEM

Taxpayer is a sole proprietor performing lawn care and landscaping services as an independent contractor. Most of Taxpayer's clients are businesses, but several of her clients are personal residences. Taxpayer's business clients report payments to Taxpayer on Form 1099-MISC. Taxpayer's residential clients do not report payments to Taxpayer, and many routinely pay cash for Taxpayer's services. Taxpayer is an IRS Form 1040, Schedule C taxpayer and is required to make estimated tax payments quarterly. Taxpayer genuinely intends to pay accurate and timely estimated payments, but sometimes experiences cash flow difficulties and finds it difficult to make full estimated tax payments in a timely manner. Because Taxpayer receives several unreported payments from residential customers, she sometimes reports and pays tax on payments reported to the IRS on Form 1099 only, and then vows to be more accurate next quarter.

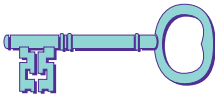
#### PRESENT LAW

##### Estimated Income Tax Payments

IRC § 6654 imposes a penalty on individual taxpayers who underpay estimated income taxes. In order to avoid this penalty, individual taxpayers generally must make estimated income tax payments in four installments due April 15, June 15, September 15, and January 15 of the following taxable year.<sup>23</sup> The estimated tax payment requirement generally applies to self-employed individuals because individuals that are employees

<sup>22</sup> For a detailed explanation of the CIS *see* Inland Revenue, Construction Industry Scheme, Construction Industry Series IR14/15(CIS), available at [www.hmrc.gov.uk/pdfs/ir14-15cis.pdf](http://www.hmrc.gov.uk/pdfs/ir14-15cis.pdf).

<sup>23</sup> IRC § 6654(c).



usually have taxes withheld and deposited with the IRS throughout the year.<sup>24</sup>

### Depository Taxes

IRC § 6656 generally imposes a penalty on employers who fail to deposit employment taxes (i.e., withheld income taxes, Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes – collectively, “depository taxes”) within the required time and in the proper manner. IRC § 6302(h) requires the IRS to collect at least 94 percent of depository taxes through EFTPS.<sup>25</sup> This “applicable required percentage” was phased in beginning at three percent for fiscal year 1994, to 94 percent for fiscal year 1999 and all fiscal years thereafter.<sup>26</sup>

### EFTPS

IRC § 6302(h)(1) required the IRS to develop and implement an electronic fund transfer system to collect depository taxes. The IRS complied with § 6302(h)(1) by creating the Electronic Funds Transfer Payment System. EFTPS allows both individual and business taxpayers to have tax payments debited from their bank account and transferred to the U.S. Treasury. Taxpayers may enroll in EFTPS and schedule payments on the EFTPS website: [www.eftps.gov](http://www.eftps.gov). The website is accessible 24 hours a day, seven days a week. Individual taxpayers can use EFTPS to schedule automatic payments up to 365 days in advance. To enroll in EFTPS, a taxpayer must submit his or her TIN and financial institution information.<sup>27</sup>

### REASONS FOR CHANGE

Current law requires the IRS to use EFTPS to collect at least 94 percent of depository taxes. In FY 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS.<sup>28</sup> In contrast, the IRS received less than one percent of all estimated tax payments (and less than one percent of all estimated tax dollars) through EFTPS in tax year 2004.<sup>29</sup> The IRS is not required to collect estimated tax payments through EFTPS.

Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers who are juggling many different duties. The process of estimating income, remembering odd payment dates that do not coincide with calendar quarters, and saving

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<sup>24</sup> See IRC § 6654(g).

<sup>25</sup> IRC § 6302(h)(2)(C)(ii)(V).

<sup>26</sup> IRC § 6302(h)(2).

<sup>27</sup> EFTPS website, [www.eftpsouth.com/eftps](http://www.eftpsouth.com/eftps).

<sup>28</sup> Senior Tax Analyst, Wage and Investment Division, Customer Account Services, Submission Processing, Response to TAS Information Request (Oct. 5, 2005).

<sup>29</sup> *Id.*

enough money to pay each quarter is not particularly “user friendly.”<sup>30</sup>

EFTPS has the potential to alleviate some of these estimated tax payment problems because it is convenient and relatively easy to use. One key EFTPS feature that many taxpayers may find attractive is the ability to schedule automatic payments to be debited from a taxpayer’s bank account. A taxpayer can use this feature to make more frequent automatic estimated payments and not worry about coming up with the required amount every quarter. Using EFTPS in this way could make estimated tax payments almost as automatic as one’s monthly automobile or mortgage payment.

#### EXPLANATION OF RECOMMENDATION

Requiring the IRS to collect estimated tax payments through EFTPS would drive the IRS to actively promote EFTPS and make the system easier to use. The IRS currently complies with the statutory requirement to collect depository taxes through EFTPS and it stands to reason that it would also comply with a requirement to collect estimated tax payments through the same system. Because the IRS currently collects less than one percent of all estimated tax payment dollars through EFTPS, the seven-year phase-in period would allow the IRS to gradually promote EFTPS as it deemed appropriate.

#### RECOMMENDATION THREE

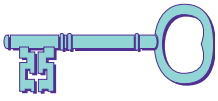
Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).

#### EXAMPLE OF PROBLEM

Taxpayer A is a hair stylist operating as an independent contractor who frequently performs services in B’s salon. A’s customers pay the salon directly and then B makes payments to A after subtracting a percentage for chair rental, general overhead expenses, and a “name use” commission. A also receives tips directly from his customers.

A approaches B and explains that he is having a difficult time maintaining accurate tax records and paying timely estimated tax payments. A asks B if she would be willing to withhold a certain percentage of each payment to A and send it to the IRS. B responds that she is not sure if such voluntary withholding arrangements are authorized, and that she is unsure how to set up such an arrangement even if one were permitted.

<sup>30</sup> For a detailed discussion of estimated tax payment problems see Most Serious Problem: *The Cash Economy*, *supra*.



### PRESENT LAW

IRC § 3402 generally provides that employers must withhold income and FICA and FUTA taxes from wages paid to employees. IRC § 3402(p) provides for voluntary withholding agreements in certain cases that are not subject to withholding under the general rule. When a payor and payee enter into a voluntary withholding agreement under section 3402(p), payments made with respect to the agreement are treated as wage payments from an employer to an employee.

Section 3402(p)(1) provides for voluntary withholding on certain federal payments (such as Social Security benefits). Section 3402(p)(2) provides for voluntary withholding on unemployment compensation payments. Section 3402(p)(3) provides for “other voluntary withholding” agreements and authorizes the Secretary, by regulation, to provide for withholding from (1) payments from employer to employee that do not constitute wages, and (2) “any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of [IRC chapter 24, Collection of Income Tax at Source].”

Section 3402(p)(3) also provides that any voluntary withholding agreement entered into under § 3402(p)(3) “shall be in such form and manner as the Secretary may by regulations prescribe.” The Secretary has not prescribed regulations under § 3402(p)(3) that set forth the form and manner of voluntary withholding agreements in a non-employer/employee relationship.

IRC § 162(a)(1) generally allows taxpayers to deduct all ordinary and necessary business expenses paid or incurred during the taxable year. Self-employed taxpayers generally report these deductions on IRS Form 1040, *U.S. Individual Income Tax Return*, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*.

### REASONS FOR CHANGE

Even though withholding is not required on payments to independent contractors, some independent contractors may wish to enter into withholding agreements with their payors to avoid the burdens of saving and making quarterly estimated tax payments.<sup>31</sup> These payors may be willing to do this as a convenience to the independent contractors they pay, particularly where payors already withhold and remit employment taxes on their own employees. It is currently unclear, however, whether statutory authority exists to enter into such agreements.

IRC § 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402 as a whole applies specifically to withholding in the employer/employee context and § 3402(p)(1) and 3402(p)(2) apply to voluntary withholding agreements in specific limited situations. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent

<sup>31</sup> See discussion, *supra*.



contractor would be permitted. Section 3402(p)(3)(A), however, applies specifically to remuneration for services provided by an employee to an employer. Thus, if there is any statutory authority at all for voluntary withholding agreements between a payor and an independent contractor, it would lie in § 3402(p)(3)(B), which reads:

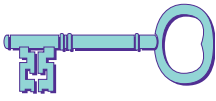
The Secretary is authorized by regulations to provide for withholding from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter, if the employer and employee, or the person making and the person receiving such other type of payment agree to such withholding. Such agreement shall be in such form and manner as the Secretary may by regulations prescribe.

There are at least two problems with voluntary withholding agreements between a payor and an independent contractor under § 3402(p)(3)(B). First, this section only authorizes the Secretary to provide for such agreements by regulation. There are no tax regulations providing for voluntary withholding agreements between payors and independent contractors. Second, in order to prescribe such regulations, the Secretary must find that voluntary withholding agreements between payors and independent contractors “would be appropriate under the provisions of [IRC chapter 24, Collection of Taxes at the Source].” IRC chapter 24 deals with collection of taxes at the source with respect to employees – *i.e.*, wage withholding. Independent contractors are not subject to wage withholding, thus it is questionable whether the Secretary could find voluntary withholding agreements between payors and independent contractors “appropriate” under the Code provisions dealing with employee wage withholding.

#### EXPLANATION OF RECOMMENDATION

Amending the Internal Revenue Code to specifically allow voluntary withholding agreements between independent contractors and their payors would clarify the application of the current statute and facilitate tax compliance. Independent contractors entering into such agreements with their payors would be relieved of the burden of making quarterly estimated tax payments. Additionally, those payors willing to incur the administrative cost of entering into voluntary withholding agreements with one independent contractor would likely offer this service to all independent contractors performing services for the payor.

Amending the Internal Revenue Code to specify that independent contractors who enter into voluntary withholding agreements with a payor service recipient are treated as employees for purposes of such agreements would only prevent employee classification for other tax purposes. Most significantly, such an amendment would allow independent contractors to continue to deduct ordinary and necessary business expenses under



IRC § 162 and continue to report these deductions on IRS Form 1040, Schedule C.<sup>32</sup>

#### RECOMMENDATION FOUR

Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(a)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code), with 50 or fewer shareholders.

#### EXAMPLE OF PROBLEM

Taxpayer A and Taxpayer B both operate window washing businesses in City. A conducts business as a sole proprietor, while B conducts business as a state Limited Liability Company that B has elected to treat as an association taxable as a corporation for federal tax purposes. B's business name contains the expression, "Inc." A and B are competitors and frequently wash windows for mutual clients. When A washes windows for a client, the client generally must report payments to A on Form 1099-MISC. When B washes windows for a client, however, the client is not required to report payments to B on Form 1099-MISC because B conducts business as a corporation.

#### PRESENT LAW

IRC § 6041A(a) provides that if a service-recipient engaged in a trade or business pays in the course of such trade or business, in any calendar year, an aggregate amount of \$600 or more to any person for services performed by such person, then the service-recipient must file an information return reporting these payments. The applicable information return is IRS Form 1099-MISC, *Miscellaneous Income*. Most incorporated service providers, however, are exempt from Form 1099-MISC reporting.<sup>33</sup> In other words, under IRC § 6041A(a), service-recipients are required to report payments to individuals only. A service-recipient may treat a service provider payee as a corporation for purposes of IRC § 6041A(a) if the name of the payee contains an unambiguous expression of corporate status, *i.e.*, "Incorporated," "Inc.," "Corp.," or "P.C." (but not "Company" or "Co.").<sup>34</sup>

IRC § 6041A(f) requires persons receiving reportable payments under § 6041A(a) to provide to the payor, the payee's name, address and TIN. Payees generally use IRS Form

<sup>32</sup> See IRS Employment Tax Handbook 104.6, Sec. 5.8.4(5) (April 21, 1999) which specifies that "statutory employees" under IRC § 3121(d)(3) are not treated as employees for purposes of deducting business expenses.

<sup>33</sup> Treas. Reg. §§ 1.6041-3(p)(1) and 1.6049-4(c)(1)(ii)(A). Payments made by federal executive agencies to contractors organized as corporations are not exempt from Form 1099-MISC reporting. IRC § 6041A(d)(3).

<sup>34</sup> However, a service-recipient may not treat a payee as a corporation if the service-recipient has actual knowledge that the payee is not a corporation. Treas. Reg. § 1.6049-4(c)(1)(ii)(A)(1). A service-recipient may also treat a payee as a corporation (absent actual knowledge to the contrary) if the service-recipient has the payee's corporate resolution or similar document on file; the payee provides the service-recipient with a valid IRS Form W-9 that includes a valid Employer Identification Number and a statement indicating that the payee is a domestic corporation; or the payee provides the service-recipient with a valid withholding certificate certifying that the payee is a foreign corporation. Treas. Reg. § 1.6049-4(c)(1)(ii)(A).

W-9 to provide this information. Form W-9 also requires payees to declare whether they conduct business as an individual/sole proprietor, corporation, partnership, or other business entity.

IRC § 7701(a)(3) provides that “the term ‘corporation’ includes associations, joint-stock companies, and insurance companies.” Treas. Reg. § 301.7701-2(b) provides that for federal tax purposes, the term corporation means (among other things) a business entity organized under a federal or state corporate statute or an association as determined under Treas. Reg. § 301.7701-3. Treas. Reg. § 301.7701-3(a) provides that an “eligible entity”<sup>35</sup> may elect its classification for federal tax purposes. All eligible entities can elect to be classified as an association treated as a corporation for federal tax purposes.

### REASONS FOR CHANGE

Taxpayers report 96 percent of income from transactions subject to information reporting.<sup>36</sup> The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape 1099-MISC information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to 1099-MISC reporting if the taxpayer were conducting business as a non corporate entity. Furthermore, a taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC § 6041A reporting requirements, regardless of whether the service provider is actually incorporated.

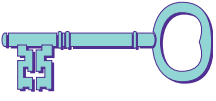
For Form 1099-MISC information reporting purposes, there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated (or represents that it has incorporated). There are, of course, many valid reasons for choosing to conduct business as a corporation rather than as another entity, but information reporting avoidance should not be such a reason. Corporate taxpayers that intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed, or to IRS awareness of this compensation.

### EXPLANATION OF RECOMMENDATION

Amending IRC § 6041A to provide that both individual taxpayers and corporate taxpayers with 50 or fewer shareholders are subject to 1099-MISC reporting would directly reduce the cash economy by increasing transactions subject to information reporting. And because taxpayers report 96 percent of income subject to information reporting, increasing the transactions subject to such reporting will also increase reported income.

<sup>35</sup> An eligible entity is a business entity that is not classified as a *de facto* corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8).

<sup>36</sup> IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).



# RECOMMENDATIONS

The National Taxpayer Advocate, however, recommends that 1099-MISC reporting be limited to corporations with 50 or fewer shareholders. Corporations with more than 50 shareholders are generally subject to more frequent IRS compliance activity, thus the potential for noncompliance through unreported transactions is lower. Additionally, this proposal is intended to place similarly situated taxpayers performing comparable services on the same ground with respect to 1099-MISC reporting. Larger corporations generally are not competing in the same marketplace with self-employed individuals, thus the proposal is limited to smaller corporate taxpayers.

Consistent with this recommendation, the IRS would revise Form W-9 to allow payees to declare whether they are a corporation with 50 or fewer shareholders.

## 3

**KEY LEGISLATIVE RECOMMENDATION: TAX REFORM FOR FAMILIES:  
A COMMON SENSE APPROACH****PROBLEM**

The Internal Revenue Code contains six provisions related to a taxpayer's family status: the Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Child and Dependent Care Credit (CDCC), personal and dependency exemptions, head of household filing status, and the "separated spouse" rules of IRC § 7703(b). Each of these six provisions directly or indirectly confers a tax benefit on taxpayers who meet the various eligibility requirements. At least one of these six provisions impacts every individual income tax return filed in the United States today.

In 2004, Congress adopted a Uniform Definition of Child.<sup>1</sup> The uniform definition creates a single definition of a "qualifying child" for purposes of the EITC, CTC, CDCC, dependency exemption, and head of household filing status. Despite this significant step towards simplification, taxpayers claiming the different family status provisions must still navigate a labyrinth of complex rules and requirements for each provision. These rules are often counter-intuitive and therefore lead to many inadvertent errors, while providing opportunities for deliberate fraud in some instances. IRS examinations of EITC returns alone account for 48 percent of all individual income tax return examinations annually.

**EXAMPLE**

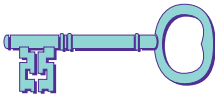
Taxpayer provides a home and all support for her 12-year-old cousin for the entire year. Because the child does not have a "qualifying" relationship with Taxpayer, Taxpayer cannot claim the dependency exemption for the child (and therefore is not eligible for the Child Tax Credit.) Taxpayer also cannot claim the Child and Dependent Care Credit for child care expenses because the child is not her dependent. Although Taxpayer is the only individual providing support for her cousin, Taxpayer receives food stamps and housing assistance from federal and state agencies in excess of half of the cost of maintaining the home. Moreover, Taxpayer has been estranged from her spouse for over ten years, but does not qualify as "not married" under IRC § 7703(b) because (1) she cannot claim the child as a dependent and (2) she cannot show that she provides over one-half of the cost of maintaining the household. Thus, taxpayer must file as "married filing separately" and is ineligible for the Earned Income Tax Credit.

**RECOMMENDATIONS**

The National Taxpayer Advocate makes the following recommendations to build upon the simplification achieved with the Uniform Definition of Child by further simplifying the family status provisions:

- ◆ Combine the personal and dependency exemptions, Child Tax Credit, and aspects

<sup>1</sup> The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).



of the EITC into a single refundable Family Credit available to all taxpayers, regardless of income. One component of the Family Credit would be available to the taxpayer (or each taxpayer, in the case of married taxpayers), and a second component of the Family Credit would be available to any taxpayer who is the “main caregiver” of a qualifying child. There would be no cap on the number of children the taxpayer could claim as “main caregiver.”

- ◆ Separate the Child and Dependent Care Credit into two credits. The Child Care Credit would be available to the taxpayer who claimed the Family Credit. The Dependent Care Credit would be available to taxpayers who provided primary care for members of their extended family inside or outside of their home.
- ◆ Eliminate Head of Household filing status. Allocate the tax benefits attributable to Head of Household filing status between the Family Credit and the Dependent Care Credit.
- ◆ Replace the Earned Income Tax Credit with the Family Credit and a modified Earned Income Tax Credit. The modified Earned Income Tax Credit would provide a refundable credit to low income workers based solely on the taxpayer’s earned income and would be available to workers age 18 and over for whom no one filed as the “main caregiver.” Retain the investment income rule of IRC § 32(i) so that the benefits of this refundable credit go to low income taxpayers who do not have significant investments.
- ◆ Amend IRC § 7703(b) to permit taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the tax year to be considered “not married” for purposes of determining filing status.
- ◆ Create a separate credit for noncustodial parents of qualifying children who pay all child support obligations legally due for that tax year.

### PRESENT LAW

The following section outlines the uniform definition of child as well as the eligibility requirements for the family status provisions of the Code.

#### Uniform Definition of Child

In the Working Families Tax Relief Act of 2004, Congress created a uniform definition of child in IRC § 152(c) of the Code. Beginning in tax year 2005, the Code defines the term “dependent” as a qualifying child or a qualifying relative.<sup>2</sup> The single definition of qualifying child, with certain modifications, applies for purposes of claiming the EITC, CTC, CDCC, dependency exemption, and head of household filing status.

An individual must meet four tests in order to be a qualifying child under IRC § 152(c):

<sup>2</sup> IRC § 152(a). If an individual does not meet the definition of a qualifying child under § 152(c), he or she may meet the definition of a qualifying relative under IRC § 152(d).

relationship,<sup>3</sup> age,<sup>4</sup> residency,<sup>5</sup> and support.<sup>6</sup> If an individual can be claimed as a qualifying child by more than one taxpayer, IRS § 152(c)(4) establishes a tie-breaker rule to determine which taxpayer can claim the child.<sup>7</sup>

### Earned Income Tax Credit – IRC § 32

The Earned Income Tax Credit (EITC) entitles certain working low income taxpayers to claim a refundable credit of up to \$4,400.<sup>8</sup> To qualify for the EITC, a taxpayer must meet certain general eligibility requirements related to residency,<sup>9</sup> filing status,<sup>10</sup> certain foreign benefits,<sup>11</sup> and status as a qualifying child of another taxpayer.<sup>12</sup> The tax-

<sup>3</sup> A qualifying child must be a taxpayer's son, daughter, stepson, stepdaughter, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them. IRC §§ 152(c)(2), (f)(1)(A), & (f)(4). In the case of an adopted child, the child is treated as the child of the taxpayer. IRC § 152(f)(1)(B). In the case of an eligible foster child, the child is treated as the child of the taxpayer provided the child was placed with the taxpayer by an authorized placement agency or by the courts. IRC § 152(f)(1)(A)(ii), & (f)(1)(C).

<sup>4</sup> A qualifying child must be under the age of 19 at the end of the year, under age 24 at the end of the year and a full time student, or any age if permanently and totally disabled. IRC § 152(c)(3).

<sup>5</sup> A qualifying child must have the same principal place of abode as the taxpayer for more than half of the taxable year. IRC § 152(c)(1)(B). The Code makes special exceptions for temporary absences, children who were born or died during the taxable year, kidnapped children, and children of divorced or separated parents. IRC § 152(e) & (f)(6); Treas. Reg. § 1.152-1(b), & 1.152-2(a)(2)(ii).

<sup>6</sup> A qualifying child must not have provided more than one-half of his or her own support for the taxable year. IRC § 152(c)(1)(D).

<sup>7</sup> In cases where more than one taxpayer can claim an individual as a qualifying child, the taxpayers can decide who will treat the child as a qualifying child. The taxpayer who claims the qualifying child is entitled to the dependency exemption for the child, head of household filing status, the CTC, the EITC, and the CDCC (unless the rules for divorced or separated parents apply and assuming all other eligibility requirements are met). If, however, the taxpayers cannot decide who will treat the child as a qualifying child, the tie-breaker rule in IRC § 152(c)(4) determines which taxpayer can claim the child. If only one of the taxpayers claiming a child is the child's parent, then the child will be treated as the qualifying child of the parent. IRC § 152(c)(4)(A)(i). If both taxpayers claiming a child are the child's parents, then the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time during the taxable year. IRC § 152(c)(4)(B)(i). If the child lived with both parents for the same amount of time during the taxable year, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income. IRC § 152(c)(4)(B)(ii). If neither of the taxpayers claiming a child is the child's parent, then the child is treated as the qualifying child of the taxpayer with the highest adjusted gross income for the taxable year. IRC § 152(c)(4)(A)(ii).

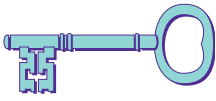
<sup>8</sup> IRC § 32. The maximum amount of the credit is available to a taxpayer with two or more qualifying children. For tax years beginning in 2005, the maximum credit available for a taxpayer with one qualifying child is \$2,662 and for a taxpayer with no qualifying children is \$399. Rev. Proc. 2004-71, 2004-50 I.R.B. 970. The actual amount of the EITC varies depending on the earned income of the taxpayer.

<sup>9</sup> A taxpayer is not eligible for the EITC if he or she is a nonresident alien for any portion of the taxable year, unless the taxpayer files a joint return with a spouse who is a United States citizen or resident alien. IRC § 32(c)(1)(D).

<sup>10</sup> A taxpayer is not eligible for the EITC if he or she is filing married filing separately. IRC § 32(d).

<sup>11</sup> A taxpayer is not eligible for the EITC if he or she claims a foreign earned income exclusion or deducts or excludes a foreign housing amount. IRC § 32(c)(1)(C).

<sup>12</sup> A taxpayer is not eligible for the EITC if he or she is the qualifying child of another taxpayer. IRC § 32(c)(1)(B).



payer must also have a taxpayer identification number,<sup>13</sup> earned income,<sup>14</sup> and limited amounts of income.<sup>15</sup> The EITC is available to taxpayers either with or without a qualifying child. Taxpayers wishing to claim the EITC without a qualifying child must meet additional eligibility requirements.<sup>16</sup> To be considered a qualifying child for the EITC, an individual must meet the definition of qualifying child in § 152(c),<sup>17</sup> they must be unmarried at the end of the taxable year (unless the taxpayer is entitled to a deduction under § 151 for the married individual),<sup>18</sup> and their principal place of abode must be in the United States.<sup>19</sup>

### Child Tax Credit – IRC § 24

The Child Tax Credit (CTC) entitles a taxpayer to claim a credit of up to \$1,000 for each qualifying child, as defined in § 152(c), who is under age 17.<sup>20</sup> The amount of the credit is applied to any taxes due and in some instances, is refundable.<sup>21</sup>

### Child and Dependent Care Credit – IRC § 21

The Child and Dependent Care Credit (CDCC) entitles a taxpayer to claim a credit for expenses incurred so the taxpayer (and spouse, if married) could work or look for work.<sup>22</sup> To qualify for the credit, a taxpayer must maintain a home for one or more

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<sup>13</sup> A taxpayer cannot claim the EITC if he or she does not have a valid social security number. IRC § 32(c)(1)(E).

<sup>14</sup> A taxpayer cannot claim the EITC unless he or she has earned income. IRC § 32(a).

<sup>15</sup> A taxpayer's earned income, adjusted gross income, and investment income must all be within limits established annually. IRC § 32(a)(2) & (j).

<sup>16</sup> A taxpayer is not eligible to claim the EITC without a qualifying child unless the taxpayer's principal place of abode is in the United States for more than half the taxable year, the taxpayer is at least 25 but under age 65 at the close of the taxable year, and the taxpayer does not qualify as a dependent of another taxpayer under § 151 for the taxable year. IRC § 32(c)(1)(A)(ii).

<sup>17</sup> IRC § 32(c)(3)(A). For purposes of the EITC, a qualifying child under § 152(c) is determined without regard to § 152(c)(1)(D) (requiring that a qualifying child not have provided over one half of his or her own support for the taxable year) and § 152(e) (describing special rules for divorced parents). IRC § 32(c)(3)(A).

<sup>18</sup> IRC § 32(c)(3)(B).

<sup>19</sup> IRC § 32(c)(3)(C).

<sup>20</sup> IRC § 24(a), & (c). The amount of the Child Tax Credit is reduced by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds the threshold amount (\$110,000 in the case of a joint return, \$75,000 in the case of a taxpayer who is not married, and \$55,000 in the case of a married taxpayer filing separately). IRC § 24(b)(1) & (2).

<sup>21</sup> IRC § 24(d).

<sup>22</sup> IRC § 21. The amount of the credit is a percentage, based on adjusted gross income, of the amount of employment-related expenses paid by the taxpayer during the taxable year. IRC § 21(a)(2), & (c). A taxpayer may claim a credit of up to 35 percent of child and dependent care expenses paid during a taxable year, up to a maximum of \$3,000 for a taxpayer with one qualifying individual or \$6,000 for a taxpayer with two or more qualifying individuals. IRC § 21(a), & (2) (c). This percentage is reduced one percentage point for every \$2,000 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds \$15,000. IRC § 21(a)(2).

A taxpayer may not claim this credit based on household or care expenses paid to a relative who is a dependent of the taxpayer or the taxpayer's child who is not over 19. IRC § 21(e)(6).



qualified individuals.<sup>23</sup> Additionally, a taxpayer must have earned income<sup>24</sup> and must meet certain filing status requirements.<sup>25</sup>

### Dependency Exemption – IRC § 151

The dependency exemption entitles a taxpayer to claim an additional exemption for each dependent who is a qualifying child or qualifying relative of the taxpayer, as defined in IRC § 152. A qualifying child must be under the age of 19 at the close of the taxable year, under 24 and a full-time student, or be permanently and totally disabled.<sup>26</sup>

### Head of Household – IRC § 2(b)

Head of household filing status entitles a taxpayer to a larger standard deduction and a more favorable tax rate than a taxpayer filing single or married filing separately.<sup>27</sup> To qualify as head of household, a taxpayer must be unmarried or “considered unmarried” at the end of the taxable year.<sup>28</sup> For more than half of the taxable year, a taxpayer must maintain, as the taxpayer’s home, a household that is the principal place of abode of a qualifying child<sup>29</sup> or a qualifying relative as defined under IRC § 152(d)(2)(A)-(F), for whom the taxpayer can claim a dependency exemption under IRC § 151.<sup>30</sup> Additionally, the taxpayer can qualify for head of household status if they maintain a household which is the principal place of abode of the taxpayer’s mother or father for whom the taxpayer can claim a dependency exemption under IRC § 151.<sup>31</sup>

<sup>23</sup> IRC § 21(a)(1). A qualified individual is a dependent, defined as a “qualifying child” under § 152(a)(1) who is under the age of 13, a dependent who is physically or mentally incapable of caring for himself or herself, or a spouse of the taxpayer who is physically or mentally incapable of caring for himself or herself. IRC § 21(b)(1). Special rules apply for children of divorced or separated parents, allowing only the custodial parent to claim the CTC even if the noncustodial parent claims the child as a dependent under the rules of § 152(e). IRC § 21(e)(5).

<sup>24</sup> IRC § 21(d)(1). Special rules apply for calculating earned income with regard to the spouse of a taxpayer who is a student or who is physically or mentally unable to care for himself. IRC § 21(d)(2).

<sup>25</sup> IRC § 21(e)(2).

<sup>26</sup> IRC § 151(c)(1) 152(a) & (c). For tax year 2005, the dependency exemption amount is \$3,200. Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

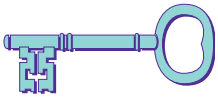
<sup>27</sup> For tax year 2005, the standard deduction for head of household is \$7,300. Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

<sup>28</sup> IRC § 2(b). A taxpayer whose spouse died during the taxable year is considered married for that year. IRC § 2(b)(2)(C). A taxpayer is not considered as married if he or she is legally separated from his or her spouse under a decree of divorce or separate maintenance or if his or her spouse is a nonresident alien at any time during the taxable year. IRC §§ 2(b)(2)(A), (B). A taxpayer is also considered unmarried if he or she is treated as unmarried under the provisions of § 7703. IRC § 2(c).

<sup>29</sup> IRC § 2(b)(1)(A)(i). IRC § 2(b)(1)(A)(i) contains specific rules for married children. Additionally, for purposes of head of household, a qualifying child is determined under the rules of § 152(c) but without regard to the rules for divorced or separated parents under § 152(e). IRC § 2(b)(1)(A)(i).

<sup>30</sup> IRC § 2(b)(1)(A)(ii). A taxpayer is considered as maintaining a household if the taxpayer provides over half of the cost of maintaining the household for the taxable year. IRC § 2(b).

<sup>31</sup> IRC § 2(b)(1)(B).



### Separated Spouse Rule Under IRC § 7703(b)

Under IRC § 7703(a), the determination of whether an individual is married is generally made as of the last day of the individual's tax year. As an exception to this rule, IRC § 7703(b) provides that certain married persons who are living apart from their spouses may be treated as unmarried. A married taxpayer (as determined under the general rule of IRC § 7703(a)) living apart with a dependent child will qualify as an unmarried person if each of the following conditions is met:

- ◆ The taxpayer must file a separate tax return;
- ◆ The taxpayer must pay more than half the cost of maintaining his or her household for the tax year;
- ◆ The taxpayer's spouse must not be a member of the household during the last six months of the year; and
- ◆ The household must, for more than six months of the year, be the principal home of the taxpayer's child (as defined in IRC § 152(f)(1)) for whom the taxpayer can claim a dependency exemption, or could claim such an exemption except for the special rules for divorced parents under IRC § 152(e).

### REASONS FOR CHANGE

As demonstrated in the preceding Present Law section, the current family status provisions, which affect virtually every individual taxpayer, impose a complex web of eligibility requirements. This bewildering array of family status provisions leads to inadvertent noncompliance and, in some instances, provides opportunities for taxpayers to game the tax system. Moreover, because of congressional and administrative concern about noncompliance with respect to the Earned Income Tax Credit, the IRS disproportionately audits returns including EITC claims.<sup>32</sup> Because of the provision's complex and often counter-intuitive eligibility rules, these audits impose high compliance burdens on a population least able to meet such demands.

The current family status provisions provide little recognition of the fact that many children today live in split households and that noncustodial parents who maintain a second household have a reduced ability to pay taxes. Further, the current rules that permit custodial parents to release the dependency exemption (and Child Tax Credit) to the noncustodial parent are fraught with complexity and permit family law courts to arbitrate claims for and to award federal tax benefits.

The EITC, as currently structured, provides little assistance to the working poor who do not have qualifying children and who are under 25 and over 65, despite 65 percent of

<sup>32</sup> In FY 2004, the IRS examined 1,007,874 individual tax returns. Of the returns examined, 48 percent – or 487,461 returns – contained EITC claims. *IRS Data Book 2004*, Publication 55B (rev. 3-2005), Table 10, Examination Coverage. In comparison, only 17 percent of all individual returns filed contained an EITC claim. *Statistics of Income, Tax Year 2002 Complete Data*, Table 4. For a detailed discussion of IRS EITC examinations, see *Most Serious Problem: EITC Examination Issues*, *supra*.

people between the ages of 20 and 24 who are employed in the civilian workforce, and 36 percent of males and 26 percent of females who are still employed at age 65.<sup>33</sup>

Over the years, many learned tax theorists, practitioners, and scholars have proposed reforms of the Code's family status provisions. Most recently, the President's Advisory Panel on Federal Tax Reform proposed replacing the standard deduction, personal exemptions, Child Tax Credit, and head of household filing status with a Family Credit and the Earned Income Tax Credit and the refundable Child Tax Credit with a Work Credit. Britain revamped its delivery of family and work benefits over a period of seven years and is now providing benefits through its tax system in the form of a Child Tax Credit and a Working Tax Credit.

The IRS is conducting exciting research about the Earned Income Tax Credit and using the information to better understand the taxpayer population eligible for the EITC. For example, the 2002 joint Treasury-IRS EITC Task Force identified that the IRS was able to systemically verify relationships between taxpayer and child in 80 percent of the tax returns claiming EITC. Moreover, the IRS was able to be reasonably confident, based on its own and other studies, that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than one-half the year. This population accounted for 80 percent of EITC tax returns.

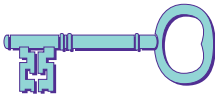
The IRS is also learning that where the IRS cannot systemically verify certain eligibility requirements, taxpayers may not be opposed to "certifying" eligibility in advance. The IRS's recent report to Congress about its EITC Certification Initiative notes that

[t]axpayers also appear not to object to the concept of proving eligibility prior to receiving the EITC. About 64 percent of the test group and 59 percent of the control group taxpayers thought that taxpayers should be required to prove they meet the EITC requirements before they received the EITC. About 30 percent of the test group answered no to this question, as did 36 percent of the control group.<sup>34</sup>

This confluence of the enactment of the Uniform Definition of Child, IRS research initiatives, and thoughtful reform proposals, create an excellent environment in which fundamental and positive change can occur. One goal for this reform should be to relieve the IRS and taxpayers from the tax agency's poking around into taxpayers' personal lives in a very intrusive fashion and focusing disproportionately on the private lives of the working poor.

<sup>33</sup> U.S. Census Bureau, *Employment Status 2000*, August 2003. Economic Policy Institute, *Snapshot*, June 15, 2005.

<sup>34</sup> Internal Revenue Service, *IRS Earned Income Tax Credit (EITC) Initiative, Final Report to Congress*, 43 (October 2005).



### EXPLANATION OF RECOMMENDATIONS

Our proposals attempt to redefine the eligibility rules for the Code’s family status provisions in a way that allows the tax system to get to “yes” in most instances without imposing intolerable compliance burdens on taxpayers. They build on the IRS’s current technology and revenue protection strategies, and establishes eligibility requirements based on our ability to verify those requirements either systemically or with minimal burden to the taxpayer. Thus, the proposals reverse the current structure of the family tax provisions, which establishes complex and rigid eligibility tests and then makes taxpayers tie themselves up in knots in order to prove to the IRS that they are eligible.

In making our proposals, we do not flesh out all relevant rules, nor do we take a position on the distribution of family or work benefits. We expect that Congress will hear from many sources on these very points, and indeed, there are many studies to guide one in making these decisions.<sup>35</sup> However, as Congress works through reform of these family tax provisions, it must keep in mind that in the family status area, a trade off exists between rigidity, complexity, and taxpayer burden on the one hand, and flexibility, simplicity, and taxpayer compliance on the other. A multitude of rules that focus on the perceived abuse-of-the-day ends up creating traps and burdens for *all* taxpayers.

By combining several provisions into one Family Credit, we eliminate complex and often contradictory eligibility requirements still extant in the Code today. The definition of “main caregiver” should include aspects of the Uniform Definition of Child but also permit greater flexibility in satisfying the requirements. Thus, for a taxpayer to be eligible for the Family Credit, the taxpayer must live in the United States for more than half the year and be the “main caregiver” for a child. That child must be younger than 19 (24 if a full-time student),<sup>36</sup> or any age if disabled. The “main caregiver” requirement can be satisfied by the taxpayer and the child having a primary relationship, or by the “main caregiver” providing the principal residence for the child or otherwise providing the principal financial support for the child.

Where there are no competing claims for the child, the IRS would accept the claim, providing, of course there were no indications that the taxpayer was ineligible to claim the child as a main caregiver. Where there are competing claims, Congress could establish a

<sup>35</sup> See, e.g., The President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (November 2005); Adam Carasso, Jeffrey Rohaly, and C. Eugene Steuerle, A Unified Children’s Tax Credit, National Tax Association Proceedings (May 15, 2005), available at <http://www.urban.org/uploadedPDF/1000790.pdf>; Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Sized Adjustment to the Minimum Wage*, 57 *Tax Law Rev.* 301 (Spring 2004); Max B. Sawicky, Robert Cherry and Robert Denk, *The Next Tax Reform: Advancing Benefits for Children*, Economic Policy Institute (2002).

<sup>36</sup> We retain the current law eligibility provision for students under age 24 who attend institutions of higher learning on a full-time basis. Although Congress could provide assistance to families with older children who are students as a separate education tax credit, many families will incur costs even where students receive scholarship or other financial assistance. Moreover, it makes little sense to impose separate eligibility requirements and tests on taxpayers where the children are still part of the family unit, as those additional requirements or tests add to complexity.

hierarchy, as with the current EITC tie-breaker rule.

The Family Credit includes a basic credit for the taxpayer, another credit for the taxpayer's spouse (although under our proposal for repealing Joint and Several Liability,<sup>37</sup> each spouse would claim his or her own credit), and a credit for each qualified child for whom the taxpayer is the "main caregiver."

In most instances, the IRS would be able to verify eligibility for the family credit through its current databases. Where the IRS could not systemically verify eligibility, taxpayers could either apply to the IRS in advance and "certify" their eligibility, or submit their claims with their tax returns. Under either method, the IRS would retain the record of "main caregiver" status for that taxpayer until a competing claim or other new information indicated a shift in eligibility. Thus, the vast majority of taxpayers would not have to certify at all, and all but a very few would have to certify only once.

Since there is no cap on the number of children who can be claimed by a taxpayer and the Family Credit is refundable at lower income levels but also available to taxpayers with higher incomes, taxpayers will not find themselves having to "lend" or "borrow" children. Where there are no "dueling" claims for children, the IRS will pay out the Qualifying Child component of the credit so long as the IRS verifies that the child exists and is of the requisite age (via the Social Security database). Taxpayers in non-traditional households can still be eligible for the credit but would have to certify, either in advance of or at the time of filing.

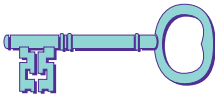
The new credit for noncustodial parents who pay their entire child support obligations for the calendar year addresses the fundamental concept of taxing persons based on their ability to pay. The credit will also reduce many of the current competing claims for dependency exemptions, child credit, head of household filing status, and EITC. Taxpayers can demonstrate child support payment compliance through affidavits from the payee or from the appropriate child support enforcement agency.

Repeal of head of household filing status eliminates some tax benefits for persons maintaining a home for parents or other persons who are not the taxpayer's child. Thus, we propose to allocate some of the tax benefits associated with head of household filing status to the new Dependent Care Credit, which would be available to taxpayers who provide primary care for members of their extended family either inside or outside of their homes.

Taxpayers will be eligible for the modified Earned Income Tax Credit as a single earner or a married household.<sup>38</sup> Because the presence or absence of a child is not an eligibility factor, the IRS can check eligibility on the basis of income reporting. Congress

<sup>37</sup> See Key Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*, *infra*.

<sup>38</sup> The modified EITC would retain the phase-in/plateau/phase-out structure of the current EITC so that it is targeted to low income workers, although the precise break points might change based on policymakers' distribution decisions.



## RECOMMENDATIONS

should establish a goal for the IRS and Social Security to work together so the IRS can screen all EITC claims against third party documents for income eligibility by May 1 of each year and issue checks by July 1. The financial impact of this delay on low income taxpayers will be offset in part by their receiving the refundable portion of the Family Credit immediately (*i.e.*, no delay once eligibility is satisfied) and the availability of the Advanced Earned Income Tax Credit. Congress should require the Secretary of the Treasury to deliver this credit to taxpayers electronically, through low-cost bank accounts, thereby eliminating the need for taxpayers to obtain expensive Refund Anticipation Loans (RALs).<sup>39</sup>

The net effect of these proposals is to take the IRS out of the business of looking intrusively into taxpayers' family situations. The tax provisions relating to family status will be subject to common sense rules that recognize the variety of family circumstances in the United States. While there are winners and losers (as with all reform proposals), the net effect of these proposals is to eliminate conflicting, counter-intuitive eligibility rules, remove the IRS from custody and divorce contests, and focus much of its compliance work in this area on data that can be verified through third-party reporting, other government and private databases, and in a relatively few instances, from the taxpayer him or herself, with a minimum of taxpayer burden.

<sup>39</sup> See Most Serious Problem: *Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives*, *supra*.

## 4

## KEY LEGISLATIVE RECOMMENDATION: ANOTHER MARRIAGE PENALTY – TAXING THE WRONG SPOUSE

## PROBLEM

The federal income tax liabilities of married persons are often imposed on or collected from a spouse who did not earn the income subject to tax, *i.e.*, the “wrong” spouse. Each taxpayer who files a joint return with his or her spouse is “jointly and severally” liable for tax on all of the couple’s income, regardless of who earned or spent it.<sup>1</sup> The only way to avoid joint and several liability is to file separately. However, married individuals filing separately lose many of the benefits they would otherwise be entitled to receive. Even if married taxpayers file separately, each is generally subject to tax on one-half of any “community income,” including income earned by his or her spouse.<sup>2</sup>

Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse’s income, at least in cases where he or she does not know about the income or significantly benefit from it, Congress enacted relief rules.<sup>3</sup> These rules reallocate income (and other items) between spouses or relieve one spouse of liability for taxes attributable to the other. However, the relief rules are sometimes overly narrow, complex, costly for the IRS to administer, and burdensome for taxpayers.<sup>4</sup> Further, even if these rules apply so that an “innocent spouse” is not liable for the other spouse’s tax, the IRS may be able to collect the other spouse’s tax liability from the innocent spouse in community property states.<sup>5</sup>

## EXAMPLES

*Example 1: Community Income.* A married couple “domiciled” in a community property state separate in February, but each spouse’s earnings continue to be community property under state law.<sup>6</sup> The husband earns more than the wife and receives a significant bonus in December of the same year. The wife erroneously includes on her return all of the income she earned and omits all of the income her husband earned, including the bonus. The IRS audits her return and determines that she is liable for tax on one-half of the community income, including the husband’s bonus. She does not qualify for “traditional” or “equitable” community property relief under IRC § 66(c) because

<sup>1</sup> IRC § 6013(d)(3). “Joint and several liability” means that the IRS may collect 100 percent of the liability from either spouse.

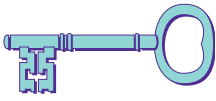
<sup>2</sup> See *Poe v. Seaborn*, 282 US 101 (1930). Married taxpayers in community property states have “community income” under state law. *Id.* However, various exceptions override community property rules, as discussed below.

<sup>3</sup> See IRC §§ 6015 (joint and several liability relief); 66 (community property relief).

<sup>4</sup> For further discussion, see Most Serious Problem: *Innocent Spouse Claims*, *supra*.

<sup>5</sup> See, e.g., *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

<sup>6</sup> Which state’s law applies depends on a person’s “domicile.” See, e.g., *U.S. v. Mitchell*, 403 U.S. 190 (1971); IRM § 25.18.1.2.1 (Feb. 15, 2005). A domicile is the permanent legal home the taxpayer intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. *Id.* Domicile is not always where the taxpayer presently lives or resides. *Id.*



she cannot establish that she did not know or have reason to know about her husband's earnings. However, if she were domiciled in a common law state, she would include on her return 100 percent of her earnings and none of his.

*Example 2: Joint and Several Liability.* A husband is a self-employed carpenter. The wife needs to file a joint return to obtain the earned income tax credit to provide for her children. The husband conceals some of his income from the wife and does not report it on the joint return. Three years later the IRS assesses additional tax associated with the husband's unreported income. The husband ignores the assessment and conceals all of the collection notices sent to the couple's home, including Letter 1058(c), *Notice of Intent to Levy and Notice of Your Right to a Hearing*, addressed to the wife.<sup>7</sup> Three years after the IRS sends the Letter 1058(c), the wife learns of the understatement and separates from the husband.<sup>8</sup> She is not eligible for "innocent spouse" relief under IRC § 6015 because more than two years have passed since the IRS began collection activities with respect to her.<sup>9</sup>

*Example 3: Collection of Community Property.* Assume the same facts as Example 1, except that the wife establishes that she did not know or have reason to know about the husband's bonus and obtains community property relief under IRC § 66(c). As a result, the husband is subject to tax on the entire bonus (and the wife is not), but he is unwilling or unable to satisfy the liability. If the couple is domiciled in Wisconsin, a community property state, the IRS can garnish up to 100 percent of the wife's wages to collect the husband's liability.<sup>10</sup> If the couple is domiciled in a common law state the IRS can not garnish any of the wife's wages to collect the husband's liability.<sup>11</sup>

## RECOMMENDATIONS

The National Taxpayer Advocate's recommendations are as follows:

- ◆ Eliminate joint and several liability for joint filers.<sup>12</sup> Require married taxpayers to file a split-column tax return, which identifies separate items of income, deduc-

<sup>7</sup> Letter 1058(c) is usually sent via certified mail, return receipt requested. See IRM § 5.19.8.4 (Oct. 1, 2002). Even if sent via certified mail, the U.S. Postal Service will deliver it to anyone who receives mail at the address unless the sender pays an additional \$3.50 for Restricted Delivery. See <http://www.usps.com/customersguide/dmm100.htm#1> (last visited Dec. 12, 2005).

<sup>8</sup> An "understatement" of tax or "deficiency" is generally the difference between the amount of tax that the IRS determines should have been shown on the return and the amount actually shown on the return. See Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* (Feb. 2004).

<sup>9</sup> See IRC § 6015(b)(1)(E), (c)(3)(B); Treas. Reg. § 1.6015-5(b)(1); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

<sup>10</sup> See Wis. Stat. § 766.55(2)(b) (West 2005) (obligations incurred by either spouse in the interest of the marriage or the family may be satisfied from all marital (community) property); Wis. Stat. § 766.55(1) (West 2005) (obligations incurred by a spouse during marriage presumed incurred in the interest of the marriage or the family); Wis. Stat. § 766.31(4) (West 2005) (income earned by either spouse during marriage is marital (community) property, even if the spouses are separated).

<sup>11</sup> See, e.g., *United States v. Craft*, 535 U.S. 274 (2002).

<sup>12</sup> Revise IRC § 6013(d), which imposes joint and several liability.



tion, credit, and payment, similar to the combined return adopted by a number of states.<sup>13</sup>

- ◆ Repeal the rule of *Poe v. Seaborn*<sup>14</sup> that each spouse is taxed on one-half of any community income. Apply the federal rules for allocating a nonresident alien’s community income to all couples, with slight modification.<sup>15</sup>
- ◆ Require the IRS to exhaust efforts to collect against assets under the liable spouse’s control before collecting against assets under the nonliable spouse’s control, unless such efforts would be futile.<sup>16</sup>

These recommendations will tax married persons more fairly by aligning each person’s tax with his or her individual ability to pay and by minimizing the impact of state property and collection rules, where these rules subject taxpayers to different amounts of federal income tax just because they are in different states. The recommendations will also significantly reduce complexity. If adopted, the following complex processes could be eliminated or substantially simplified: “innocent spouse” relief, community property relief, “injured spouse” relief,<sup>17</sup> and numerous Code provisions that override community property rules in an *ad hoc* fashion.

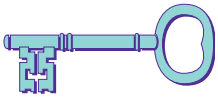
<sup>13</sup> The National Taxpayer Advocate made a similar proposal in 2001. See National Taxpayer Advocate 2001 Annual Report to Congress 128. The American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) also support eliminating joint and several tax liability. See ABA Recommendation #1992-12, 13-4 Newsletter 13 1995-2, available at <http://www.abanet.org/tax/pubs/aba.pdf> (the “1995 ABA Recommendation”); American Bar Association Section of Taxation Domestic Relations Committee, *Comments on Liability of Divorced Spouses for Tax Deficiencies on Previously Filed Joint Returns*, 50 Tax Law. 395 (Winter 1997) (the “1997 ABA Comments”); Testimony of David Lifson, Vice Chair Tax Executive Committee American Institute of Certified Public Accountants Before the Committee on Ways and Means, Hearing on the Marriage Penalty (Jan. 28, 1998) (including AICPA’s Comments on Notice 96-19, hereinafter “AICPA Comments”). For ease of administration, our proposal would: (1) sever joint liability when the IRS first asserts an underpayment or deficiency against a joint filer; (2) disallow separate refunds of voluntary payments made before the IRS asserts an understatement or underpayment that would otherwise be paid solely as a result of severing the joint liability; and (3) allocate liability for deficiencies on an item-by-item basis. These modifications are similar to those described in the 1997 ABA Comments.

<sup>14</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>15</sup> See IRC § 879(a). Our proposal would allocate “other income” to the spouse with control of the income.

<sup>16</sup> This requirement would mirror what is required before the IRS may collect on a transferee liability under current law. See, e.g., *U.S. v. Russell*, 241 F.2d 879 (1st Cir.1957); IRM § 4.10.13.3 (Mar. 30, 2005).

<sup>17</sup> The IRS may offset a joint refund to collect either spouse’s separate liabilities unless the nonliable spouse obtains “injured spouse” relief. See, e.g., IRC § 6402; Treas. Reg. § 301.6402-6(i).



**PRESENT LAW**

The following table illustrates how present law can tax the wrong spouse, and identifies the relief rules, if any, that are intended to address the problem on a case-by-case basis:

**TABLE 2.4.1, SUMMARY OF PRESENT LAWS THAT TAX THE WRONG SPOUSE AND POTENTIAL RELIEF RULES BY TAXPAYER LOCATION AND FILING STATUS**

Location/Law	Community Property Law States		Common Law States		Federal Relief Rules	
	Separate	Joint	Separate	Joint	Separate	Joint
Filing Status						
Taxed on income earned by spouse?	Yes	Yes	No	Yes	§ 66	§ 6015
Liable for spouse's tax?	No	Yes	No	Yes	No relief	§ 6015
Earnings collected for spouse's tax?	Yes	Yes	No	Yes	No relief	No relief

**Community Income**

*General Rule*

A taxpayer's federal taxable income depends on state property law. In common law states, income is generally taxed to the spouse who earns it or holds title to the property generating the income.<sup>18</sup> In contrast, in community property states, income earned during marriage is generally taxed one-half to each spouse, *i.e.*, the spouses "split" marital income for federal income tax purpose.<sup>19</sup> Nine states have community property laws, including: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.<sup>20</sup>

*Lack of Uniformity*

Because federal taxable income is determined by reference to state law, taxpayers in common law states are subject to tax on different amounts of income when compared to similarly situated taxpayers in community property states. In addition, similarly situated taxpayers in different community property states are subject to tax on different amounts of income.

**DIFFERENT PERIODS DURING WHICH INCOME IS COMMUNITY PROPERTY.** In general, only income earned during marriage is community property. However, the states have varying rules about the events that begin and end the period during which earnings will be community property. Some states recognize a "common law" marriage as beginning this period, while others do not.<sup>21</sup> In Wisconsin, this period terminates on the day the

<sup>18</sup> See, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930).

<sup>19</sup> See *Poe v. Seaborn*, 282 US 101 (1930).

<sup>20</sup> IRM Exhibit § 25.18.1-1 (Feb. 15, 2005). Complexities may arise if several jurisdictions are involved. See, e.g., *Jones v. Weaver*, 123 F.2d 403 (9th Cir. 1942); *Commissioner v. Cavanagh*, 125 F.2d 366 (9th Cir. 1942).

<sup>21</sup> See IRM Exhibit § 25.18.1-1 (Feb. 15 2005). A common law marriage is generally a legal marriage arising without a legal ceremony. Texas, a community property state, recognizes common law marriage. See, e.g., *Schmidt v. Commissioner*, T.C. Memo. 1981-38.

court enters a valid decree of divorce or legal separation.<sup>22</sup> In California, however, it terminates on the date the spouses separate if they both intend to permanently end the marriage.<sup>23</sup>

**EARNINGS ON SEPARATE PROPERTY.** Another difference among community property states is the treatment of earnings from separate property. In Wisconsin, earnings from separate property (called individual property) during the marriage are community property.<sup>24</sup> In California, however, earnings from separate property generally remain separate property.<sup>25</sup> The following example illustrates these differences.

*Example 4: Variations in Federal Taxable Income by State.* A married couple separate on March 31 with the intention to permanently end the marriage, but are unable to obtain a legal separation or divorce during the year. During the year the husband (H) earns \$2,000 in wages each month. The wife (W) earns \$5,000 in wages and \$4,000 in interest income on separately owned CDs each month. W also receives a \$10,000 bonus on December 1 of the same year. H and W do not commingle separate property, and file separate tax returns for the year.<sup>26</sup> The following table illustrates how H's and W's taxable income, tax liability, and effective tax rates would change under various state laws using 2005 tax rates.

**TABLE 2.4.2, FEDERAL TAXABLE INCOME, LIABILITY AND EFFECTIVE TAX RATE BY STATE**

	Illinois (common law)		California (community)		Wisconsin (community)	
	W	H	W	H	W	H
H's Wages	—	\$24,000	\$3,000	\$21,000	\$12,000	\$12,000
W's Wages	\$60,000	—	\$52,500	\$7,500	\$30,000	\$30,000
W's Bonus	\$10,000	—	\$10,000	—	\$5,000	\$5,000
W's Interest	\$48,000	—	\$48,000	—	\$24,000	\$24,000
<b>Taxable Income<sup>27</sup></b>	<b>\$118,000</b>	<b>\$24,000</b>	<b>\$113,500</b>	<b>\$28,500</b>	<b>\$71,000</b>	<b>\$71,000</b>
<b>Tax Liability</b>	<b>\$26,678</b>	<b>\$2,009</b>	<b>\$25,129</b>	<b>\$2,684</b>	<b>\$12,457</b>	<b>\$12,457</b>
<b>Effective Rate<sup>28</sup></b>	<b>23%</b>	<b>8%</b>	<b>21%</b>	<b>11%</b>	<b>11%</b>	<b>52%</b>

<sup>22</sup> See Wis. Stat. § 766.55(2m) (West 2005).

<sup>23</sup> See Cal. Fam. Code § 910 (West 2005); *In re McIntyre*, 222 F.3d 655 (9th Cir. 2000); *In re the Marriage of Von Der Nuell*, 28 Cal. Rptr. 2d 447 (Mar. 21, 1994); IRM § 25.18.1.2.3 (Feb. 15, 2005).

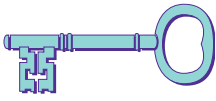
<sup>24</sup> See Wis. Stat. § 766.01(10) (West 2005). See also, *Lloyd v. Lloyd*, 487 N.W.2d 647 (Wis. Ct. App. 1992); Rev. Rul. 2004-71, 2004-30 I.R.B. 74.

<sup>25</sup> See Cal. Fam. Code § 770 (West 2005). See also Rev. Rul. 2004-72, 2004-30 I.R.B. 77.

<sup>26</sup> Because they are married at the end of the year they must use a “married” filing status. See IRC § 7703(a)(1) (determining marital status as of the last day of the year).

<sup>27</sup> The term “taxable income” refers to income subject to federal income tax and corresponds to “total income” shown on Form 1040.

<sup>28</sup> For purposes of calculating effective tax rate (liability/income), we use the common law definition of income.



Although H only earned \$24,000, depending on which state law applies, his taxable income could be as high as \$71,000, producing a tax liability of \$12,457, which represents 52 percent of his earnings. Similarly, although W earned wages and interest of \$118,000, her taxable income could be as low as \$71,000, producing the same tax liability of only \$12,457, which represents just 11 percent of her earnings and interest income.

### *Community Property Exceptions*

Although a taxpayer's federal taxable income generally depends on state property law, the Internal Revenue Code contains a patchwork of *ad hoc* exceptions. These exceptions generally ignore state community property laws for federal income tax purposes, discussed below.

PHYSICALLY AND ECONOMICALLY SEPARATE FOR ONE YEAR. Any community income is allocated for federal income tax purposes in accordance with IRC § 879 (discussed below) rather than local community property laws if:

- ◆ The couple lived apart at all times during the year;
- ◆ The couple did not file a joint return;
- ◆ At least one spouse had “earned income”<sup>29</sup> which was community income; and
- ◆ No portion of such earned income was transferred, directly or indirectly, between the spouses during the year.<sup>30</sup>

Thus, this exception does not apply: (1) in the year of the separation, (2) if one spouse makes one or more payments to the other out of earned income, or (3) if neither spouse has earned income from personal services.

When this exception applies, community income is allocated under IRC § 879 similar to the way income is allocated in common law states, as follows:

- ◆ Earned income from personal services is allocated to the spouse who rendered the services;<sup>31</sup>
- ◆ Trade or business income is allocated to the spouse carrying on the trade or business, or if the trade or business is jointly operated, on the basis of their respective distributive shares;<sup>32</sup>
- ◆ Partnership income is allocated to the spouse who is the partner;<sup>33</sup>
- ◆ Income from the separate property of one spouse is allocated to that spouse; and<sup>34</sup>

<sup>29</sup> “Earned income” is generally income attributable to personal services. See IRC § 911(b).

<sup>30</sup> See IRC § 66(a). Payments are presumed to be made out of earned income. See Treas. Reg. § 1.66-2(c).

<sup>31</sup> IRC § 879(a)(1); Treas. Reg. § 1.879-1(a)(2); IRC § 911(d)(2).

<sup>32</sup> IRC § 879(a)(2); IRC § 1402(a)(5).

<sup>33</sup> IRC § 879(a)(2); Treas. Reg. § 1.879-1(a)(4); IRC § 1402(a)(5).

<sup>34</sup> IRC § 879(a)(3); Treas. Reg. § 1.879-1(a)(5).

- ◆ Other income – consisting of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children -- is allocated in accordance with local law.<sup>35</sup>

NONRESIDENT ALIENS. Any community income of married taxpayers one or both of whom are nonresident aliens is allocated in accordance with IRC § 879 rather than local community property laws, absent an election.<sup>36</sup>

SELF-EMPLOYMENT AND OTHER TAXES. Even if a taxpayer does not qualify for any exceptions to the community property rules, various Code provisions disregard the community property income allocation rules. For example, the rules relating to the following provisions apply without regard to community property law:

- ◆ Self-employment taxes,
- ◆ Relief from joint and several liability (innocent spouse relief),
- ◆ Earned income tax credit,
- ◆ Individual Retirement Accounts (IRAs),
- ◆ Employee benefit plans,
- ◆ Deferred compensation plans,
- ◆ Archer Medical Savings Accounts,
- ◆ Health savings accounts,
- ◆ Methods of accounting, and
- ◆ Coverdell Education Savings Accounts.<sup>37</sup>

### *Community Property Relief*

Those married taxpayers who are subject to community property income allocation rules and file a separate return (or no return), may request two types of relief from its operation – “traditional relief” or “equitable relief.”<sup>38</sup>

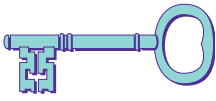
TRADITIONAL RELIEF. Traditional relief may be available to reallocate an item of community income from the “requesting” spouse to the “nonrequesting” spouse if the requesting spouse:

<sup>35</sup> IRC § 879(a)(4); Treas. Reg. § 1.879-1(a)(6). Our proposal would adjust this allocation rule.

<sup>36</sup> See IRC § 879(a).

<sup>37</sup> See, e.g., IRC §§ 32(c)(2)(b)(i) (earned income tax credit), 402(e)(4)(g)(5) (employee benefit plan distributions), 408(g)(IRA's), 219(f)(2) (deferred compensation deduction limits), 220(b)(4) (Archer MSAs), 223(d)(4)(D) (health savings accounts), 448(d)(4)(A) (limitation on cash method of accounting), 457(d)(7) (certain deferred compensation plans), 530(f) (Coverdell Education Savings Accounts), 932(d) (coordination of US and USVI income taxes), 1402(a) (self-employment tax), and 6015(a) (innocent spouse). See also *Bunney v. Commissioner*, 114 T.C. 259 (2000) (allocating income from IRA distributions without regard to community property law).

<sup>38</sup> See IRC § 66(c). Joint filers may obtain similar relief under the “innocent spouse” rules.



- ◆ Does not include in gross income for the year an item allocable to the other spouse,
- ◆ Establishes that he or she did not know of, and had no reason to know of, such item of community income, and
- ◆ Shows that it is “inequitable” to include the item of community income in such individual’s gross income (as discussed below).<sup>39</sup> One of the factors for determining inequity is whether the requesting spouse directly or indirectly benefited from the income.<sup>40</sup>

Thus, traditional relief is not available if the requesting spouse knows or has reason to know about a spouse’s income, even if he or she did not receive or benefit from any of it. Nor is traditional relief generally available if the nonrequesting spouse uses any of the income to benefit the requesting spouse (*e.g.*, by paying for joint expenses), even if the requesting spouse does not know about the income.<sup>41</sup>

**EQUITABLE RELIEF.** Equitable relief may be available, in the absence of fraud or certain intra-spousal asset transfers, to relieve one spouse from liability for unpaid tax or deficiency due to the operation of community property laws if the IRS determines it is “inequitable” to hold the individual liable for the tax.<sup>42</sup> The equitable relief test generally focuses on the requesting spouse’s:

- ◆ Knowledge (or reason to know),
- ◆ Economic hardship in the absence of relief,
- ◆ Significant benefit from the income,
- ◆ Relationship with his or her spouse (*e.g.*, separation, divorce, abuse, etc.),
- ◆ Legal rights and obligations pursuant to any divorce decree or agreement,
- ◆ Mental and physical health at the time of signing the return, and
- ◆ Tax compliance in subsequent years.<sup>43</sup>

Notably, the requesting spouse’s knowledge or reason to know about the nonrequesting spouse’s income or underpayment is relevant to determining whether to grant equitable relief.

**LIMITED PERIOD FOR REQUESTING RELIEF.** Taxpayers must request community property relief during potentially short periods, which vary depending on the type of request

<sup>39</sup> See IRC § 66(c). Joint filers may obtain similar relief under the “innocent spouse” rules.

<sup>40</sup> See Treas. Reg. § 1.66-4(a)(3).

<sup>41</sup> The “benefit” test under IRC § 66 differs from the “significant benefit” test under IRC § 6015, discussed below.

<sup>42</sup> See Treas. Reg. § 1.66-4(a)(3); Treas. Reg. § 1.66-4(b).

<sup>43</sup> See Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

and whether it relates to an underpayment or deficiency.<sup>44</sup> For example, the period for requesting equitable relief with respect to a deficiency year is: after the date the requesting spouse receives notice of an audit or a letter from the IRS indicating that there may be an outstanding liability with regard to the year, and within two years of the first collection activity against the taxpayer with respect to the liability.<sup>45</sup>

**SPOUSAL NOTIFICATION.** The IRS is required to contact the nonrequesting spouse when the requesting spouse files a claim for relief.<sup>46</sup> The IRS needs to contact the nonrequesting spouse to obtain information relevant to its determination and because relief granted to the requesting spouse will sometimes result in additional tax liability for the nonrequesting spouse.<sup>47</sup> Although this requirement is reasonable, it may inhibit some taxpayers from seeking relief, especially those subject to or recovering from spousal abuse.

## Joint and Several Liability

### *General Rule*

Each joint filer is jointly and severally liable for all tax, penalties, and interest due with respect to the joint return, regardless of whether they are domiciled in a community property or common law state.<sup>48</sup> Married taxpayers can avoid such joint and several liability by filing separately, but by filing separately they pay higher tax rates and lose various tax benefits.<sup>49</sup> As one IRS publication helpfully explains, by filing separately:

1. Your tax rates will increase at income levels that are lower than those for a joint return filer.
2. Your exemption amount for figuring the alternative minimum tax will be half of that allowed a joint return filer.
3. You cannot take the credit for child and dependent care expenses in most cases.
4. You cannot take the earned income credit.
5. You cannot take the exclusion or credit for adoption expenses in most instances.
6. You cannot take the credit for higher education expenses (Hope and lifetime learning credits), the deduction for student loan interest, or the deduction for tuition and fees.

<sup>44</sup> See Treas. Reg. § 1.66-4(j)(2); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

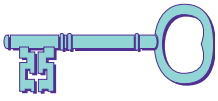
<sup>45</sup> See Treas. Reg. § 1.66-4(j)(2)(ii); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

<sup>46</sup> Treas. Reg. § 1.66-4(k).

<sup>47</sup> See Treas. Reg. § 1.66-4(d), (k).

<sup>48</sup> IRC § 6013(d)(3).

<sup>49</sup> See, e.g., IRC §§ 21(e)(2) (child and dependent care credit); 22(e)(1) (credit for the elderly or disabled); 23(f)(1) (adoption expense credit); 25A(g)(6) (HOPE and Lifetime Learning credit); 32(d) (earned income credit); 63(c)(6)(A) (separate filer not eligible for standard deduction when spouse itemizes); 86(c)(1)(C)(i) (exclusion for certain social security and railroad retirement benefits); 135(d)(3) (interest exclusion on savings bonds for higher education); 137(e) (adoption assistance exclusion); 221(e)(2) (student loan interest deduction); 408A(c)(3)(B)(ii) (rollover IRA to Roth IRA).



## RECOMMENDATIONS

SECTION  
TWO

7. You cannot exclude the interest from qualified savings bonds that you used for higher education expenses.
8. If you lived with your spouse at any time during the tax year:
  - a. You cannot claim the credit for the elderly or the disabled,
  - b. You will have to include in income up to 85% of any social security or equivalent railroad retirement benefits you received, and
  - c. You cannot roll over amounts from a traditional IRA into a Roth IRA.
9. Your income limits that reduce the child tax credit, retirement savings contributions credit, itemized deductions, and amount you can claim for exemptions will be half of the limits allowed a joint return filer.
10. Your capital loss deduction limit is \$1,500 (instead of \$3,000 on a joint return).
11. Your basic standard deduction, if allowable, is half of that allowed a joint return filer.<sup>50</sup>

THE INCOME SPLITTING BENEFIT OF JOINT FILING. Under our progressive tax rate structure, a higher tax is levied upon a set amount of income if it is earned by one taxpayer than if it is earned by two (one-half each). In 1930, the Supreme Court created a tax loophole when it determined that state community property law automatically “splits” a married taxpayer’s income for federal income tax purposes, but common law does not.<sup>51</sup> Between 1930 and 1948, married taxpayers domiciled in community property jurisdictions paid less tax than similarly situated taxpayers in common law states if they filed separate returns. In response, Michigan, Nebraska, Oklahoma, Oregon, Pennsylvania, and Hawaii adopted community property laws, so their citizens could enjoy the income splitting benefit.<sup>52</sup> In 1948, Congress extended this benefit to all married couples filing joint returns by reducing tax rates for joint filers.<sup>53</sup> However, geographic disparity still exists for married taxpayers who file separately because those in community property jurisdictions enjoy the income splitting benefit, but those in common law jurisdictions do not. Under the facts of Example 4, above, H’s and W’s combined liability is significantly higher if they file separately than if they file jointly, especially if they are domiciled in a common law state, as shown in the following table.

<sup>50</sup> IRS Pub. 504, *Divorced or Separated Individuals* 4-5 (2005).

<sup>51</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>52</sup> See Joseph D. Seckelman, 3 *Mertens Law of Fed. Income Tax’n* § 19:02 (West 2004).

<sup>53</sup> See Pub. L. No. 471, 80th Cong., 2nd Sess. (Apr. 2, 1948). Interestingly, after passage of the Revenue Act of 1948 all of the newly converted community property states repealed their community property laws, presumably because their citizens could obtain the income splitting benefit by filing jointly. See Joseph D. Seckelman, *supra*.



TABLE 2.4.3, H AND W'S FEDERAL TAX SAVINGS FROM JOINT FILING BY STATE

	Illinois (common law)	California (community)	Wisconsin (community)
Combined Separate Liabilities	\$28,687	\$27,813	\$24,914
Joint Liability	\$24,900	\$24,900	\$24,900
<b>Tax Savings from Joint Filing</b>	<b>\$3,787</b>	<b>\$2,913</b>	<b>\$14</b>

H and W would save \$3,787 by filing jointly if they lived in Illinois, a common law state, but only \$14 if they lived in Wisconsin, a community property law state. This savings reflects the income-splitting benefit available to joint filers.

*Example 5: Joint and Several Liability for Understatements.* Assume the same facts described in Example 4, above, except that H and W file a joint return and W omits her \$10,000 bonus. The joint liability shown on the return would be \$22,230 regardless of which state law applies. Although H earned only \$24,000 he would be liable for tax of \$24,900 on joint income of \$142,000, including the \$2,670 understatement (\$24,900 tax required to be shown on the joint return - \$22,230 tax actually shown on the joint return), even though he received no benefit from W's income and did not live with W for most of the year. H may only avoid liability for the entire \$24,900 plus interest and penalties if innocent spouse relief is granted.

#### *Joint and Several Liability Relief – Innocent Spouse Rules*

If a taxpayer files a joint return, he or she may obtain relief from joint and several liability for understatements of tax by filing a timely claim under IRC § 6015 for “traditional” innocent spouse relief, a “separate liability election,” or “equitable” relief.<sup>54</sup> “Equitable relief” may also apply to underpayments.<sup>55</sup> Any determination under IRC § 6015 is made without regard to community property law.<sup>56</sup> Thus, joint filers in community property states may obtain relief from both joint and several liability and community property rules under IRC § 6015.

TRADITIONAL RELIEF. To obtain traditional relief the taxpayer must demonstrate:

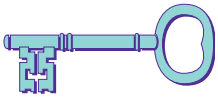
- ◆ An understatement of tax is attributable to an erroneous item of the nonrequesting spouse (determined without regard to community property law),
- ◆ The requesting spouse did not know or have reason to know of the understatement; and
- ◆ It would be “inequitable” to hold the requesting spouse liable (discussed above).<sup>57</sup>

<sup>54</sup> IRC § 6015(b) (traditional relief), 6015(c) (separate liability election), 6015(f) (equitable relief).

<sup>55</sup> IRC § 6015(f).

<sup>56</sup> IRC § 6015(a).

<sup>57</sup> IRC § 6015(b); Treas. Reg. § 1.6015-2(a).



Thus, as with traditional community property relief, traditional innocent spouse relief is not available if the taxpayer knew or had a reason to know about the understatement.

SEPARATE LIABILITY ELECTION FOR TAXPAYERS SEPARATED FOR 12 MONTHS. A taxpayer may make a separate liability election if:

- ◆ The taxpayer is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for the 12-month period ending on the date of the election;<sup>58</sup>
- ◆ The IRS does not demonstrate that he or she had actual knowledge of the item giving rise to the understatement;<sup>59</sup> and
- ◆ No assets were transferred between the spouses as part of a fraudulent scheme.<sup>60</sup>

A separate liability election limits a taxpayer's liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items (without regard to community property laws).<sup>61</sup> The portion of any deficiency allocated to the electing spouse, however, is increased by the value of any assets transferred to the electing spouse from the nonelecting spouse with the principal purpose of tax avoidance.<sup>62</sup>

EQUITABLE RELIEF. If a taxpayer is not eligible for traditional innocent spouse relief or a separate liability election, and it would be "inequitable" to hold the taxpayer liable, the taxpayer may qualify for equitable relief.<sup>63</sup> The equitable relief test is similar to the equitable relief test applied in the context of community property relief.<sup>64</sup> A taxpayer may obtain equitable relief for both deficiencies and underpayments of tax. The IRS generally considers the same facts and circumstances under this test as the other equitable relief tests, except that it will ordinarily grant relief for underpayments if the requesting spouse:

- ◆ Is no longer married to, is legally separated from, or was not a member of the same household as the nonrequesting spouse for the previous 12 months;
- ◆ Will suffer an economic hardship if the IRS does not grant relief; and
- ◆ Had no knowledge or reason to know that the nonrequesting spouse would not pay the tax liability.<sup>65</sup>

<sup>58</sup> IRC § 6015(c)(3)(A)(i); Treas. Reg. § 1.6015-3(a).

<sup>59</sup> IRC § 6015(c)(3)(C).

<sup>60</sup> IRC § 6015(c)(3)(A)(ii).

<sup>61</sup> IRC §§ 6015(c)(1), (d); 6015(a). Items otherwise allocable to the nonelecting spouse are allocated to the electing spouse to the extent he or she received a tax benefit on the joint return from such items. IRC § 6015(d)(3)(B).

<sup>62</sup> IRC § 6015(c)(4).

<sup>63</sup> IRC § 6015(f); Treas. Reg. § 1.6015-4.

<sup>64</sup> See Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

<sup>65</sup> See *id.* at § 4.02.

Notably, the requesting spouse's knowledge or reason to know of the underpayment or deficiency is relevant to determining whether to grant equitable relief.

**LIMITED PERIOD FOR REQUESTING RELIEF.** The IRS will not consider a taxpayer's request for relief from joint and several liability filed before the date the requesting spouse receives notice of an audit or a letter from the IRS indicating that there may be an outstanding liability with regard to the year.<sup>66</sup> In addition, the IRS will not consider any such request filed after the two-year period beginning on the date of any collection activity.<sup>67</sup>

**SPOUSAL NOTICE.** As with community property relief requests, the IRS is required to contact the nonrequesting spouse after the requesting spouse files a claim for relief in order to give the nonrequesting spouse an opportunity to submit information to the IRS.<sup>68</sup> In addition, the nonrequesting spouse may appeal the IRS's preliminary decision to grant relief before the decision becomes final.<sup>69</sup>

## Collection

### *Collection of Property Controlled by a Nonliable Spouse*

**COMMON LAW STATES.** In common law states, the IRS may collect a taxpayer's separate property as well as one-half of any property held jointly or as joint tenancy by the entireties.<sup>70</sup> The IRS may not garnish a taxpayer's wages to collect his or her spouse's separate liability.<sup>71</sup>

**COMMUNITY PROPERTY STATES.** In community property states, the IRS may generally collect one spouse's separate liability out of his or her separate property as well as any community property held by, and community income earned by, the nonliable spouse.<sup>72</sup> Thus, in community property states the IRS may garnish a person's wages to collect a liability that the IRS has determined is solely the other spouse's responsibility. Depending on the state, the IRS's right to collect against the nonliable spouse may depend upon whether the liability was incurred before, during, or after the marriage, or on the existence of certain marital agreements.<sup>73</sup>

<sup>66</sup> See *Id.*; Treas. Reg. § 1.6015-5(b)(1), (5).

<sup>67</sup> IRC §§ 6015(b)(1)(E); 6015(c)(3)(B); Rev. Proc. 2003-61, 2003-2 C.B. 296, § 4.01(3) and § 5; IRM § 25.15.5.11 (May 1, 2005).

<sup>68</sup> See, e.g., IRC § 6015(h)(2); Treas. Reg. § 1.6015-6(a)(1); Publication 971, *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* (Mar. 2004).

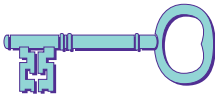
<sup>69</sup> See *Id.*; Rev. Proc. 2003-19, 2003-1 C.B. 371.

<sup>70</sup> See, e.g., *United States v. Craft*, 535 U.S. 274 (2002); Notice 2003-60, 2003-2 C.B. 643.

<sup>71</sup> See *Id.*

<sup>72</sup> See, e.g., *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989). In addition, the IRS may collect a liable spouse's tax out of the nonliable spouse's community property that is controlled by the liable spouse. *Id.*

<sup>73</sup> See IRM § 25.18.4 (Feb. 15, 2005).



### *IRS Not Subject to State Law Exemptions Protecting Nonliable Spouses*

State law exemptions sometimes prevent creditors, other than the federal government, from collecting income earned or controlled by a nonliable spouse to satisfy the liable spouse's debts. Under Texas law, for example, any community property subject to a spouse's sole "management, control, and disposition" (e.g., wages) is generally not subject to collection by his or her spouse's creditors.<sup>74</sup> Unlike other creditors, however, the IRS is not subject to any such state law exemptions and may collect at least one-half, and sometimes all, of any community property or community income to satisfy one spouse's separate liability.<sup>75</sup>

### *Transferee Liability Addresses Abusive Transfers to a Spouse*

If the IRS cannot collect separate liabilities from the liable spouse, transferee liability will often permit the IRS to collect the tax liability from the nonliable spouse or any other person to whom the liable spouse transferred property.<sup>76</sup> In general, transferee liability may arise from property transfers for less than reasonably equivalent value if the debtor:

- ◆ Is insolvent or becomes insolvent as a result of the transfer; or
- ◆ Made the transfer with actual intent to hinder, delay, or defraud a creditor.<sup>77</sup>

If transferee liability applies, the transferee is secondarily liable for the lesser of: (a) the amount of the liability and (b) the value of the property received from the debtor.<sup>78</sup> Because the transferee is secondarily liable (rather than primarily liable) for the transferor's debt, the government must exhaust efforts to collect from the transferor before attempting to collect from the transferee, unless such efforts would be futile.<sup>79</sup>

### REASON FOR CHANGE<sup>80</sup>

#### **Marriage Does Not Extinguish Individual Economic Identity**

Taxing each spouse on one-half of the community income and imposing joint and several liability for a spouse's taxes are each logical extensions of the concept that marriage extinguishes an individual's identity, merging husband and wife into a single economic

<sup>74</sup> See TEX. FAMILY CODE ANN. § 3.202 (Vernon 2004) (successor to §5.61(b)).

<sup>75</sup> See IRC §§ 6321 (liens); IRC § 6331(a) (levies); 6334(c) (no exemptions from levy other than those specifically identified); *U.S. v. Mitchell*, 403 U.S. 190 (1971). See also *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

<sup>76</sup> See IRC § 6901.

<sup>77</sup> See Subpart D of the Federal Debt Collection Procedures Act of 1990, 28 U.S.C. §§ 3301-3308 (West 2005). State fraudulent conveyance statutes provide the IRS with additional rights to collect from transferors. See, e.g., IRM § 4.10.13.3 (Mar. 30, 2005).

<sup>78</sup> See *Id.*

<sup>79</sup> See *Id. U.S. v. Russell*, 241 F.2d 879 (1st Cir.1957).

<sup>80</sup> The reasons for change have been comprehensively discussed elsewhere. See, e.g., Richard C.E. Beck, *The Innocent Spouse Problem: Joint And Several Liability for Income Taxes Should be Repealed*, 43 Vand. L. Rev. 317 (Mar. 1990); 1995 ABA Recommendation; AICPA Comments.

unit.<sup>81</sup> A 1923 ruling justified joint and several liability on the basis that “a single joint return is one return of a taxable unit and not two returns of two units on one sheet of paper.”<sup>82</sup> Under this reasoning, it does not matter if one spouse pays tax on the other spouse’s income because the law does not recognize individual members of the economic unit.

In reality, husbands and wives are individuals who often have separate assets and incomes that they do not control equally. In 2001, 61 percent of all married women and 77 percent of all married men worked outside the home.<sup>83</sup> One recent survey estimated that 48 percent of married couples have separate checking accounts.<sup>84</sup> About 3.2 million happily married couples do not even live together and another 4.5 million are separated because of marital discord.<sup>85</sup> At current rates, about 48 percent of all American marriages are expected to end in divorce within the next 20 years, in which case they will separate their finances even further.<sup>86</sup> Most importantly, studies confirm that even married taxpayers who live together do not control income equally.<sup>87</sup> Thus, for the tax law to treat all married taxpayers as a single economic unit does not align with their behavior.

### Tax Not Imposed In Accordance with “Ability to Pay”

Because married taxpayers do not always share income equally, taxing one spouse on income earned by the other or holding one spouse liable for tax on the other’s income violates the fundamental principle that tax should be imposed in accordance with ability to pay.<sup>88</sup> The Ninth Circuit stated in *Cole v. Commissioner*:

<sup>81</sup> For a recent discussion of the evolution of this theory, see Bryan T. Camp, *The Unhappy Marriage of Law and Equity in Joint Return Liability*, 108 Tax Notes 1307 (Sept. 12, 2005).

<sup>82</sup> I.T. 1575, II-1 C.B. 144 (1923).

<sup>83</sup> See U.S. Census Bureau, Statistical Abstract of the United States, No. 568. Labor Force Participation Rates by Marital Status, Sex, and Age: 1970 to 2001 (2002), available at <http://www.census.gov/prod/2003pubs/02statab/labor.pdf>.

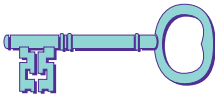
<sup>84</sup> See MSN Money, *Marriage and Money: Coordination is Key* (July 25, 2005) at <http://msnbc.msn.com/id/8418129/> (last visited Dec. 7, 2005) (citing a survey of 1,200 households by the Raddon Financial Group in Oakbrook Terrace, Illinois).

<sup>85</sup> U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement (Feb. 22, 2005), available at <http://www.census.gov/population/socdemo/foreign/ppl-176/tab05-2.pdf> (2004 data, Table 5.2).

<sup>86</sup> See Andrew J. Cherlin, *American Marriage in the Early Twenty-First Century, The Future of Children*, 36 (Princeton-Brookings, Fall 2005), available at [http://www.futureofchildren.org/usr\\_doc/03\\_FOC\\_15-2\\_fall05\\_Cherlin.pdf](http://www.futureofchildren.org/usr_doc/03_FOC_15-2_fall05_Cherlin.pdf).

<sup>87</sup> See, e.g., Frances Woolley, *Control over Money in Marriage*, MARRIAGE AND THE ECONOMY, 105-129 (Shoshana A. Grossbard-Schechtman ed., Cambridge University Press 2003) (May 2000) available at <http://www.carleton.ca/economics/cep/cep00-07.pdf>; Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 Hastings L.J. 63, 80-92 (1993) (citing several studies).

<sup>88</sup> Such a tax also contradicts the fundamental principle that income is taxed to the person who earns and controls it even if another receives or otherwise benefits from the income. See, e.g., *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930); *Helvering v. Horst*, 311 U.S. 112 (1940). Accord IRC § 678.



One of the fundamental principles of taxation is that the incidence of a tax should be in accordance with the ability to pay. In income taxation, this means that the tax should be levied in proportion to income.... If this cardinal principle is followed, justice will be done.<sup>89</sup>

Perhaps for this reason, joint and several liability for married filers is the exception rather than the norm in the international community.<sup>90</sup>

IRS statistics suggest that joint and several liability and community property rules often require low income women who are divorced and caring for children to pay a husband's or ex-husband's tax liability (or pay tax on his income) unless relief is applicable. For example, 65 percent of the taxpayers who request innocent spouse or community property relief make less than \$30,000 per year.<sup>91</sup> Ninety percent are women.<sup>92</sup> Thirty-four percent are single filers and another 51 percent file as "head of household," meaning they are unmarried and maintain a home for children or other persons.<sup>93</sup>

Even imposing one-half (rather than all) of the liability on each spouse would not, on average, tax them in accordance with ability to pay. As noted above, studies confirm that spouses often do not control marital assets equally; rather, the spouse with greater earnings exerts more control.<sup>94</sup> On average, women earn only 25 percent of the income reported on a joint return.<sup>95</sup> Thus, the most frequent effect of joint and several liability may be to require low income women who are often raising children by themselves, to insure the IRS against underreporting or underpayment of tax on income earned by a husband or former husband. The community property rules have a similar affect.

### Relief Rules Imperfect

#### *Spouses Must Audit Each Other*

To avoid being the government's insurer against a spouse's noncompliance, an "innocent spouse" must often show that he or she had no "actual knowledge" or "reason to know" of a spouse's underreporting or underpayment.<sup>96</sup> For example, a wife is expected

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<sup>89</sup> *Cole v. Commissioner*, 81 F.2d 485, 487 (9th Cir. 1935), *rev'g*, 29 B.T.A. 602 (1933).

<sup>90</sup> See, e.g., 1995 ABA Recommendation; Richard C.E. Beck, *The Innocent Spouse Problem: Joint And Several Liability for Income Taxes Should be Repealed*, 43 Vand. L. Rev. 317, 382-389 (Mar. 1990).

<sup>91</sup> W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (statistics based on 2001 data).

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> See, e.g., Frances Woolley, *supra*, note 87 (concluding that the spouse with a higher income generally has more control over marital assets).

<sup>95</sup> W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (statistics based on 2001 data).

<sup>96</sup> One of the most common reasons for innocent spouse and community property claims to be denied is because of the taxpayer's knowledge or reason to know. Innocent Spouse Tracking System (Jan. 30, 2005).

to show that she exercised due diligence to detect and rectify a husband's noncompliance. When a husband prepares a joint return reporting his income and tells his wife to sign it, (absent abuse) she is expected to review the return and cause him to correct any inaccuracies that she has "actual knowledge" or "reason to know" about.<sup>97</sup> If she entrusts the family tax affairs to her husband, relief may not be available. To be prudent, each spouse should actively participate in preparing the joint return. Indeed, since ignorance of the law is not considered in determining a taxpayer's reason to know, each spouse may be well advised to consult with a tax advisor.<sup>98</sup> Such duplicated efforts frustrate one of the primary non-tax benefits of joint filing, *i.e.*, the benefit of delegating to one spouse the responsibility for preparing the family tax return and communicating with a professional tax preparer, if necessary.

#### *Spouses Must Investigate Each Other Even if Filing Separately*

The community property relief rules have a similar requirement that a spouse must not have any reason to know about a spouse's income.<sup>99</sup> As a result, even separate filing will not discharge married taxpayers from their duty to investigate a spouse on the government's behalf, at least if they are domiciled in a community property state.

#### *Innocent Spouse Processing Difficulties*

In contrast to our normal self-assessment tax system in which taxpayers determine their liability, the relief rules require the IRS to make complex and time consuming case-by-case determinations, provided taxpayers can figure out how to apply for relief within the limited periods for requesting it.<sup>100</sup> Once they apply for relief, which is granted on only about 30 percent of all claims, taxpayers have to wait months or years to obtain it.<sup>101</sup> In FY 2005, the IRS took 192 days to process innocent spouse claims that the examination function ultimately allowed in full.<sup>102</sup> Processing time jumps to 807 days, or more than two years, for claims elevated to the Appeals function. Taxpayers may have to wait even longer if litigation is required. Interest and penalties continue to accrue during these periods. Further, under current law some taxpayers may be unable to obtain any meaningful review of IRS decisions by a court.<sup>103</sup>

<sup>97</sup> The "no actual knowledge" requirement does not apply in cases where the requesting spouse establishes that he or she was a victim of domestic abuse and that the abuse resulted in the requesting spouse's failure to challenge the treatment of an item on the joint return. See Treas. Reg. § 1.6015-3(c)(2)(v). However, the spousal notification requirements may inhibit such persons from seeking relief.

<sup>98</sup> See *e.g.*, Treas. Reg. § 1.6015-3(c)(2)(ii).

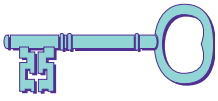
<sup>99</sup> See IRC § 66(c)(3).

<sup>100</sup> See Most Serious Problem: *Innocent Spouse Claims*, *supra* (discussing challenges faced by the Innocent Spouse Program).

<sup>101</sup> Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

<sup>102</sup> See Most Serious Problem: *Innocent Spouse Claims*, *supra*.

<sup>103</sup> See, *e.g.*, Bryan T. Camp, *The Unhappy Marriage of Law and Equity in Joint Return Liability*, 108 Tax Notes 1307 (Sept. 12, 2005) (describing how jurisdictional rules may deny court review to deserving taxpayers and result in the application of different standards of review depending upon the procedural posture of the case).



### Joint Filing – A Trap for the Unwary and those Seeking Marital Harmony

Many married taxpayers are probably unaware that they may avoid joint and several liability by filing separately. Form 1040, *U.S. Individual Income Tax Return*, does not warn taxpayers that filing a joint return will result in joint liability.<sup>104</sup> Although the Form 1040 instruction booklet discloses that joint filing may subject a taxpayer to joint and several liability, it offers a “tip,” that taxpayers should “choose the one [filing status] that will give you the lowest tax.”<sup>105</sup> Of course, taxpayers who have delegated responsibility for family tax preparation to a spouse are unlikely to read the instruction booklet. Taxpayers who are aware of the consequences of joint filing are probably most aware that federal income tax rates (the “income splitting” benefit) and various tax benefits often provide an immediate incentive for married taxpayers to file jointly.

Even if a taxpayer knows that joint filing may theoretically subject him or her to liability for a spouse’s understatement or underpayment, it may be just as difficult to believe that a trusted spouse might understate or underpay his or her taxes as it is to believe that the marriage might end in divorce. Although researchers expect almost half of all marriages to result in divorce, only 1.5 to 10 percent of all married taxpayers enter prenuptial agreements.<sup>106</sup> Studies attribute the relatively low number of such agreements to optimism, bias, and a fear of signaling distrust to a fiancé.<sup>107</sup> Similar concerns may deter married taxpayers from filing separately. Even if one spouse does not necessarily trust the other, he or she may be faced with a choice of (a) signing the joint return without question, (b) questioning a spouse’s tax reporting, or (c) filing separately, which may cost the family significant tax benefits. The only choice that does not present the possibility of marital conflict is to sign the joint return without question. Perhaps for this reason, taxpayers rarely take the precaution of filing separately. Ninety seven percent of all married filers, over 100 million taxpayers, submitted joint returns for tax year 2003, subjecting themselves to joint and several liability for a spouse’s tax.<sup>108</sup>

<sup>104</sup> See Form 1040, *U.S. Individual Income Tax Return* (2005).

<sup>105</sup> Instructions for Form 1040, *U.S. Individual Income Tax Return* 16-17 (2005).

<sup>106</sup> See, e.g., Heather Mahar, *Why Are There So Few Prenuptial Agreements?*, Harvard John M. Olin Discussion Paper No 436 (Sept. 2003), available at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/436.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/436.pdf).

<sup>107</sup> See, e.g., *Id.*

<sup>108</sup> Of the 104 million married filers, 101 million filed jointly. TAS Research, Tax Year 2003 IRTF Data (May 3, 2005).



### Little Justification for Joint and Several Liability

#### *Price of Joint Filing*

One rationale sometimes given for joint and several liability is that it is the price married taxpayers must pay for joint filing.<sup>109</sup> Historically, however, joint filing did not always trigger joint liability. The privilege of joint filing was granted by the Revenue Act of 1918, but joint filers were not subject to joint and several liability until 1938.<sup>110</sup> More importantly, the amount of any joint liability bears no relation to the benefits of joint filing. Moreover, if joint liability is the price of joint filing, the price is imposed on the wrong spouse. The spouse who has the highest income derives the greatest income-splitting benefit from joint filing, but the price of joint filing – liability for a spouse’s taxes – is often imposed on the spouse with the lowest income, as illustrated above. Thus, the benefits of joint filing do not justify joint and several liability.

#### *Administrative Reasons*

In 1938, when Congress explicitly imposed joint and several liability, legislative history cited “administrative” reasons.<sup>111</sup> Eliminating joint and several liability would affect how both taxpayers and IRS administer their respective responsibilities.

ADMINISTRATIVE ISSUES FOR THE IRS. In 1998, when the Treasury Department studied the option of eliminating joint and several liability and requiring married taxpayers to file separate returns, it noted a number of administrative challenges the IRS would face, including the following:

- ◆ IRS computer systems would need an upgrade to handle separate liabilities;
- ◆ The IRS’s data entry costs would increase;
- ◆ The IRS would need to revise its document matching and audit selection criteria and techniques; and
- ◆ The IRS might have difficulty collecting separate liabilities out of assets owned as joint tenancy by the entireties.<sup>112</sup>

These administrative challenges have significantly declined since 1998, as follows:

- ◆ **Computer Issues.** In 2005, the IRS began to use a computer system called the Customer Account Data Engine (CADE), which will gradually replace its old “master file” and certain “non-master file” systems over the next few years.<sup>113</sup> We

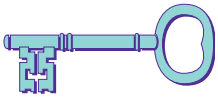
<sup>109</sup> The IRS made such an argument in the *Cole* case. See *Cole v. Commissioner*, 81 F.2d 485, 487 (9th Cir. 1935), *rev’g*, 29 B.T.A. 602 (1933) (joint filers **not** jointly and severally liable for tax).

<sup>110</sup> See *Id.*; Revenue Act of 1938, Pub. L. No. 75-554, Ch. 289, § 51(b), 52 Stat. 447, 476.

<sup>111</sup> H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938), 1939-1 C.B. (Part 2) 728, 749.

<sup>112</sup> See Department of the Treasury, Report to the Congress on Joint Liability and Innocent Spouse Issues 27-43 (Feb. 1998).

<sup>113</sup> See David Perera, IRS 5.0 - *After numerous failed modernization efforts, the IRS now believes it has a model that works*, Federal Computer Week (July 18, 2005).



understand that CADE could be programmed to handle separate liability processing. Thus, computer system limitations would be less challenging today than they were in 1998.

- ◆ **Data Entry.** The IRS received only 19 percent (25 million out of 123 million) of all tax individual income tax returns electronically in FY 1998, but that figure increased to 52 percent (68 million out of 131 million) in FY 2004, and the IRS goal is to increase the number of returns received electronically to 80 percent by 2007.<sup>114</sup> Because returns received electronically do not require significant data entry, a split column return would not entail as much additional data entry today as it would have in 1998.
- ◆ **Collection Issues.** In 2002 the Supreme Court held that the IRS could collect separate tax liabilities out of property held as joint tenancy by the entireties.<sup>115</sup> Thus, the IRS would not have as much difficulty collecting separate liabilities out of assets held as joint tenancy by the entireties if joint liability were eliminated as it might have had prior to 2002.

The IRS's administrative challenges could also be partially offset by the reduction in, or elimination, of innocent spouse relief, community property relief, injured spouse relief, and numerous Internal Revenue Code (IRC) provisions that override community property rules in an *ad hoc* fashion, as noted above.

**ADMINISTRATIVE ISSUES FOR TAXPAYERS.** If married taxpayers filing jointly were not subject to joint and several liability, they would need to provide the IRS with enough information to divide tax liabilities and tax payments. Although providing such information would involve some additional effort, in most cases the additional effort would be minimal for the following reasons.

- ◆ **Information Reporting and Tax Forms Make it Easier.** In most instances, married taxpayers could readily allocate items solely based on information reported to them by employers, the government, and financial institutions. At least 84 percent of all income reported on tax returns in TY 2002 was subject to information reporting, including income from: wages (73 percent), pensions (6 percent), interest (3 percent), and social security (2 percent).<sup>116</sup> Similarly, about 99 percent of all voluntary payments in TY 2002 were allocable to withholding (67 percent), estimated tax payments (21 percent), payments included with the return (7 percent), or payments included with an extension request (4 percent).<sup>117</sup> Like wages, withholding is subject to information reporting, which should help married taxpayers determine how

<sup>114</sup> IRS Pub 55B, Data Book (Mar. 1998) (Tables 3 and 4); IRS Pub 55B, Data Book (Mar. 2005) (Tables 3 and 4); IRS Restructuring and Reform Act of 1998, Pub. L. 105-206 § 2001 (1998) (IRC § 6011 (note)).

<sup>115</sup> See *United States v. Craft*, 535 U.S. 274 (2002); Notice 2003-60, 2003-2 C.B. 643.

<sup>116</sup> TAS Research, Tax Year 2002 Compliance Research Information System Model Form 1040 PY 2003 V1 (Dec. 19, 2005).

<sup>117</sup> *Id.*

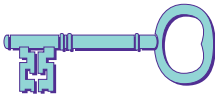
much each paid the IRS. The IRS could easily revise the estimated tax payment and extension forms to allow married taxpayers to allocate estimated tax payments and payments made with extensions. Payments made with the return would be allocated on the face of the return. Thus, existing information reporting combined with a few tax form changes could minimize the effort required for most married taxpayers to allocate their items of income, deduction, and payment or credit on their return.<sup>118</sup>

- ◆ **Information Already Provided on State Tax Returns.** Many married taxpayers already allocate income reported to state tax authorities when they file their state income tax returns. For example, married taxpayers filing combined returns in Arkansas, Delaware, Iowa, Kentucky, Mississippi, and Montana must report each spouse’s income separately.<sup>119</sup> It would be easy for taxpayers who already report income separately for state tax authorities to provide the same information to the IRS.
- ◆ **Information Already Provided on Injured Spouse Forms.** Some taxpayers already provide the IRS with information sufficient to allocate both tax liability and payments when one spouse (called an “injured spouse”) requests his or her portion of a joint overpayment that the IRS would otherwise offset against a single spouse’s debt, such as child support, state or federal income taxes, or student loans.<sup>120</sup> However, some taxpayers provide this allocation information either with the joint return or months or years after they initially prepare it. By collecting such information on all joint returns, the IRS would save many taxpayers the trouble of providing the same information in connection with an injured spouse request when records may no longer exist.
- ◆ **Spouses Could Stop Auditing Each Other.** Married taxpayers who do not allocate items on a state return or file an “injured spouse” claim might have to spend additional time to allocate items on their federal return. However, the burden of allocating items on a return would be offset, at least in part, by the fact that married taxpayers would no longer be expected to question items reported by a spouse or whether a spouse was really going to pay the tax. Moreover, as discussed above, this allocation burden should be minimal for income subject to third-party information reporting.

<sup>118</sup> However, separate filers are sometimes required to trace payments to allocate expenses under current law. See, e.g., IRS Pub. 504, *Divorced or Separated Individuals* 5 (2005); Richard C.E. Beck, *supra*, 393-400 (discussing current law) and Martha W. Jordan, *The Innocent Spouse Problem: Defining A Proportionate Solution*, 24 Ohio N.U. L. Rev. 517, 527-541 (1998) (same). For example, expenses for interest and taxes can only be taken by the spouse who is liable, even if they are paid out of separate funds of another. See *Id.* If both spouses are jointly liable for an expense then the spouse who paid the expense may be entitled to the deduction. See *Id.* If joint or community funds are used to pay a joint expense, each spouse may be entitled to one-half of the deduction. See *Id.* Congress should consider simplifying these allocation rules.

<sup>119</sup> Married taxpayers in Virginia filing a joint state income tax return must report each spouse’s income separately to obtain an adjustment to reduce the state marriage penalty. See Virginia 760 Resident Individual Income Tax Booklet 12-13 (2004) available at [http://www.tax.virginia.gov/Web\\_PDFs/indForms/currentyear/760instweb.pdf](http://www.tax.virginia.gov/Web_PDFs/indForms/currentyear/760instweb.pdf) (Line 16, Spouse Tax Adjustment (STA)).

<sup>120</sup> See, e.g., Form 8379, *Injured Spouse Claim and Allocation* (Dec. 2002).



### Little Potential for Abuse

Separate liability would not significantly increase the potential for abuse. Married taxpayers willing to divert assets or income from one spouse to the other to intentionally avoid paying tax liabilities can already avoid joint and several liability under current law by filing separately. However, such a strategy is generally undesirable, primarily for two reasons. First, transferee liability is likely to follow any assets transferred with intent to defraud creditors, even if the transferor is not rendered insolvent by the transfer. Second, such a strategy actually requires one spouse to transfer assets or income to the other. Since almost half of all marriages are expected to end in divorce, it is risky to try to avoid tax liabilities by shifting a significant amount of assets or income to a spouse.

### Limits on Collection

Existing collection rules allow the IRS to collect one spouse's separate liability from the other spouse's income and assets, even in cases where other creditors in the same situation cannot.<sup>121</sup> IRS collection actions against a nonliable spouse may present the very same inequity that the innocent spouse relief rules are intended to rectify. Such collections undermine the purpose of the injured spouse rules. Further, such broad collection powers are unnecessary. Existing transferee liability laws allow the IRS to collect one spouse's liability out of assets transferred to the other spouse in abusive situations.<sup>122</sup>

To be sure, any restraints on the IRS's collection powers should not unduly impair its ability to collect delinquent taxes, nor should they primarily benefit other creditors instead of the nonliable or innocent spouse. By the same token, it makes no sense for the IRS to grant innocent spouse relief and then collect the very same liability from the innocent spouse. In balancing these concerns, we considered the following alternatives:

- ◆ **Prohibiting the IRS from levying on a nonliable spouse's wage, pension, disability, and similar payments.** An exception could apply to the extent that such payments are used for the benefit of the liable spouse. This approach would put taxpayers in community property jurisdictions on a more equal footing with those in common law jurisdictions, where the IRS generally cannot reach such payments. In some cases, this approach might benefit other creditors, but in other cases these creditors would be prohibited from collecting such assets under state law exemptions.
- ◆ **Subjecting the IRS to the same collection exemptions that apply to other creditors under state law.** Such limitations would not primarily benefit other creditors because other creditors are subject to collection exemptions provided under state law. For example, as noted above, in Texas other creditors cannot collect one

<sup>121</sup> See, e.g., *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989). The IRS's collection powers are also superior in other ways. For example, unlike other creditors, the IRS may use its administrative levy and seizure powers to enforce a tax lien without judicial assistance. See, e.g., IRC § 6331.

<sup>122</sup> If Congress is concerned about abuse, it could supplement existing transferee liability as it has in connection with separate liability elections. See IRC § 6015(c)(4) (reducing relief to the extent of any "disqualified asset" transfers with the "principal purpose" of tax avoidance).

spouse's liability out of assets under the other spouse's management and control. However, applying state exceptions to the IRS would perpetuate differences between the states.

- ◆ **Requiring the IRS to exhaust reasonable efforts to collect assets under the liable spouse's control before collecting against assets under the nonliable spouse's control.** Although this requirement might slow down collection of assets held by a nonliable spouse, it would not foreclose the IRS's ability to reach them. In some cases this approach might benefit other creditors, but in many cases other creditors would be prohibited from collecting such assets under state law exemptions. Moreover, a similar requirement often applies when the IRS seeks to collect under transferee liability provisions.

## EXPLANATION OF RECOMMENDATIONS

### Repeal Joint and Several Liability

#### *Split Column Return*

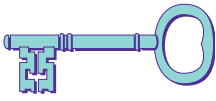
Married taxpayers would file on a split-column tax return to contemporaneously identify separate income, deductions, credits, and payments. The return would be similar to the combined return adopted by a number of states.<sup>123</sup>

#### *When to Sever the Joint Liability*

For ease of administration, this proposal would (1) separate the joint liability when the IRS first asserts an underpayment or deficiency against a joint filer, and (2) disallow separate refunds of amounts, voluntarily paid before the IRS asserts an underpayment or deficiency, that would otherwise result from severing the joint liability. These modifications would relieve the IRS from having to collect underpayments from one spouse while simultaneously refunding voluntary overpayments to the other with respect to a single tax year.

*Example 6: When to Sever the Joint Liability.* Assume the facts of Example 5: H and W file a joint return that shows net income of \$132,000, \$108,000 allocated to W and \$24,000 to H. The total tax liability on the return is \$22,230. If the tax liability were separated, H would be liable for \$1,769 and W would be liable for \$20,461. H and W each voluntarily pay \$11,115. Because the IRS has not yet asserted a deficiency or underpayment, the liability remains joint and several. As a result, the IRS does not need to issue a \$9,346 refund to H and assess a \$9,346 underpayment against W. When the IRS asserts a deficiency attributable to W's \$10,000 underreported income, the joint liability would automatically separate so that W would be separately liable for the entire deficiency. Because H voluntarily overpaid his share of liability before the IRS asserted an underpayment or deficiency, he would not be entitled to a refund.

<sup>123</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 144-145 (illustrating a federal split-column return).



### *How to Sever the Joint Liability*

SEPARATE LIABILITY FORMULA ALREADY EXISTS UNDER CURRENT LAW. Joint liabilities could be allocated under current law. Under current law, the aggregate joint liability is allocated to each spouse in proportion to his or her hypothetical liability computed as if he or she filed separately.<sup>124</sup> Thus, any legislative repeal of joint and several liability would not need to change existing rules for allocating each spouse's share of the joint liability.

However, for ease of administration under our proposal in the case of assessments for deficiency, joint liability would be separated on an item-by-item basis. The item-by-item method would be similar to how deficiencies are allocated when taxpayers make a separate liability election under IRC § 6015.<sup>125</sup> There would be no need to recompute each spouse's hypothetical liabilities as if they filed separately to determine each spouse's share of a deficiency, as there would be under current law. When the IRS has enough information to assert a deficiency, it should have little difficulty determining whose income was omitted or whose deduction was overstated.

*Example 7: How to Allocate Joint Liability.* Assume the same facts as Example 6. The joint return shows a \$22,230 liability but contains a \$2,670 tax deficiency attributable to W's \$10,000 bonus. If the return reflected W's bonus, the liability would be \$24,900 (\$22,230 tax on the income shown + \$2,670 tax on the unreported bonus). If H and W filed using the married filing separately (MFS) filing status, H would have been liable for tax of \$2,009 and W would have been liable for tax of \$26,678 (\$23,238 tax on income shown + \$3,440 tax on the unreported bonus).

Under current law, if joint and several liability were simply repealed, upon filing the joint return, H would be liable for \$1,769 and W would be liable for \$20,461, representing each spouse's share of the \$22,230 liability reported on the return.<sup>126</sup> When the IRS assesses the tax deficiency, H would be liable for \$1,744 and W would be liable for \$23,156, representing their respective shares of the \$24,900 liability after the assessment.<sup>127</sup> Because each spouse's share of the liability is based on what his or her liability would have been if he or she filed separately, each spouse's MFS liability has to be recomputed each time an item is adjusted on the return. Our proposal would not require such recomputation. Understatements would be allocated on an item-by-item basis.

<sup>124</sup> The separate liability formula for making such an allocation is: (one spouse's separate tax / sum of both spouse's separate tax) \* joint liability. See, e.g., Rev. Rul. 80-7, 1980-1 C.B. 296.

<sup>125</sup> See IRC §§ 6015(c) and (d).

<sup>126</sup> H's \$1,769 liability is computed as follows: \$22,230 joint liability \* \$2,009 H's MFS liability / (\$23,238 + \$2,009) the sum of H and W's MFS liability). W's \$20,461 liability is computed as follows: \$22,230 joint liability \* \$23,238 W's MFS liability / (\$23,238 + \$2,009) the sum of H and W's MFS liability).

<sup>127</sup> H's \$1,744 liability is computed as follows: \$24,900 total joint liability \* \$2,009 H's MFS liability / (\$2,009 + \$26,678) the sum of H and W's MFS liability). W's \$23,156 liability is computed as follows: \$24,900 total joint liability \* \$26,678 W's MFS liability / (\$2,009 + \$26,678) the sum of H and W's MFS liability).

Under our proposal, H would be liable for \$1,769, representing his portion of the liability reported on the joint return. W would be liable for \$23,131, representing her share of the liability reported on the joint return (\$20,461), plus the entire understatement of tax (\$2,670) attributable to her \$10,000 bonus.

#### *Simplification and Burden Reduction*

Eliminating joint and several liability and requiring joint filers to use a split-column return would facilitate significant simplification and burden reduction in other areas. For example, separating individual tax liabilities would reduce complexity and the administrative burdens imposed by current relief rules. Spouses would no longer need to investigate each other to ensure tax compliance, and the current innocent spouse rules could be significantly simplified or eliminated.<sup>128</sup> In addition, since the IRS would have enough information to allocate any refund at the outset, one spouse would not need to request injured spouse relief to keep the IRS from offsetting his or her refund against a spouse's separate liabilities. Rather the IRS could automatically ensure that one spouse's share of a joint overpayment is not offset against the other spouse's separate liability.

#### **Repeal Seaborn – Allocate Community Income based on Federal Law**<sup>129</sup>

Under our proposal, each spouse would only be subject to tax on the income under his or her control. The rules for allocating a nonresident alien's income under IRC § 879(a) (described above) would apply to all couples, with slight modification. IRC § 879 is similar to the existing income allocation rules applicable in every state except the nine community property law states.

#### *Tax Income to the Person with Control*

Our proposal would modify the current rule under IRC § 879 that “other income” such as investment income, is allocated to the spouse with a “proprietary vested interest” under local law.<sup>130</sup> Under that rule, for example, if a husband holds stock that is community property, any dividends paid on the stock may be taxed one-half to the wife.<sup>131</sup> Under our proposal, “other income” would be taxed to the person with the power to dispose of it, which is generally the person holding title to the asset generating the income. The income would be taxed one-half to each spouse only if each spouse had equal power to dispose of it under local law. This proposal will help to ensure that a taxpayer is not taxed on income he or she does not control.

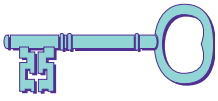
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<sup>128</sup> A simple form of the existing rules may be useful in rare cases, for example, to address situations where the allocation shown on a joint tax return is the product of abuse but not duress. See Treas. Reg. § 1.6015-3(c)(2)(v) (eliminating the “no actual knowledge” requirement if abuse caused the requesting spouse not to challenge the treatment of an item on the joint return).

<sup>129</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>130</sup> See IRC § 879(a)(4); Treas. Reg. § 1.879-1(a)(6).

<sup>131</sup> See Treas. Reg. § 1.879-1(a)(7)(Ex. 7).



*Simplify the Code*

Many Code provisions specifically override community property rules, as noted above. Thus, by repealing *Seaborn* and imposing one standard income allocation rule, Congress could significantly simplify the Code because each specific carve-out could be removed as unnecessary.

**Collect from Liable Spouse First**

Under our proposal, the IRS would be required to exhaust all reasonable efforts to collect against the assets under the liable spouse’s control before collecting against assets under the nonliable spouse’s control.<sup>132</sup> This requirement would require the IRS to collect only from the “right” spouse whenever possible, and help prevent collection efforts from undermining the other proposed changes.

<sup>132</sup> This proposal is only relevant to collection in community property jurisdictions where the IRS can collect one spouse’s liabilities from assets under the nonliable spouse’s control.



## 5

**KEY LEGISLATIVE RECOMMENDATION: REQUIRING BROKERS TO TRACK AND REPORT COST BASIS FOR STOCKS AND MUTUAL FUNDS****PROBLEM**

When taxpayers sell mutual fund shares or stock holdings, they generally are required to report the net gain or loss on the transaction on their federal income tax returns.<sup>1</sup>

If the proceeds a taxpayer receives upon a sale exceed his “adjusted basis” in the asset, the taxpayer recognizes a gain.<sup>2</sup> If the proceeds the taxpayer receives upon the sale are less than his “adjusted basis” in the asset, the taxpayer recognizes a loss.<sup>3</sup> Because taxpayers are required to report transactions in the year of sale, they generally have very little difficulty determining the amount of the proceeds they received from the sale. Moreover, where the shares are publicly traded, brokers are required to report the gross sales proceeds on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.

The determination of “adjusted basis,” however, can be much more challenging for two main reasons. First, the original purchase may have occurred years in the past and the taxpayer may no longer have a record of the date of purchase, the number of shares purchased, or the original cost of the asset. Indeed, the taxpayer may have received the shares as a gift or by inheritance.<sup>4</sup> Second, the “adjusted basis” required for tax reporting is not merely the taxpayer’s original cost. The taxpayer’s adjusted basis often reflects multiple transactions that have occurred since the original purchase date.

In the case of stocks, basis is affected by stock splits, mergers, and other corporate reorganizations. In the case of mutual funds, taxpayers typically elect to have dividend and capital gain distributions automatically reinvested, and each such distribution constitutes a taxable event in the year of occurrence and gives rise to an offsetting increase in the taxpayer’s aggregate adjusted basis to prevent a second round of taxation when the taxpayer ultimately sells the mutual fund.

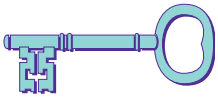
Under current law, financial institutions are not required to keep track of the adjusted basis of stocks and mutual funds for investors (although many do so for customer service reasons). In addition, an investor who holds an asset in an account at one financial institution may move his account to another financial institution, perhaps because the other institution charges lower fees or pays a higher rate of interest on cash deposits. Although an investor may elect to have the entire account, including stocks and mutual funds, transferred directly from one financial institution to another, records regarding the taxpayer’s adjusted basis are not currently transferred.

<sup>1</sup> Sales of assets held in tax-exempt accounts, such as qualified retirement accounts or Section 529 plans, generally are not subject to taxation.

<sup>2</sup> IRC § 1001(a).

<sup>3</sup> *Id.*

<sup>4</sup> The tax rules applicable to the receipt of stock by gift or inheritance are discussed in the Explanation of Recommendations, *infra*.



The absence of accurately maintained and reported information imposes significant compliance burdens on taxpayers, because taxpayers are required to report cost basis information on their tax returns. The absence of accurately maintained and reported information also provides opportunities for deliberate noncompliance. Because sophisticated taxpayers know that their adjusted basis generally is not reported to the IRS, some consciously overstate their basis in order to reduce their reported gains or to claim losses.

### EXAMPLES

#### 1. Mutual Funds: Automatically Reinvested Dividends and Capital Gains

A taxpayer invested \$10,000 in a mutual fund on January 2, 1992, and elected to have all dividend and capital gain distributions automatically reinvested in the fund. In each subsequent year, the fund made at least one dividend distribution and at least one capital gain distribution. The taxpayer also had directed that 10 percent of each monthly paycheck he received between 1992 and 1997 be deposited into the fund. He withdrew funds on two occasions – once for a home purchase and once when he purchased a car. On December 16, 2005, the taxpayer sold his position in the mutual fund for \$40,000.

On his 2005 tax return, the taxpayer will be required to report as a net gain or loss the excess of the proceeds he received upon the sale (\$40,000) over his aggregate adjusted basis. If the taxpayer held the mutual fund through a single financial institution that kept track of the basis for him, he is in luck. But if the financial institution did not keep track of the basis or if the taxpayer transferred the holding from one financial institution to another during his 14-year holding period, the taxpayer will need records for each of the past 14 years to compute his basis and it will not be easy to do. The taxpayer's aggregate adjusted basis in the fund changed each time he received a dividend or capital gain distribution (he received at least 28 such distributions), each time 10 percent of his monthly paycheck was deposited into the fund over a five-year period (60 investments), and each time he made a withdrawal (twice).<sup>5</sup>

If the taxpayer no longer has all of his records, it will be impossible for the taxpayer to compute his adjusted basis.

#### 2. Mutual Funds: Frequent Withdrawals from Bond Funds

Today, some large financial institutions allow investors to write checks against monies invested in bond mutual funds. Because bond funds typically pay higher rates of interest than stable-dollar money market funds, this is an attractive option for many middle-income investors. Assume an investor has a portion of his paycheck automatically deposited into a short-term bond fund and he pays his monthly mortgage by writing a check against that fund.

<sup>5</sup> The taxpayer's withdrawals for the home purchase and automobile purchase were also taxable events in the years in which they occurred.

While this approach may be optimal from a financial standpoint, it creates considerable complexity from a tax standpoint. Each time a portion of the paycheck is deposited into the fund, it is considered an investment that increases his aggregate adjusted basis. Each time the taxpayer pays his mortgage by writing a check on the account, the payment is considered a taxable withdrawal. Thus, the taxpayer in this example will have to report 12 taxable events during the year and determine the adjusted basis at the time of each of those 12 withdrawals.

If the taxpayer holds the bond mutual fund for many years and the fund does not keep adequate track of the taxpayer's basis, it will be very difficult for the taxpayer to reconstruct his basis even if he has retained complete records and impossible for the taxpayer to reconstruct his basis if his records are incomplete.

### 3. Stocks: Stock Splits and Reorganizations

In 1983, AT&T was the most widely held stock in the United States. Assume a taxpayer purchased 100 shares of AT&T stock on January 3, 1983, at a price of \$60 per share and sold the stock on December 13, 2005, at a price of \$25 per share. An unsophisticated taxpayer might assume that the value of the company's stock declined from \$60 to \$25 during the past 22 years and might report a loss of \$3,500 (*i.e.*, \$35 loss per share multiplied by the 100 share initial purchase).

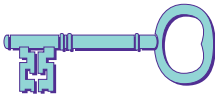
In fact, the computation of the taxpayer's basis is far more complex:<sup>6</sup>

On January 1, 1984, AT&T divested of its local phone service operations and distributed the stock of seven newly formed regional phone companies to its shareholders. Each AT&T shareholder received one share in each new company (Ameritech, Bell Atlantic, Bell South, NYNEX, Pacific Telesis, Southwestern Bell, and U.S. West) for every ten shares of AT&T owned. Prior to that date, the taxpayer's basis in AT&T stock had been \$6,000 (*i.e.*, the \$60 per share purchase price multiplied by the 100 shares purchased). As a result of the spin-offs, 28.5 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was \$1,710. The remaining basis was allocated among the seven regional Bell companies in varying percentages totaling 71.5 percent.

On September 30, 1996, AT&T spun off newly formed Lucent Technologies and distributed 0.324084 shares of Lucent common stock for each share of AT&T owned. As a result of the spin-off, 72.01 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was \$1,231.37. The remaining basis was allocated to the taxpayer's new holding of Lucent stock.

On December 31, 1996, AT&T spun off newly formed NCR Corporation and distributed 0.0625 shares of NCR common stock for each share of AT&T owned. As a result of the spin-off, 95.23 percent of the taxpayer's basis remained with the AT&T shares.

<sup>6</sup> These adjustments are described on the AT&T corporate website.



Thus, the taxpayer's new basis in his AT&T stock was \$1,172.63. The remaining basis was allocated to the taxpayer's new holding of NCR stock.

On April 15, 1999, AT&T implemented a 3 for 2 stock split. As a result, the taxpayer's aggregate basis in AT&T stock remained \$1,172.63, but the number of shares he held increased from 100 shares to 150 shares.

On July 9, 2001, AT&T split off newly formed AT&T Wireless Services and distributed 0.3218 shares of AT&T Wireless Services common stock for each share of AT&T owned. As a result of the split-off, 77.66 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was \$910.66. The remaining basis was allocated to the taxpayer's new holding of AT&T Wireless Services stock.

On November 18, 2002, two transactions occurred. First, AT&T entered into a stock transaction with Comcast Corporation and distributed to its shareholders 0.3235 shares of Comcast common stock for each share of AT&T owned. As a result of the transaction, 37.4 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was \$340.59. The remaining basis was allocated to the taxpayer's new holding of Comcast stock. On the same date, AT&T implemented a reverse 1 for 5 stock split. As a result, the taxpayer's aggregate basis in AT&T stock remained \$340.59, but the number of shares he held declined from 150 shares to 30 shares.

On November 18, 2005, AT&T merged with SBC Communications. As a result of the transaction, the taxpayer received 0.77942 shares of new AT&T stock for each share of AT&T stock he owned previously. Thus, the number of shares he held declined from 30 shares to 23 shares, and he received cash in lieu of a 0.3826 fractional share. The amount of the cash payment, \$5.57, reduced the taxpayer's basis in his AT&T stock from \$340.59 to \$335.02.

As a result of all these transactions, the taxpayer should properly report a loss of \$239.98 upon the sale of his entire AT&T stock holding. This represents his proceeds of \$575 (23 shares x \$25 sales price) reduced by his basis of \$335.02.

Note that the taxpayer in this example acquired stock in 11 additional companies directly – and most of them engaged in subsequent corporate restructurings – and the taxpayer ultimately likely will need to compute his basis in each of those companies' stock. In addition, if the taxpayer did not keep a record of his original purchase or received the shares as a gift, he would have no idea where to begin.

This example is not atypical. Corporate restructurings and stock splits occur daily in the marketplace. Moreover, 3.2 million shareholders owned AT&T stock in 1983, so many taxpayers have faced the need to reconstruct their basis in AT&T and its distributed companies as described in this example.

#### 4. Tax Cheating Via Overstatement of Basis

On January 2, 1987, a taxpayer purchased 100 shares of Microsoft Corporation at \$47.75 per share. His aggregate basis therefore was \$4,775. On December 5, 2005, the taxpayer sold his position at \$28 per share. Due to eight stock splits, however, the taxpayer now held 28,800 shares. Thus, the proceeds from his sale (leaving aside trading costs) came to \$806,400. His net gain (*i.e.*, the difference between his proceeds and his basis) was \$801,625.

Because there is no requirement that brokers track and report basis to the IRS, the taxpayer might be tempted to overstate his basis. For example, he might indicate that he purchased 28,800 shares on September 26, 2003, when the stock was selling for \$30 per share, giving him a cost basis of \$864,000. Therefore, instead of reporting a gain of \$801,625, he would report a loss of \$57,600 (*i.e.*, basis of \$864,000 reduced by proceeds of \$806,400). Unless the IRS were to audit this taxpayer, the IRS would probably not detect this misstatement.

#### RECOMMENDATIONS

Amend Internal Revenue Code § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks.

To facilitate accurate basis reporting, financial institutions that hold mutual funds or stock for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.

#### CURRENT LAW

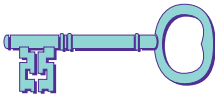
##### Information Reporting

Section 6045(a) of the Internal Revenue Code currently requires brokers to provide information returns showing the name and address of each customer along with details regarding gross proceeds and such other information as the Secretary may require.

##### Computation of Basis

Section 1011 provides generally that the adjusted basis for determining gain or loss from the sale or other disposition of property is the cost of the property, as described in Section 1012, subject to certain adjustments, as described in Section 1016.

For purposes of computing basis, Treasury regulations set forth several methods that may be used. If a taxpayer purchased all shares of a stock at the same price and later sells some of the shares, there is no ambiguity about the cost basis because there was only one purchase price. If a taxpayer purchases stock at different prices and later sells



some but not all of the shares, however, his basis will vary depending on which of the shares he is treated as having sold. The method of determining the cost basis of the shares sold depends on whether it is possible to identify the specific lot from which the shares were originally purchased. If the specific lot cannot be adequately identified, the default method under the regulations is to treat the shares sold as coming from the earliest lots purchased or acquired. This is sometimes referred to as the “first in, first out,” or “FIFO,” method. If the specific lot can be adequately identified, then the shares sold will be treated as coming from that lot.<sup>7</sup>

In the case of mutual funds, two additional methods are available that are designed to measure “average basis.” One is referred to as the “single-category method,” and the other is referred to as the “double-category method.”<sup>8</sup> The mechanics of these alternative methods are described in detail in the regulations.

### REASONS FOR CHANGE

#### Taxpayer Burden

Today, more Americans own stocks, either directly or through mutual funds, than ever before. According to a 2005 survey conducted jointly by the Investment Company Institute (ICI) and the Securities Association of America (SEA), the number of households owning stocks or mutual funds has more than tripled since the early 1980s, rising from 16 million households in 1983 to 57 million households in 2005.<sup>9</sup> While much of the growth in equity ownership has occurred in tax-exempt retirement plans, the survey found that about 31 million households own mutual funds or stocks in taxable accounts.<sup>10</sup>

Many of these 31 million households do not maintain adequate records of stock and mutual fund holdings over multi-year periods to determine basis, and many taxpayers that do maintain adequate records nonetheless have difficulty making the complex computations required to determine their basis.

As illustrated in the Examples above, most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund investors also make periodic investments in or withdrawals from the fund, and each of these events also causes their aggregate adjusted basis to change. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not.

With regard to stock investors, most brokers keep track of purchases their customers

<sup>7</sup> Treas. Reg. § 1.1012-1(c).

<sup>8</sup> Treas. Reg. § 1.1012-1(e).

<sup>9</sup> Investment Company Institute & Securities Industry Association, *Equity Ownership in America, 2005*, at 1 (Figure 1).

<sup>10</sup> *Id.* at 9 (Figure 12) and 15.

make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings.

For both mutual fund and stock investors, a particularly significant problem arises when an investor transfers assets from one financial institution to another. The transferring broker does not provide information about the investor's basis to the transferee broker. Therefore, to the extent that many investors rely on their financial institution to track their adjusted basis in their holdings, they are no longer able to rely on the financial institution's records after an asset transfer. This problem is almost surely arising with increasing frequency, because the accessibility of low-cost brokerage firms via the Internet enables investors to shop around for the lowest commissions and the highest interest rates. As a consequence, the transfer of assets from one financial institution to another is now commonplace.

While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time. Even where a taxpayer does keep complete records, the task of computing changes in adjusted basis can be overwhelming. This is particularly true for mutual fund investors who must make multiple adjustments each year for investments, withdrawals, and automatically reinvested dividend and capital gain distributions and for investors in stocks that undergo stock splits and corporate restructurings, as illustrated by Example 3 above involving an investor in AT&T stock.

### Revenue Protection

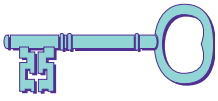
The IRS Research function recently updated its findings regarding the magnitude and sources of the tax gap. The results confirm what earlier studies have found: When transactions are subject to information reporting to the government, tax compliance is generally very high – well over 90 percent. However, when transactions are not subject to information reporting to the government, the tax compliance rate drops precipitously to a range of about 20 percent to about 68 percent, depending on the type of transaction.<sup>11</sup>

As illustrated in Example 4, the opportunity for noncompliance upon the sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government. IRS data for Tax Year 2003 show that nearly 30 million taxpayers filed Form 1040, Schedule D, "Capital Gains and Losses,"<sup>12</sup> and in a recent article published in *Tax Notes*, Professors Joseph Dodge and Jay Soled estimate that noncompliance in this area will come to about \$250 billion over the next 10 years and could be higher.<sup>13</sup>

<sup>11</sup> IRS National Headquarters, Office of Research, July 2004.

<sup>12</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2003).

<sup>13</sup> Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question*, 106 *Tax Notes* 453 (Jan. 24, 2005).



A basis-reporting requirement should virtually eliminate this source of noncompliance.

#### EXPLANATION OF RECOMMENDATIONS

Requiring financial institutions to track and report adjusted basis to taxpayers and the IRS is a win-win proposition for taxpayers and the government. Taxpayers will no longer have to struggle with attempting to reconstruct their basis in assets they have sold during the year, and the government will be able to collect the proper amount of tax due on such sales.

As a threshold matter, we note that the Secretary of the Treasury probably has the authority to require brokers to report adjusted basis under existing law. Section 6045 of the Internal Revenue Code authorizes the Secretary to prescribe regulations requiring brokers to make a return showing details “regarding gross proceeds *and such other information as the Secretary may by forms or regulations require.*” (Emphasis added.) In our view, the term “such other information” is broad enough to encompass adjusted basis. However, opponents of this proposal might argue that because Section 6045 specifically mentions gross proceeds but does mention adjusted basis, Congress did not intend to give Treasury authority to require that basis information be reported. For that reason, and because requiring basis reporting could be controversial, we believe it would be helpful for Congress to amend Section 6045 to clarify the Secretary’s authority to require basis reporting.

In writing regulations to require reporting of adjusted basis, there are some technical issues that would need to be worked out.

One issue involves how reporting would work in light of the multiple basis-computation methods currently authorized by Treas. Reg. § 1.1012-1. With respect to stocks, the FIFO method is generally used by default unless an investor provides prior notice to the broker that he or she wants to use the specific identification method. With respect to mutual funds, virtually all financial institutions that track basis for their customers use an average-cost method. Treasury could require brokers to track and report adjusted basis in light of these rules and practices and then allow a taxpayer to elect to use an alternative method by submitting an explanation with his return. We note that the existing basis-computation methods are regulatory, not statutory, so Treasury could modify these methods as it deems appropriate.

A second issue involves how a broker would address situations where stocks or mutual funds are transferred by gift or upon death. Where capital assets are transferred by gift, the recipient generally takes a carryover basis in the asset but is limited in his or her ability to claim losses attributable to periods before receiving the gift.<sup>14</sup> Where capital assets are transferred upon the owner’s death, the recipient currently receives a step-up

<sup>14</sup> IRC § 1015(a).



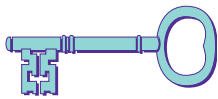
in basis as of the holder's date of death or alternate valuation date.<sup>15</sup> When mutual funds or stocks are transferred from the account of the original owner to the account of a successor owner, then, the broker would need to receive paperwork documenting sufficient details about the transfer to continue to track the holder's basis accurately.

A third issue involves the technological modifications brokers would be required to make to their computerized record systems to ensure that they can accurately track and report basis. The technology to do this clearly exists, and brokers already transfer considerable information when customers move their stock or mutual fund holdings from one broker to another. At the same time, we acknowledge that financial institutions would incur some costs in implementing this proposal. Depending on the cost estimates, Congress could consider providing brokers with a one-time credit to offset the expenses of implementing the requirements of this proposal. If the revenue gains to the government are anywhere close to Professor Dodge & Soled's estimate of \$250 billion over 10 years, a modest credit would pay for itself quickly and many times over.

The National Taxpayer Advocate believes these technical issues are resolvable and that a basis-reporting requirement would ultimately benefit all honest taxpayers – both taxpayers who face daunting challenges in computing their basis and taxpayers who are paying more in taxes to subsidize noncompliance by those who overstate their basis and thereby fail to pay their fair share.

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<sup>15</sup> IRC §§ 1014(a)(1) & 2032(a). The federal estate tax has been repealed effective in 2010. As part of that change in law, some recipients of inherited stock will assume the decedent's basis (*i.e.*, they will not receive a step-up in basis). They therefore will need to determine the basis the decedent held in the asset. For a discussion of the impact this change may have on taxpayers, see Key Legislative Recommendation: *Tracking Cost Basis as a Result of Estate Tax Repeal, infra*.



## 6

## KEY LEGISLATIVE RECOMMENDATION: TRACKING COST BASIS AS A RESULT OF ESTATE TAX REPEAL

## PROBLEM

Under the current estate tax regime, the basis of property in the hands of a person acquiring property from a decedent is, generally, the fair market value (FMV) of the property at the date of the decedent's death.<sup>1</sup> This basis is commonly referred to as a "step-up" in basis. When the estate tax is repealed for 2010, such persons will no longer receive a step-up in basis. Instead, property acquired from a decedent dying after December 31, 2009, will be treated as transferred by gift, and the basis of the person acquiring the property from such a decedent will be the lesser of the decedent's adjusted basis or the FMV of the property at the date of the decedent's death.<sup>2</sup> This rule has been referred to as the "modified carryover basis rule."

Requiring modified carryover basis calculations places an inordinate burden on taxpayers. Even the most conscientious taxpayers may find it impossible to reconstruct the basis of property that was passed on from generation to generation. Moreover, the modified carryover basis rules are projected to apply to 71,400 estates in contrast to the 7,500 expected to face estate tax liability under the rules for 2009, thereby shifting the burden of the estate tax from 0.3 percent of estates to 2.9 percent – in other words, multiplying its impact nearly tenfold.<sup>3</sup> Congress should explore ways to lessen the compliance burden of this unintended consequence of the estate tax repeal.

## EXAMPLE

An unmarried man dies in 2009, leaving behind \$3 million in property and an aggregate basis in the property of \$500,000. In 2009, estates under \$3.5 million in property will not pay any estate tax. The person acquiring the property would receive a step-up in basis to \$3 million (the FMV of the property at the decedent's date of death). Essentially, this person could sell all the property immediately and receive \$3 million free of tax.

Now assume the same man dies in 2010, when the estate tax is repealed. The person acquiring the property would be limited to a basis increase of \$1.3 million, bringing the aggregate basis increase up to \$1.8 million (\$500,000 aggregate adjusted basis plus \$1.3 million aggregate basis increase). If this person decides to sell all the property at that point for \$3 million, he would be required to pay capital gains tax on the gain of \$1.2

<sup>1</sup> See IRC § 1014(a).

<sup>2</sup> See IRC § 1022(a).

<sup>3</sup> The Census Bureau estimates that approximately 2.5 million persons will die during 2009 in the United States. The Joint Committee on Taxation (JCT) estimates that the estates of approximately 7,500 persons who die during 2009 will have an estate tax liability under current law. The JCT further estimates that the estates of 71,400 persons who die during 2009 will have estates worth in excess of \$1.3 million. See John Buckley, *Estate Tax Repeal: More Losers than Winners*, 2005 TNT 30-17 (Feb. 14, 2005); see also Tax Policy Center, *Table T05-0151, \$3.5 Million Exemption Indexed for Inflation After 2010 and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2011* (July 25, 2005).

million (\$3 million FMV less \$1.8 million basis). Furthermore, if this person does not readily know the decedent's adjusted basis in the property, he will be forced to reconstruct the adjusted basis for transactions that may have occurred decades ago.

### RECOMMENDATION

The National Taxpayer Advocate does not endorse any specific proposal to remedy this problem. Rather, she encourages Congress to examine this issue and explore alternatives that would ease the compliance burden for taxpayers.

Possible solutions include:

- ◆ Increasing the amount that executors may elect to apply to step-up basis to exclude more taxpayers from modified carryover basis calculations;
- ◆ Requiring brokerage firms and mutual fund administrators to track basis; or
- ◆ Reverting to the pre-EGTRRA (Economic Growth and Tax Relief Reconciliation Act) rules with indexing of applicable exclusion amounts.

### PRESENT LAW

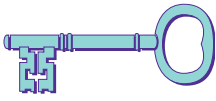
The United States has had an estate tax since 1916.<sup>4</sup> The estate tax is calculated as a percentage of the part of the estate that exceeds the applicable exclusion amount. Under current law, the applicable exclusion amount will increase steadily from \$1.5 million in 2005 to \$3.5 million in 2009.<sup>5</sup> For estates that exceed the applicable exclusion amount, an estate tax is calculated using the applicable rates (for 2005, rates ranged from 43 percent to 47 percent).

Lawmakers have amended the Internal Revenue Code many times, lowering or raising the applicable rate and increasing or decreasing the applicable exclusion amount for estate tax purposes. Most recently, the Economic Growth and Tax Relief Reconciliation Act of 2001<sup>6</sup> (EGTRRA) reduced estate tax rates and increased the applicable exclusion amounts from 2002 through 2009. The EGTRRA eliminates the estate tax altogether in 2010. In 2011, the EGTRRA is scheduled to expire, and the estate tax rates and exemption amounts will revert back to pre-EGTRRA levels.

<sup>4</sup> Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses 1* (July 2005).

<sup>5</sup> See IRC § 2010(c).

<sup>6</sup> Pub. L. No. 107-16, June 7, 2001.

**TABLE 2.6.1, SCHEDULED CHANGES IN TAX RATES AND APPLICABLE EXCLUSION AMOUNTS FOR ESTATE AND GIFT TAXES UNDER EGTRRA**

Year	Lowest Tax Rate (%)	Highest Tax Rate (%)	Applicable Exclusion Amount (Millions of \$)
2002	41	50	1.0
2003	41	49	1.0
2004	43	48	1.5
2005	43	47	1.5
2006	45	46	2.0
2007	45	45	2.0
2008	45	45	2.0
2009	45	45	3.5
2010	0	0	n/a
After 2010	41	55/60 <sup>7</sup>	1.0

The appreciation in value of property is generally subject to tax only when the asset is sold.<sup>8</sup> For income tax purposes, “adjusted basis” is the term used to describe the amount paid for property, plus or minus a variety of adjustments such as improvements or depreciation.<sup>9</sup> When property is sold, the adjusted basis is subtracted from the sale price to compute taxable gain or loss.<sup>10</sup>

One significant adjustment to basis relates to property acquired from a decedent. The adjusted basis of property acquired from a decedent is generally “stepped up” to FMV at the date of death.<sup>11</sup> For example, if a decedent passes property on to another person, the property’s basis is stepped up to its FMV *at the date of the decedent’s death*. In situations where appreciated property is held until death, the appreciation in value of the property from acquisition until death escapes taxation.

However, when the estate tax is repealed in 2010<sup>12</sup>, a person acquiring property from a decedent must determine the modified carryover basis of the property. Under the modified carryover basis rules, the basis of the property is increased by its basis increase, which is defined as a portion of the aggregate basis increase allocated to the property.

<sup>7</sup> Estates valued at \$10 million to \$17.184 million are subject to a maximum tax rate of 60 percent in order to eliminate the value of the exempt amount of assets. Estates valued at more than \$17.184 million are taxed at an average rate of 55 percent.

<sup>8</sup> See IRC §§ 1001, 1014.

<sup>9</sup> See IRC §§ 1011, 1012.

<sup>10</sup> See IRC § 1001(a).

<sup>11</sup> See IRC § 1014(a).

<sup>12</sup> Under current law, the estate tax is to be repealed for year 2010 only, as EGTRRA is set to expire in 2011 and the pre-EGTRRA estate tax regime is to be reinstated.

The aggregate basis increase is \$1.3 million.<sup>13</sup> A person acquiring property from a decedent will use the modified adjusted basis (carryover basis plus basis increase) to determine gain or loss on the sale of the property.

### REASONS FOR CHANGE

Due to the scheduled increases in applicable exclusion amounts, the estate tax will affect only the estates of the wealthiest Americans. Recent estimates show that by 2009 just the top 0.3 percent of estates will be required to pay the tax.<sup>14</sup> Put another way, 997 of every 1000 families would be unaffected by the estate tax if the current estate tax laws did not change from 2009 to 2010.

Ironically, the estate tax repeal that looms in 2010 will have a significant adverse affect on a far greater number of taxpayers. Individuals who acquire property from a decedent may no longer use stepped-up basis to compute gain or loss on the sale of property acquired from a decedent.<sup>15</sup>

Determining a decedent's adjusted basis in property is no easy chore. Even taxpayers who have kept impeccable records on their own properties may find it impossible (or at least impracticable) to reconstruct the records of the decedent to arrive at an accurate calculation of a decedent's adjusted basis. This task will be especially difficult if the decedent had not anticipated the need to retain records of amounts paid and basis adjustments.

For example, suppose Taxpayer A purchased 100 shares of stock in AT&T in 1970. If Taxpayer A dies in 2010, the stock will pass on to Taxpayer B. When Taxpayer B subsequently disposes of the stock, he must use Taxpayer A's adjusted basis, plus a portion of the aggregate basis increase, in calculating gain or loss on the transaction. Given that more than 40 events have affected the cost basis of AT&T stock since 1984 alone (including stock splits, reverse stock splits, spin-offs, distributions, and reacquisition of previously spun-out assets)<sup>16</sup>, it is unlikely that Taxpayer A retained all the paperwork that reflected basis adjustments through the years and passed it on to Taxpayer B in an easily accessible, understandable manner.

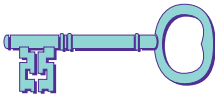
Reconstructing adjusted basis in property is difficult enough while taxpayers with such assets are alive; after death, it becomes next to impossible. Furthermore, where the property is something other than publicly traded stock, the prospect of finding docu-

<sup>13</sup> IRC § 1022(b)(2)(B). For property passed on to a surviving spouse, an executor will be allowed to increase the adjusted basis of property by the aggregate spousal property basis increase of \$3 million. See IRC § 1022(c)(2).

<sup>14</sup> Center on Budget and Policy Priorities, *Estate Tax Reform, Rather than Repeal, Could Preserve Much Needed Revenues and Help Restore Social Security Solvency* 3-4 (Apr. 12, 2005).

<sup>15</sup> See IRC § 1014(f).

<sup>16</sup> See XciTax, *AT&T Cost Basis: A Case Study* (Feb. 2005), available at <http://xcitax.com/atccasestudy.pdf>. For further discussion of the difficulties in tracking AT&T stock basis, see Key Legislative Recommendation: *Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds*, *supra*.



mentation substantiating basis is even less likely.

#### EXPLANATION OF RECOMMENDATION

The impending estate tax repeal will have significant (and likely unintentional) consequences for many taxpayers. Taxpayers who receive distributions from an estate with greater than \$1.3 million in property (projected to be 2.9 percent of estates by 2009<sup>17</sup>) may no longer use the stepped-up basis for property acquired from a decedent. Once the estate tax is repealed, these taxpayers must use the modified carryover basis, which may require extremely complex calculations to determine the property's adjusted basis in the hands of the decedent just prior to death, and then allocate a portion of the aggregate basis increase to that property to determine the property's basis in the hands of the person acquiring the property from the decedent.

The National Taxpayer Advocate does not believe it was the intent of Congress to impose such an onerous requirement on such a large segment of the population. She urges Congress to revisit this issue and explore less burdensome alternatives.

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<sup>17</sup> See John Buckley, *Estate Tax Repeal: More Losers than Winners*, 2005 TNT 30-17 (Feb. 14, 2005).

## 7

## KEY LEGISLATIVE RECOMMENDATION: RESTRUCTURING AND REFORM OF COLLECTION DUE PROCESS PROVISIONS

## PROBLEM

For the last three years, the National Taxpayer Advocate has identified weaknesses in the IRS's Collection Due Process (CDP) hearing program.<sup>1</sup> CDP hearings afford taxpayers the opportunity to ask for a meaningful review of certain IRS collection actions by an impartial officer of the IRS Office of Appeals (Appeals) at two separate points in the collection process: after the initial filing of a federal tax lien and prior to an initial levy of the taxpayer's assets.<sup>2</sup> The CDP process, which includes the right to judicial review, stays some collection actions but not others.<sup>3</sup> Thus, CDP rights provide important protections to taxpayers. As we and others have noted, however, there are shortcomings to the CDP legislation.<sup>4</sup> CDP rights are both under-inclusive and over-inclusive,<sup>5</sup> denying judicial review of some lien and levy actions while encouraging counterproductive behavior on the part of other taxpayers and on the part of the IRS.

CDP rights are under-inclusive because taxpayers can only seek CDP's protections once following the first Notice of Federal Tax Lien issued with respect to a particular tax for a particular period,<sup>6</sup> and once upon issuance of the first Notice of Intent to Levy with respect to that tax.<sup>7</sup> Thus, CDP provides a snap-shot of a taxpayer's financial situation at one point in a collection process that is fluid.<sup>8</sup> For example, taxpayers do not receive

<sup>1</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 110 (addressing taxpayer's confusion about the CDP process and delays in Appeals); see also National Taxpayer Advocate 2003 Annual Report to Congress 38 (addressing Most Serious Problem of delays in CDP hearings); and National Taxpayer Advocate 2004 Annual Report to Congress (making Key Legislative Recommendation to eliminate *de novo* review of the underlying liability and also making administrative recommendations to improve the hearing process and better educate taxpayers about what can be achieved in the hearing process).

<sup>2</sup> IRC § 6320(b) governs a taxpayer's right to a CDP hearing after the filing of the first federal tax lien with respect to a tax liability, and IRC § 6330(b) governs a taxpayer's right to a CDP hearing prior to the first levy on the taxpayer's property with respect to that liability.

<sup>3</sup> CDP hearings occur post-issuance of the Notice of Federal Tax Lien, and thus, do not bar the IRS from perfecting its security interest in assets of the taxpayer. IRC § 6320(a)(2). If taxpayers timely elect CDP hearings, levy action will be stayed until the completion of the hearing unless the IRS determines that collection of the tax is in jeopardy. IRC § 6330(e)(1) and (f)(1). Additionally, the IRS can levy while a case is on appeal before a court if it can demonstrate "good cause." IRC § 6330(e)(2).

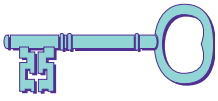
<sup>4</sup> Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1148 (2004); see also Bryan T. Camp, *Failure of Collection Due Process*, Pt. 1: *The Collection Context*, 104 Tax Notes 969 (Aug. 30, 2004); Bryan T. Camp, *The Failure of CDP, Part 2: Why it Adds No Value*, 104 Tax Notes 1567 (Sept. 27, 2004); Bryan T. Camp, *The Costs of CDP*, 105 Tax Notes 1445 (Dec. 6, 2004); Bryan T. Camp, *Replacing CDP*, 107 Tax Notes 1039 (May 23, 2005); Dashera Cords, *Reforming Not Replacing CDP*, 108 Tax Notes 817 (Aug. 15, 2005); Dashera Cords, *Collection Due Process: The Scope and National of Judicial Review*, 73 U. Cin. L. Rev. 1021 (2005); Diane L. Fahey, *The Tax Court's Jurisdiction over Due Process Collection Appeals: Is It Constitutional*, 55 Baylor L. Rev. 453 (2003).

<sup>5</sup> Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1203 (2004).

<sup>6</sup> IRC § 6320(b)(2).

<sup>7</sup> IRC § 6330(a)(1).

<sup>8</sup> Bryan T. Camp, *Replacing CDP*, 107 Tax Notes 1039 (May 23, 2005).



CDP's protections for subsequent levies after the taxpayer's financial condition may have worsened, or where the IRS later denies viable collection alternatives, or where the IRS refuses or otherwise fails to release levy proceeds.<sup>9</sup>

CDP rights are also over-inclusive in two important respects. First, CDP allows some taxpayers to contest their underlying liability before Appeals and in *de novo* judicial review proceedings on appeal from Appeals' determination, even where the taxpayer self-assessed the liability.<sup>10</sup> Second, some taxpayers use the CDP process to raise frivolous issues or *solely* for the purpose of delaying levy action. Some believe that CDP deprives the IRS Collection function of valuable leverage in getting taxpayers to pay delinquent taxes. That is, the taxpayer can respond to a proposed levy action by electing a CDP hearing and remove the collection case from the control of IRS Collection personnel and into Appeals, and the courts, for an extended period of time.

#### EXAMPLE

Taxpayer A has an unpaid tax liability from the tax year 2003, for which he previously received a CDP notice. Instead of requesting a CDP hearing, taxpayer entered into an installment agreement. Taxpayer A's financial position changes for the worse and he decides to submit an offer in compromise in order to resolve the tax problem once and for all. Taxpayer A files his offer for \$2,400 to be paid in \$100 monthly installments, and the offer is processed through the IRS's Centralized Offer in Compromise Program (COIC). In justifying the amount that the taxpayer can pay, the taxpayer provides records of actual expenses in the amount of \$3,989. While reviewing the offer, however, the IRS offer specialist uses national expense standards of \$4,644 and rejects the offer, concluding that the taxpayer cannot make the payments. The taxpayer appeals the specialist's determination to the Office of Appeals in a non-CDP appeal pursuant to IRC § 7122(d); however, the Appeals officer comes to the same conclusion and the offer is rejected. The taxpayer has no further recourse.

<sup>9</sup> See IRC § 6343(d)(2).

<sup>10</sup> Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1188-1190, (2004) noting:

One important way to limit CDP costs and to address the over inclusive nature of CDP as it is currently written is to eliminate or reduce the opportunities a taxpayer has to challenge his underlying liability in CDP hearings... Even if Congress is unwilling to eliminate the liability category completely, it should legislatively overrule *Montgomery v. Commissioner*, which held that taxpayers can challenge the amount or existence of a liability in a CDP hearing even if the liability arises from filing a tax return with an unpaid liability.



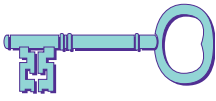
Taxpayer B has the same facts as Taxpayer A except that Taxpayer B receives a *Notice of Intent to Levy and Your Right to a Hearing*. Taxpayer B elects his right to a CDP hearing and submits his offer as a collection alternative at the CDP hearing. The Appeals officer applies the higher national expense standards, rather than utilizing the taxpayer's actual expenses. In response to the Notice of Determination from Appeals rejecting the offer, Taxpayer B files a petition in the Tax Court, which holds that it was an abuse of discretion for the Appeals officer to have rejected the offer in compromise under the circumstances.<sup>11</sup>

### RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to retain and enhance taxpayer protections in the tax collection process while ensuring that the IRS's ability to collect the correct amount of tax is not unreasonably impaired.

- ◆ Amend IRC §§ 6330(a)(2) and (a)(3)(C) to require the IRS to issue the CDP levy notice at the time it undertakes its first levy action with respect to a tax. Such notice shall describe the specific levy action (levy source, date levy will occur) and provide a name and contact information for the IRS employee whom the taxpayer can contact in order to otherwise resolve the tax debt.
- ◆ Amend IRC § 6330(a)(2)(C) to clarify that when the IRS mails a Notice of Right to a CDP Hearing prior to a proposed levy, it shall send that CDP notice by certified or registered mail but not with “return receipt requested.”
- ◆ Amend IRC § 6330(d)(1) to consolidate judicial review of CDP in the United States Tax Court, and clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over the taxpayers' cases under IRC § 6330(d)(2). The scope of continuing judicial oversight should include review of IRS's authority to release levies under IRC § 6343(a) and to return levy proceeds under IRC § 6343(d).
- ◆ Codify the IRS Collection Appeals Program (CAP).
- ◆ Codify the IRS Audit Reconsideration Process.
- ◆ Amend IRC § 6330(c)(2)(B) to specifically include “audit reconsideration” as an alternative to be considered *within* the CDP hearing process.
- ◆ Amend IRC § 6330(d)(1) to provide that the Tax Court's authority to review the underlying liability shall be limited to a determination of whether the IRS abused its discretion in failing or refusing to consider the underlying liability in the CDP hearing.

<sup>11</sup> The example was taken from *Fowler v. Commissioner*, where the Tax Court held that the IRS had abused its discretion in rejecting the offer in compromise under similar facts. *Fowler v. Comm'r*, T.C. Memo. 2004-163.



### PRESENT LAW AND ADMINISTRATIVE PROVISIONS

We briefly describe below existing CDP provisions and compare them to administrative provisions applicable to:

- ◆ Certain administrative procedures available outside of CDP for taxpayers in the collection process who want to contest disputed deficiency assessments (*i.e.*, the Audit Reconsideration Process); and
- ◆ Administrative procedures for taxpayers seeking relief from certain IRS collection actions who have either exhausted or failed to exercise their CDP rights (*i.e.*, Collection Appeals Program).

### Notice of Federal Tax Lien

Prior to the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS was not required to issue a notice to the taxpayer when it filed a Notice of Federal Tax Lien (NFTL). IRC § 6320(a)(1) now requires the IRS to provide notice to the taxpayer each time it files a NFTL.

### Notice of Intent to Levy

The IRS is required to send taxpayers a notice of its intent to levy prior to taking levy action.<sup>12</sup> The Notice of Intent to Levy must be provided to taxpayers at least 30 days before the date of the proposed levy.<sup>13</sup> Unlike the Notice of Federal Tax Lien, the IRS is only required to issue one Notice of Intent to Levy with respect to any particular tax debt.

### Collection Due Process

CDP hearings provide taxpayers an opportunity for an independent review of a Notice of Federal Tax Lien<sup>14</sup> filed by the IRS or a proposed IRS levy action.<sup>15</sup> CDP provisions can be divided into five components:

- ◆ Notice of Right to Hearing;
- ◆ Hearing and Determination;
- ◆ Stay on levy actions;
- ◆ Judicial Review; and
- ◆ Continuing Appeals Jurisdiction.

<sup>12</sup> IRC § 6331(d).

<sup>13</sup> IRC § 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

<sup>14</sup> IRC § 6320.

<sup>15</sup> IRC § 6330.

*Notice of Right to Hearing*

The IRS must notify the taxpayer of the right to a CDP hearing after the IRS files its first Notice of Federal Tax Lien with respect to a particular tax debt.<sup>16</sup> The CDP hearing notice must be provided to the taxpayer not more than five days after the filing of the NFTL and must inform the taxpayer of his or her right to request a CDP hearing with the 30-day period that begins on the expiration of the fifth day after the filing of the NFTL.<sup>17</sup>

In the case of a levy, the CDP hearing notice must be provided to the taxpayer not less than 30 days before the first levy, and must inform the taxpayer of his or her right to request a hearing 30 days from the date that the notice is sent.<sup>18</sup> Issuance of the Notice of Intent to Levy and Your Right to Hearing does not signify that the IRS has determined which specific property it will levy.

*Hearing and Determination*

Taxpayers are entitled to one CDP hearing with respect to the first Notice of Federal Tax Lien (NFTL) and one CDP hearing for the first proposed levy action.<sup>19</sup> The CDP hearing process allows a pause in the collection process so that the taxpayer can raise issues germane to the collection of the tax, including:

- ◆ Appropriateness of collection actions;<sup>20</sup>
- ◆ Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;<sup>21</sup>
- ◆ Appropriate spousal defenses;<sup>22</sup> 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.<sup>23</sup>

A 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

<sup>16</sup> IRC 6320(a) and 6320(b)(2).

<sup>17</sup> IRC § 6320(a)(2). The Notice of Federal Tax Lien can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address. IRC § 6320(a)(3)(B). See National Taxpayer Advocate 2004 Annual Report to Congress 463-464 for a discussion of legislative recommendation to change date from which the 30 day period begins to run.

<sup>18</sup> IRC § 6330(a)(2). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

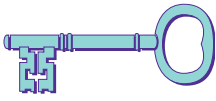
<sup>19</sup> Treas. Reg. §§ 301.6320-(b)(1) and 301.6330-(b)(1). If the IRS sends the Notice of Federal Tax Lien and the Notice of Intent to Levy together, the IRS can hold a single CDP hearing rather than have two separate hearings. IRC § 6330(b)(4).

<sup>20</sup> IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

<sup>21</sup> IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

<sup>22</sup> IRC §§ 6330(c)(2)(A)(i) and 6320(c).

<sup>23</sup> IRC §§ 6330(c)(2)(B) and 6320(c).



hearing or proceeding.<sup>24</sup>

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within 30 days of the date of the lien filing or the date of the notice, respectively.<sup>25</sup> Taxpayers who request a CDP hearing after the 30 day period expires will receive an “equivalent hearing,” which is the same as a CDP hearing except there is no judicial review of an equivalent hearing.<sup>26</sup> Proposed revisions to the CDP regulations require the taxpayer to put the reasons for the CDP hearing in writing (preferably using Form 12153), and the failure to provide the basis for hearing may result in a denial of a face-to-face hearing.<sup>27</sup> Proposed revisions also eliminate the availability for equivalent hearings if the taxpayer does not make a request for a hearing within one year from the date of issuance of the CDP Notice.<sup>28</sup>

Collection Due Process hearings are informal. The Office of Appeals presumptively establishes telephonic CDP hearings, and it is incumbent on the taxpayer to request a face-to-face hearing.<sup>29</sup> Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals officer,<sup>30</sup> but instead can take place by telephone,<sup>31</sup> or by an exchange of correspondence.<sup>32</sup> The hearing is to be held by an impartial officer from the Appeals function of the IRS.<sup>33</sup> In addition to addressing any issues described above that the taxpayer raises, the Appeals officer must obtain verification that the requirements of all laws and procedures have been satisfied for the IRS to proceed with collection activity.<sup>34</sup> Finally, and perhaps most importantly, in making its determination, Appeals must weigh the issues raised by the taxpayer and

<sup>24</sup> IRC §§ 6330(c)(4) and 6320(c).

<sup>25</sup> IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B).

<sup>26</sup> Treas. Reg. § 301.6330-1(i).

<sup>27</sup> Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1. Taxpayers will be given an opportunity to cure a failure to provide a basis for the CDP hearing. At least one professional group has expressed concerns about these provisions, including the language in the proposed regulation about face-to-face hearings. See American Bar Association Section of Taxation, Comments on Proposed Regulations Relating to Changes to Collection Due Process Procedures Under Sections 6320 and 6330 (Dec. 27, 2005).

<sup>28</sup> Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1.

<sup>29</sup> Appeals Letter 3855. See also Treas. Reg. § 301.6320-1(d)(2) Q&A D6 and Treas. Reg. § 301.6330-1(d)(2) Q&A D6 regarding the informality of CDP hearings.

<sup>30</sup> For example, in *Casey v. Comm’r*, T.C. Memo. 2004-228, the Tax Court held that a face-to-face hearing was not required where taxpayer had a reasonable opportunity for a hearing, but changed addresses and failed to provide the IRS her new address. However, in *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 2004-1522 (D. N.J. 2004), where the facts were disputed as to whether the taxpayer knew that phone conversations constituted the taxpayer’s CDP hearing, the court remanded the case for Appeals to provide a face-to-face hearing.

<sup>31</sup> In *Whiting v. Comm’r*, T.C. Memo. 2004-136, the Tax Court held that two phone conversations by the taxpayer’s representative and the Appeals officer were sufficient to constitute a CDP hearing in the absence of testimony regarding the content of the phone conversations.

<sup>32</sup> Treas. Regs. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

<sup>33</sup> IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).

<sup>34</sup> IRC § 6330(c)(1).

determine whether the proposed levy action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.<sup>35</sup>

### *Stay on Collection*

The IRS must suspend levy action throughout the CDP hearing process, unless it determines that the collection of the tax is in jeopardy.<sup>36</sup> Collection by levy is also suspended throughout any judicial review of Appeals' determination, unless the IRS can demonstrate to the court good cause to resume levy action.<sup>37</sup>

### *Judicial Review*

Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court or, where appropriate, the U.S. district court for judicial review of Appeals' determination.<sup>38</sup> Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the tax liability will be reviewed by the appropriate court on a *de novo* basis.<sup>39</sup> Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.<sup>40</sup> Taxpayers can raise any issue on judicial review which is permitted to be raised at a CDP hearing provided that the issue is actually raised at the CDP hearing.<sup>41</sup> Thus, issues such as whether the IRS abused its discretion in rejecting a collection alternative are reviewable on appeal from a CDP hearing, whereas rejection of those same collection alternatives would not be reviewable by any court if submitted at any other stage in the collection process, including as part of the Collection Appeals Process (discussed below).

### *Continuing Appeals Jurisdiction*

Internal Revenue Code section 6330(d)(2) provides that the Office of Appeals shall retain jurisdiction over any CDP determination made by that office. This continuing jurisdiction shall include subsequent hearings requested by the taxpayer to consider:

<sup>35</sup> IRC § 6330(c)(3).

<sup>36</sup> IRC § 6330(e)(1) provides the general rule for the suspension of collection by levy while IRC § 6330(f) provides that section 6330 does not apply if the IRS has determined that collection of the tax is in jeopardy.

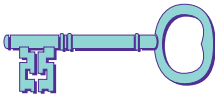
<sup>37</sup> IRC § 6330(e)(1) and 6330(e)(2). In *Burke v. Comm'r*, 124 T.C. 189 (2005), the Tax Court granted the IRS's motion to levy while the case was on appeal since the taxpayer was espousing only frivolous arguments; see also *Howard v. Comm'r*, T.C. Memo. 2005-100, where the IRS moved for and obtained from the court an order allowing resumption in levy activity on the taxpayer due to the taxpayer's frivolous arguments made solely for the purpose of delaying collection.

<sup>38</sup> IRC §§ 6330(d)(1) and 6320(c).

<sup>39</sup> The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No. 105-599 at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

<sup>40</sup> *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004) (noting that *abuse of discretion* means an adjudicator's decision which is arbitrary, capricious, clearly unlawful or without a sound basis in law or fact).

<sup>41</sup> Treas. Reg. § 301.6320-1(f)Q&A-F5; Treas. Reg. § 301.6330-1(f)Q&A-F5.



- ◆ Collection actions taken or proposed with respect to the CDP determination, and
- ◆ Any change in the taxpayer's circumstances that may affect such determination, but only after the taxpayer exhausts all administrative remedies.

### Audit Reconsideration Process

Through the IRS's Audit Reconsideration Process, individual taxpayers<sup>42</sup> are able to:

- ◆ Seek reevaluation of the results of a prior audit when the taxpayer disagrees with the original determination by providing information that was not considered in the original examination; or
- ◆ Contest the Substitute for Return (SFR) determination made by the IRS by filing an amended return.<sup>43</sup>

This process allows taxpayers another opportunity to argue before the IRS Examination function that the assessed liability is incorrect.<sup>44</sup> Taxpayers can be referred to the IRS Examination function from Collection,<sup>45</sup> Appeals,<sup>46</sup> or the Taxpayer Advocate Service. If the taxpayer's request for relief is denied by the Examination function, the taxpayer can appeal the result to the Office of Appeals unless the taxpayer did not qualify for audit reconsideration, or failed to appear for the audit reconsideration appointment.<sup>47</sup>

Audit reconsideration differs from liability determinations in CDP hearings in three important respects. First, taxpayers in the audit reconsideration process are able to dispute the underlying liability without regard to whether the taxpayer actually received a notice of the audit or a Notice of Deficiency or otherwise had an opportunity to dispute the liability. In CDP hearings, taxpayers are prohibited from raising the underlying liability if they received a Notice of Deficiency or otherwise had an opportunity to dispute the liability.<sup>48</sup> Second, there is no judicial review from Appeals' review of the audit reconsideration. Third, audit reconsideration is not required by statute whereas CDP is

<sup>42</sup> Audit reconsideration is not available for taxpayers who file tax returns other than Form 1040, i.e. corporations or other entities. IRM § 4.13.3.1.1.

<sup>43</sup> IRC § 6020(b) allows the IRS to file a return for a taxpayer when the taxpayer has failed to file a tax return.

<sup>44</sup> IRM § 4.13.1.3 provides some reasons a taxpayer might request audit reconsideration, such as where the taxpayer:

- did not appear for the audit;
- moved and did not receive correspondence from the IRS;
- has new documentation to present;
- disagrees with an assessment from an audit and has additional information to present; or
- disagrees with an assessment created under the Substitute for Return authority under IRC § 6020(b).

<sup>45</sup> IRM § 4.1.4.27.1.

<sup>46</sup> IRM § 4.1.4.41.

<sup>47</sup> IRM § 4.13.6.1(2).

<sup>48</sup> IRC § 6330(c)(2)(B). Certain categories of taxpayers are excluded from audit reconsideration that are not excluded under CDP, such as taxpayers who only advance frivolous arguments. IRM § 4.1.4.27.1. Audit reconsideration also excludes taxpayers who file returns on forms other than Form 1040, are claiming inability to pay, raise issues related to address changes, seek proof of prior payment, request explanation of account balances, and make refund inquiries. IRM § 4.13.3.1.1; IRM § 4.13.3.1.2.

codified in Internal Revenue Code sections 6320 and 6330.

### Collection Appeals Program (CAP)

The Collection Appeal Program (CAP) allows taxpayers to appeal specific collection actions or proposed actions to the Office of Appeals, namely:

- ◆ Filing or planned filing of a Notice of Federal Tax Lien;
- ◆ Levy action or proposed levy action; and
- ◆ Rejection of proposed installment agreement or termination of an existing installment agreement.<sup>49</sup>

CAP is distinct from CDP in a number of ways. CAP is the only means for taxpayers to appeal a Notice of Federal Tax Lien both *before or after* it is filed.<sup>50</sup> In contrast, CDP hearings occur *after* the lien is filed.<sup>51</sup> Under CAP, appeals of levy actions can also occur *before or after* the levy action occurs.<sup>52</sup> CDP hearings typically occur *before* levy unless the IRS determines that collection of the tax is in jeopardy or unless the asset levied upon is a state tax refund.<sup>53</sup> CAP is a much quicker appeal process than CDP, and its scope of review is much narrower than that of CDP. The Office of Appeals' goal is to complete CAP cases within five business days.<sup>54</sup> In contrast, the average cycle time for a CDP hearing – measured from the point when a taxpayer's request for a hearing is filed with the IRS until a CDP Notice of Determination is issued – is approximately 236 days.<sup>55</sup> However, Appeals officers in CAP proceedings are still required to assemble a record to support the determination.<sup>56</sup>

CAP also serves as the forum to hear taxpayer appeals of rejected or terminated installment agreements. Internal Revenue Code § 6159(e) requires that the IRS provide for administrative review of proposed terminations of existing installment agreements. Section 7122(d)(2) requires the IRS to establish procedures for taxpayers to appeal the rejections of proposed installment agreement to the Office of Appeals. The IRS implemented both of these provisions as part of the CAP program. Rejections of offers in compromise can also be appealed to Appeals and are worked under different procedures.<sup>57</sup> Thus, CAP can be narrower than CDP in that it cannot be used to appeal rejections of

<sup>49</sup> IRM § 8.7.2.2.

<sup>50</sup> IRM § 5.1.9.4.

<sup>51</sup> IRC § 6320(a).

<sup>52</sup> IRM § 5.1.9.4.

<sup>53</sup> IRC § 6330(f).

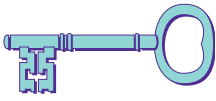
<sup>54</sup> IRM § 8.7.2.2.8.

<sup>55</sup> Information provided by the Office of Appeals as of June 30, 2005.

<sup>56</sup> IRM § 8.7.2.2.3 provides that:

At a minimum, the appeals file should include: a. copies of the relevant levy, lien, seizure documents; b. Form 433A or B; c. Any other relevant documents, such as copies of deeds, mortgages, counsel opinions.

<sup>57</sup> IRC § 7122(d); IRM 8.13.2.



offers-in-compromise or to raise other issues that can be appealed through separate procedures, such as Trust Fund Recovery Penalties, penalty appeals or jeopardy levies.<sup>58</sup>

### Other Collection Relief Provisions

#### *Release of Liens*

Section 6325 requires that the IRS release a lien when: (1) the liability for the amount assessed (with interest) has been fully satisfied or has become legally unenforceable; or (2) a bond is furnished to the Service guaranteeing payment of the amount assessed (with interest) within the period of limitations on collection.<sup>59</sup> The release of a federal tax lien extinguishes the underlying assessment lien on the property.<sup>60</sup>

#### *Subordination of Liens*

The Service may also subordinate a lien if (1) an amount equal to the amount of the lien or interest to which the certificate subordinates the tax lien is paid, (2) the IRS believes that the amount realized will be increased by the subordination of the lien, or (3) if the lien was imposed by section 6324B (relating to additional estate tax), if the government will be adequately secured after such subordination.<sup>61</sup> The IRS has discretion in deciding whether to subordinate liens.<sup>62</sup>

#### *Release of Levies and Return of Levy Proceeds*

The Internal Revenue Service *may* release levies at any time and for any reason as a matter of administrative discretion. Internal Revenue Code section 6343(a), however, *mandates* that levies be released on the occurrence of certain events, such as where the taxpayer enters into an installment agreement or where the IRS determines that the levy is creating an economic hardship due to the financial condition of the taxpayer.<sup>63</sup> Pursuant to IRC section 6343(d), the IRS has authority to return levy proceeds in certain cases, including where the taxpayer has entered into an installment agreement with

<sup>58</sup> IRM § 8.7.2.2.2.

<sup>59</sup> IRC § 6325(a)(1) and (2).

<sup>60</sup> IRC § 6325(f)(1)(A).

<sup>61</sup> IRC § 6325(d). *See also*, Treas. Reg. § 301.6325-1(d).

<sup>62</sup> Treas. Reg. § 301.6325-1(d).

<sup>63</sup> IRC § 6343(a)(1) provides in part:

- (1) In general.—Under regulations prescribed by the Secretary, the Secretary shall release the levy upon all, or part of, the property or rights to property levied upon and shall promptly notify the person upon whom such levy was made (if any) that such levy has been released if—
  - (A) the liability for which such levy was made is satisfied or becomes unenforceable by reason of lapse of time,
  - (B) release of such levy will facilitate the collection of such liability,
  - (C) the taxpayer has entered into an agreement under section 6159 to satisfy such liability by means of installment payments, unless such agreement provides otherwise,
  - (D) the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer, or
  - (E) the fair market value of the property exceeds such liability and release of the levy on a part of such property could be made without hindering the collection of such liability.



the IRS or the return of the levy proceeds will be in the best interests of the taxpayer and the government.<sup>64</sup>

Elsewhere in this report we discuss the problem of untimely levy releases in the Automated Collection System and the problem of additional levies taking place after an agreement to enter into an installment agreement has occurred or after the IRS has determined that the levy is causing the taxpayer an economic hardship.<sup>65</sup> If these additional levies occur, taxpayers can seek return of levy proceeds by filing a claim for the return of the property within nine months of the date of the levy.<sup>66</sup> If the request is denied, the taxpayer can file an appeal. Generally, there is no judicial review available to the taxpayer if the IRS denies his or her request for return of property. If the IRS fails to return property in violation of the law, however, the taxpayer may file suit in district court for damages under IRC § 7433.<sup>67</sup>

### REASONS FOR CHANGE

Collection Due Process hearings enhance tax administration by providing taxpayers with important protections against IRS overreaching and abuse of its discretion in its collection powers. The CDP program affords taxpayers, who are caught up in a collection process that is largely automated, an opportunity to raise facts and circumstances relevant to the collection of tax before an independent Appeals officer.

In those instances where the taxpayer believes that Appeals did not make a determination that is supported by the facts and the law, taxpayers have access to judicial review. Judicial review is an essential component of CDP rights because in some instances the IRS collection system demonstrates:

- ◆ Resistance to taking into consideration taxpayers' changed circumstances;<sup>68</sup>

<sup>64</sup> IRC § 6343(d)(2) grants the IRS the authority to return levied property where:

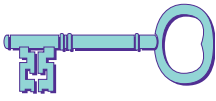
- (2) the Secretary determines that—
  - (A) the levy on such property was premature or otherwise not in accordance with administrative procedures of the Secretary,
  - (B) the taxpayer has entered into an agreement under section 6159 to satisfy the tax liability for which the levy was imposed by means of installment payments, unless such agreement provides otherwise,
  - (C) the return of such property will facilitate the collection of the tax liability, or
  - (D) with the consent of the taxpayer or the National Taxpayer Advocate, the return of such property would be in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

<sup>65</sup> See Most Serious Problem: *ACS Levy Releases*, *supra*.

<sup>66</sup> IRC § 6343(b) and (d).

<sup>67</sup> IRC § 7433 requires taxpayers to prove that an officer or employee of the IRS “recklessly or intentionally, or by reason of negligence” disregarded a provision of the Code or Treasury regulations to prove damages.

<sup>68</sup> In *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004), the court held that it was an abuse of discretion for the IRS to refuse to consider the changed financial circumstances of a taxpayer whose inability to pay was diminished. The court rejected the IRS’s policy-based argument that it would open the door to devious taxpayers who could take advantage of the system.



- ◆ Adherence to administrative procedures over the substance of account resolution;<sup>69</sup>
- ◆ The desire to obtain efficiencies of scale at the expense of providing taxpayers with a reasonable CDP hearing;<sup>70</sup> and
- ◆ Willingness to proceed with collection of a liability when it is uncertain or doubtful that the liability is validly owed.<sup>71</sup>

On the other hand, CDP fails to address the thousands of IRS collection determinations that taxpayers raise outside of the CDP process.<sup>72</sup> Some commentators note that CDP's biggest flaw is that it provides a static "picture frame" review for what is a dynamic "video" process.<sup>73</sup> In other words, the circumstances of taxpayers change throughout the tax collection process; CDP, however, provides Appeals and the courts with a single review of the taxpayer's circumstances.

### IRS Experience with CDP

Since its enactment, the IRS Collection function and the Office of Appeals have struggled to handle CDP cases in a timely manner.<sup>74</sup> Yet, despite millions of CDP notices issued annually, taxpayers have not flooded the IRS with requests for CDP hearings, nor have they flooded the courts with CDP petitions. As Table 2.7.1 demonstrates, of the 2,276,684 CDP notices sent to taxpayers in FY 2004, only 1.24 percent of taxpayers requested CDP hearings.<sup>75</sup>

<sup>69</sup> *Ramirez v. Comm'r*, T.C. Summ. Op. 2004-48 (holding it was an abuse of discretion for Appeals officer not to review offer in compromise when Appeals received the offer 8 days after the deadline and 3 days after the Appeals officer closed the case, but 4 days prior to the mailing of the Notice of Determination). See also, *Johnson v. Comm'r*, T.C. Summ. Op. 2005-47 (denying motion for summary judgment because petitioner's income for the years at issue was in dispute and raised a genuine issue of material fact. The Appeals officer had rejected collection alternatives raised by a homeless taxpayer who had not filed tax returns for 2001 and 2002, finding that although the taxpayer's income appeared to be below the level required for filing, payments on the mortgage during these years exceeded the amount of known income indicating possible self-employment income).

<sup>70</sup> *Parker v. Commissioner*, T.C. Memo. 2004-226 (holding that the taxpayer did not waive his right to a hearing at the nearest appeals office (New Orleans) when the taxpayer agreed to a telephone conference with Appeals in Jackson, Mississippi, 180 miles away).

<sup>71</sup> *Skrizowski v. Comm'r*, T.C. Memo. 2004-229 (holding it was an abuse of discretion to not fully investigate the offer in compromise before rejecting it and not basing rejection on taxpayer's income, assets and allowable expenses, and ability to pay. The court found that the taxpayer did not receive \$5 million in business income reported on taxpayer's return when taxpayer was intoxicated when he submitted the delinquent return after allegedly being told by an IRS collections officer that he could go to jail if he did not file the return, and further noted that the Appeals officer did not believe the reported income was valid).

<sup>72</sup> Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1148 (2004).

<sup>73</sup> Bryan T. Camp, *Replacing CDP*, 107 Tax Notes 1039 (May 23, 2005).

<sup>74</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 110; see also National Taxpayer Advocate 2003 Annual Report to Congress 38.

<sup>75</sup> By way of comparison, in FY 2004 of the approximately 500,000 Notices of Deficiency issued, approximately 16,000 (or 3.2 percent) filed petitions with the Tax Court. Audit Information Management Systems (AIMS), Closed Case Database FY 2004.

TABLE 2.7.1, COLLECTION DUE PROCESS – FY 2004

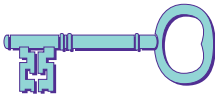
Collection Due Process – FY 2004			
IRC 6320 - Lien	NFTLs Filed	CDP Lien Requests*	% of CDP Requests
ACS	280,284	6,925	2.47%
CFf	257,539	2,612	1.01%
Total	537,823	9,537	1.77%
IRC 6330 - Levy	CDP Levy Notices	CDP Levy Requests*	% of CDP Requests
ACS –	1,628,467	13,951	.86%
CFf	110,394	4,645	4.21%
Total	1,738,861	18,596	1.07%
<b>Grand Total</b>	<b>2,276,684</b>	<b>28,133</b>	<b>1.24%</b>

### Timing of CDP Hearings

Taxpayers are provided the right to request a CDP hearing before the IRS takes its first levy action with respect to any tax (or after it files its first Notice of Federal Tax Lien, but still before its first levy action). If a taxpayer timely requests a CDP hearing, the IRS generally cannot take any levy action until the hearing is final, which can take years in the case of a taxpayer who seeks judicial review of the hearing determination.<sup>76</sup> This stay on levy action can lead to counterproductive and even improper behavior on the part of the IRS and on the part of taxpayers.

CDP hearings were enacted to provide taxpayers with a chance to resolve their tax collection problems at the earliest point in the collection process, by providing taxpayers with an opportunity to deal with all issues – liability, collection alternatives, spousal defenses – at one time. However, the collection stay's real and perceived effect on the ability of the IRS to collect has caused the IRS to try to accelerate the CDP process. For example, to improve collection cycle time, the IRS Collection Field function has changed its procedures to provide certain taxpayers with Notices of Intent to Levy and Right to Due Process Hearing *before* the taxpayer has shown that he or she will not work with the IRS to resolve the liability and when the IRS does not yet know whether it

<sup>76</sup> IRC § 6330(e)(1) provides a suspension of levy actions, along with the running of the 10 year statutory period for collecting tax. An exception exists when the IRS determines that the collection of tax is in jeopardy. IRC § 6330(f). Additionally, with a showing of good cause, the IRS can move to lift the suspension of collection activity while the case is on judicial review, provided the underlying liability is not at issue. IRC § 6330(e)(2).



will, in fact, levy.<sup>77</sup> In fact, when the IRS tested its Initial Contact Initiative for business taxpayers in the IRS’s Collection Field function, the percentage of taxpayers exercising CDP rights decreased from 4.1 percent to 0.12 percent.<sup>78</sup>

The IRS may argue that because these taxpayer cases are in the Collection Field function, the IRS will most certainly take levy action against these taxpayers. This argument is unpersuasive, since it is precisely this type of generalized assumption of taxpayer behavior – as opposed to a facts and circumstances analysis – that CDP was designed to avoid. Although many taxpayers in the Collection Field function may indeed have some levy action taken against them, CDP exists so that taxpayers who are trying to work things out with the IRS have a one-time opportunity to place all their “collection cards” on the table.

The IRS is also currently planning to reduce the number of notices sent to taxpayers in the “notice stream” portion of the collection cycle prior to issuing a Notice of Intent to Levy and Right to Collection Due Process Hearing.<sup>79</sup> Business taxpayers will receive the CDP notice in the second collection notice, and it is proposed that individual taxpayers will receive the CDP notice in the fourth collection notice. While these changes enable the IRS to reduce collection cycle time, this approach will harm taxpayers, particularly individual taxpayers, by increasing the likelihood that taxpayers will *not* actually receive the CDP hearing notice. This is so because the notice will be sent before the IRS checks the taxpayer’s “last known address” against commercial databases and verifies whether there is a more current address for the taxpayer.<sup>80</sup>

On the other hand, in at least 35 of the 209 CDP opinions (or approximately 17 percent) that were reviewed for this year’s most litigated issue, Collection Due Process, courts deemed arguments made by taxpayers frivolous and made solely for the purpose

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<sup>77</sup> In 2005, the IRS Collection Field function established an initiative whereby it would issue delinquent taxpayers the *Notice of Intent to Levy and Your Right to a Hearing* (which triggers the 30-day period for the taxpayer to request a CDP hearing) on initial contact with taxpayers. The National Taxpayer Advocate objected to the initiative for several reasons, including that taxpayers who were just beginning to work cooperatively with the IRS were handed a notice informing them that their CDP rights would expire within 30 days, thereby forcing the taxpayers to decide between electing CDP rights prematurely or foregoing these rights altogether. The IRS agreed to limit the initiative to business taxpayers who habitually fail to remit payroll taxes as well as those business taxpayers who have delinquent individual accounts. See National Taxpayer Advocate’s Report to Congress: Fiscal Year 2006 Objectives 12.

<sup>78</sup> Small Business/Self-Employed Division, *Initial Contact Study of BMF Taxpayers* (2005).

<sup>79</sup> Generally, individual taxpayers receive four collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing. Business taxpayers receive two collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing. See IRM § 5.19.1 and Exhibit 5.19.1-2(1)(n).

<sup>80</sup> In an IRS study of the effect of issuing CDP notices in the Collection Field function at the time of first contact with the taxpayer, business taxpayers only requested CDP hearings 0.12 percent of the time. This figure differs significantly from the 4.21 percent response rate in FY 2004 for the Collection Field function. Thus, from the taxpayers’ perspective, the early issuance results in a virtual elimination of CDP rights.

of delay, imposing at least \$160,100 in penalties against CDP litigants in the aggregate.<sup>81</sup> The courts are clearly addressing this abuse of process. Moreover, the IRS, in proposed regulations, recently suggested procedures for dealing with taxpayers who seek to raise *only* frivolous issues in CDP hearings before the Office of Appeals.<sup>82</sup> Over time, procedures such as these will help to protect the integrity of the CDP process.<sup>83</sup>

### Judicial Oversight of Later Collection Actions

One of the major flaws in the CDP hearing process is that it provides no protection for taxpayers who have failed to request a CDP hearing, and thus cannot seek judicial oversight of subsequent IRS levy actions with respect to a particular tax debt. The availability of the Collection Appeals Program (CAP) provides administrative oversight of some lien and levy action. However, the CAP process with respect to liens and levies exists as an exercise of the IRS's administrative discretion and could be curtailed according to that discretion. Moreover, CAP determinations are not subject to judicial review.

### Review of Underlying Liability

In the 2004 Annual Report to Congress we set forth our reasons for proposing that *de novo* judicial review of the underlying liability in the context of CDP hearings be replaced with judicial review of whether the Office of Appeals abused its discretion in refusing to consider or failing to properly consider the underlying liability in CDP hearings.<sup>84</sup> Under current procedures, if the taxpayer has actually received the Notice of Deficiency or otherwise had an opportunity to dispute the tax liability, the underlying liability is not within the purview of the CDP hearing, and it is left to the Appeals Officer's discretion whether to consider the underlying liability after he or she has issued the Notice of Determination.<sup>85</sup> This approach, while defensible under the statute because this type of liability determination is not subject to judicial review, is backward,

<sup>81</sup> IRC § 6673(a) allows the Tax Court to impose up to \$25,000 in fines against a taxpayer who makes frivolous arguments or engages in litigation solely for the purpose of delay. The percentage of frivolous CDP cases (i.e. where the court deemed the taxpayer's arguments frivolous) *reviewed* is down from 23 percent in 2004 and 52 percent in 2003. See National Taxpayer Advocate 2004 Annual Report to Congress 510.

<sup>82</sup> Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1.

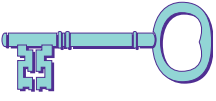
<sup>83</sup> *But see* American Bar Association Comments on Proposed Regulations Relating to Changes to Collection Due Process Procedures Under Section 6230 and 6330 (Dec. 27, 2005):

To reduce the risk that taxpayers who could raise nonfrivolous issues are inadvertently classified as advancing solely frivolous positions and denied a face-to-face conference, we suggest that the IRS continue to publish on its website and to begin including in the instructions to Form 12153 the positions it deems frivolous.

The National Taxpayer Advocate agrees with this recommendation.

<sup>84</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 481 - 483.

<sup>85</sup> Internal Revenue Service procedures do not provide clear guidance to Appeals officers on how to exercise their discretion to review the validity of the underlying liability when taxpayers are procedurally barred from raising the issue in CDP hearings. While the procedures require that Appeals Officers should make reference in the Notice of Determination that consideration of the liability issue was addressed under separate consideration from the CDP hearing (see IRM § 8.7.2.3.13(5)(f)), tax practitioners inform us that in practice the decision of whether to exercise such discretion is routinely made after the Notice of Determination is issued.



in that the IRS *first* determines whether it should take levy action and only *later* determines whether there is any debt to be collected at all.

#### EXPLANATION OF RECOMMENDATIONS

The Collection Due Process provisions require Congress and the IRS to carefully balance the taxpayers' interest in having collection action be as least intrusive as possible while protecting the government's and all taxpayers' interest in ensuring that all taxpayers pay their fair share of tax. In making these legislative recommendations, the National Taxpayer Advocate has carefully considered these concerns.

We propose that the Notice of Right to a Collection Due Process Hearing under IRC § 6330 be issued at the time the IRS takes its first levy action, rather than at least 30 days before it plans to take levy action. Specifically, we propose separating the Notice of Intent to Levy under IRC § 6331 and the Notice of Right to CDP Hearing under IRC § 6330. Under this proposal, the IRC § 6331 notice will serve to inform the taxpayer that the IRS is now poised to take levy action and advise the taxpayer of the various rights he or she has with respect to levies and liens.<sup>86</sup> On the other hand, the IRC § 6330 notice will clearly advise the taxpayer that the IRS has now determined that it will take a specific (first) levy action and the taxpayer now has 30 days to request a CDP hearing.

This change will force the IRS to give clear and distinct notice of the right to a CDP Hearing when it actually intends to take a specific action. It will prevent the IRS from issuing the CDP Hearing notice so far in advance of a specific proposed levy action it intends to take as to render the right to a hearing meaningless. Moreover, it will prevent the IRS from issuing this notice either before it has determined that the taxpayer will not work with the IRS in resolving the debt or before it has taken steps to ensure that the CDP notice is being sent to the most current address for the taxpayer. This change will also enable the IRS to take the specific levy action immediately after the expiration of the 30-day period. Thus, taxpayers will be on notice that the IRS is poised to take a specific action (*e.g.*, levying on a specific bank account or garnishing wages), and the IRS, having issued the CDP hearing notice concurrent with the notice to specifically identify the source of funds, will be poised to take action in the event the taxpayer does not request a CDP hearing.

We further propose that where the CDP Notice under IRC § 6330(a)(1) is mailed, the IRS must use certified or registered mail, but it should no longer be required to send such notices by return receipt requested. This change will save taxpayers millions of dollars in postage each year without impairing rights to receive notice, and bring CDP procedures in conformity with mailing requirements for the CDP Lien Notice under IRC § 6320.

<sup>86</sup> IRC 6331(d)(4) provides a list of the information to be provided with this notice.

Clearly, taxpayers need effective judicial oversight of IRS lien and levy actions both at the outset of collection case and during its progression. The IRS, however, needs to be able to pursue lien and levy action without being stopped for months or even years every time it initiates such action. The National Taxpayer Advocate believes that these two needs can be reconciled by clarifying in the Code the role of judicial oversight of Appeals' ongoing jurisdiction in CDP cases. Thus, for a subset of U.S. taxpayers, the courts will have the authority to review the entirety of the collection life cycle. In turn, where the courts find that the IRS has abused its discretion, all taxpayers will benefit from the changes in procedures or additional training that result from such decisions. Moreover, by clarifying that the scope of the courts' continuing jurisdiction includes the IRS's authority to release levies and return levy proceeds, Congress will improve the oversight of these important provisions.

Moreover, by consolidating CDP jurisdiction in the United States Tax Court, Congress will eliminate confusion and delay as a result of multiple cases dealing with one taxpayer (and one set of financial assets and income sources available for collection) and two types of tax. Consolidation will also place oversight of IRS lien and levy action in a court that is known for its taxpayer-friendly procedures.

As a matter of fairness and due process of law, the government should only collect the correct amount of tax. Thus, the audit reconsideration process, which currently exists by administrative grace, should be codified in order to prevent injustice. Further, the CDP statute should be amended to clarify that the Appeals Officer conducting a CDP hearing shall consider the underlying liability not only when the taxpayer has not received the Statutory Notice of Deficiency or not had an opportunity to otherwise dispute the tax, but also when the issue meets the criteria for audit reconsideration. The Appeals Officer's findings should be part of the Notice of Determination and the administrative record. The courts, however, will only review the issue of whether the IRS abused its discretion in failing to consider the underlying liability properly or at all.

Finally, to ensure that taxpayers continue to have the right to go to the Office of Appeals for administrative review of IRS collection actions outside of Collection Due Process Hearings, Congress should codify the Collection Appeals Program. We anticipate that the process of codifying both CAP and Audit Reconsideration will provide Congress with an opportunity to hear from stakeholders and the IRS about concern with these programs, how IRS Collection and Examination practice can be improved, and what is the appropriate role of judicial oversight for all taxpayers in the IRS collection process.

**ADDITIONAL LEGISLATIVE RECOMMENDATION: DIRECT DEPOSIT OF INCOME TAX REFUNDS****PROBLEM**

Under present law, there are no procedures in place for the IRS, the government's Financial Management Service (FMS), and financial institutions to address inadvertent errors by taxpayers relating to direct deposits of tax refund checks.<sup>1</sup> There are also no provisions to allow the IRS to take money out of an incorrect account or receive confidential information about the owner of an incorrect account from the financial institution. This situation leaves the IRS with access only to the information the incorrect account owner voluntarily provides to the IRS after the bank contacts the customer on behalf of the IRS. Thus, any dispute over the accuracy of a direct deposit refund must currently be resolved between the taxpayer and the financial institution itself, with little assistance from the IRS. While financial institutions can correct a mistake that they made, they do not always take corrective action when the taxpayer himself made the mistake. Without a process in place for handling these cases, there is no remedy for the taxpayer.

**EXAMPLE**

Jane Jones prepared her 2003 tax return herself and was entitled to a \$2,500 refund from the IRS. On February 15, 2004, Jane filed her return electronically, providing her bank account and routing numbers so she could receive her refund quickly through IRS direct deposit. On March 15, 2004, Jane checked her bank account and realized she had not yet received her refund from the IRS. Jane used the "Where's My Refund?" tool on the IRS website ([www.irs.gov](http://www.irs.gov)) and learned her refund was deposited in her account on March 1, 2004. Jane checked the printout of her 2003 return and realized she had made a mistake – the account number she provided the IRS was off by one number. In this case, the mistake was due entirely to Jane's error. Although this mistake was a minor one, the IRS did exactly as instructed with Jane's refund, and as a result, her refund was deposited in someone else's account.

**RECOMMENDATION**

Amend the Internal Revenue Code to create a process through which the IRS and financial institutions work together to identify the incorrect recipient of a direct deposit refund and request the return of the improperly deposited funds. The Right to Financial Privacy Act, 12 U.S.C. § 3401 *et seq.*, prohibits financial institutions from releasing financial records except under limited circumstances.<sup>2</sup> 12 U.S.C. § 3413(c) provides an exception to the financial disclosure rules, allowing for the sharing of financial records in

<sup>1</sup> For a detailed discussion of problems arising out of misdirected direct deposit tax refunds, see Most Serious Problem, *Direct Deposit of Income Tax Refunds*, *supra*.

<sup>2</sup> Under 12 U.S.C. § 3402, financial institutions may not release information to government authorities without customer authorization, administrative subpoena or summons, search warrant, judicial subpoena, or a formal written request which meets the requirements of 12 U.S.C. § 3408.



accordance with procedures in the Internal Revenue Code. The Internal Revenue Code should be amended to establish a formal procedure through which the IRS can receive limited information about an account holder who receives a misdirected direct deposit refund. The information provided to the IRS would be limited to the account holder's name, social security number, and necessary contact information to allow the IRS to contact the account holder and attempt to recover the misdirected funds.

The National Taxpayer Advocate further recommends that Congress amend Title 31, Money and Finance, of the current U.S. Code to treat misdirected direct deposit refunds in the same manner as checks.<sup>3</sup> 31 U.S.C. § 3343 provides a fund for the replacement of checks that are lost, stolen, destroyed, or defaced. There is currently no similar provision available providing a fund for the replacement of direct deposit refunds misdirected as a result of fraud.

<sup>3</sup> This recommendation was made by the joint Wage and Investment, Taxpayer Advocate Service Direct Deposit Task Force. For a discussion of the administrative recommendations the task force proposed, *see* Most Serious Problem: Direct Deposit of Income Tax Refunds, *supra*.

## ADDITIONAL LEGISLATIVE RECOMMENDATION: SOCIAL SECURITY LEVIES

## PROBLEM

The Code exempts from IRS levy certain pension and annuity payments (including payments under the Railroad Retirement Act), but does not exempt from levy retirement, survivors, and disability insurance payments made under the Social Security Act.<sup>1</sup> As discussed in the Most Serious Problem entitled “Levies on Social Security Payments,” levies by the IRS on Social Security benefits can cause particularly severe hardships for low income taxpayers who rely on these payments as their primary or sole source of income. By definition, recipients of Social Security benefits are elderly or disabled workers, or the surviving dependents of deceased workers.

Congress recognized that taxpayers need a certain amount of income to live on and established an exemption from levies.<sup>2</sup> This exemption amount is indexed for inflation and varies based on the taxpayer’s filing status and family size. However, this exemption does not apply to levies generated by the automated Federal Payment Levy Program (FPLP).<sup>3</sup> As a result, the IRS may levy on the first dollar of Social Security benefits via the FPLP, regardless of the amount of monthly benefits the taxpayer is receiving.

For nontax debts, Congress provided a mechanism to safeguard against excessive collection action against those who are suffering from economic hardship and cannot afford to pay. The Debt Collection Improvement Act of 1996,<sup>4</sup> among other things, exempted the first \$9,000 per year (which results in an exemption of \$750 per month) of Social Security and certain other federal benefits from administrative offset for the collection of nontax debts owed to federal agencies.

The IRS has been unable to develop an effective mechanism to identify and exclude taxpayers who might experience significant hardship if levied under the FPLP. The absence of any statutory exemption, combined with the IRS’ inability to devise an effective screen administratively, increases the likelihood of FPLP levies being applied against low income Social Security recipients and causing significant economic harm.

<sup>1</sup> See IRC § 6334(a)(6). The SSA provides two general categories of benefits – Supplemental Security Income (SSI) and Old-Age, Survivors, and Disability Insurance (OASDI). The SSI program provides needs-based (means-tested) benefits to individuals who are age 65 or older, blind, or disabled. The OASDI program protects against the loss of earnings due to retirement, death, or disability. The exemption in 6334(a)(11)(A) applies to SSI only.

<sup>2</sup> IRC § 6334(a)(9) provides a minimum exemption for wages, salary, and other income, as determined under IRC § 6334(d). This exemption amount is published in Publication 1494.

<sup>3</sup> See IRC §§ 6334(f); 6331(h).

<sup>4</sup> Pub. L. No. 104-134 (1996); 31 U.S.C. § 3701 *et seq.*

**EXAMPLE**

Jane Doe is a retired widow whose sole source of income consists of a \$600 monthly benefit from Social Security. Ms. Doe owns a home and a car, but no other assets of value. Three years ago, the IRS assessed \$5,000 against a joint return filed by Ms. Doe and her deceased husband, and now seeks to recover this amount via levy.

Because Ms. Doe earns less than the exemption amount under IRC 6334(a)(9) (\$683.33 per month for single taxpayers with one exemption claimed<sup>5</sup>), the IRS is prohibited from applying a manual levy. However, because the exemption amount does not apply to FPLP levies, the IRS may levy 15 percent (\$90) of Ms. Doe's monthly Social Security benefit.

**RECOMMENDATION**

The National Taxpayer Advocate recommends that Congress exempt Social Security payments altogether from IRS levy by amending IRC 6334(a)(6) to include payments under the Social Security Act. This proposal would treat Social Security payments on par with payments made under the Railroad Retirement Act, which are exempt from IRS levy under current law.

In the alternative, the National Taxpayer Advocate recommends that Congress extend the automatic exemption amount to FPLP levies on Social Security payments by amending IRC § 6331(h)(1) and IRC § 6334(f) to state that the exemption in IRC § 6334(a)(9) will apply whenever the "specified payment" being levied is made under the authority of the Social Security Act. This change would provide for a minimum exemption amount that would apply automatically for all levies of Social Security payments, regardless of the type of levy the IRS chooses to issue. This proposal would also make the automated levy process more consistent with the automated offset process applicable to nontax debts.

<sup>5</sup> See IRS Pub. 1494, *Table for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income* (2005).

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**ADDITIONAL LEGISLATIVE RECOMMENDATION: DEBT COLLECTION TECHNIQUES ON EITC BENEFITS BY REFUND ANTICIPATION LOAN INDUSTRY**


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**PROBLEM**

Financial institutions or banks that issue refund anticipation loans (RALs) are currently permitted to offset, or set off, RAL proceeds to satisfy outstanding delinquencies owed on RALs previously issued by either the contracting bank or a third party bank. Although the loan documents disclose this debt offset collection practice, it is unclear whether RAL customers fully comprehend its ramifications. Further, the practice allows banks to effectively seize earned income tax credit (EITC) benefits and transfer the funds to themselves or third party banks to satisfy delinquencies on previously issued RALs.

Federal law prohibits banks from exercising their right to set off on Social Security benefits.<sup>1</sup> IRC § 32 contains no analogous provision to prevent banks from offsetting EITC benefits to pay off delinquencies owed by RAL customers, despite the fact that the EITC is the largest federal means-tested anti-poverty program.<sup>2</sup> At the very least, the law should prohibit banks from transferring to a third party bank any portion of a federal tax refund representing the EITC.

**EXAMPLE**

In February 2006, Taxpayer visits a commercial tax return preparer (Preparer) to prepare his 2005 federal income tax return. To pay off some delinquent utility bills, Taxpayer decides to take out a refund anticipation loan (RAL) with the financial institution associated with Preparer (Bank). Taxpayer is due a refund of \$3000, which includes the EITC. After all of the loan documents and disclosure forms have been signed and Bank has approved the loan, Taxpayer receives only \$1,200 of the \$3,000 RAL he expected. Under a provision of the signed RAL agreement, Bank transmitted the remaining \$1,800 to a third party financial institution that issued a RAL to Taxpayer during 2005 for his tax year 2004 income tax refund. Taxpayer still owed \$1,800 on the previous RAL because the IRS did not release the entire expected refund for 2004.

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<sup>1</sup> 42 U.S.C. § 407(a) provides:

The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.

See, e.g., *Hambrick v. First Security Bank*, 336 F. Supp.2d 890 (E.D.Ark. 2004.); *Tom v. First American Credit Union*, 151 F.3d 1289 (10th Cir. 1998).

<sup>2</sup> In tax year 2003, 21.4 million taxpayers received credits totaling over \$38 billion. Earned Income Tax Credit Fact Sheet: Tax Years 2001, 2002 and 2003 Returns (July 19, 2005).

**RECOMMENDATION**

Amend IRC § 32 to include language similar to that contained in the Social Security Act.<sup>3</sup> This legislative language would protect the EITC portion of RAL proceeds from being transferred pursuant to the banks' debt offset or cross-collection practices.<sup>4</sup>

<sup>3</sup> See 42 U.S. C. § 407(a).

<sup>4</sup> An example of language protecting EITC benefits from offset can be found in the Taxpayer Abuse Prevention Act, S.324, 109th Cong. § 2 (Feb 9, 2005), as follows:

Section 32 of the Internal Revenue Code of 1986 (relating to earned income tax credit) is amended by adding at the end the following new subsection:

'(n) Prevention of Diversion of Credit Benefits- The right of any individual to any future payment of the credit under this section shall not be transferable or assignable, at law or in equity, and such right or any moneys paid or payable under this section shall not be subject to any execution, levy, attachment, garnishment, offset, or other legal process except for any outstanding Federal obligation. Any waiver of the protections of this subsection shall be deemed null, void, and of no effect.'

Section 3 of S.324 includes language prohibiting the general cross-collection practice by banks issuing RALs or refund anticipation checks (RACS).

