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**NATIONAL**

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**TAXPAYER**

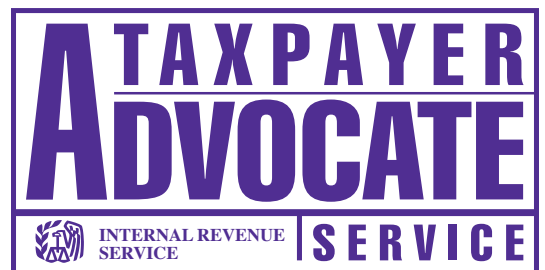
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**ADVOCATE**

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2006 ANNUAL REPORT TO CONGRESS

**VOLUME 1**



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*The National Taxpayer Advocate gratefully dedicates this  
report to the remarkable employees of  
the Taxpayer Advocate Service,  
who day in and day out serve America's taxpayers.*

*Through their commitment to helping taxpayers,  
they manage to do more with less.*

*Our tax system is better as a result of their efforts.*

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To

*Janet Altman Spragens*

*A fearless champion of the rights of low income taxpayers,  
a sage mentor to many in the tax world, and a good friend.*

*In memoriam.*

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**HONORABLE MEMBERS OF CONGRESS:**

I respectfully submit for your review the National Taxpayer Advocate's 2006 Annual Report to Congress. This year's report is in many ways a "Greatest Hits" version of past reports in that many of the Most Serious Problems we identify or the legislative recommendations we make were discussed in previous reports. But there are new wrinkles in all of these subjects, if only because the problems they identify – such as the Alternative Minimum Tax and the Tax Gap – become aggravated with the passage of time, when not addressed early on. In addition, as in past years, we include a second volume that contains two research studies – one on taxpayer needs and preferences for taxpayer service and one on the factors that drive taxpayers into the hands of the Taxpayer Advocate Service (the "Downstream Consequences" study). We believe that both of these studies will lead to a better understanding of the problems taxpayers face in complying with their tax obligations.

**Toward a More Expansive Concept of Taxpayer Compliance**

Traditional tax policy analysis suggests that the structure of taxation must meet three criteria – equity, efficiency, and administrability. These criteria can apply just as well to tax administration. In order to achieve maximum compliance with the tax laws, tax administration must treat similarly situated persons in a similar fashion; it must not distort taxpayers' economic decisions; and it must be designed such that its processes and requirements do not place an inordinate burden on either taxpayers or the tax administrator.

In the real world, of course, the IRS must grapple with budget constraints, training, hiring and attrition challenges, new tax legislation, archaic computer systems, and unexpected events like hurricanes and floods. The challenge for tax administration is to balance all these competing priorities in a way that maximizes taxpayers' voluntary compliance while addressing truly asocial noncompliance. As a new Congress convenes and IRS and Treasury prepare to respond to Congress' focus on the tax gap, this challenge will be front and center.

Over the last few years, the IRS has adopted the equation "Service + Enforcement = Compliance" to indicate the need for a balanced approach to tax administration. While I understand the importance of providing a succinct policy statement to taxpayers, Congress, and IRS employees, I believe we need to consider a slightly different formulation, and by not doing so, we risk losing the very balance we hope to achieve with the equation.

In reality, there are three types of IRS actions – service, enforcement *and* compliance. We all understand what activities constitute taxpayer service: filing returns, publishing forms and guidance, answering tax law and account questions, conducting outreach and education sessions. We also have a visceral understanding of what constitutes an enforcement action: a levy on a taxpayer's account, a garnishment of wages, a seizure of a principal residence, a criminal investigation. But what about all the activities in

between? Is a “math error” adjustment a taxpayer service or an enforcement action? If the IRS corrects a taxpayer’s addition on a return, aren’t we really just informing the taxpayer that he or she made an arithmetic or clerical error and that we’ve “fixed” it?

And what about audits of tax returns? Certainly, some examinations are predecessors to “enforcement” actions, as where a taxpayer is running a cash business, or has participated in an abusive tax scheme, and is intentionally and knowingly underreporting his or her income. Because of the taxpayer’s intent to underreport income, the examination turns into an investigation that likely will lead to some sort of enforced collection action. But consider the taxpayer who has simply made an error based on an honest misunderstanding of the law, or even a reasonable interpretation of an unclear statute that just happens to differ from the IRS’s interpretation. Surely this taxpayer should not be approached in the same manner as one who has intentionally “gamed” the tax laws.<sup>1</sup>

The IRS is more than a mere enforcement agency – much more. As our Study of Taxpayer Needs, Preferences, and Willingness To Use IRS Services in Volume 2 of this report demonstrates, taxpayers look to the IRS for assistance in many different forms, from direct assistance to assisted self-help to assistance to stakeholders who in turn assist taxpayers. And the IRS’s tax gap data show overwhelmingly that the vast majority of U.S. taxpayers comply with their tax obligations in good faith.<sup>2</sup> Most taxpayers sit down every April to file and pay their taxes, voluntarily if not cheerfully. Employers throughout the year withhold and pay over employment taxes, and then report wages and non-employee compensation at year-end. These taxpayers expect – and I believe they have the *right* to expect – that if they make a mistake that results in an audit or a collection notice, their good faith efforts will be recognized and they will not be treated as someone who intentionally and knowingly skirted the law – that is, someone who is the subject of an enforcement action.

Thus, I suggest that the IRS begin to talk to taxpayers, its employees and Congress about the “compliance” activity it undertakes, in addition to its taxpayer service and

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<sup>1</sup> Of course, even persons who intentionally attempt to game the tax laws are entitled to certain taxpayer rights and protections. For example, the IRS recently announced a new policy under which its Office of Appeals will send certain unagreed cases back to the examination function for further development. *See* IRS Announcement 2006-100. The rationale for this decision was that the IRS does not develop cases as fully for Appeals consideration as for litigation. This rationale demonstrates a fundamental flaw in the way the IRS handles its cases. If the issues the IRS fails to develop fully before Appeals’ consideration are material, then Appeals presumably cannot make proper decisions without more information. If the issues the IRS fails to develop fully before Appeals’ consideration are not material, then there is no basis to create a dramatic departure from Appeals’ historic role as the final stop before taxpayers may litigate disputes with the IRS in the Tax Court. The IRS justified this deviation on the ground that these taxpayers engaged in “listed” transactions, but by effectively relegating administrative appeals to an intermediate step in the examination process, the IRS both in perception and in reality undermines the right of all taxpayers to an independent administrative appeal.

<sup>2</sup> The voluntary compliance rate for all taxpayers is 83.7 percent. IRS Office of Research, *Tax Gap Map for Tax Year 2001* (Feb. 2006).

enforcement actions.<sup>3</sup> These different categories of IRS action are not mere academic distinctions. They influence how IRS employees view their roles and how these employees interact with taxpayers. Taxpayers, too, respond to different types of IRS actions in different ways. If the IRS treats a taxpayer who has a “compliance” problem in the same way as it treats a taxpayer who has an “enforcement” problem, we are likely to alienate that taxpayer and not achieve the long-term voluntary compliance that should be our goal. Moreover, we have violated one of the central tenets of tax administration – treating similarly situated people alike and, by extension, not treating differently situated people the same.

It is true that my categorization does not lend itself to a neat equation. But neither does human experience nor, most certainly, taxpayer behavior. The categories of taxpayer service, compliance, and enforcement can be analogized to a three-legged stool that is the tax system. Remove any one leg, and the stool becomes wobbly and falls. By viewing IRS as an agency that only undertakes service and enforcement actions, we hobble tax administration, undermine our goal of achieving maximum voluntary compliance, and harm taxpayers.

### **Toward a More Transparent Tax Administration System**

The primary theme of this year’s report, however, is transparency and the role it plays in tax administration and tax compliance. According to my well-thumbed 1953 copy of Webster’s New Collegiate Dictionary, the word “transparent” means “readily understood” and “clear,” “easily detected” or “perfectly evident.” Each of these definitions has relevance to tax administration. For example, as discussed in the Most Serious Problem on Transparency of the IRS, IRS public statements about its procedures, positions on tax law, and expectations of taxpayers (collectively, “guidance”) must be clear and readily understandable. They should not be hidden from public view, absent compelling law enforcement considerations. Moreover, given the National Taxpayer Advocate’s statutory responsibility to ensure that taxpayer rights are protected, her access to such information is paramount. It is disturbing, then, and unprecedented that despite repeated requests to review randomly selected guidance provided by the Office of Chief Counsel to IRS program heads, the National Taxpayer Advocate was denied the ability to review this guidance and determine, on her own, whether taxpayers would benefit from the publication – the making transparent – of that guidance.

But transparency in tax administration is a two-way street. Not only must the IRS be transparent in its guidance to employees, in its official positions, and in its disclosure of how it measures its own performance, but taxpayers also must be willing to engage in transparent (perfectly evident) transactions. In our Most Serious Problem on the tax

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<sup>3</sup> This analysis is not unique. The IRS’s service center activities used to be organized into processing, accounts, and compliance. See Most Serious Problem, Correspondence Delays, *infra*. More recently, in the course of an audit of the Taxpayer Advocate Service (TAS), the Government Accountability Office (GAO) suggested that TAS align its case “issue codes” into three groups – service, compliance, and enforcement.

gap, we note that a significant determinant of tax compliance is transparency.<sup>4</sup> By saying this, we mean that certain tax administration tools – notably, information reporting – have the virtue of making taxable transactions “transparent” or easily detected.

### **Transparency and the Annual Report to Congress**

The National Taxpayer Advocate’s Annual Report to Congress serves to increase the transparency of IRS operations. By design, we identify what we think are 20 of the most serious problems facing taxpayers, describe those problems and the IRS processes or policies that either cause or exacerbate them, and publish the IRS’s (unedited) response. Finally, we make our own recommendations for mitigating the problems, including legislative recommendations.

It is notable this year that, in addition to our being thwarted in one instance when attempting to obtain information, the IRS has begun its response to seven of the 21 Most Serious Problems we identify by stating that it “disagrees” with our findings, or otherwise dismisses them.<sup>5</sup> These IRS responses are of concern because in every instance we have carefully described the basis for our identifying these issues as problems, and provided copious, documented sources in support of our positions. The IRS, in most of its responses to our concerns, has made declarative statements without citing any sources that make it possible to verify those statements.

We also note an increased tendency to look for “efficient” approaches to tax administration (from the perspective of IRS resources) and a resistance to undertake analysis from the taxpayer perspective. This approach is most notable in the series of Most Serious Problems addressing IRS collection activities. These seven problems highlight the IRS’s short-term perspective on compliance. Rather than intervening early with taxpayers and making personal contact (which the IRS views as resource intensive), the IRS often waits until taxpayers’ debts become so large that they warrant the (much more expensive) intervention of IRS field collection personnel. The IRS’s solution to early intervention is to relegate many of these taxpayers to the Private Debt Collection Initiative, whereby the government (aka taxpayers) has the “privilege” of paying up to 25 percent of any taxes collected to private collection agencies, even while estimates show that IRS employees could perform the work far more efficiently, with a return on investment of approximately 13:1. We ask, in this report, what business case exists for such an arrangement, and conclude that there is none. As a result, we recommend that Congress repeal

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<sup>4</sup> See Most Serious Problem, Transparency of the IRS, *infra*.

<sup>5</sup> These Most Serious Problems include *Collection Issues of Low Income Taxpayers*; *Small Business Outreach*; *Correspondence Examination*; *Disaster Response and Recovery*; *IRS Implementation of Math Error Authority Impairs Taxpayer Rights*; *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance*; and *Concerns With the IRS Office of Appeals*, in which the IRS response stated that the issues raised are nearly identical to those in prior reports and “without any level of detail or documentation.”



Internal Revenue Code section 6306 and terminate the Private Debt Collection initiative once and for all.<sup>6</sup>

There are numerous other ways in which short-term vision impairs tax administration and affects taxpayers. The existing budget procedures under which the IRS develops its budget and Congress makes IRS funding decisions undercuts the IRS's ability to achieve maximum taxpayer compliance. As we discuss in detail in our Key Legislative Recommendation, *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*, the current procedures treat the IRS as a classic government spending program and pit the IRS dollar-for-dollar against many other federal programs for resources. We point out, however, that the IRS is the Accounts Receivable Department of the federal government, collecting \$2.24 trillion a year on a budget of \$10.6 billion – a 210:1 return on investment. Studies show that each additional dollar appropriated for the IRS would generate far more than a dollar in additional federal revenue, helping to close the tax gap and reduce the federal deficit. Thus, we suggest a set of guidelines for making IRS funding decisions that recognizes the IRS's unique role as the revenue generator for the federal government and seeks to maximize tax compliance, especially voluntary tax compliance (with due regard for protecting taxpayer rights and minimizing taxpayer burden).

We also highlight several bright spots in tax administration this year. We are pleased to report, as a status update, on the progress made by the IRS on its Questionable Refund Program, which we designated as the second most serious problem facing taxpayers in last year's report.<sup>7</sup> The IRS has made significant strides in addressing our concerns about the program, and even more commendably, has been forthright (transparent) in describing both the improvements and the challenges ahead. These improvements are all the more notable because the program had been defended for so long as one without problems.

### Transparency and Taxpayer Service

Another bright spot in tax administration this year is the Taxpayer Assistance Blueprint (TAB). Last year, we identified "Trends in Taxpayer Service" as the most serious problem affecting taxpayers. We recognized that the formation of the Taxpayer Assistance Blueprint (TAB) team was an important first step in the IRS's efforts to develop a long-term strategy to meet taxpayer needs and preferences. Moreover, we committed to participating in and working with the TAB team to develop this strategy.

Over the past year, the TAB has conducted numerous research studies designed to understand taxpayer needs and preferences. We are pleased with the work the TAB is

<sup>6</sup> We also note, in the Private Debt Collection arena, a stunning lack of transparency. The IRS has contractually agreed to let the private collection agencies determine whether their "operational plans" (akin to the Internal Revenue Manual) will be released to the public, resulting in taxpayers not knowing what practices, letters, or scripts the agencies will use. See Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *infra*.

<sup>7</sup> See Status Report, *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*, *infra*; see also National Taxpayer Advocate 2005 Annual Report to Congress 25-55 (Most Serious Problem: Criminal Investigation Refund Freezes).

doing, and believe the IRS is in a much better place than it was last year in this area. With the publication of the Taxpayer Assistance Blueprint, the IRS will make available its first strategic plan for delivering taxpayer service, one that is based on current research and envisions further studies and refinements. In the following section and in volume 2 of this report, we discuss both our perspective on the TAB and what we have learned about taxpayer needs and preferences. It will be up to Congress and the Administration to ensure that the important work of the Taxpayer Assistance Blueprint is not ignored or short-changed. The IRS and the TAB must be allowed to adequately analyze and understand the available research to develop an accurate picture of taxpayer needs and preferences, and make recommendations for delivering taxpayer service that are based on that research. Without the necessary transparency, taxpayers will not have confidence that the tax administration system is meeting their needs.

Respectfully submitted,



Nina E. Olson  
National Taxpayer Advocate  
31 December 2006

## TAXPAYER ASSISTANCE BLUEPRINT: THE NATIONAL TAXPAYER ADVOCATE'S PERSPECTIVE

In September 2005, the IRS formed the Taxpayer Assistance Blueprint (TAB) team, with employees from several IRS functions, including the Taxpayer Advocate Service (TAS), in response to a congressional directive to develop a five-year plan for taxpayer service.<sup>1</sup> The TAB delivered an initial report to Congress in April 2006,<sup>2</sup> and plans to release its final report in early 2007. The critical portion of the upcoming report is the five-year plan for how the IRS should provide taxpayer service. The following discussion provides a framework for understanding the work of the TAB and the challenges the IRS faces in implementing this strategic plan.

In the 2005 Annual Report to Congress, the National Taxpayer Advocate noted that the first step for developing a plan for taxpayer service is for the IRS to conduct a comprehensive study to determine what services different groups of taxpayers need, and how they prefer to obtain those services.<sup>3</sup> Over the past year, the TAB conducted numerous research studies designed to understand taxpayer needs and preferences. This research forms the basis for the five-year plan for taxpayer service, but for the plan to succeed, the IRS must first understand the definition of a taxpayer “need” and “preference.” We believe that defining needs and preferences is a necessary step.<sup>4</sup>

### Taxpayer Needs

Last year, the National Taxpayer Advocate recommended that the IRS “[e]ngage in a detailed needs assessment, from the taxpayers’ perspective, as part of the IRS’ five-year plan for taxpayer service.”<sup>5</sup> Needs can be defined as the services taxpayers need to comply with their tax obligations. While all taxpayers require some combination of information and services, in order to comply with their tax obligations, needs will differ from taxpayer to taxpayer according to their specific situations.

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<sup>1</sup> H. Rep. No. 109-307, at 209 (2005). The Senate Committee Report provides further detail on the content of the five-year plan, directing the IRS to:

... undertake a comprehensive review of its current portfolio of taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how it [IRS] plans to meet the service needs on a geographic basis (by State and major metropolitan area), including any proposals to realign existing resources to improve taxpayer access to services, and address how the plan will improve taxpayer service based on reliable data on taxpayer service needs. As part of this review, the Committee strongly urges the IRS to use innovative approaches to taxpayer services, such as virtual technology and mobile units. The IRS also should expand efforts to partner with State and local governments and private entities to improve taxpayer services.

S. Rep. No. 109-109, at 133-34 (2005).

<sup>2</sup> IRS, *Taxpayer Assistance Blueprint: Phase I* (April 16, 2006).

<sup>3</sup> National Taxpayer Advocate 2005 Annual Report to Congress 10.

<sup>4</sup> For a detailed discussion of taxpayer needs and preferences, including findings from several of the TAB research studies, see National Taxpayer Advocate 2006 Annual Report To Congress vol II at 1 (Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

<sup>5</sup> National Taxpayer Advocate 2005 Annual Report to Congress 24.

When discussing taxpayer needs, two factors must be taken into consideration:

- ◆ Is the product or service being delivered in such a way that the taxpayer can understand and use the product or service to comply with his or her tax obligations; and
- ◆ Can the taxpayer obtain the needed product or service without experiencing an unreasonable burden?

The IRS must structure service options so the service successfully meets the taxpayer's needs as delivered and allows the taxpayer to comply with his or her tax law obligations. Burden can limit a taxpayer's ability to use certain services, thereby impacting voluntary compliance, and the IRS must remain cognizant of the burden associated with using certain IRS services. If the use of a needed service is too burdensome, the IRS is not successfully meeting taxpayer needs. While needs differ according to taxpayer, all taxpayers have a basic set of needs, and where the IRS is obligated to provide services, taxpayers must be able to use these services conveniently and correctly.

In developing a five-year plan for taxpayer service and weighing various policy and budget considerations, the IRS must decide what obligation it has to provide information and services to taxpayers to meet their needs. There are a number of sources available to meet taxpayer needs, including the IRS, volunteer organizations, and paid practitioners. When deciding how to meet taxpayer needs in the future, the IRS must be sure it is not shifting this responsibility from itself to volunteers and paid practitioners. While volunteer groups and practitioners play an important role in the tax community, where the IRS is the best source for providing information and services to meet taxpayer needs, it should not shift that responsibility to outside groups over which it has little or no control.

### Taxpayer Preferences

In addition to understanding taxpayer needs, last year the National Taxpayer Advocate also recommended that the IRS “[d]evelop an understanding of what taxpayers prefer....”<sup>6</sup> Preferences can be defined as the methods or channels through which taxpayers choose to obtain the services they need.

Taxpayer preferences are linked to their ability to use a certain channel. If taxpayers are not willing to use a channel, they will likely not indicate a preference for it. Willingness is driven by a number of issues, many of which are outside of the control of the IRS. Taxpayers' willingness to share personal data over the Internet or the phone, or to deal with an IRS assistor over the phone or in person, can drive the channels they prefer to use to get the service they need. Factors such as age, income, literacy, language skills, and disability also influence preferences.<sup>7</sup> When analyzing taxpayer preferences, the IRS must keep in mind the needs of certain taxpaying populations such as the elderly, low

<sup>6</sup> National Taxpayer Advocate 2005 Annual Report to Congress 24.

<sup>7</sup> See Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities*, *infra*; see also Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Language And Cultural Barriers to Tax Compliance*, *infra*.

income, low literacy, limited English proficiency (LEP), and disabled. While the general taxpayer population may have certain preferences for obtaining needed services, these preferences may not hold true for all taxpayers. The IRS owes an obligation to provide services in a manner that all taxpayers can access them, including those taxpayers whose needs differ from the general population.

### **Use as an Indicator of Needs and Preferences**

In defining taxpayer needs and preferences and analyzing the related research, it is important to understand that use or nonuse of a service or channel is not an accurate determinant of what taxpayers need or prefer. While use is one indicator that taxpayers need and prefer the service or channel, it does not provide a complete picture, because use is contingent on awareness. If a taxpayer is not aware of a service or channel, he or she will not use it.

Use is also contingent on ability to use. If a taxpayer is aware of a service or channel, but unable to make use of it (*e.g.*, the taxpayer lives too far away, does not have Internet access, or the service or channel is too burdensome), then the taxpayer will not use the service or channel even though it is needed. Further, a taxpayer's current use of a service or channel does not indicate future need. A taxpayer may not currently visit a Taxpayer Assistance Center (TAC) or walk-in site because he or she does not have any outstanding tax issues. However, in the future, that same taxpayer may have a question about a tax account and wish to visit the local TAC to resolve the issue.

In developing the five-year plan for taxpayer service, it is important to know the current usage of IRS services and channels. These usage rates, however, must be considered in context and should not be taken as indicators of taxpayer needs and preferences.

### **Five-Year Plan for Taxpayer Service**

The main outcome of the TAB is the development of a five-year plan for taxpayer service. The TAB conducted a large number of significant research studies which provide the IRS with a wealth of previously unknown information. However, this research will not be useful and the five-year plan will not be successful unless the TAB takes the time to understand what the new data tells us. Additionally, in its report and the five-year plan, the TAB must be sure to present all of the research, even where different studies yield different results. Each research finding tells the IRS something new, and only by examining all of the research can the IRS and Congress truly understand what taxpayers need and develop a plan that best meets those needs.

The work of the TAB is just the first step in improving IRS delivery of taxpayer services. As the delivery of taxpayer services changes, so will taxpayer needs and preferences. Therefore, the IRS must continue to engage in meaningful research to understand these evolving customer needs.

In September 2006, the Department of Treasury Office of Tax Policy issued an aggressive strategy for reducing the tax gap.<sup>8</sup> As part of the strategy, Treasury recognized that taxpayer service plays an important role in compliance. One component of the tax gap strategy is a multi-year commitment to research, including research on the impact of customer service on compliance.<sup>9</sup> The strategy also recommends enhanced taxpayer service as a way to help taxpayers avoid errors.<sup>10</sup> The National Taxpayer Advocate commends this approach. She notes that the research conducted during the TAB focused mainly on taxpayer needs and preferences. The IRS needs to continue the efforts started with the TAB and conduct follow-up research to examine the link between service and compliance. Toward this end, the National Taxpayer Advocate has two commissioned research studies, one exploring the causes of and influences on taxpayer behavior, and one examining the role of return preparers and practitioners in taxpayer compliance (or noncompliance). The National Taxpayer Advocate will publish these studies in 2007.

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<sup>8</sup> Department of Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Sept. 26, 2006).

<sup>9</sup> *Id.* at 12.

<sup>10</sup> *Id.* at 14-15.

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**NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS – VOLUME II**

Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services  
Downstream Impact Project: Identifying Drivers of TAS Workload



# MOST SERIOUS PROBLEMS

## ENCOUNTERED BY TAXPAYERS

### INTRODUCTION: THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

The Internal Revenue Code (IRC) requires the Annual Report to Congress to discuss at least 20 of the most serious problems encountered by taxpayers each year.<sup>1</sup> This year, the National Taxpayer Advocate has identified, analyzed, and provided recommendations for resolving 21 of these problems. The report also includes a status update on an issue discussed in the 2005 Annual Report – the IRS’s Questionable Refund Program, operated by the Criminal Investigation (CI) division.<sup>2</sup> While this issue remains an area of concern, the National Taxpayer Advocate believes the IRS has significantly improved the program, and thus we provide a status report on both the work accomplished and the challenges ahead as IRS continues to address the problems we identified.

Consistent with the statutory requirement, we note that this report contains discussions of at least 20 of the most serious problems encountered by taxpayers – but not necessarily the top 20 most serious problems. That is by design. First, there is no objective way to determine the 20 most serious problems. We use a methodology (described immediately below) that assists us in compiling our list, but it is inherently subjective in many respects. Second, and more significant, simply listing the top 20 problems would require us to repeat large sections of the report from year to year. In a tax system in which nearly 100,000 IRS employees collect more than \$2 trillion dollars each year from about 135 million individual income tax filers<sup>3</sup> (not to mention corporate and other taxpayers), there are many glitches that inevitably occur and require attention. By providing flexibility in selecting topics for the report, the statute allows the National Taxpayer Advocate to select topics with an eye toward resolving problems rather than merely listing them.

### Methodology of the Most Serious Problem List

TAS considers a number of factors in identifying, evaluating, and ranking the most serious taxpayer problems. The 21 issues discussed in this section of the Annual Report were ranked according to the following criteria:

- ◆ Impact on taxpayer rights;
- ◆ Number of taxpayers affected;
- ◆ Interest to the National Taxpayer Advocate, Congress, and other external stakeholders;
- ◆ Barriers these problems present to tax law compliance, including cost, time, and burden;
- ◆ The revenue impact of noncompliance; and
- ◆ TAS management information data.

<sup>1</sup> IRC § 7803(c)(2)(B)(ii)(III).

<sup>2</sup> National Taxpayer Advocate 2005 Annual Report to Congress 25-55.

<sup>3</sup> IRS, *2005 Data Book*, Tables 1 and 3

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### **Taxpayer Advocate Management Information System (TAMIS) List**

The most serious problems reflect not only the mandates of Congress and the Internal Revenue Code, but TAS’s integrated approach to advocacy – using individual taxpayer cases as a method of detecting trends and identifying systemic taxpayer problems. TAS tracks individual taxpayer cases on the Taxpayer Advocate Management Information System (TAMIS). The top 25 case issues, which are listed in Appendix 1, reflect TAMIS receipts based on taxpayer contacts from October 1, 2005 through September 30, 2006.

### **IRS Responses**

TAS provides the IRS operating divisions and functional units with the opportunity to comment on and respond to the problems described in each year’s report. These responses appear, unedited, under the heading “IRS Comments,” followed by the National Taxpayer Advocate’s own comments and recommendations.

## PROBLEM

## TOPIC #1

## ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

The most serious problem facing taxpayers today is the complexity of the Internal Revenue Code. In this report, we are choosing to shine our primary spotlight on the poster child for tax-law complexity – the Alternative Minimum Tax for individuals (AMT).

The AMT is a parallel and complex tax structure that is imposed on top of the regular tax structure. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, it now affects large groups of middle-class taxpayers with no tax-avoidance motives at all.

Significantly, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. Today, the AMT is left to punish taxpayers for engaging in such “classic tax-avoidance behavior” as having children or living in a high-tax state. In the first instance, the AMT disallows the personal exemptions that parents are allowed to claim under the regular tax rules to reflect the additional costs they incur in raising children. In the second instance, the AMT disallows the deduction for the payment of state and local income, sales, and property taxes that taxpayers are allowed to claim under the regular tax rules to reduce “double taxation” at the federal and state levels on the same income. This, in essence, is today’s AMT.

The AMT is ensnaring an ever-growing number of taxpayers because the amount of income exempt from the AMT (the AMT “exemption amount”) is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was \$30,000 for all taxpayers. If that amount had been indexed, it would be equal to about \$165,000 today.<sup>1</sup> Instead, the exemption amount, after a temporary increase that will expire after 2006, is \$45,000 for married taxpayers and \$33,750 for most other taxpayers.<sup>2</sup> As a result, it is now projected that in 2010, 32.4 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the

<sup>1</sup> Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See *The 1969 Economic Report of the President: Hearings before the Joint Economic Comm.*, 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has increased more than six fold since 1966, so the kinds of taxpayers who caught Congress’ attention back then would be making about \$1.25 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (as of Oct. 31, 2006). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.25 million. By 2010, it has been estimated that 82 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 36 percent will have incomes under \$100,000. See Greg Leiserson & Jeffrey Rohaly, *The Individual Alternative Minimum Tax: Historical Data and Projections updated November 2006* (Nov. 1, 2006) (available on the Urban Institute-Brookings Institution Tax Policy Center website at [www.taxpolicycenter.org](http://www.taxpolicycenter.org) and published in Tax Notes Today, accessible at 2006 TNT 219-50) [hereinafter “Urban Institute/Brookings Institution Tax Policy Center”], table 5.

<sup>2</sup> IRC § 55(d).

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AMT.<sup>3</sup> Among the categories of taxpayers hardest hit, 89 percent of married couples with adjusted gross income (AGI) between \$75,000 and \$100,000 and with two or more children will owe AMT.<sup>4</sup>

The burden that the AMT imposes is substantial. In dollar terms, it is estimated that the average AMT taxpayer will owe an *additional* \$6,782 in tax in 2006.<sup>5</sup> In terms of complexity and time, taxpayers often must complete a 16-line worksheet,<sup>6</sup> read nine pages of instructions,<sup>7</sup> and complete a 55-line form<sup>8</sup> simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 77 percent of AMT taxpayers hire practitioners to prepare their returns.<sup>9</sup>

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

The following two examples illustrate the impact of the AMT on individual taxpayers:

- ◆ A mother of five earned \$57,000 in 2005. She is seeking a legal separation from her husband and lived apart from him during the final months of the year and thus claimed “married filing separately” filing status. Because she was entitled to claim the children as her dependents and claim the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of \$2,380 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of \$95.
- ◆ A taxpayer filed a joint return claiming two dependent children for 2005. The taxpayer had an adjusted gross income (AGI) of \$190,000 and paid state income and property taxes totaling \$28,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional tax liability of \$5,042 due to the AMT.

<sup>3</sup> Urban Institute/Brookings Institution Tax Policy Center, tables 1 & 3. The AMT projections made by the Urban Institute/Brookings Institution Tax Policy Center are the most detailed available. In the past, we have compared its projections with projections made by the Department of the Treasury’s Office of Tax Analysis and the Joint Committee on Taxation, and the disparities have been minor.

<sup>4</sup> Urban Institute/Brookings Institution Tax Policy Center, table 3.

<sup>5</sup> Urban Institute/Brookings Institution Tax Policy Center, table 4.

<sup>6</sup> IRS Form 1040, *Individual Income Tax Return*, Instructions at 39 (2006).

<sup>7</sup> IRS Form 6251, *Alternative Minimum Tax - Individuals*, Instructions (2006).

<sup>8</sup> IRS Form 6251, *Alternative Minimum Tax - Individuals*, Instructions (2006).

<sup>9</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF), Tax Year 2004.

Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of \$202.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is penalizing taxpayers for such non-tax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

### RECOMMENDATION

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government has dealt fairly with them. To say the least, “gotcha” taxation is not good for taxpayers or the tax system.

The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the Alternative Minimum Tax for individuals.<sup>10</sup>

The National Taxpayer Advocate previously designated the AMT as the most serious problem facing taxpayers in her 2003 report to Congress,<sup>11</sup> and she recommended in both her 2001 and 2004 reports that the AMT be repealed.<sup>12</sup> She also has recommended repeal of the AMT in several appearances before Congress, including at a hearing of a Senate Finance subcommittee that specifically focused on the AMT.<sup>13</sup> For a comprehensive discussion of the AMT and the National Taxpayer Advocate’s concerns, see her testimony and previous reports (available at <http://www.irs.gov/advocate>).

<sup>10</sup> As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining § 53 of the Code.

<sup>11</sup> National Taxpayer Advocate 2003 Annual Report to Congress 5-19.

<sup>12</sup> National Taxpayer Advocate 2004 Annual Report to Congress 383-385; National Taxpayer Advocate 2001 Annual Report to Congress 166-177.

<sup>13</sup> *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. On Taxation and IRS Oversight of the Senate Comm. On Finance (2005).*

## PROBLEM

## TOPIC #2

## THE TAX GAP

The federal tax gap is one of the most serious problems facing taxpayers today, and it is one of the top two most serious problems facing tax administration.<sup>1</sup>

It's easy to see why the tax gap is a problem for tax administration. According to the results of the IRS National Research Program study of 2001 tax returns, the government is failing to collect \$290 billion of tax revenue that is due each year.<sup>2</sup>

But the tax gap is also a serious problem for the vast majority of compliant taxpayers who pay their taxes willingly and honestly every year. If we divide the estimated \$290 billion net tax gap by the roughly 130 million individual income tax returns filed, we can see that each return was effectively assessed a "surtax" of more than \$2,200 to subsidize noncompliance by others. That's an extraordinary burden to expect the average taxpayer to bear. Nobody likes to feel like a "tax chump." If we do not manage to close the tax gap, particularly with all the attention the subject has been receiving of late, we run a real risk that our compliant taxpayers will become less compliant over time.

The tax gap data show that the most significant determinant of tax compliance is transparency. Where payments of income are reported to the IRS (*e.g.*, on a Form W-2, Employee's Wage and Earnings Statement, a Form 1099, U.S. Information Return, or a Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.), compliance is generally 95 percent or higher.<sup>3</sup> Where payments of income are not reported to the IRS, compliance plummets to below 50 percent. IRS data indicate that 99 percent of income earned by wage earners is reported on a tax return, yet only about 43 percent of income earned by self-employed persons is reported.<sup>4</sup>

The National Taxpayer Advocate has long advocated three broad strategies to close the tax gap:

- ◆ Fundamental tax simplification, with an emphasis on making economic transactions more transparent;
- ◆ Expanded third-party information reporting and, in certain situations, tax withholding on non-wage income; and
- ◆ Improved IRS compliance initiatives that appropriately balance taxpayer service and enforcement.

<sup>1</sup> The National Taxpayer Advocate believes that the most serious problem facing both taxpayers and the IRS is the complexity of the Internal Revenue Code. See Most Serious Problem, *The Alternative Minimum Tax For Individuals*, *supra*; National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (designating the complexity of the Internal Revenue Code as the most serious problem facing taxpayers and the IRS alike).

<sup>2</sup> See IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006). In fact, the IRS acknowledges the actual tax gap is larger. For example, the study did not even venture a guess as to the amount of illegal source income that goes unreported and on which taxes are not paid.

<sup>3</sup> See IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

<sup>4</sup> *Id.*

The National Taxpayer Advocate has discussed the tax gap in considerable detail in her annual reports to Congress<sup>5</sup> and in testimony at congressional hearings on the tax gap over the past 2½ years.<sup>6</sup>

This year, we emphasize three issues that we think warrant particular attention:

- ◆ Improving taxpayer service to meet the needs of our nation’s taxpayers;
- ◆ Ensuring that the IRS’s stepped-up enforcement activity proceeds successfully and without violating taxpayer rights; and
- ◆ Revising the federal budget process to ensure that decisions about IRS funding are made in a way designed to maximize compliance with the tax laws, especially voluntary compliance, thereby leading to a reduction in the tax gap and an increase in overall federal revenue.

The first two issues flow from the IRS’s strategic formula: “Service + Enforcement = Compliance.”<sup>7</sup> Although this formula is rather light on specifics, it reflects the indisputable premise that service and enforcement both play an important role in maximizing compliance with our nation’s tax laws. The IRS views service as including such activities as publicizing the requirement to file tax returns and pay taxes, publishing tax forms and explanatory guidance, answering taxpayers’ tax-law questions and even preparing tax returns, and assisting taxpayers who need other help in complying. The IRS views enforcement as including such activities as verifying compliance on the part of taxpayers, reaching determinations about a taxpayer’s correct tax liability if different from what the taxpayer reported, litigating against taxpayers where disputed issues arise, and taking actions to collect unpaid tax.

Where successful, taxpayer service is to be preferred to enforcement for at least two important reasons. First, it is much better for our civic culture when taxpayers report their income and pay their taxes voluntarily. Second, at a more practical level, the IRS

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<sup>5</sup> National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (discussing the cash economy) and 381-396 (making legislative proposals to improve compliance in the cash economy); National Taxpayer Advocate 2004 Annual Report to Congress 211-263 (discussing IRS examination strategy, IRS collection strategy, and the application of the Federal Payment Levy Program to noncompliant federal contractors) and 478-489 (making legislative recommendations to combat the tax gap, which includes a chart identifying and commenting on 24 options); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (discussing noncompliance by self-employed taxpayers) and 256-269 (proposing tax withholding on non-wage workers, a position the National Taxpayer Advocate subsequently modified in her 2005 report cited above in this footnote).

<sup>6</sup> The National Taxpayer Advocate has testified at the following Senate hearings focused on the federal tax gap: Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Sept. 26, 2006); Senate Finance Subcommittee on Taxation and IRS Oversight (Jul. 26, 2006); Senate Budget Committee (February 15, 2006); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (April 14, 2005); Senate Finance Committee (July 21, 2004).

<sup>7</sup> See IRS Strategic Plan 2005-2009. In the Preface to this report, the National Taxpayer Advocate discusses an alternative way to view IRS programs based on taxpayer behavior.

## PROBLEMS

lacks the resources to close the tax gap through audits alone. The examination rate is currently less than one percent, and the majority of examinations are limited-scope examinations conducted by mail.<sup>8</sup> Even if we were somehow able to double the examination rate, more than 98 percent of taxpayers would not be examined each year. So we need to focus on maximizing voluntary compliance by simplifying the tax laws and improving IRS outreach and education efforts, while reserving targeted enforcement actions to combat clear abuses and send a message to all taxpayers that noncompliance has consequences.<sup>9</sup>

With regard to taxpayer service, the Senate Appropriations Committee report accompanying the FY 2006 IRS funding bill expressed concern that the IRS was not giving adequate emphasis to taxpayer service, and it directed the IRS, its Oversight Board, and the National Taxpayer Advocate to develop a five-year plan for taxpayer service that includes long-term goals that are strategic and quantitative and that balance enforcement and service.<sup>10</sup> Over the past year, my office has worked very closely with the IRS in developing a taxpayer service strategic plan, and I believe the undertaking has substantially advanced IRS's understanding of taxpayer needs and taxpayer preferences. There is a discussion of this project, known as the Taxpayer Assistance Blueprint, or the "TAB," immediately following the Preface to this report.

With regard to IRS's stepped-up enforcement activity over the past few years, we are beginning to see signs that taxpayer rights are not being protected as well as they have been in recent years, particularly in the collection process. Perhaps this is almost inevitable when enforcement is ramped up quickly and pressure is applied to program managers to show results, but we believe it is important to highlight our concerns and for the IRS to take our concerns seriously to avoid the risk that the enforcement overzealousness which plagued the agency in the mid-1990s will recur. In this section of the Annual Report to Congress, where we list at least 20 of the most serious problems facing taxpayers, fully seven relate to IRS collection practices.

The National Taxpayer Advocate believes strongly that the tax gap cannot and should not be closed by ramping up enforcement activities too quickly or by pressuring IRS examination and collection personnel to hit revenue targets either directly or indirectly through shorter cycle times. Increasing the number of enforcement personnel too quickly would require the IRS to divert experienced personnel from revenue-producing priority work to train new employees. Moreover, new hires generally have lower productivity rates and require significantly closer supervision than experienced employees to ensure they do not take incorrect actions, including actions that impair or violate

<sup>8</sup> IRS, *2005 Data Book*, Table 10, at 19. The IRS also proposes adjustments using math-error authority and its automated under-reporter (AUR) and automated substitute for return (ASFR) programs.

<sup>9</sup> For research purposes, we believe it is important to study inadvertent errors as well as deliberate misreporting. Knowledge about inadvertent errors can be used to clarify ambiguous laws or administrative guidance to help improve compliance.

<sup>10</sup> S. Rep. No. 109-109, at 133-134 (2005).



taxpayer rights. Similarly, revenue targets would inevitably lead to taxpayer rights violations by providing an incentive for enforcement personnel to maximize revenue. That is inconsistent with the IRS's mission, as the government's tax administrator, to achieve the correct tax result in each case.

As a counterpart to the five-year strategic plan the IRS has developed for taxpayer service, the National Taxpayer Advocate recommends that the IRS, in conjunction with the Advocate and the IRS Oversight Board, develop a five-year strategic plan for tax law enforcement that includes long-term goals that are strategic and quantitative in nature (*e.g.*, an increase in the voluntary compliance rate) and that balances enforcement and taxpayer service, including the protection of taxpayer rights. The IRS Strategic Plan 2005-2009, a blueprint the IRS published in 2004, contains some relevant objectives, but a revised plan focused specifically on enforcement, and developed using the results of newer research studies, could help the IRS optimize its allocation of resources to improve compliance.

Finally, with regard to IRS funding, we encourage Congress to re-evaluate the procedures by which IRS funding decisions are made. Under current procedures, the IRS is treated as just another federal spending program, without any clear mechanism for recognizing the revenue that the IRS brings in. Inasmuch as the IRS brings in almost all federal revenue (more than \$2 trillion), these procedures are illogical. The appropriate congressional committees should consider creating a separate process to make IRS funding decisions that gives priority consideration to maximizing tax compliance, particularly voluntary compliance. To illustrate the shortcoming with the present procedures, assume that an additional \$2 billion spent on the IRS would generate an additional \$8 billion in federal revenue. It would seem a "no-brainer" that this expenditure should be made, yet it often cannot be made under the existing rules because Congress sets hard spending caps at the beginning of the budget process, and each dollar spent on the IRS leaves one less dollar available for other programs. In the Key Legislative Recommendations section of this report, we offer a general proposal to improve the budget decision-making process.

In sum, we are pleased that Congress is showing increased interest in closing the federal tax gap. We continue to believe that tax simplification and expanded third-party information reporting are central to that effort. At the IRS level, we believe that a vigorous compliance program that appropriately balances taxpayer service and enforcement with due regard for taxpayer rights can produce better results; and we believe Congress should revise its budget procedures to take into account IRS's unique role as the revenue generator of the federal government when making IRS funding decisions.

**PROBLEM****TOPIC #3****TRANSPARENCY OF THE IRS****RESPONSIBLE OFFICIALS**

Kevin M. Brown, Deputy Commissioner, Services and Enforcement  
 Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
 Richard J. Morgante, Commissioner, Wage and Investment Division  
 Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division  
 Steven T. Miller, Commissioner, Tax Exempt and Government Entities  
 Sarah Hall Ingram, Chief, Appeals  
 Nancy J. Jardini, Chief, Criminal Investigation  
 Donald L. Korb, Chief Counsel  
 Mark J. Mazur, Director, Research, Analysis and Statistics

**DEFINITION OF THE PROBLEM**

Like all federal agencies, the IRS is required by law to make certain procedures and guidance available to the public (*i.e.*, it is required to be transparent).<sup>1</sup> Although the IRS makes a significant amount of information available to the public, TAS has received complaints that the IRS is not fully complying with this requirement. We have determined that such complaints have merit, and although the IRS has taken steps to improve its transparency in recent years, we believe the IRS's lack of transparency is a serious problem.<sup>2</sup> The IRS's failure to consistently and promptly publish certain procedures and guidance deprives the IRS of valuable feedback that it could use to improve the procedures and guidance. It also deprives taxpayers and their representatives of information that is vitally important in resolving tax problems and disputes.

For example, since November 2004, the specialized group of IRS employees that is supposed to evaluate all offers to compromise tax debts based on "equity and public policy" considerations has been using unpublished guidance to determine whether to accept such offers.<sup>3</sup> As a result, some taxpayers who would be eligible for an offer may not have bothered to apply because they did not know they would qualify. The IRS employees who screened the offers that taxpayers did submit may not have referred them to the specialized group because the employees did not know the taxpayers would qualify either. Since taxpayers did not know what facts the IRS would consider, they most probably did not emphasize (in their offer packages) the facts that the IRS considers most important. Thus, the IRS is more likely to have rejected such offers. Further,

<sup>1</sup> See generally, 5 U.S.C.A. § 552.

<sup>2</sup> Even TAS itself has recognized the need to improve its procedures for complying with these requirements.

<sup>3</sup> SB/SE, Collection Policy, *Non-Hardship ETA* (first circulated in October or November 2004); SB/SE, Collection Policy, *Offers In Compromise, Additional Guidance Regarding the Use of "Non-Hardship" Effective Tax Administration OICs* (first circulated in September 2005). As of October 11, 2006, SB/SE's guidance had not been signed, widely distributed beyond the specialized group, or made available to the public.

the IRS has not had the opportunity to receive input from the public that would be helpful in refining its guidance.

### ANALYSIS OF THE PROBLEM

#### Freedom of Information Act (FOIA)

In addition to certain items that the Freedom of Information Act (FOIA) requires the IRS to release upon request or publish in the Federal Register, the law requires the IRS to make available to the public all “administrative staff manuals and instructions to staff that affect a member of the public” unless an exemption applies.<sup>4</sup>

Such exemptions generally protect against disclosure that would harm important interests, such as national security, individual privacy, proprietary business interests, and the functioning of government.<sup>5</sup> For example, certain inter-agency or intra-agency memoranda or letters may be exempt from disclosure to encourage frank discussions between IRS officials. Information used for law enforcement purposes, such as a tolerance level (*i.e.*, a level of noncompliance that the IRS will not pursue), is exempt to prevent taxpayers from using such information to evade detection or abuse the system.<sup>6</sup> But, if disclosure would not harm other important interests, there are good reasons for the IRS to make its instructions to staff available to the public.

#### Benefits of Transparency

##### *Transparency Promotes Better Decisions*

The government often uses disclosure (*i.e.*, transparency) to promote reasonable behavior by taxpayers and practitioners. For example, “reportable transaction” rules require taxpayers to disclose potentially abusive transactions to the IRS.<sup>7</sup> One rationale for these rules is that such transparency may prompt taxpayers to avoid taking unreasonable posi-

<sup>4</sup> See 5 U.S.C.A. § 552(a)(2)(C). The IRS is also supposed to make available all: (1) Final opinions made in the adjudication of cases; (2) Statements of policy and interpretations adopted by the IRS; (3) Copies of all records, which have been released under FOIA upon request, that the agency determines have become or are likely to become the subject of subsequent requests; and (4) An index of all such records. *Id.* However, this discussion focuses primarily on “instructions to staff.”

<sup>5</sup> See generally, 5 U.S.C.A. § 552(b). The IRS is not required to disclose: (1) Matters related solely to internal personnel rules and practices; (2) Matters specifically required to be withheld pursuant to a statute other than FOIA; (3) Trade secrets or other confidential commercial or financial information; (4) Inter-agency or intra-agency memoranda or letters that would not be available by law to a private party in litigation; (4) Personnel, medical files, and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy; and (5) Certain records or information compiled for law enforcement purposes. Other exemptions, which rarely apply to the IRS, include: (1) Certain matters specifically authorized by an Executive Order to be kept secret in the interest of national defense or foreign policy; (2) Matters related to certain reports prepared by or for an agency responsible for regulating or supervising financial institutions; and (3) Certain geological or geophysical information. *Id.*

<sup>6</sup> *Id.* The IRS generally designates such instructions to staff that are exempt from disclosure as “official use only” (OUO). See generally, IRM 11.3.12 (July 25, 2005).

<sup>7</sup> See, e.g., Treas. Reg. § 1.6011-4.

tions in the first place.<sup>8</sup> For the same reasons, transparency reduces the likelihood that government decision makers will adopt unreasonable policies.<sup>9</sup>

The law implicitly recognizes that transparency promotes better decisions by policy-makers. Courts generally give more weight and deference to regulations promulgated pursuant to formal “notice and comment” procedures, which require the agency to consider public comments.<sup>10</sup> The courts grant such deference, in part, because transparency resulting from the notice and comment process promotes a healthy dialogue with taxpayers and helps the government to write better regulations.<sup>11</sup>

#### *Transparency Promotes Consistency and Fairness*

Transparency also helps to ensure that all IRS employees use the same guidance and procedures, and it assures taxpayers that the IRS is not arbitrarily treating some more favorably than others. Along the same lines, when the IRS compromises a taxpayer’s liability, it must make the terms of the compromise available for public inspection.<sup>12</sup> Such transparency may assure taxpayers that the IRS is not arbitrarily or unfairly compromising tax liabilities.

Perhaps most importantly, transparency prevents the inequity that can result if taxpayers who know about undisclosed IRS guidance or processes obtain benefits that similarly situated but uninformed taxpayers are unable to obtain. If only a few practitioners

<sup>8</sup> See, e.g., TD 8876, 65 FR 11,215 (Mar. 2, 2000) (noting that the confidential corporate tax shelter registration provisions were intended “to improve tax compliance by giving the Treasury Department earlier notification of transactions that may not comport with Federal tax law and by discouraging taxpayers from entering into questionable transactions.”).

<sup>9</sup> According to the Supreme Court, “the basic purpose of FOIA is to ensure an informed citizenry, vital to the functioning of a democratic society, needed to check against corruption and to hold the governors accountable to the governed.” *NLRB v. Robbins Tire & Rubber Co.*, 437 US 214 (1978). A 1996 Report from the House Committee on Government Reform and Oversight further explained: “The Act reflects the view that the full disclosure of information to the public about government wrongdoing and other mistakes will ultimately generate appropriate corrective responses. Such revelations may have a certain degree of preventative effect, prompting a higher degree of probity and conscientiousness in the performance of government operations. Exposures resulting from FOIA disclosures, and the reactions they produce, are critical to maintaining an open and free society.” H.R. Rep. No. 104-795 at 7 (1996).

<sup>10</sup> See, e.g., *U.S. v. Mead Corp.*, 533 U.S. 218 (2001). The Administrative Procedure Act requires a notice of proposed rulemaking to be published in the Federal Register. See Administrative Procedure Act (APA), 5 U.S.C.A. § 553.

<sup>11</sup> According to the Fourth Circuit Court of Appeals, “[t]he purpose of the notice-and-comment procedure is both ‘to allow the agency to benefit from the experience and input of the parties who file comments and to see to it that the agency maintains a flexible and open-minded attitude towards its own rules.’ The notice-and-comment procedure encourages public participation in the administrative process and educates the agency, thereby helping to ensure informed agency decisionmaking.” (citations omitted). *Chocolate Mfrs. Ass’n of U.S. v. Block*, 755 F.2d 1098 (4th Cir. 1985).

<sup>12</sup> IRC § 6103(k)(1); Statement of Procedural Rules, 26 C.F.R. § 601.702(d)(8).

know about a process, only a few taxpayers will be able to benefit from it.<sup>13</sup> Thus, transparency promotes fair tax administration.<sup>14</sup>

### FOIA Challenges Not Unique to the IRS

Despite the benefits of transparency, many agencies have had difficulty implementing the FOIA. Since 1946, when a predecessor of the FOIA was enacted, agencies have narrowly interpreted disclosure laws and have had difficulty complying with them.<sup>15</sup> Although the requirement for agencies to post materials electronically became law (called E-FOIA) in 1996, a study by the General Accounting Office (GAO, now the Government Accountability Office) found that seven out of 25 agencies still had not complied in 2002.<sup>16</sup>

### IRS Procedures for Disclosing “Instructions to Staff”

The Internal Revenue Manual (IRM) is supposed to serve as the single official source of IRS “instructions to staff” such as procedures, guidelines, policies, and delegations of authority.<sup>17</sup> The official version of the IRM is available on the Internet in the IRS’s “electronic reading room.”<sup>18</sup>

Because updating an official IRM can be a lengthy process, many IRS business units send “interim guidance” directives to their staffs with the intent of incorporating these

<sup>13</sup> According to a report by the Senate Judiciary Committee: “Administrative operations and procedures are public property which the general public, rather than a few specialists or lobbyists, is entitled to know or to have the ready means of knowing with definiteness and assurance.” S. Rept. No. 79-752, at 12 (1945). In discussing whether private letter rulings had to be disclosed, the District Court for the District of Columbia stated:

[a] body of “private law” has in fact been created which is accessible to knowledgeable tax practitioners and those able to afford their services. It is only the general public which has been denied access to the IRS’ private rulings. The IRS’ argument that publication would cause grave damage to its ruling system, then, is viewed by this Court as a specter having little basis in fact. Those taxpayers most likely to rely upon or challenge the rationale of letter rulings issued to others already have access to many rulings through their own efforts. Publication would simply make available to all what is now available to only a select few, and subject the rulings to public scrutiny as well. Such public availability and scrutiny are the very fundamental policies of the Freedom of Information Act. For, “one fundamental principle is that secret law is an abomination.” [Internal citation omitted]. *Tax Analysts and Advocates v. Internal Revenue Service*, 362 F.Supp. 1298 (D.C.D.C. 1973), *modified and remanded* by 505 F.2d 350 (D.C. Cir. 1974).

<sup>14</sup> As noted above, the FOIA requires the IRS to make available to the public only the instructions to staff that “affect a member of the public.” Since the determination about which instructions “affect a member of the public” is difficult, reasonable people can disagree about which instructions to staff are required to be available under FOIA. However, it may be beneficial, as described above, to make instructions to staff available to the public even if such materials are not required to be available to the public pursuant to FOIA.

<sup>15</sup> See, e.g., H.R. Rept. No. 104-795 at 7-11 (1996).

<sup>16</sup> General Accounting Office, GAO-02-493, *Information Management, Update on Implementation of the 1996 Electronic Freedom of Information Act Amendments* 45-46 (Aug. 2002). The Treasury Department was not one of the agencies identified as noncompliant.

<sup>17</sup> IRM 1.11.2.1 (Oct. 1, 2005).

<sup>18</sup> The IRS’s electronic reading room is at <http://www.irs.gov/foia/article/0,,id=110353,00.html> and IRS instructions to staff are at <http://www.irs.gov/foia/content/0,,id=132732,00.html>.

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into the next IRM revision.<sup>19</sup> In the past, the IRS has been criticized for “managing by memo,” *i.e.*, avoiding disclosure by issuing instructions to staff in the form of memoranda or other internal communication that is not timely disclosed rather than by updating the public IRM.<sup>20</sup>

Perhaps in response to such criticism, as of January 2002 all instructions to staff contained in job aids, desk guides, web sites, documents, or any other sources were to be incorporated into the IRM.<sup>21</sup> In October 2004, the IRS instituted procedures to ensure that “instructions to staff” such as “interim guidance” memos were made publicly available on its external website.<sup>22</sup> Pursuant to those procedures, interim guidance issued in November 2004 or later that affects the public, is national in scope, and will be in force for three months or more was supposed to be posted to the Internet in the IRS’s “electronic reading room.”<sup>23</sup>

Alternatively, the IRS sometimes issues interim guidance by updating an unofficial version of the IRM, which is available only to IRS employees on an internal system called the Servicewide Electronic Research Program (SERP), rather than by issuing memoranda. The IRS Wage and Investment Operating Division (W&I) issues almost all of its interim guidance using SERP.<sup>24</sup> When an IRM author submits an update to the SERP, changes

<sup>19</sup> Although interim guidance is supposed to be incorporated into the IRM and expire within one year, it sometimes remains effective for longer periods or is reissued without being incorporated into the IRM. For example, on February 2, 2006, Collection Policy reissued interim guidance first issued on June 24, 2004. Memorandum for Directors, Collection Area Operations from Cheryl Sherwood, Director, Collection Policy, *Re-Issued Guidance on Preparation of Summons* (Feb. 2, 2006). Although such guidance should have expired on June 24, 2005, in the absence of new published guidance, between June 25, 2005 and February 2, 2006, the public did not know whether IRS employees would continue to follow the expired interim guidance.

<sup>20</sup> See, e.g., Bryan E Gates, *Management By Memorandum, Promulgation by Pub.*, 1999 TNT 99-76 (May 24, 1999); Amy Hamilton, *Rossotti Confirms IRS Is ‘Managing By Memorandum,’* 2000 TNT 87-5 (May 3, 2000).

<sup>21</sup> Memorandum from Bob Wenzel, Deputy Commissioner Operations for Division Commissioners, Chiefs, Assistant Commissioners, National Directors, National Taxpayer Advocate, *Issuing and Controlling Interim Procedures* (Aug. 15, 2000); IRM 1.11.2.1 (Oct. 1, 2005).

<sup>22</sup> Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research and Beth Tucker, Director, SB/SE Communications and Liaison for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Directives Memorandum and the Freedom of Information Act (FOIA)* (Oct. 27, 2004). See also, IRM 1.11.1 (Oct. 1, 2005); IRM 1.11.2 (Oct. 1, 2005); and IRM 11.3 (May 24, 2005).

<sup>23</sup> Because of difficulty in implementing these procedures, the IRS later revised its procedures to provide that only interim guidance issued on or after June 1, 2005 would be posted. Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research, for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Guidance and the Freedom of Information Act (FOIA)* (April 6, 2005).

<sup>24</sup> Chief, Performance Improvement W&I Strategy and Finance, *Response to TAS Information Request* (Jun. 16, 2006).

are reflected on the SERP IRM and available to IRS employees within 48 hours.<sup>25</sup> However, the SERP IRM is not available to the public on the Internet.

### Opportunities to Improve IRS Transparency

#### *SERP IRM Not Available to the Public*

When the IRS updates the SERP IRM, it does not always concurrently update the official IRM that is available to the public on IRS.gov.<sup>26</sup> For example, as of July 11, 2006, some interim guidance published on the internal SERP IRM as early as February 2004 had not been incorporated into the official IRM available to the public in the electronic reading room on IRS.gov.<sup>27</sup>

As another example, on February 24, 2005, the IRS added section 5.19.7.3.23.3 to the SERP IRM. This new section clarifies the process that the IRS will follow when it determines that it erroneously terminated an agreement to compromise a taxpayer's liability. As of October 25, 2006, the IRM available to the public in the electronic reading room did not include the new section.<sup>28</sup> As a result, taxpayers who do not know about these processes are likely to have more difficulty getting offers reinstated than other taxpayers who have somehow learned about them.<sup>29</sup>

#### *Multiple IRM Versions May Confuse IRS Employees*

Some IRS employees may have difficulty figuring out what guidance to follow when various versions of the IRM appear to conflict. Although most IRS employees who regularly use sections of the IRM that appear in SERP know to check the SERP IRM, some others may not. The result may be that some will not follow proper procedures.

<sup>25</sup> IRM 1.11.7.8 (Jun. 1, 2006). Changes to the SERP IRM that are not reflected in the official IRM appear in yellow on the SERP IRM. IRM 1.11.7.9.1 (Jun. 1, 2006).

<sup>26</sup> The official IRM is supposed to be kept up to date and printed for employees on a quarterly or yearly basis. IRM 1.11.7.9 (Jul. 28, 2006). The IRS made 711 updates to the SERP IRM between October 2005 and July 2006. Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (Jul. 11, 2006).

<sup>27</sup> Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (Jul. 11, 2006).

<sup>28</sup> The official IRM section 5.19.7 was shown as having been updated most recently on February 1, 2004. Similarly, on July 21, 2006, the IRS published rewritten IRM sections on SERP describing audit reconsideration procedures (section 4.13), but as of October 12, 2006 the official IRM available on IRS.gov still reflected the procedures adopted on February 1, 2003. On October 25, 2006, TAS noticed that section 4.13 was reflected in the official IRM with an October 1, 2006 revision date.

<sup>29</sup> At least one practitioner sought TAS's assistance in getting a taxpayer's offer reinstated solely because other IRS employees were unaware of the correct procedure for having offers reinstated. Had this section of the SERP IRM been available to the public, she would have been able to assist her client more effectively without TAS's assistance.

To make matters worse, the IRS intranet (the IRS employees-only network) includes an “IRM Online,” yet another version of the IRM, in a searchable web-based format.<sup>30</sup> The IRM Online does not include interim guidance posted to SERP unless it is generated using certain software.<sup>31</sup> The IRS estimates that only 25 percent of the interim guidance on SERP is generated using such software.<sup>32</sup> Thus, some of the interim guidance reflected on SERP will be reflected in IRM Online, but most will not. To the extent such inconsistencies confuse IRS employees, causing some to use different procedures than others, similarly situated taxpayers may be treated differently.

#### *IRS Does Not Always Disclose Interim Guidance Memoranda*

The IRS’s new policy of posting interim guidance to the electronic reading room has been difficult to implement. The IRS estimated that roughly 122 interim guidance memos were issued during calendar year 2004, but as of November 2005 only one had been posted.<sup>33</sup> The IRS later determined to post at least 18 of the memos issued in 2004.<sup>34</sup> A Taxpayer Advocate Service (TAS) comparison of interim guidance memoranda available on the IRS intranet and interim guidance available in the electronic reading room suggests that the IRS is posting much more of its official interim guidance memoranda.<sup>35</sup>

Nonetheless, some IRS business units still have not completed the process of developing standard procedures for posting all required interim guidance memos.<sup>36</sup> TAS identified

<sup>30</sup> Another version of the IRM, which includes PDF files of a hard copy of the IRM, is available on the IRS intranet as part of the Electronic Publishing Catalog. According to the IRS, the IRM published on the Electronic Publishing Catalog is the source document for delivery of two additional IRM applications: SERP and IRM Online. The IRS indicates that *except for the interim procedural updates made to the IRM sections on SERP*, all three of these products originate from the same source documents, only the platform on which they are delivered is different. We refer to these IRM sources as different “versions,” however, because if one source of the IRM contains different information than another, as the IRS indicates they do, most people would perceive them to be different versions.

<sup>31</sup> Office of Servicewide Policy, Directives and Electronic Research, *Response to TAS Information Request* (July 11, 2006).

<sup>32</sup> *Id.*

<sup>33</sup> Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), *Response to TAS Information Request* (Jul. 11, 2006) (noting that IRS estimated 122 were issued in 2004); Servicewide Policy, Directives and Electronic Research IMD Oversight Council Meeting Minutes (Nov. 16, 2005) (noting that only one had been posted to IRS.gov, but that many were available on the intranet).

<sup>34</sup> Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), *Response to TAS Information Request* (Jul. 11, 2006).

<sup>35</sup> The IRS Criminal Investigation (CI) intranet site is available to CI employees only. Information received from CI in response to TAS’s information request to CI on June 6, 2006 is not conclusive. As a result, we have not determined if CI has improved its compliance.

<sup>36</sup> For example, the Large and Midsized Business Operating Division is in the process of developing such procedures. LMSB, Director, Performance, Quality and Audit Assistance, *Response to TAS Information Request* (Aug. 14, 2006). TAS is also working to develop and implement such procedures. The Small Business/Self-Employed Operating Division, however, has a very well organized intranet website for interim guidance.



a number of important memos that the IRS did not timely post to the electronic reading room.<sup>37</sup> For example:

**Example 1.** On March 2, 2006, the Appeals function issued interim guidance to modify procedures described in IRM 4.51.4 by expanding the Fast Track Settlement (FTS) process for use in the Large and Mid-Sized Business Division's (LMSB's) pre-filing Compliance Assurance Process (CAP).<sup>38</sup> Although some of the information in the interim guidance had been made public, some had not.<sup>39</sup>

**Example 2.** On December 16, 2005, Appeals issued interim guidance to implement the Treasury Inspector General for Tax Administration's (TIGTA's) recommendation to inform taxpayers of their rights and the conditions of the FTS program before they apply for it.<sup>40</sup> While such rights and conditions are already available to the public, the premise of TIGTA's recommendation was that taxpayers were not always aware of them.

**Example 3.** On October 5, 2005, the Small Business and Self Employed Division's (SB/SE) Examination function issued interim guidance to clarify existing procedures and revised the form letters that the IRS would use in situations where the

<sup>37</sup> In response to TAS's inquiry, SB/SE identified 16 additional interim guidance memoranda that had not been posted, and has committed to more timely posting such memos in the future. SB/SE Management and Program Analyst, *Response to TAS Information Request* (Sept. 20, 2006). The E-FOIA statute does not directly address when "instructions to staff" must be available to the public except to say that an index of such materials must be published "quarterly or more frequently." See 5 USCA § 552(a)(2) (flush). Since Interim Guidance expires within a year, it would be pointless to post it after more than a year. We understand the IRS's policy of not posting Interim Guidance in force for less than three months is based on the notion that, in light of the quarterly indexing requirement and the size of the IRS, it would be unrealistic to require the IRS to post guidance more frequently than every three months. Thus, we use the term "timely" to refer to Interim Guidance that is available to the public within three months.

<sup>38</sup> Memorandum for Director, Field Operations, East, Director, Field Operations, West, Director, Technical Guidance, and Director, Appeals Processing Services, from Diane S. Ryan, Director, Technical Services, *Compliance Assurance Process - Fast Track Settlement* (Mar. 2, 2006). This guidance was not on IRS.gov as of August 4, 2006. Appeals has now posted this guidance. The CAP is a process that taxpayers may use to resolve issues arising in connection with a return before it is filed and FTS is a form of alternative dispute resolution.

<sup>39</sup> See Announcement 2005-87, 2005-50 I.R.B. 1144 (noting that FTS may be available in CAP, but providing few details).

<sup>40</sup> Memorandum for Director, Field Operations, East, Director, Field Operations, West, Director, Technical Guidance from: L. P. Mahler, Director, Technical Services, *Interim Guidance: TIGTA Report on the Independence of Appeals - Recommendations Specific to Fast Track Settlement* (Dec. 16, 2005). As of August 14, 2006, this item was not on IRS.gov and neither of the IRM sections that were listed as affected by the guidance had been updated. See IRM 4.51.4 (Nov. 15, 2004) and IRM 8.2.1.2.3 (Jun. 20, 2003). Appeals has since posted this guidance.

IRS may need to “bypass” the taxpayer’s representative (*i.e.*, communicate with a taxpayer directly rather than through the representative).<sup>41</sup>

Ensuring that interim guidance gets posted to the Internet may not be a top priority for some IRS managers who have limited resources and are often trying to focus on more pressing tax administration issues. In fact, TAS itself recently recognized the need to improve its internal procedures in this regard. However, Congress has determined that FOIA compliance must be a priority for all agencies because transparency is an essential component of good government.

#### *Instructions to Staff Sometimes Remain Unapproved and Undisclosed*

Another barrier to transparency is that IRS managers sometimes issue instructions to staff that are not timely signed and approved by these managers or any senior manager or executive. The nondisclosure of such instructions raises the same concerns as the nondisclosure of instructions that are approved. As noted above, since November 2004, the group of offer in compromise (OIC) specialists that is supposed to process all of the offers based on equity and public policy has been using unofficial, unsigned, and unpublished internal guidance to determine whether to accept such offers.<sup>42</sup> The IRS failure to publish such guidance, which it has been using for a long period, has likely resulted in inconsistent treatment of similarly situated taxpayers. Qualified taxpayers who know which facts to emphasize (*e.g.*, because they have come to TAS for assistance) may be able to get their offers accepted, while other similarly situated taxpayers who do not know which facts to emphasize may not get their offers accepted.

To be fair, however, when the IRM is incomplete, frontline employees sometimes need immediate guidance to help them do their jobs before higher level managers have an opportunity to approve official interim guidance that can be incorporated into the IRM. This very problem may have led to inconsistent campus procedures, which we identified in last year’s report, as local campus directors established local procedures to fill the void.<sup>43</sup> Thus, as a practical matter, it may be difficult for the IRS to completely eliminate the lag between the time managers provide informal instructions to staff and

<sup>41</sup> Memorandum for Examination Area Directors, from K. Steven Burgess, Director, Examination, *Bypass of Taxpayer Representative* (Oct. 5, 2005). As of October 25, 2006, this item was not on IRS.gov and neither of the IRM sections that were listed as affected by the guidance had been updated. See IRM 4.10.3 (Mar. 1, 2003) and IRM 4.11.55 (Jan. 15, 2005). SB/SE released similar interim guidance for using bypass procedures in Collection cases. See Memorandum for Directors, Collection Area Operations, from Cheryl Sherwood, Director, Collection Policy, *Interim Guidance - Bypassing of Taxpayer’s Representative* (Dec. 23, 2005). As of August 14, 2006, this memo was available on IRS.gov, but was removed when it was incorporated into IRM 5.1.1.7.

<sup>42</sup> SB/SE, Collection Policy, *Non-Hardship ETA* (first circulated in October or November 2004); SB/SE, Collection Policy, *Offers In Compromise, Additional Guidance Regarding the Use of “Non-Hardship” Effective Tax Administration OICs* (first circulated in September 2005).

<sup>43</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 132-142 (Most Serious Problem: Inconsistent Campus Procedures); IRM 3.12.251.1.6 (Jan. 1, 2006) (referencing local procedures). In addition, SBSE recently published training materials for instructors, telling them to incorporate local forms and desk guides into their Centralized Offer in Compromise Process Examiner training. SB/SE, *Instructor Guide, Centralized offer in Compromise (COIC), Process Examiner CPE*, Catalog Number 48482G (April 2006).

when such instructions are approved and made available to the public on the Internet. However, the IRS must be particularly diligent in reducing that period with respect to guidance that, if not disclosed, could result in disparate treatment of similarly situated taxpayers.

Along the same lines, the National Taxpayer Advocate is concerned that the IRS Office of Chief Counsel may sometimes render potentially significant legal advice by email, rather than by memo.<sup>44</sup> She is concerned that legal advice rendered by email is less likely to be subject to appropriate internal review and disclosure procedures.

#### *Guidance to “Clarify” the IRM Not Always Incorporated into the IRM*

The IRS has many job aids, desk guides, training materials, and similar documents on its intranet that have not been incorporated into the IRM. For example, like many campus functions, the Accounts Management function in the Ogden Campus has a voluminous Desk Reference Guide (DRG), which is filled with clarifying procedures, on its intranet. As each section of the DRG states, “DRGs supplement the IRM by providing the ‘how to’ not contained in the IRM. They consolidate information contained in multiple chapters/IRMs and provide local procedures when instructed by the IRM.” Job aids, desk guides, and training materials exist to help employees make better decisions. Although some information in these materials might be required to be available to the public under E-FOIA, most is probably not required to be available to the public either because it does not directly “affect a member of the public” or because it simply reproduces information already available to the public.<sup>45</sup>

IRS policy, however, requires all instructions to staff that may be contained in job aids, desk guides, web sites, documents, or any other sources to be incorporated into the IRM.<sup>46</sup> If these materials are not incorporated into the IRM, IRS management will find it very difficult to comply with E-FOIA because the agency will not have a central repository of instructions to staff that it can publish and monitor. Further, if the IRM is unclear or confusing, or not reflective of current procedures, and only some IRS employees receive clarifying guidance, the IRS and taxpayers will not reap the benefits of transparency and the purposes of the FOIA will be frustrated.

#### *Disclosure Policy Applicable to Local Procedures Easily Misinterpreted*

IRS employees may fail to disclose important procedures based on the impression that they do not need to post “local” procedures, such as campus procedures, to the elec-

<sup>44</sup> See *Tax Analysts v. Internal Revenue Service*, 416 F. Supp.2d 119 (D.D.C. 2006), *appeal pending*, No. 06-5136 (D.C. Cir.). According to the IRM, significant advice should be issued “in writing.” IRM Exhibit 33.1.2-1 Q&A #5 (Aug. 11, 2004).

<sup>45</sup> An exhaustive review of all such material is beyond the scope of this report.

<sup>46</sup> Memorandum from Bob Wenzel, Deputy Commissioner Operations for Division Commissioners, Chiefs, Assistant Commissioners, National Directors, National Taxpayer Advocate, *Issuing and Controlling Interim Procedures* (Aug. 15, 2000); IRM 1.11.2.1 (Oct. 1, 2005).

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tronic reading room.<sup>47</sup> As noted above, IRS policy only requires interim guidance that is “national in scope” to be posted to the electronic reading room on IRS.gov.<sup>48</sup> This local guidance exception could easily be misinterpreted.

Since current IRS procedures do not clearly require “local” guidance to be posted on the electronic reading room, the IRS may not post its campus procedures unless they are ultimately incorporated into the IRM.<sup>49</sup> Further, if the local guidance exception is misinterpreted as applying to all campus procedures, the IRS is likely to become less and less transparent as it centralizes national functions to “local” campuses.

As an example, consider the discussion of Appeals Campus Centralization in the National Taxpayer Advocate’s 2005 Annual Report to Congress.<sup>50</sup> In that report, the National Taxpayer Advocate discussed Appeals campus procedures that were only known to her because of descriptions available in internal IRS documents. In its response to the report, Appeals indicated that it was following different procedures than those described by the National Taxpayer Advocate.

If even the National Taxpayer Advocate, who has access to many internal IRS documents, does not have access to current IRS procedures, the IRS will not receive the benefit of any feedback regarding those procedures from the National Taxpayer Advocate, much less the public.<sup>51</sup> Such secrecy may also harm taxpayers if it makes TAS less effective in helping them to navigate the IRS when normal IRS procedures break down. Moreover, if those procedures are not available to the public, taxpayers represented by practitioners who have recently worked in IRS campus operations may be able to obtain better results for their clients than other practitioners.

<sup>47</sup> IRM 1.11.2.11 (Oct. 1, 2005) (authorizing local procedures that do not contradict or duplicate IRM procedures). See also IRM 3.12.251.1.6 (Jan. 1, 2006) (authorizing Campus Submission Processing managers to promulgate local “Desk Procedures,” which are not incorporated into the IRM).

<sup>48</sup> Memorandum from Susan B. Novotny, Director, Servicewide Policy, Directives and Electronic Research for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility, *Interim Guidance and the Freedom of Information Act (FOIA)* (April 6, 2005); IRM 1.11.1.9.1 (Oct. 1, 2005).

<sup>49</sup> *Id.*; IRM Exhibit 1.11.2-1 (Oct. 1, 2005). The IRM provides “local procedures may be issued to meet office needs, the needs of a specific group of taxpayers, or the culture of the taxpayer base, as long as they supplement and support prescribed IRM procedures.... Local procedures should be communicated through email, posted on a bulletin board and/or placed on local office websites.” IRM 1.11.2.11 (Oct. 2, 2005).

<sup>50</sup> National Taxpayer Advocate 2005 Annual Report to Congress 136-161.

<sup>51</sup> On May 10, 2006, we found a document entitled “Campus Appeals - Field Counsel Fresno ‘S’ Case Procedures” dated Aug. 12, 2004, on Appeals’ intranet site, which we could not locate on IRS.gov. Under current IRS procedures, it may not be clear that this document must be available to the public because it may appear to be local in scope. However, it includes “instructions to staff that affect a member of the public” and that practitioners would find informative. For example, it says that if the taxpayer desires a face-to-face conference with an Appeals Officer, the Fresno Campus Appeals Office will transfer the case to the local Field Appeals Office so that a conference can be held. Moreover, it affects taxpayers nationwide.

*The IRS Does Not Post Interim Guidance that Needs to be Redacted*

The IRS does not post to its website interim guidance memos that contain any “official use only” (OUO) material because it has no redaction process for interim guidance.<sup>52</sup> According to the IRS, about 14 percent of all IRM sections, representing about 32 percent of the IRM’s pages, have been designated as OUO, which is not publicly available.<sup>53</sup> The absence of any redaction process could thus prevent a significant amount of important guidance from being available to the public as contemplated by the E-FOIA.

*IRS Does Not Always Publish Changes to Its Published Positions*

The IRS does not always publish memoranda that reflect changes to legal opinions that are available to the public.<sup>54</sup> As an example, in late 2004 and early 2005, the Office of Chief Counsel drafted a series of memoranda recommending that the IRS update the IRM to revise the discussion of how the statute of limitations period should be applied to an injured spouse claim for refund. Although the SERP IRM was apparently updated on October 1, 2006 to reflect Counsel’s most recent advice, as of November 1, 2006 the IRM available to the public had not been updated.<sup>55</sup> Further, the Counsel memoranda were not released to the public even though they made a publicly available General Counsel Memorandum, GCM 39542 (July 30, 1986), obsolete.<sup>56</sup>

As a result of this particular nondisclosure regarding the period for claiming injured spouse relief, some taxpayers may have wasted the time and expense of making untimely claims for refund. Others may have had their untimely claims processed because IRS employees were not aware of Counsel’s revised legal analysis. The IRS’s failure to publicize its most current legal analysis may cause both taxpayers and IRS employees to continue to rely on the obsolete legal analysis contained in the publicly available

<sup>52</sup> IRM 1.11.1.9.1 (Oct. 1, 2005). Redacted interim guidance memos may be available in the IRS’s physical reading room. Unfortunately, the physical reading room has been closed for the last few months due to a June 2006 flood in the IRS headquarters building.

<sup>53</sup> Deputy Director, Office of Servicewide Policy, Directives and Electronic Research (SPDER), Response to TAS Information Request (Nov. 14, 2006).

<sup>54</sup> IRC § 6110 mirrors FOIA by requiring the IRS to make “written determinations” (*i.e.*, letter rulings, determination letters, technical advice memorandum, and Chief Counsel Advice) available to the public; but, unlike FOIA, section 6110 specifically allows the taxpayer who is the subject of these documents to participate in the redaction process. The IRS routinely makes these written determinations available to the public.

<sup>55</sup> IRM 21.4.6.5.9.8 (Oct. 1, 2006). IRM 21.4.6.5.9.8 will not be available to the public electronically because it is part of IRM 21.4.6, which contains sections designated as OUO. However, we understand that IRM 21.4.6.5.9.8 will be available in the physical FOIA reading room at the main IRS building once that building reopens. It is currently closed due to flooding in the basement.

<sup>56</sup> These memoranda were not released to the public because advice from the National Office of the Office of Chief Counsel to national program managers is not required to be made available to the public under IRC § 6110. *See generally*, IRC § 6110(i)(1)(A); IRC § 6110(i)(3)(B). However, such advice might be subject to disclosure upon request. *See Tax Analysts v. Internal Revenue Service*, 294 F.3d 71 (D.C. Cir. 2002), *on remand*, No. 1:96-cv-02285-CKK (D.D.C. Aug. 21, 2002). Although the IRS has not adopted any procedure for releasing such memoranda, in late September, 2006 it began to post in its electronic reading room, on a going-forward basis, certain legal advice signed by executives in the National Office of the Office of Chief Counsel and issued to national program managers. For a discussion of such legal advice, *see* Notice CC-2006-013 (May 5, 2006).

GCM that was no longer current.<sup>57</sup> Even though the IRS will eventually update the IRM available to the public (even if only in its physical FOIA reading room), to reflect its revised legal conclusions, the unexplained conflict between the analysis contained in the public GCM and conclusions in the IRM (once it is available to the public) could lead to confusion and litigation. Thus, in order to avoid confusion and inconsistent treatment of similarly situated taxpayers, unless there is a compelling reason for nondisclosure, the IRS should immediately let the public know when it discovers the public legal analysis by its attorneys is incorrect or misleading by releasing the revised analysis to the public. If such disclosure is not required, the IRS should use its authority to voluntarily disclose the revised analysis.

#### *No Formal Procedure for Voluntary Disclosure of Legal Analysis*

The IRS has not, however, established a process that allows IRS attorneys to determine, on a case by case basis, whether to make legal analysis available to the public voluntarily. For example, although the author of the memoranda described above, pertaining to the period for claiming injured spouse relief, could have elevated the matter through the Counsel organization and suggested the IRS issue a notice or other public pronouncement, there is no internal process for disclosing the memoranda.<sup>58</sup> While there is a process for the IRS to make discretionary disclosures in response to FOIA requests, on April 8, 2005, the IRS Office of Chief Counsel issued a notice stating that it had determined, under its discretionary authority, not to release any documents pertaining to published guidance, statements of policy, instructions to staff, or written determinations, “except in extraordinary circumstances after receiving an appropriate level of review.”<sup>59</sup>

#### *Amount and Significance of Undisclosed Legal Analysis Unknown*

The magnitude of any potential tax administration problem posed by undisclosed legal memos depends on the content and number of undisclosed memos at issue. TAS asked the Office of Chief Counsel for a small sample of recent undisclosed memos to national program managers and an estimate of how many exist. The Office of Chief Counsel declined to provide them, citing mainly logistical obstacles to locating the memos.<sup>60</sup> For the same reasons, it declined to estimate the number of undisclosed memos. TAS followed up by proposing a simpler method of gathering a small sample of these memos

<sup>57</sup> Written determinations released pursuant to IRC § 6110 may not be cited as precedent. IRC § 6110(k)(3). Nonetheless, the citations and analysis contained in such documents are often used by lawyers inside and outside the government as a shortcut to reach legal conclusions by applying the same analysis, and as an indication of the views of the government attorneys who wrote and reviewed them.

<sup>58</sup> There are, however, procedures for announcing changes to litigating positions (*see* IRM 36.3.1.10 (Aug. 11, 2004)) and for changes to longstanding advice (*see* IRM 33.2.1.4 (Aug. 11, 2004)). But these procedures do not specifically address how such changes should be made available to the public.

<sup>59</sup> Chief Counsel Notice CC-2005-005 (Apr. 8, 2005); IRM 11.3.13.7.2.5(6)-(10) (Jan. 1, 2006). This notice implemented the IRS’s revised discretionary disclosure policy statement to provide that discretionary disclosures should be made only after “full and deliberate consideration.” Policy Statement 11-13 (Apr. 23, 2004).

<sup>60</sup> Office of Chief Counsel, *Response to TAS Information Request* (Oct. 30, 2006).

and asked Counsel to propose any reasonable alternative method it would prefer. The Office of Chief Counsel still declined to provide them. Thus, the National Taxpayer Advocate has not been able to determine whether, or to what extent, legal advice on material tax law or procedural issues has been provided out of public view or to form an opinion about whether tax administration would benefit from the disclosure of such advice.

### CONCLUSION

Given the size of the IRS and the vast body of legal and procedural guidance that it issues daily, the IRS faces formidable challenges in complying with the disclosure mandates imposed by the FOIA and IRS policies. Indeed, the IRS does make a significant amount of information available to the public, and it has taken steps to improve its transparency in recent years. However, the IRS can and should do better. Transparency in tax administration is essential for purposes of assuring taxpayers that the laws are being administered fairly. Taxpayers and their representatives need to know what standards IRS personnel are applying in order to demonstrate or achieve tax compliance. IRS employees, taxpayers, and practitioners all need to know which procedures and guidance are the most current. For these reasons, the National Taxpayer Advocate believes transparency issues merit further attention.

### IRS COMMENTS

The IRS is committed to improving the way it manages instructions to staff. We acknowledge we have experienced growing pains as we have moved towards electronic creation and delivery of the plethora of instructions to staff we produce.

It is the goal of the IRS to use the Internal Revenue Manual (IRM) as the primary source of agency procedures and guidance to ensure fair and consistent application of the nation's tax laws, as well as fair and consistent treatment taxpayers. The IRM ensures the public at large and all IRS employees have one set of procedures. It also ensures that we are transparent in our operations.

Instructions to staff are written for the express purpose of providing consistent policies, procedures, and guidelines to be followed by employees. By using the IRM as a central repository for instructions to staff, a foundation is established for fulfilling legal obligations to preserve and document agency directives, decisions, procedures, etc., required by, for example, the U. S. Code (44 USC § 3101), Code of Federal Regulations (36 CFR § 1222), and the Freedom of Information Act (5 USC § 552). The IRS believes that the use of a centralized repository (the IRM) is evidence of our commitment, which goes beyond statutory obligations. Our response describes the improvements we are actively pursuing to satisfy all of these requirements while at the same time delivering an IRM that for employees is a reliable source of instructions for how to perform their jobs.

## PROBLEMS

All organizations in the IRS, including the Taxpayer Advocate Service, are expected to properly manage the issuance of instructions to staff according to the established policy. This includes (1) using the IRM as the primary source of IRS instructions to staff; (2) converting memorandums, e-mails, and other communications immediately into the appropriate IRM section; (3) establishing a skilled and trained cadre of IRM authors; and (4) devoting the resources to updating the IRM so that it reflects how the IRS really operates.

The IRS agrees that it can do better in making its instructions to staff available to the public. The National Taxpayer Advocate reinforces the value of the IRM by identifying “transparency of IRS operations” as one of the “most serious problems” (MSPs) in her annual report to Congress. This is a timely reminder that the IRM remains the best way to be “transparent” in our operations. It also highlights that IRS employees are not the only ones who look at the IRM. It is widely used by practitioners, taxpayers, state agencies, and even foreign governments to understand how the IRS carries out its tax administration responsibilities.

The National Taxpayer Advocate’s report reaffirms the IRS efforts to more strategically manage issuance of instructions to staff. In 1999, to establish a strategic approach and reaffirm the IRM as the primary source of the agency’s policies, procedures, guidelines, and delegations, the Office of Servicewide Policy, Directives, and Electronic Research (SPDER) was created to manage and modernize the internal management documents process in IRS. The SPDER office provides oversight of the IRM process, coordinates cross functional decisions regarding IRM activities, and sets guidelines for controlling the issuance of instructions to staff outside of the IRM. The operating divisions are responsible for preparing and issuing instructions to staff, including incorporating into the IRM any policy, procedures, and guidelines issued in the form of memos, desk guides, e-mail, and intranet web sites.

Beginning in 2000, the IRS has communicated the requirements for managing procedures and guidance. Executives in the major business units have been reminded of the importance of the IRM as the official source of instructions to staff. Training and outreach has been conducted for authors and managers, and memoranda and instructions have been issued to ensure interim guidance is included in the IRM. Footnotes in the National Taxpayer Advocate’s report, in fact, identify many of the internal communications that have been issued on this subject.

Since 2004, a concerted effort has been made to increase Servicewide awareness of the FOIA requirements of making available to the public any administrative staff manuals and instructions to staff that affect a member of the public. The following are actions the IRS has taken:

- ◆ **May 2004** – Initiated a task force with Governmental Liaison and Disclosure (GLD) and the Business Operating Divisions on actions to meet FOIA requirements.



- ◆ **October 27, 2004** – Issued a joint memorandum with SB/SE Communication and Liaison for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility on the requirement to make interim directive memoranda available to the public as required under the FOIA.
- ◆ **April 6, 2005** – Issued a memorandum for Division Commissioners, Chiefs, National Taxpayer Advocate, Chief Counsel, Director, Office of Research Analysis and Statistics, Director, Office of Professional Responsibility providing guidance and procedures on electronic public availability of instructions to staff including interim guidance meeting the FOIA requirements.
- ◆ **October 1, 2005** – Revised IRM 1.11.1, Internal Management Documents to include procedures on FOIA requirements for making instructions to staff including interim guidance available electronically to the public.
- ◆ **March 2005 to present** – Conducted training, outreach and presentations to the Business Operating Divisions and Functions on the FOIA requirements.

As of November 2006, most of the business units have developed and implemented internal standard procedures for posting interim guidance memoranda, conducted training and workshops on the FOIA and the requirements for electronic availability. The IRS has made progress on the transparency of interim guidance since the 2005 process was established. As of November 2006, 41 interim guidance memoranda were posted on IRS.gov.

Each business unit has indicated it has either posted identified interim guidance memoranda in the electronic reading room or are in the process of doing so. SPDER will ensure the identified guidance is appropriately disclosed or incorporated into an IRM and that training and outreach will be conducted. Beginning FY 2007, we will monitor the interim guidance issued by each business unit to ensure it gets posted to IRS.gov. SPDER will be working with each business unit to provide greater attention to the importance of transparency, including conformance with the FOIA law, and to ensure the IRM is the central official repository of procedures of the IRS.

The IRS has demonstrated that progress is underway to improve the way we manage instructions to staff and to restore the IRM as our primary source of these instructions. We are also taking steps to address other inconsistencies in our processes that we have recognized as barriers.

- ◆ The disclosure policy applicable to local procedures can be easily misinterpreted. We intend to issue a clarification to the exception of local procedure. Although the issuance of local procedures is minimal and discouraged, clarification will be obtained early in fiscal year 2007 to ensure local procedures are appropriately transparent.

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- ◆ A new process for posting redacted interim guidance issued by the business units has been established. A memorandum will be issued in December 2006, and incorporated into the applicable IRMs clarifying this process. Training and outreach will be conducted to support this newly established process in fiscal year 2007. Once completed, redacted guidance will be posted to the electronic reading room on IRS.gov.
- ◆ We eliminated multiple unofficial IRM sources by establishing the IRS corporate publishing repository version as the official IRM. From that official source file in the Media and Publications repository, the IRS now distributes the IRM through two internal delivery methods and one external delivery method: (1) IRM sections in PDF; (2) a web based product known as “IRM Online” that includes interactive links to IRM sections and IRS forms; and (3) an HTML version for IRS.gov.
- ◆ SERP is a customized tool for the accounts management assistors. The IRM on SERP begins from the IRS corporate repository. SERP updates and Submission Processing Hot Topics are issued solely to quickly disseminate evolving guidance to employees who are frontline assistors to taxpayers or processing tax returns. These “interim” instructions are to be incorporated into the IRM within a year of issuance, which generally is the next filing season update. An analysis for FOIA applicability of SERP IRM updates and Submission Processing Hot Topics is being conducted and a methodology for public access is being considered. SPDER will begin monitoring SERP IRMs and Submission Processing Hot Topics over one year old and providing appropriate non-compliance reports to management.
- ◆ SPDER has initiated long-term process improvements to eliminate the lag between the time instructions to staff are provided and when such instructions are officially available to the public on the internet. This includes: (1) IRM process redesign project to address this technological gap of officially publishing procedures as soon as procedures are approved, (2) creation of an electronic clearance process to address the issue of length of time of paper clearance, and (3) establishing an improved web-based IRM for use by employees.

In conclusion, it is the goal of the IRS to use the Internal Revenue Manual (IRM) as the primary source of agency instructions to staff and to reduce reliance on other internal dissemination methods. We have made great progress since the 2000 reorganization and will continue to do so. Through the IRM, the IRS will continue to ensure the timely issuance, and public availability, of instructions to staff.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate commends the IRS, and especially SPDER, for the steps it has taken to improve disclosure of instructions to staff and to address the concerns identified in the report. She agrees that the IRS has made significant progress since 2000. Most of the actions the IRS is taking to address the National Taxpayer Advocate's concerns, however, are being taken by SPDER, rather than by other IRS business units, which are in a better position than SPDER to identify their unpublished instructions to staff that affect the public. Mere memoranda alone will not make guidance public; what is required is the personal commitment of each IRS executive. As a start, the National Taxpayer Advocate recommends that each head of office have a specific annual performance commitment and goal to achieve greater transparency with respect to instructions to staff.

Like other IRS business units, the Taxpayer Advocate Service (TAS) has, in the past, not given enough attention to transparency issues. However, TAS recently developed detailed internal procedures for promptly issuing instructions to staff in the form of interim guidance memoranda and then promptly posting those memoranda to the electronic reading room on IRS.gov. If there is any doubt about whether instructions should be issued in the form of an interim guidance memo or another communication vehicle, TAS will generally issue an interim guidance memo. If there is any doubt as to whether an interim guidance memo should be posted, TAS will generally post it. Because of the uncertainty caused by the local guidance exception, TAS will not use that exception, *i.e.*, it will post even local guidance if it may affect the public. TAS has also recently reviewed existing unpublished interim guidance and has posted (or is in the process of posting) those items identified as possibly affecting the public.

The National Taxpayer Advocate invites other IRS business units to follow her lead to ensure not only that they are complying with the law, but also that all employees are using the same procedures and all taxpayers face a level playing field in their dealings with the IRS. Such transparency may also enable them to receive constructive feedback from practitioners and other interested parties in a timely fashion when they adopt new procedures.

The National Taxpayer Advocate is concerned that some IRS business units may view transparency as SPDER's responsibility rather than their own. For example, as of this writing, although SB/SE has received and had the opportunity to comment on this report, it has still failed to post its guidance to the group of employees charged with evaluating all offers in compromise based on effective tax administration, which was first provided as instructions to employees in 2004.<sup>61</sup> In fact, the National Taxpayer Advocate has learned that SB/SE also recently declined to release this guidance in

<sup>61</sup> On December 11, 2006, after these comments were completed, the National Taxpayer Advocate received a signed memo containing the guidance. Memorandum For Directors, Collection Area Offices, From Director, Collection, *Guidance Regarding "Non-hardship" Effective Tax Administration Offers in Compromise* (Nov. 30, 2006). We commend the IRS for finally issuing this memo, which was posted on IRS.gov in late December.

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response to a specific FOIA request from a practitioner. One consequence of SB/SE's failure to make these instructions to staff available to the public is that Appeals and Compliance employees now appear to be applying different versions of the guidance. Although Compliance has recently updated its version of the guidance in response to concerns raised by the National Taxpayer Advocate, Appeals appears to be using an older and more restrictive version of the guidance. As a result, the Appeals process is useless for many taxpayers because Appeals is applying a different and stricter standard than Compliance. When advocating for taxpayers whose offers should be accepted under Compliance's revised guidance, TAS has to try to get the cases reconsidered by Compliance rather than by Appeals. Since Compliance employees do not normally reach a different conclusion in a given case without direction from above, each case has to be elevated to a very high level to be resolved and taxpayers who do not come to TAS are at a distinct disadvantage. Such efforts, which are necessary, in part, because SB/SE has neglected to make its guidance available to the public, are a significant waste of resources.

In addition, the IRS response does not address what IRS business units plan to do to ensure instructions to staff that are being used by IRS employees do not remain unapproved for extended periods of time. Nor does it address how the IRS plans to ensure that its voluminous job aids, desk guides, and similar information are incorporated into the IRM as required by IRS policy.

Further, the IRS's comments do not provide any additional explanation for the Office of Chief Counsel's lack of transparency with respect to potentially significant e-mail, as well as technical advice memos to national program managers that may be inconsistent with advice that is publicly available. Nor has the Office of Chief Counsel agreed to make any additional changes to its policies or procedures as a result of the issues raised in the report.

As noted in the report, the IRS takes the position that it is not legally required to disclose certain legal advice from a national office component of the Office of Chief Counsel to other IRS employees in the national office, including national program managers. It is easy to imagine that undisclosed legal memos from Chief Counsel attorneys in the national office to national program managers frequently involve issues of significant importance that affect many taxpayers. As discussed above, for example, the IRS recently changed its policy for computing the period of time within which a taxpayer must file an injured spouse claim and allocation. While the policy itself has been incorporated into the IRM, the basis for computing the time period is not explained in the IRM and the Office of Chief Counsel has refused to disclose a legal memorandum that explains the basis for the change in policy and the way the time period should be computed. Further, the undisclosed memo's analysis and conclusion contradict the analysis and conclusions contained in a public GCM that the IRS has not publicly obsoleted or revoked. Thus, taxpayers who seek injured spouse relief -- and practitioners who might represent such taxpayers -- lack important information that would assist them.

More fundamentally, the National Taxpayer Advocate is deeply concerned about the refusal of the Chief Counsel to allow her staff to review samples of recent legal advice to national program managers that has not been released to the public. As a consequence of real and perceived enforcement abuses in the 1990s, Congress created the position of National Taxpayer Advocate in its current form and directed the National Taxpayer Advocate to report directly to the tax-writing committees each year on problems encountered by taxpayers. At the time, there were serious discussions about whether to place the Advocate's position inside or outside the IRS, and among the chief perceived benefits of placing the Advocate within the IRS was to enable the Advocate to have access to internal IRS information.

Since the Office of the Taxpayer Advocate "stood up" in 2000, this is the first instance of which we are aware in which an IRS function has flatly refused to provide information requested by the Advocate to prepare her annual report to Congress. The effect of this refusal is to thwart congressional intent in seeking a taxpayer perspective on potential problems within the IRS. Without the ability to review the documents in question, the Office of the Taxpayer Advocate cannot fulfill its statutory mission of determining whether the Office of Chief Counsel's policies have harmed taxpayers.<sup>62</sup> As a consequence, Congress is being left in the dark, and taxpayers are being harmed.

<sup>62</sup> The Office of Chief Counsel justified its refusal to provide TAS with access to these documents on the ground that there is pending litigation with Tax Analysts, the publisher of Tax Notes Today, over whether some of the documents are required to be disclosed under FOIA. We find this justification unpersuasive for two reasons. First, the Tax Analysts lawsuit was instituted in 1996, so Counsel's justification effectively means that TAS would never have been entitled to determine whether Counsel's policy of keeping this guidance secret is harming taxpayers. Second, TAS offered in advance both (1) to avoid describing any memo in detail and (2) to avoid articulating any conclusion about whether it believed any document we reviewed was subject to disclosure under FOIA. We agreed to describe solely the nature of the documents and to discuss solely whether we believe the documents should be available to taxpayers as a normative matter and without regard to FOIA. On November 3, 2006, we made our final request as follows:

TAS is asking to review a representative sample of memoranda or other written legal advice or guidance issued by the National Office of the Office of Chief Counsel to IRS national program managers or industry directors over the past year or so that has not already been released to the public. This request is made without regard to whether the guidance is the subject of litigation, and we would make clear that any conclusions we draw reflect solely a taxpayer advocacy perspective and not a judgment about whether the guidance is subject to disclosure under existing law. TAS believes a request by the Chief Counsel or his designee to the Associate Chief Counsels for recent memoranda would produce a sufficient sample very quickly. If the specific method we are suggesting is not feasible, we are open to any other reasonable way to arrive at the same result. In our report to Congress, we would describe any documents we review only in general terms, if at all, and we would make clear that our observations relate to what we believe is desirable from a taxpayer advocacy perspective and do not constitute an opinion about whether documents are subject to release under FOIA (which should address Counsel's concern about possible effects of our report on the pending litigation with Tax Analysts).

On November 9, 2006, the Office of Chief Counsel provided the following response:

As we have discussed, the FOIA lawsuit with Tax Analysts over the applicability of the FOIA to written legal advice or guidance issued by the National Office of the Office of Chief Counsel to IRS national program managers or industry directors remains pending before Judge Kollar-Kotelly of the United States District Court for the District of Columbia. Inasmuch as that matter has not been resolved, it would be inappropriate for our office to provide to you the documents you have requested.

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## RECOMMENDATIONS

1. The Office of Chief Counsel should establish a process to allow for prompt disclosure of legal advice or analysis that is not otherwise required to be made available to the public if it is inconsistent with IRS legal analysis that is available to the public.
2. The Deputy Commissioner for Services and Enforcement should issue a memo directing all IRS business units to take steps to eliminate informal procedures and guidance that are being used but are not formally approved or available to the public. Any such instructions to staff that affect the public must be disclosed under FOIA whether or not they are formally signed and approved.
3. The Commissioner of the IRS should establish a time table with specific and realistic goals for when each business unit will have incorporated all training materials, desk guides, job aids and other documents that contain instructions to staff into the publicly available IRM in accordance with IRS policy. Each business unit should be required to report on its progress in achieving these goals as part of its business performance review.
4. SPDER should work with Modernization & Information Technology Services (MITS) and other IRS business units to establish automated or manual procedures to ensure that updates to the SERP IRM are promptly reflected on the IRM that is posted to IRS.gov, IRM-Online, and the IRM found in the Electronic Publishing Catalog.
5. In coordination with the Office of Chief Counsel, SPDER should either eliminate the “local guidance” exception to the requirement to post “instructions to staff” or clarify that it does not apply to any procedures that “affect a member of the public,” especially local instructions that may affect taxpayers nationwide.
6. SPDER should work with MITS and other IRS business units to post portions of the IRM and interim guidance that contain Official Use Only information to the electronic reading room in a redacted form.
7. SPDER should also work with MITS and other IRS business units to reduce the period between the time when guidance is issued and when it is made electronically available to the public.
8. Each IRS head of office should have a specific annual performance commitment and goal to achieve greater transparency with respect to instructions to staff.

According to the IRS comments (above), SPDER has already begun to implement recommendations 4-7. We applaud these efforts and renew our commitment to ensure TAS guidance is quickly available to the public.<sup>63</sup>

<sup>63</sup> For a description of TAS’s interim guidance procedures, see <http://www.irs.gov/foia/content/0,,id=160715,00.html>.

## IRS COLLECTIONS AND LEVIES: DID YOU KNOW?

- ◆ In FY 2006, the IRS reported more delinquent tax dollars as “currently not collectible” than it actually collected on active balance due accounts (TDAs), installment agreement accounts, and offers in compromise (OIC) combined.<sup>1</sup>
- ◆ In FY 2006, the IRS reported over \$16 billion delinquent tax dollars as “not collectible,” over 85 times as many as it accepted via offers in compromise.<sup>2</sup>
- ◆ IRS studies and external experts in collection confirm that collection cases 24 months past due generally yield less than 15 cents on the dollar and after three years are practically uncollectible.<sup>3</sup>
- ◆ As of September 2006, approximately 65 percent of the IRS’s open collection accounts involved tax years over three years old.<sup>4</sup>
- ◆ Of cases in which the IRS issued a final collection notice in FY 2006, approximately 87 percent of individual tax delinquencies totaled less than \$10,000. Of those involving business taxes, 76.2 percent amounted to less than \$3,000.<sup>5</sup>
- ◆ From FY 2000 through FY 2006, the IRS has annually collected less than two percent of the revenue dollars in the “currently not collectible” inventory.<sup>6</sup>
- ◆ As of September 2006, over 779,000 delinquent taxpayer accounts were assigned to the “collection queue” awaiting active assignment to IRS personnel.<sup>7</sup> The Small Business / Self Employed division’s Collection function resolved only 11,399 accounts through accepted offers in compromise (OICs).<sup>8</sup>
- ◆ A recent IRS study indicates that over 40 percent of tax modules associated with rejected and withdrawn offers are ultimately reported as not collectible.

<sup>1</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006) In FY06, approximately \$16.2 billion in balance due accounts were reported as CNC; approximately \$7.2 billion was collected on open balance due accounts and \$7.4 billion was collected through installment agreements, i.e. formal agreements between taxpayers and the IRS to pay delinquent taxes through regularly scheduled periodic payments, usually monthly.

<sup>2</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

<sup>3</sup> IRS/Booz-Allen & Hamilton, *SBSE Collections Quick Hits Approach and Preliminary Findings 30* (Mar. 27, 2001).

<sup>4</sup> IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>5</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

<sup>6</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY-2001 - 2005).

<sup>7</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Apr. 2, 2006).

<sup>8</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

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Of those, 27 percent involving individual taxpayers were in CNC status while the IRS considered the OIC.<sup>9</sup>

- ◆ During FY 2004 and 2005, in cases where the IRS denied taxpayers' requests for installment agreements, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the taxpayers requested the agreements.<sup>10</sup>
- ◆ The number of OICs accepted by the IRS Collection operation (excluding those accepted by the Appeals function) declined by over 69 percent from FY 2001 to FY 2006.<sup>11</sup>
- ◆ A recent IRS study of the OIC program indicates approximately 80 percent of the taxpayers who had their offers accepted remained in compliance with their filing and paying requirements during the five-year post-OIC monitoring period.<sup>12</sup>
- ◆ Another study by the Treasury Inspector General for Tax Administration (TIGTA) confirmed this high degree of compliance during the post-OIC monitoring period, and also found these taxpayers remained in compliance after the monitoring period had concluded.<sup>13</sup>
- ◆ In fiscal year (FY) 2006, the IRS served 3.74 million notices of levy upon third parties, an increase of over 36 percent from FY 2005. The number of notices of levy served on third parties rose by 1,603 percent from FY 2000 to FY 2006. The IRS processed 93 percent of the levies it issued in FY 2006 through the Automated Collection System (ACS).<sup>14</sup>
- ◆ Approximately 84 percent of the levies the IRS issues as part of the automated Federal Payment Levy Program (FPLP) involve taxpayers who are elderly and/or disabled.<sup>15</sup>

<sup>9</sup> IRS, *Analysis of Various Aspects of the OIC Program 9-10* (Sept. 2004).

<sup>10</sup> IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005).

<sup>11</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. (FY 2001 – FY 2006).

<sup>12</sup> IRS, *Analysis of Various Aspects of the OIC Program 6* (Sept. 2004).

<sup>13</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-100, *The Offer in Compromise Program Is Beneficial but Needs to Be Used more Efficiently in the Collection of Taxes 7* (Jul. 17, 2006).

<sup>14</sup> IRS, Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report (Oct. 2, 2006); IRS, Collection Account Report, Field Collection Levies- NO-5000-23-240 (Oct. 2, 2006); IRS, Statistics of Income (SOI), Tax Stats 2005; Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006). FY 2005 data showed 2,743,577 levies were served while FY 2006 showed 3,742,276.

<sup>15</sup> IRS, Wage & Investment Operating Division, *FPLP Monthly Counts CUM* (May 2006).



- ◆ TAS cases involving the IRS's FPLP levies on Social Security benefits increased by 143 percent from FY 2005 to FY 2006.<sup>16</sup>
- ◆ Levy-related cases in TAS have risen by 64 percent from FY 2005 to FY 2006. Almost 65 percent of the taxpayers whose levy cases were closed by TAS in FY 2006 have received relief from their hardship, with almost 56 percent being given full relief (*i.e.*, release or removal from the FPLP process).<sup>17</sup>

<sup>16</sup> Taxpayer Advocate Service, *Taxpayer Advocate Service, Business Performance Review* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security-benefit related cases in TAS and 4,147 for FY 2006.

<sup>17</sup> Taxpayer Advocate Service, *Business Performance Management System* (as of Sept. 30, 2006). For FY 2005, there were 11,477 levy-related cases in TAS and 18,800 such cases in FY 2006. Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2006). These percentages are based on case closures meeting the provisions of IRC § 7811. Specifically, there were 15,818 closures and of these, 10,272 received some type of relief (8,823 were granted full relief and 1,449 partial).

**PROBLEM****TOPIC #4****TRUE COSTS AND BENEFITS OF PRIVATE DEBT COLLECTION****RESPONSIBLE OFFICIAL**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**DEFINITION OF PROBLEM**

In September of 2006, the IRS began assigning taxpayer accounts to private collectors as part of its Private Debt Collection (PDC) initiative.<sup>1</sup> Although the IRS originally planned to assign 40,000 accounts in this first phase (known within the IRS as Release 1.1), fewer cases have been assigned due to a number of complications.<sup>2</sup> In the next phase of the initiative (Release 1.2), the IRS plans to assign approximately 446,000 cases to private collectors over a two and one half year period.<sup>3</sup>

The results of the private collector work on these accounts have been mixed. For example, the IRS assigned approximately \$65 million of inventory (11,500 delinquent accounts) to private collectors with approximately \$1 million collected for the first month.<sup>4</sup> On the other hand, only half of that revenue collected in the first month was commissionable.<sup>5</sup> In other words, the IRS's initial contact of these taxpayers, and not any action on the private collector's part, generated the account resolution.<sup>6</sup> Approximately eight percent of the dollars placed to date have been collected.<sup>7</sup> By design, the first cases assigned to private collectors were the least complicated of the inventory eligible for assignment, and therefore the most likely to result in payment

<sup>1</sup> Three private collectors are being used in this first phase of the initiative: CBE Group Inc. of Waterloo, Iowa; Linebarger Goggan Blair & Sampson of Austin, Texas; and Pioneer Credit Recovery, Inc. of Arcade, N.Y. Internal Revenue Service News Release, IR-2006-42 (March 9, 2006).

<sup>2</sup> The National Taxpayer Advocate understands that these complications include the unforeseen extent of IRS employee involvement in the manual administration of these cases.

<sup>3</sup> These cases will be comprised of 93,000 cases in part of FY 2007 (Jan. through Sept. 30), 138,000 in FY 2008, and 215,000 in FY 2009. Internal Revenue Service, Filing & Payment Compliance (Nov. 30, 2006).

<sup>4</sup> IRS, *Filing and Payment Compliance Briefing Document* 8 (Nov. 1, 2006).

<sup>5</sup> *Id.*

<sup>6</sup> The IRS points out that after the first month the ratio of commissionable to non-commissionable income increased. By the end of October commissionable revenue was approximately \$4.7 million while non-commissionable income was approximately \$884,000. Internal Revenue Service, Filing & Payment Compliance (Nov. 30, 2006). Our point here is that minimal effort by the IRS prior to assignment of the case generated a substantial response from taxpayers. The first 11 days after the assignment of the contract is an important point for comparison. Pursuant to the contracts with the collectors, a payment is non-commissionable if it is received within 11 days of the assignment of the account to the private collector. (see Section 4.1 of contracts with collectors: TIRN-0-06-K00181; TIRN-0-06-K00179; and TIRN-0-06-K00182). After the account is assigned, the private collectors initiate their calling campaigns of taxpayers – thus, it is expected that over time the ratio of commissionable to non-commissionable collections will increase.

<sup>7</sup> As of November 1, 2006, approximately \$73 million had been placed and approximately \$5.5 million has been collected. IRS, *Filing and Payment Compliance Briefing Document* 8-9 (Nov. 1, 2006).

after an initial contact.<sup>8</sup> Yet IRS collection units with less promising inventory experience better collection results than eight percent.<sup>9</sup>

We have previously expressed our serious concerns about the private debt collection initiative as details of the plan evolved. In the 2005 Annual Report to Congress, we stated our concern about the IRS's plan to allow private collectors to train themselves on tax law topics and IRS procedures.<sup>10</sup> As we learned more details of the initiative, it has become clear that much of the rationale underlying the initiative has eroded.

In this report, we look at the central tenets underpinning the IRS's use of private debt collection and ask, in light of what we know now, whether the costs of the initiative outweigh the projected benefits. We are also concerned about the initiative's impact on vital components of our tax administration system, such as customer service, consistent treatment of similarly situated taxpayers, and emphasis on long-term tax compliance. To compound these problems, the IRS advised us that public disclosure of the operational plans and calling scripts of the private contractors is not permitted unless the private collectors consent, thereby making the IRS less transparent and rendering this initiative less accountable. Our conclusion is that this initiative is fatally flawed, risking much for a small return on investment.

### ANALYSIS OF THE PROBLEM

The relatively short history of private collectors in the business of federal tax collection has been tumultuous. The Debt Collection Act of 1982 broadly authorized federal agencies to use private collection agencies but specifically prohibited collection of federal taxes by private collectors.<sup>11</sup> Under a limited initiative authorized by Congress in 1995, the IRS was able to experiment with a limited private debt collection initiative in 1996.<sup>12</sup> In 1997, the IRS discontinued the initiative, primarily because the revenue collected was less than the IRS's direct costs plus the "opportunity costs" that resulted from directing collection resources towards support and monitoring of the private collectors.<sup>13</sup>

<sup>8</sup> Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 (Sept. 29 2006).

<sup>9</sup> For example, the Offer in Compromise Program in the Small Business/Self-Employed Division collected 17 percent of taxes compromised in FY 2006. Collection Activity Report, *Report of Offer in Compromise Activity*, No-5000-108 (Oct. 2, 2006).

<sup>10</sup> National Taxpayer Advocate 2005 Annual Report to Congress 76-93.

<sup>11</sup> The Debt Collection Act of 1982, Pub. L. No. 97-365, 96 Stat. 1749. For discussion of history of private collection agencies in Federal Government, see Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005); codified at 31 U.S.C.A. 3718(f).

<sup>12</sup> Treasury, Postal Service, and General Government Appropriations Act of 1996, Pub. L. No. 104-52, 109 Stat. 468, 473-474 (1995); see Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

<sup>13</sup> General Accounting Office, GAO/GGD-97-129R, *IRS: Issues Affecting IRS's Private Debt Collection Pilot 5* (Jul. 18, 1997).

Notwithstanding its 1997 experience, in 2002 the IRS renewed its efforts to utilize private contractors to address the growing inventory of debts that the IRS was unable to handle.<sup>14</sup> In 1998, the Federal Activities Inventory Reform (FAIR) Act was enacted to encourage competitive sourcing, a process whereby federal agencies identify commercial functions being performed by the agencies, develop a business case to determine if the private sector can efficiently compete with the agencies, and if so, determine the most efficient organization to perform the function. However, the law specially precludes the contracting out of inherently governmental functions.<sup>15</sup> The IRS and the Office of Management and Budget (OMB) have long considered the collection of taxes to be an inherently governmental function,<sup>16</sup> and have never certified the type of work being performed by the private collectors as commercial.<sup>17</sup>

In 2003, the IRS's backlog of receivables of approximately \$120 billion again caused the IRS to consider private debt collection as a solution.<sup>18</sup> To address the buildup of potentially collectible inventory, the IRS favored and the Department of Treasury proposed that Congress allow the IRS to employ private debt collectors to help collect the aging receivables in exchange for commissions based on the amount collected.<sup>19</sup> The American Jobs Creation Act of 2004 gave the IRS authority to again use private collection agencies to collect delinquent federal tax debts.<sup>20</sup> It was believed that this legislation would cure the defects of the 1996 initiative by permitting private collectors to work for commissions while at the same time allowing them to perform only such functions that were commercial in nature, rather than inherently governmental.<sup>21</sup>

<sup>14</sup> General Accounting Office, *IRS is Addressing Critical Success Factors for Contracting Out but Will Need to Study the Best Use of Resources*, GAO-04-492, 4 (May 2004).

<sup>15</sup> Federal Activities Inventory Reform Act (FAIR) of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, *see* Note § 5 (2)(b), providing that a function is “inherently governmental” under the statute if it is “so intimately related to the public interest as to require performance by Federal Government employees.” *Id.* Examples of inherently governmental functions include actions: (1) “to bind the United States to take or not take some action;” (2) “to determine, protect and advance United States. . . interests;” and (3) “to significantly affect the . . . property of private persons.” *Id.*

<sup>16</sup> In OMB Circular A-76 (which sets forth the standards under which federal work is subject to competitive sourcing), as it existed in 1999, the collection of taxes was specifically listed as an inherently governmental function. In 2003, OMB Circular A-76 was revised to remove all specific examples of inherently governmental functions; *see also* General Accounting Office, *IRS: Issues Affecting IRS's Private Debt Collection Pilot* (Jul. 18, 1997), indicating that the IRS and the Department of Treasury have long considered the collection of taxes to be an inherently governmental function.

<sup>17</sup> IRS Federal Activities Inventory Reform Act certifications, available at <http://www.treas.gov/offices/management/dco/procurement/fair/inventories/index.html>.

<sup>18</sup> This \$120 billion dollar inventory was growing at approximately four percent per year. General Accounting Office, GAO-04-492, *Tax Debt Collection, IRS is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

<sup>19</sup> General Accounting Office, GAO-04-492, *Tax Debt Collection, IRS is Addressing Critical Factors for Contracting Out but Will Need to Study the Best Use of Resources* 1 (May 2004).

<sup>20</sup> The American Jobs Creation Act of 2004, Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 6306.

<sup>21</sup> Government Accountability Office, *IRS Needs to Complete Steps to Help Ensure Contracting Out Achieves Desired Results and Best use of Federal Resources*, GAO-06-1065 (2006); *see also* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

The government's rationale for its current use of private debt collectors to collect federal taxes stood upon three pillars:

- ◆ Use of private collectors is cost efficient and effective;<sup>22</sup>
- ◆ Private collectors will work the easy cases, thereby ensuring that they will not engage in “inherently governmental” activities and that the IRS will be able to focus on more complex work;<sup>23</sup> and
- ◆ Other federal agencies have successfully used private collection agencies.<sup>24</sup>

### Cost Efficiency of IRS Private Debt Collection Initiative

*“The purpose of this program is to provide value to the American taxpayer.”<sup>25</sup>*

*“If additional IRS allocations would yield greater returns than PCA use, then there is no justification for a PCA program.”<sup>26</sup>*

*“If it [IRS] hires federal employees, they’ll spend far less than if they go out with these private collection firms. In addition to the issues of privacy, et cetera – which are horrifying to my constituents - Republican and Democrat alike – you’re spending more money than you have to collect these taxes.”<sup>27</sup>*

Pursuant to the FAIR Act, federal law requires that the government follow prescribed processes for determining whether activities performed by the government can or should be subject to outsourcing.<sup>28</sup> These processes are set forth in Office of Management and Budget (OMB) Circular A-76. Each year, agencies of the federal government must file a report with the OMB identifying the work that is commercial and that which is

<sup>22</sup> Mary Dalrymple, Associated Press, *IRS Warns Taxpayers Not to Fall for Thieves Posing as IRS Debt Collectors*, USA Today (Aug. 23, 2006) (available at: [http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection\\_x.htm?csp=34](http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection_x.htm?csp=34)), quoting an IRS spokesman who said, “The purpose of this program is to provide value to the American taxpayer.” (See discussion *infra* regarding the Federal Activities Inventory Act and OMB Circular A-76 which govern competitive sourcing in the Federal Government and the emphasis on cost efficiency).

<sup>23</sup> Testimony of Mark W. Everson, Commissioner of Internal Revenue, Private Debt Collection: Hearing Before the Subcomm. on Oversight, House Comm. on Ways and Means, 108th Cong., 1st Sess. (May 13, 2003).

<sup>24</sup> *Id.*

<sup>25</sup> Mary Dalrymple, Associated Press, *IRS Warns Taxpayers Not to Fall for Thieves Posing as IRS Debt Collectors*, USA Today (Aug. 23, 2006) (available at: [http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection\\_x.htm?csp=34](http://www.usatoday.com/money/perfi/taxes/2006-08-23-irs-collection_x.htm?csp=34)), quoting an IRS official.

<sup>26</sup> Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

<sup>27</sup> Comments of United States Congressman Steve Rothman (D-NJ) during testimony of Internal Revenue Service Commissioner, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

<sup>28</sup> Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270, 112 Stat. 2362; now codified at 31 U.S.C.A. § 501, *see* Note § 5.

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inherently governmental.<sup>29</sup> If the function is determined to be inherently governmental, the function cannot be privatized. If the function is “commercial,” the government must undertake a cost-based analysis to determine whether the function should be subject to competitive sourcing, *i.e.*, whether the function can be performed more efficiently by the private sector.<sup>30</sup> If the agency cannot establish the business case for outsourcing the function, then the function will not be outsourced.<sup>31</sup>

The American Jobs Creation Act of 2004 (AJCA) enabled the PDC initiative to circumvent the Circular A-76 process. There was no designation of collection functions as commercial, nor any rigorous cost analysis in support of a PDC business case. The IRS now acknowledges that the PDC initiative, which pays private collectors up to 25 percent of amounts collected, cannot collect the money as efficiently as the IRS’s own collection function.<sup>32</sup> Thus, the IRS admits that a central tenet for outsourcing any functions of the federal government, *i.e.*, cost efficiency, does not exist.

On the revenue side, the IRS’s initial goal for Release 1.1 is that the private agencies will collect six percent of the dollars assigned.<sup>33</sup> On the expense side, in addition to commission expenses, private collectors will also receive administrative fees for certain unresolved cases, such as those where the taxpayer has died or filed for bankruptcy and cases where the taxpayer enters into an installment agreement for longer than five years.<sup>34</sup> There are also substantial expenses for each phase of the initiative, such as systems acquisition costs and consulting fees. For example, the IRS has projected that the initial phases of the initiative (Release 1.1 and Release 1.2) will cost \$61 million and may bring in revenues of between \$56 million and \$92 million.<sup>35</sup>

Thus, the business case for using private collectors over IRS employees appears to be weak. In fact, the IRS acknowledges the accuracy of a 2002 study that concluded that if Congress budgeted an additional \$296 million to hire new collection staff, the IRS

<sup>29</sup> The Federal Activities Inventory Reform Act of 1998, Pub. L. No. 105-270; Office of Management and Budget Circular A-76; *see also* IRS Office of Competitive Sourcing, IRS Circular A-76 Primer, available at: [http://www.irs.gov/ustreas.gov/pub/cmpsrc/learn\\_more/irs\\_a76-primer.pdf](http://www.irs.gov/ustreas.gov/pub/cmpsrc/learn_more/irs_a76-primer.pdf).

<sup>30</sup> Mohab Tarek Khattab, *Revised Circular A-76: Embracing Flawed Methodologies*, 34 Pub. Cont. L. J. 469 (2005); *see also* Mark T. Resnick, *Outsourcing Federal Tax Collection*, 5 Hous. Bus. & Tax. L.J. 128, 155 (2005).

<sup>31</sup> IRS Office of Competitive Sourcing, IRS A-76 Primer, (Feb. 2005), available at: [http://www.irs.gov/pub/cmpsrc/learn\\_more/irs\\_a76\\_primer.pdf](http://www.irs.gov/pub/cmpsrc/learn_more/irs_a76_primer.pdf).

<sup>32</sup> Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

<sup>33</sup> IRS, *Filing and Payment Compliance Briefing Document 3* (July 31, 2006).

<sup>34</sup> IRS Request for Quotations, Request No. TIRNO-05-Q-00187, at I-20 and I-34 (¶ J.4.4.12).

<sup>35</sup> Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 Appendix III (Sept. 29 2006).

could collect an additional \$9.5 billion annually.<sup>36</sup> Implementation of the ideas set forth in the 2002 study contrasts favorably to the IRS's own estimate of what the private collectors will bring in over a ten year period: \$1.4 billion, less the \$330 million in commissions and other costs.<sup>37</sup> In other words, the IRS is implementing a plan that returns \$4 for every dollar invested over a plan that returns \$32 per dollar invested.<sup>38</sup>

Although the IRS points out that it did not receive the \$296 million in funding described in the 2002 study,<sup>39</sup> we do not believe that private debt collection is the only other option available for the IRS to reduce its inventory backlog. Improving its own efficiency and its approach to contacting taxpayers should be a starting point. It is apparent that the private collectors can collect delinquent accounts with considerably less than \$296 million. We have learned that the three private collection agencies are using only 75 employees in the aggregate to make calls on accounts. It is difficult to fathom how 75 employees can achieve what the IRS cannot with its thousands of collection employees and its collection budget of nearly \$2 billion.<sup>40</sup> Moreover, the IRS is allocating at least 65 of its own employees to monitor the program; thus, the IRS is using almost as much in human resources to monitor these companies as it takes the companies to do the work.<sup>41</sup>

#### *Debate over How to Measure Performance Highlights Fundamental Problem with IRS Collection Policy*

We do not believe the IRS has made an adequate business case for this initiative. In response to the requirements of the AJCA, which direct the IRS to issue a biennial report to Congress on a number of factors, including a complete cost-benefit analysis

<sup>36</sup> Testimony of Treasury Secretary John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on FY 2004 Appropriations for the Treasury Department, May 20, 2003; for referenced study see 2002 Report of IRS Commissioner Charles O. Rossotti to IRS Oversight Board, *Assessment of the IRS and the Tax System* (Sept. 2002).

<sup>37</sup> David Cay Johnston, *IRS Enlists Help in Collecting Delinquent Taxes*, New York Times (Aug. 20, 2006).

<sup>38</sup> Testimony of United States Treasury Secretary, John Snow, in an exchange with Senator Robert C. Byrd, Senate Committee on Appropriations: Subcommittee on Transportation, Treasury and General Government, Hearing on FY 2004 Appropriations for the Treasury Department, May 20, 2003.

<sup>39</sup> Testimony of Commissioner of Internal Revenue, Mark W. Everson, House Committee on Appropriations: Subcommittee on Transportation, Treasury, Housing and Urban Development, and the District of Columbia, FY 2007 Appropriations for the Internal Revenue Service (March 29, 2006).

<sup>40</sup> IRS Fiscal Year Budget in Brief, available at: <http://www.irs.gov/pub/irs-utl/bib-irs.pdf>. The IRS's budget for tax law enforcement in fiscal year 2006 was approximately \$4.7 billion dollars and its proposed enforcement budget for fiscal year 2007 is approximately \$4.8 billion dollars. IRS Budget in Brief FY 2007, available at: <http://www.irs.gov/pub/irs-news/fy07budgetinbrief.pdf>.

<sup>41</sup> This figure includes Referral Unit employees (approximately 33), Oversight Unit employees (approximately 15), and 17 other staff members. Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 49 (Sept. 29 2006).

of the initiative,<sup>42</sup> the IRS is planning to develop a cost-benefit comparison between private collectors and the IRS. However, the IRS plan drew criticism from the GAO for a number of reasons, including that the initial design omitted the most significant cost of the initiative, *i.e.*, commissions paid to the private collectors, as a separately stated expense item.<sup>43</sup> We have additional concerns about the IRS's planned PDC cost effectiveness study. The IRS intends to conduct a test using IRS employees for purposes of making a performance comparison. However, these IRS employees will be working different (and, in some instances, more complex) types of cases than private collectors handle.<sup>44</sup> Consequently, we wonder how a decision-maker can assess which approach – the IRS or the private collection agency (PCA) – is most efficient at collecting the type of inventory IRS is assigning to PCAs.

The IRS's rationale for not undertaking an “apples to apples” comparison between the IRS and private collectors is that “IRS [employees] would not work PDC inventory even if they had additional resources and are better than PCAs at working those cases.”<sup>45</sup> This IRS response essentially ignores the importance of tax compliance and taxpayer rights for those taxpayers who populate the PDC inventory. The IRS, in essence, is saying that there is a population of taxpayers whose liabilities are too trivial for the IRS to bother with, and therefore those cases should either be left to PCAs or, absent PCAs,

<sup>42</sup> The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:

(e) BIENNIAL REPORT.—The Secretary of the Treasury shall biennially submit (beginning in 2005) to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report with respect to qualified tax collection contracts under section 6306 of the Internal Revenue Code of 1986 (as added by this section) which includes—

- (1) a complete cost benefit analysis,
- (2) the impact of such contracts on collection enforcement staff levels in the Internal Revenue Service,
- (3) the impact of such contracts on the total number and amount of unpaid assessments, and on the number and amount of assessments collected by Internal Revenue Service personnel after initial contact by a contractor,
- (4) the amounts collected and the collection costs incurred (directly and indirectly) by the Internal Revenue Service,
- (5) an evaluation of contractor performance,
- (6) a disclosure safeguard report in a form similar to that required under section 6103(p)(5) of such Code, and
- (7) a measurement plan which includes a comparison of the best practices used by the private collectors with the Internal Revenue Service's own collection techniques and mechanisms to identify and capture information on successful collection techniques used by the contractors which could be adopted by the Internal Revenue Service.

<sup>43</sup> In the IRS's response to the GAO report, the Commissioner of Internal Revenue agreed to GAO's recommendation to separately state the commissions as a cost of the initiative. Government Accountability Office, GAO-06-1065 49, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources* (Sept. 29 2006).

<sup>44</sup> The IRS will be working the “next best cases,” a phrase which has yet to be defined in any meaningful way. For example, it is clear that IRS employees in the study will be working some business taxpayer cases. IRS, *Filing and Payment Compliance* (Nov. 14, 2006). It is generally understood within the IRS and the tax profession that business tax cases are more complex and can be less productive than individual taxpayer cases.

<sup>45</sup> IRS, *Filing and Payment Compliance* (Nov. 14, 2006).



should be left unworked until the amounts due become worthwhile to collect, after the accrual of penalties and interest over the years.<sup>46</sup>

If the IRS is correct in saying there is a pool of cases that will result in revenue if only someone contacted the taxpayer – and this is the fundamental premise of the Private Debt Collection initiative – then it stands to reason that we should not only determine whether the IRS itself can do this work efficiently (as compared to PCAs) but also determine whether this work is a productive use of the IRS’s own resources. Such a “proof of concept” may well demonstrate that early intervention by lower-graded IRS employees with limited collection authority (and who are authorized to make outbound calls and conduct thorough address searches, just as the PCAs are doing) will both collect past due accounts and provide a training ground and recruitment source for higher graded IRS collection positions.<sup>47</sup>

### Private Collectors will Work only the Easy Cases

*“The cases the IRS would refer to PCAs are those where the taxpayer would likely pay the outstanding tax liability if contacted by telephone.”<sup>48</sup>*

A central tenet of the PDC initiative is that the IRS has a significant number of accounts in which taxpayers could be induced into paying what they owe by a simple phone call.<sup>49</sup> It is not clear whether there are any really easy tax collection cases; however, if the cases that the IRS identified for private collection are this easy, we wonder about the wisdom of working so diligently to identify the most productive cases only to hand them off to private collectors.

A more serious problem for our tax administration system, however, is that the assigned inventory turned out to be far more complex than the IRS ever expected. In the first batch of inventory identified for possible assignment to private collectors, for example,

<sup>46</sup> In other sections of this report, we address the importance of contacting taxpayers early in the collection process, particularly for low income taxpayers, so that compliance problems can be reversed and the taxpayer is put on a path towards tax compliance. See Most Serious Problems, *Early Intervention in Collection Cases* and *Collection Issues of Low Income Taxpayers*, *infra*.

<sup>47</sup> If this “proof of concept” test takes the form of a direct comparison between IRS workers and private collectors working the same types of cases, to avoid the appearance of a conflict of interest, the test design and final analysis should be reviewed by a third party. The IRS has available employees to perform such a test. For example, we have identified a unit of IRS employees whose positions are being eliminated due to an IRS restructuring. These employees can be trained in a similar environment to private collectors and can use the IRS’s outbound call systems to contact taxpayers with delinquent accounts. Only a direct comparison between IRS employees and private collectors working the same types of cases will demonstrate whether the benefits of using private debt collectors truly outweigh the costs.

<sup>48</sup> See Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

<sup>49</sup> See Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals, 99 (February 2003), stating:

Many taxpayers with outstanding tax liabilities would make payment if contacted by telephone and, if necessary, offered the ability to make payment of the full amount in installments. If PCAs could perform these tasks for this group of taxpayers, without affecting any taxpayer protection, the IRS would be able to focus its resource on more complex cases and issues.

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there was a high incidence of shelved delinquent tax return investigations.<sup>50</sup> Under the IRS's traditional collection practices as well as the PDC required procedures, taxpayers cannot obtain installment agreements if they are not compliant for other tax years, *i.e.*, they have not paid taxes or filed returns.<sup>51</sup> While the IRS plans to include this more complicated type of case in Release 1.2 when its systems can communicate the existence of the delinquent return to the private collector assigned to the account, it did not anticipate that such cases would be among the "simple" Release 1.1 inventory. In two different statistical samplings of the Release 1.1 inventory, the IRS learned that in over 30 percent of the cases there were unresolved delinquent tax return investigations in the taxpayers' filing histories.<sup>52</sup> The finding suggests that over 30 percent of the taxpayers will not be eligible for the collection arrangement that the private collectors are authorized to offer. The initial impact of this determination was that the IRS had to remove 15,500 cases from the initial 42,800 to be assigned to the collectors.<sup>53</sup> The IRS is using other inventory, including older cases, to make up for the deficit.

The IRS also had to substitute older inventory when it identified two other unexpected case characteristics. In July of 2006, the IRS needed to eliminate another 10,000 cases from the potential inventory because payments on those accounts, which were thought to be voluntary, turned out to be involuntary levy payments.<sup>54</sup> Additionally, the IRS learned that its systems could not transfer updated account information identifying taxpayers as being represented by tax professionals. When the taxpayer files Form 2848 (Power of Attorney) with the IRS, the IRS and private collectors under this initiative must contact the taxpayer only through the authorized representative. Consequently, it removed from inventory 5,500 accounts that were intended for assignment to private collectors.<sup>55</sup> Thus, as of this date, taxpayers who can afford representation are exempt from this initiative.

#### *Inventory Problems Lead to Expansion of Case Criteria*

The shortage of the promised "easy" inventory is driving the IRS to assign inventory with the types of complexities that were never intended to be worked by private collectors. As described above, the IRS plans to assign accounts known to have delinquent tax return investigations in the account history in Release 1.2. Regardless of whether its systems can communicate this type of information to private collectors, utilizing private collectors to

<sup>50</sup> A shelved delinquent tax return investigation is an investigation of a taxpayer's failure to file a tax return for one or more years that has been closed as unresolved.

<sup>51</sup> See IRM 5.14.1 (July 2005) and IRS, *Private Collection Agency Policies and Procedures Guide*, 31 (Sept. 2006).

<sup>52</sup> IRS, Partial Production Log (March 16, 2006).

<sup>53</sup> IRS, *Filing & Payment Compliance Advisory Council Presentation 9* (Jul. 31, 2006).

<sup>54</sup> The initial criteria for assignable inventory in Release 1.1 limited inventory to cases where the taxpayer indicated the amount is due on a tax return and cases where the tax has been assessed and the taxpayer has made three or more *voluntary* payments on the tax. Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

<sup>55</sup> IRS, *Filing & Payment Compliance Advisory Council Presentation 9* (Jul. 31, 2006).

interact with taxpayers about their obligation to file tax returns raises multiple problems, including the lack of training of private collection employees as to which taxpayers are required to file tax returns.<sup>56</sup> Depending on the taxpayers' circumstances, they may be under no legal obligation to file tax returns.<sup>57</sup> Private collectors have not been trained to determine when filing is required and when it is not. In fact, since such a determination requires the exercise of judgment and discretion, the authority to make a determination of a filing requirement *cannot* be delegated to a non-governmental employee.

#### *Federal Payment Levy Program Cases*

The pressure to find steady inventory for private collectors is evident in the IRS's position with respect to accounts that have been assigned to private collectors but which are then subject to the IRS's Federal Payment Levy Program (FPLP).<sup>58</sup> The IRS agrees that it would be inappropriate to assign cases with active FPLP levies to the private collectors. In fact, the Commissioner testified that such cases would be inappropriate for private collector assignment:

The IRS would not refer to [Private Collection Agencies] PCA cases for which there is any indication that enforcement action would be required to collect the tax liabilities.<sup>59</sup>

However, if the IRS assigns to a private collector a case that is later subject to an FPLP levy, the IRS is unwilling to recall the case. While the IRS acknowledges that cases with active FPLP levies are the wrong type of cases for assignment to private collectors, the

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<sup>56</sup> IRC § 6306 (b)(1) sets forth the functions that Congress expected private collectors to be performing: “(A) to locate and contact any taxpayer specified by the Secretary, (B) to request full payment from such taxpayer of an amount of Federal tax specified by the Secretary and, if such request cannot be met by the taxpayer, to offer the taxpayer an installment agreement providing for full payment of such amount during a period not to exceed 5 years; and (C) to obtain financial information specified by the Secretary to such taxpayer...”

<sup>57</sup> See IRS Publications 501 (*Exemptions, Standard Deduction and Filing Information*) and 17 (*Your Federal Income Tax for Individuals*).

<sup>58</sup> IRC § 6331(h)(2)(A) authorizes the IRS to issue continuous levies on federal disbursements, including certain components of Social Security income such as payments under Old Age, Survivors and Disability Insurance (OASDI) of the Social Security Act (42 U.S.C.A. § 1302 *et seq.*). The IRS's other automated levy programs include the State Income Tax Levy Program and the Alaska Permanent Dividend Fund Levy Program.

<sup>59</sup> Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

IRS's position is that taxpayers under an FPLP levy of their Social Security income will benefit from the interaction with private collectors.<sup>60</sup>

By allowing private collectors to pursue installment agreements on these accounts, the IRS will needlessly be paying commissions for accounts on which the IRS is already receiving payments. More importantly, we do not believe it is appropriate for private collectors to pursue taxpayers who are already subject to FPLP levies, most of whom are elderly taxpayers and receiving Social Security payments.<sup>61</sup>

### Other Federal Agencies Use Private Collectors

*“Mr. Chairman, I appreciate Mrs. Capito’s amendment and the seriousness of this issue. When we talk about private collection of debts, we should understand that the Federal Government is already using private debt collectors in other areas. One significant example is student loans. I have certainly visited facilities where private companies are handling the confidential information involved. They are handling it with responsibility. They are handling it in compliance with all legal standards, and they are doing a very good job for the Government, not only getting revenue that we would lose otherwise if we did not collect on the debts but collecting on debts that the Federal Government was having difficulty being able to collect upon.”<sup>62</sup>*

*“Over 40 states have used private collection agencies successfully as part of their tax collection efforts, and other federal agencies have used private collection agencies for a number of years to collect a significant amount of delinquent federal nontax debt.”<sup>63</sup>*

To compare the collection of delinquent student loans and other federal debts to the collection of delinquent federal taxes is to fail to recognize:

<sup>60</sup> In February of 2006, the National Taxpayer Advocate issued a Proposed Taxpayer Advocate Directive (Proposed Taxpayer Advocate Directive 2006-1-P) ordering the IRS to alter certain aspects of the PDC initiative’s design. The National Taxpayer Advocate issues a Taxpayer Advocate Directive to order administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers. IRM 1.2.2.11.3 The IRS responded to the Proposed Taxpayer Advocate Directive and addressed the Taxpayer Advocate Service’s position with respect to FPLP levies, as follows:

Allowing PCAs to work with taxpayers with FPLP [Federal Payment Levy Program], SITLP [State Income Tax Levy Program] and Alaska Fund levies will be beneficial to taxpayers. In these cases, PCAs will assist taxpayers in resolving the situation, which will result in a levy release if an installment agreement is obtained.

Memorandum from the Commissioner of the Small Business/Self-Employed Division to the National Taxpayer Advocate Regarding Proposed Taxpayer Directive 2006-1 (March 28, 2006).

<sup>61</sup> Over the last four years, 84 percent of FPLP levies have been against Social Security benefits. IRS, Wage & Investment Division Information Request, September 28, 2005. See Most Serious Problem, *Levies*, *infra*.

<sup>62</sup> Statement of Representative Ernest J. Istook, Jr. in debate before the United States House of Representatives, between Representative Shelley Moore Capito, Representative Christopher Van Hollen and Representative Istook, regarding amendment to H.R. 5025 to prohibit use of private collectors by the IRS (September 4, 2004).

<sup>63</sup> Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

- ◆ The extensive resources the IRS receives for its collection function;
- ◆ That other federal agencies must go through a competitive sourcing process which requires cost efficiency and protections for affected employees, all of which this initiative bypassed; and
- ◆ The importance of tax collections and long-term tax compliance to our government on the one hand and the small return on investment from this initiative on the other.

Other components of the federal government may utilize private debt collectors efficiently; however, there are important differences between those agencies and the IRS. One such difference is that, in contrast to those other agencies, the IRS has a large collection infrastructure with thousands of trained employees and an annual budget of nearly two billion dollars.<sup>64</sup> The IRS has 14 Automated Collection System (ACS) sites that interact with millions of taxpayers annually, in contrast to the private collectors who operate out of single locations with 75 employees in the aggregate. The IRS continues to spend significant resources on the same technology used by private collectors, such as predictive dialer systems.<sup>65</sup> Predictive dialers are automated systems that contact taxpayers and hand off the taxpayer to a live telephone assister when the phone is answered. Effective use of these systems is central to the success of collection agencies in the private sector; yet, the IRS elects not use its predictive dialers to any real extent.<sup>66</sup> Given the IRS's collection infrastructure, it is unclear why the IRS needs private collectors to reach its own inventory.<sup>67</sup>

Another important difference between the IRS and other federal agencies is that when other agencies outsource their collection work through the competitive sourcing process, the agencies must certify the functions as “commercial,” must compile a business case using rigorous cost analysis demonstrating that the private sector can do the work more efficiently, and must then determine the most efficient organization to perform the function.<sup>68</sup> Reductions in force are a typical result of competitive sourcing when

<sup>64</sup> IRS Fiscal Year Budget in Brief, available at: <http://www.irs.gov/pub/irs-utl/bib-irs.pdf>. The IRS's total budget for tax law enforcement in fiscal year 2006 was approximately \$4.7 billion dollars and its proposed enforcement budget for FY 2007 is approximately \$4.8 billion dollars. IRS Budget in Brief FY 2007, available at: <http://www.irs.gov/pub/irs-news/fy07budgetinbrief.pdf>. For fiscal year 2006, the Small Business/Self-Employed Division allocated approximately 11,270 full time equivalents (FTEs) towards collection efforts. IRS Small Business/Self-Employed Division, FY 2006–FY 2007 Plan. The IRS Wage & Investment Division allocated approximately 3,332 FTEs to collection. Wage & Investment Division, *FY 2006 Plan*.

<sup>65</sup> In 2004, the IRS acquired an additional “predictive dialer” system used to automatically contact taxpayers. National Taxpayer Advocate 2004 Annual Report to Congress 234.

<sup>66</sup> In FY 2004, Automated Collection System use of predictive dialers constituted less than five percent of direct time. ACS Management Reports, Oct. 1, 2003, through Sept. 20, 2004. For discussion of IRS use of predictive dialers, see National Taxpayer Advocate 2004 Annual Report to Congress 234.

<sup>67</sup> For an analysis of how much more impact the IRS could achieve through improved collection strategy and practices, see Most Serious Problems, *Collection Alternatives* and *Early Intervention in Collection Cases*, *infra*.

<sup>68</sup> IRS Office of Competitive Sourcing, *IRS Circular A-76 Primer*, available at [http://www.irs.gov/ustreas.gov/pub/cmpsrc/learn\\_more/irs\\_a76-primer.pdf](http://www.irs.gov/ustreas.gov/pub/cmpsrc/learn_more/irs_a76-primer.pdf).

the private agency prevails.<sup>69</sup> Consequently, employees have rights throughout the competitive sourcing process. Employees can appeal the classification of activities as “commercial” as well as the competitiveness determination, first internally and then to the Government Accountability Office.<sup>70</sup>

The most important difference between the IRS and other federal agencies relates to the importance of taxes and tax compliance to the operation of the federal government.<sup>71</sup> Unlike the collection of delinquent student loans or other areas where the government contracts out its collection function, the Constitution of the United States confers the power to collect taxes upon Congress.<sup>72</sup> This power reflects the importance of taxes to the operation of the federal government. Taxpayers annually pay over two trillion dollars to the IRS, without any IRS follow-up or enforcement action.<sup>73</sup> These taxes are paid in part because taxpayers desire to avoid the IRS’s collection authority. This authority – and its deterrent effect – are diluted where the IRS uses civilian collection agencies that are also calling about past-due credit card accounts and medical bills.

Using private collectors also exposes taxpayers to new risks. With the private debt collection initiative, the IRS has compromised its identity as the nation’s tax collector, opening up a new avenue for scam artists to impersonate private collectors. Indeed, the IRS kicked off this initiative with a warning about the need for taxpayers to protect themselves.<sup>74</sup> Instances of fraud and misuse of taxpayer information are inevitable, as is a degraded image of the IRS.

#### HIDDEN COSTS OF PRIVATE DEBT COLLECTION – COSTS TO OUR TAX ADMINISTRATION SYSTEM

In the analysis above, we described costs of the initiative in terms of direct financial expenditures. However, we are also concerned that the initiative will exact a cost on vital components of our tax administration system, including: customer service, the transparency of IRS tax collection operations, consistent treatment for similarly situated taxpayers, and tax compliance.

<sup>69</sup> Jacques S. Gansler and William Lucyshyn, *Competitive Sourcing: What Happens to Federal Employees?* 16 (October 2004), available at [http://irs.ustreas.gov/pub./cmpsrc/an\\_p\\_gas\\_lucy.pdf](http://irs.ustreas.gov/pub./cmpsrc/an_p_gas_lucy.pdf).

<sup>70</sup> Office of Management and Budget Circular A-76 (2003); see also Jacques S. Gansler and William Lucyshyn, *Competitive Outsourcing: What Happens to Federal Employees?* 16 (October 2004), available at [http://irs.ustreas.gov/pub./cmpsrc/an\\_p\\_gas\\_lucy.pdf](http://irs.ustreas.gov/pub./cmpsrc/an_p_gas_lucy.pdf).

<sup>71</sup> As Supreme Court Justice Owen Roberts noted in 1935 as a means of explaining the importance of collecting tax revenues above other interests: “But taxes are the lifeblood of government, and their prompt and certain availability an imperious need.” *Bull v. U.S.*, 295 U.S. 247, 259, 55 S.Ct. 695 (1935).

<sup>72</sup> U.S.C.A. Const. Art. I, § 8, providing:  
The Congress shall have the Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for a common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

<sup>73</sup> Statistics of Income, *IRS Data Book*, 2004-2005, available at: <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>.

<sup>74</sup> IRS News Release, Simple Steps Can Prevent Scams as Private Debt Collection Begins (Aug. 23, 2006).

### Customer Service

*“Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes.”<sup>75</sup>*

We could not agree more that customer service is a vitally important part of achieving greater rates of tax compliance. We have also cautioned that changing or reducing services may affect taxpayers’ willingness or ability to comply with the tax law.<sup>76</sup> The IRS has made strides in the provision of its customer service.<sup>77</sup> However, by using private debt collectors, the IRS has separated taxpayers from its world class customer service.

#### *Contrast in Customer Service Approach*

The IRS’s vast resources dwarf the capacity of private collectors to duplicate the IRS’s level of customer service. The operational plans of the three contractors emphasize the importance of collection results rather than customer service and do not address the complex needs of U.S. taxpayers. The IRS’s Multilingual Initiative (MLI) provides one example of the type of quality service that private collectors will not and cannot duplicate.

Executive Order 13166 requires all federal agencies to establish a plan to ensure that persons with limited English proficiency have meaningful access to government related products and services.<sup>78</sup> The IRS created a Multilingual Initiative (MLI) Strategy Office to implement the order through the services provided by the IRS.<sup>79</sup> For taxpayers with

<sup>75</sup> *Internal Revenue Service FY 2006 Budget Request, Hearing Before the Subcomm. on Transportation, Treasury, Judiciary, Housing and Urban Development, and Related Agencies, Senate Comm. on Appropriations, 109th Cong. 1st Sess. (Apr. 7, 2005) (Statement of Mark W. Everson, Commissioner of Internal Revenue).*

<sup>76</sup> *See National Taxpayer Advocate 2005 Annual Report to Congress 2 (discussing trends in taxpayer service).*

<sup>77</sup> The IRS recently described improvements to its customer services, including:

- ◆ Employment of advanced call routing technology;
- ◆ Developed interactive job aids for IRS employees;
- ◆ Improved information systems;
- ◆ Strengthened managerial and executive involvement in service delivery;
- ◆ Expanded service to alternative locations (such as post offices, federal and state offices, libraries, and community organizations) during filing season; and
- ◆ Providing return preparation services using volunteers and Taxpayer Assistance Center personnel.

*See National Taxpayer Advocate 2005 Annual Report to Congress 18, where the IRS responded to Most Serious Problem, Trends in Taxpayer Service.*

<sup>78</sup> Exec. Order 13166; 65 Fed. Reg. 50,121 (Aug. 11, 2000). The IRS has interpreted the Executive Order to require:

- ◆ The availability of transcription services so that any IRS letter to a taxpayer who speaks a regularly encountered language can have the letter translated into that language;
- ◆ Oral language assistance will be provided for regularly encountered languages; and
- ◆ Educational and outreach documents will be translated for regularly encountered languages. IRM 22.31.1.6.1 (April 2006).

<sup>79</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006 12* (Feb. 2006).

limited English proficiency, the MLI will improve all other services provided by the IRS, by opening access and lines of communication which were heretofore unavailable.<sup>80</sup>

In contrast, the three private collection agencies have taken next to no steps to address taxpayers with limited English proficiency. One of the collectors had a telephone number for Spanish speaking individuals on its contact letters; however, when representatives from TAS dialed the number, there was only an English speaking voice that first transferred the call to another line, after which the call was automatically terminated. After TAS drew the IRS's attention to the problem, the IRS ensured that this particular problem was corrected, but we believe the example to be symptomatic of the problems with this initiative. The other two collectors have not taken any meaningful action to provide services for taxpayers with limited English proficiency.

#### **“Proprietary Information” and the Lack of PCA Transparency of Operations**

*“The Treasury Department and the IRS determined early on that no proposal to engage PCAs would ever be feasible unless and until those developing the proposal could assure themselves and others that taxpayer rights would not be weakened in any way.”<sup>81</sup>*

Elsewhere in this report, we have detailed the obligation of the IRS to disclose most policies and procedures and the effect that a lack of transparency can have on taxpayer rights.<sup>82</sup> Likewise, we noted that the Internal Revenue Manual (IRM) is supposed to serve as the single, official source of IRS “instructions to staff” such as procedures, guidelines, policies, and delegations of authority.<sup>83</sup> Generally, the IRS adheres to its disclosure obligations, although we have provided some serious examples in this report where it has not. While the IRS substantially complies with its disclosure obligations, it has failed to ensure that the operations of its private collectors are equally transparent to the public and to decision makers.

Some aspects of the plans reflect dramatic departures from IRS practice and impact taxpayer rights. We would like to discuss some of the specifics in this report, but the IRS has advised us that much of the information in the PCA operational plans and calling scripts is designated as “proprietary information,” and generally cannot be released without the consent of the PCAs. The operational plans and calling scripts describe such things as belated Fair Debt Collection Practices Act (FDCPA) warnings and psychological techniques used to coax debtors into paying.

<sup>80</sup> For an extensive discussion of problems facing taxpayers who speak English as a second language (if at all), see this report for the Most Serious Problem, *Multilingual and Cultural Barriers*, *infra*. While we have suggestions for improving the IRS's services to these taxpayers, there is simply no comparison between private collectors and the IRS as to the sophisticated array of services and outreach that the IRS provides.

<sup>81</sup> Testimony of the Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

<sup>82</sup> See Most Serious Problem, *Transparency of the IRS*, *supra* see generally, 5 U.S.C.A. § 552.

<sup>83</sup> IRM 1.11.2.1 (Oct. 1, 2005).



Throughout the development of the PDC initiative, there was general agreement that all restrictions that apply to IRS collection employees would also apply to PCA employees and that, to achieve this objective, the rules would provide for a “level playing field” for IRS employees and PCA employees. Significantly, the IRS publishes the procedures its collection personnel must follow in the Internal Revenue Manual, yet it now turns out that private collection agencies are employing proprietary collection techniques that are not published, that cannot be revealed without the private contractors’ consent, and that even the National Taxpayer Advocate, the Government Accountability Office, and the Treasury Inspector General for Tax Administration presumably cannot report on publicly. This lack of transparency is a serious problem for taxpayers and a serious flaw of this initiative.

### Inconsistent Treatment of Taxpayers

*“A taxpayer contacted by the PCA would enjoy the same rights and protections as a taxpayer contacted by an IRS employee.”<sup>84</sup>*

As a result of the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS reorganized from its geographic structure into operating divisions designed to serve different types of taxpayers, *i.e.*, the Wage & Investment Division, Small Business/Self-Employed Division, Large & Mid-Sized Business Division, and Tax Exempt/Government Entities Division.<sup>85</sup> One goal of this reorganization was to ensure consistency in service so that similarly situated taxpayers received the same treatment.<sup>86</sup> Lack of consistency results in poor customer service and can also lead to impairment or violations of taxpayers’ rights.

At this stage of the PDC initiative, there are three private collectors, all with their own operational plans, form collection letters, and collection scripts to use when they get taxpayers on the telephone. In Release 1.2, there will be up to 12 collectors with 12 operational plans and dozens of different ways to communicate the same issue to taxpayers.<sup>87</sup> A review of those plans and letters demonstrates how different these agencies’ approaches to collection are from that of the IRS, and from each other. Some examples of inconsistencies are demonstrated below.

<sup>84</sup> Testimony of Commissioner of Internal Revenue, Mark W. Everson, before the Subcommittee on Oversight of the House Committee on Ways and Means, Private Debt Collection (May 13, 2003).

<sup>85</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title I, Subtitle A, § 1001(a)(2) and (3), 112 Stat. 685.

<sup>86</sup> Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, Part Two, Title I.A.1, IRS Mission and Restructuring (§§ 1001 and 1002), 17.

<sup>87</sup> Internal Revenue Service News Release, IR-2006-131 (August 23, 2006), indicating up to 10 private collectors; but *see* Government Accountability Office, *IRS Needs to Take Steps to Help Ensure that Contracting Out Achieves Desired Results and Best Use of Federal Resources*, GAO-06-1065 Appendix 1 (Sept. 29, 2006), indicating up to 12 private collectors.

*Obtaining Financial Information:*

Under IRS procedures, no financial statements are required as a condition of entering into an installment agreement if the liability is under \$25,000, provided the taxpayer indicates an inability to pay and the taxpayer otherwise qualifies for an installment agreement.<sup>88</sup> IRS collection information statements are lengthy financial statements that require detailed information of income, expenses, assets, and liabilities. In the initial drafts of the operating plans, each of the private collectors planned to obtain financial information on each account where the taxpayer indicated that he or she could not fully satisfy the liability. The IRS has negotiated with the collectors on the issue; however, the plans still do not provide clear guidelines about when and when not to obtain financial information.

*Collection Scripts*

The IRS requires its telephone representatives to seek full payment, but they cannot employ trickery or any device to manipulate taxpayers. For example, training given to IRS Automated Collection Service (ACS) collection representatives includes an emphasis on fairness, accuracy, and taxpayer rights.<sup>89</sup> In contrast, we are concerned that the private collectors are using trickery, device, and belated Fair Debt Collection Practices Act warnings to take advantage of taxpayers.<sup>90</sup> At the IRS's request, we have removed specific references to the scripts of the private collectors.<sup>91</sup>

**Tax Compliance**

The IRS's outreach and enforcement efforts are designed to be compliance based. For example, the IRS requires its collectors to conduct interest-based interviews when attempting to resolve past accounts in order to structure the resolution in the taxpayer's and the IRS's long-term interest. Therefore, to avoid future noncompliance, current withholding amounts should be adjusted before allocating amounts towards installment agreements.<sup>92</sup> The IRS is requiring the collectors to inquire about the adequacy

<sup>88</sup> Under IRS procedures, no financial statements are required as a condition of entering into an installment agreement if the assessed liability does not exceed \$25,000 and this balance will be fully paid within 60 months (or fully paid prior to the collection limitations period, whichever comes first), provided the taxpayer otherwise qualifies for an installment agreement. IRM 5.14.5.2.(10).

<sup>89</sup> ACS Basic Modules A-1 (Training Course 6602-102) is an eight week training course in a classroom setting for employees to the ACS function, which emphasizes listening to taxpayers. Materials include a 326 page training document containing seven modules. Training Publication 6602-102, Module B: Understanding the Rights of Taxpayers also teaches seven modules including the Taxpayer Bill of Rights, the IRS Restructuring and Reform Act of 1998, and IRC § 6103.

<sup>90</sup> 15 U.S.C.A. § 1692e (11), requiring creditors to warn debtors that the communication is an attempt to collect a debt and that any information obtained will be used for that purpose.

<sup>91</sup> See discussion, *supra*, of IRS's insistence that operational plan information is "proprietary information" and cannot be disclosed.

<sup>92</sup> IRM 5.14.1.5(3).

of withholding to meet the current year's obligation but is not providing any training or guidance on the purpose or procedure for doing this.<sup>93</sup>

At the heart of the IRS's compliance based approach to tax administration is an appreciation that the \$2 trillion paid by taxpayers annually, without enforcement, is fostered by a consistent, fair, and long-term approach to tax administration. In contrast to the trillions of dollars paid voluntarily each year, the IRS predicts that the private debt collection initiative will collect \$1.4 billion, less costs, over ten years. Thus, with the private debt collection initiative, we have risked much for a small return on investment.

### CONCLUSION

A decision by the federal government to outsource one of its core functions to the private sector should not be undertaken lightly. By taking this step, the government is substituting private-sector employees with a narrow objective, *i.e.*, to maximize profits, for civil-service employees who are trained to think and act for the public good. It is true that there are many functions performed by the government that are commercial in nature and that can be privatized in an appropriate and cost-efficient manner. On the other hand, there are other functions that are so inherently governmental that the involvement of public employees is required throughout the process to further and protect the long-term interests of the government, its employees, and more importantly, its citizens.

To balance these complex interests, the government employs the OMB Circular A-76 procedures, which follow a defined process of identifying commercial activities, conducting a rigorous cost analysis to determine whether outsourcing makes the most business sense, and then finding the most efficient organization to perform the function. This process, while not without problems, provides protections for employees who can make challenges at critical steps along the path towards privatization. The private debt collection provisions in the AJCA and the manner in which the initiative was implemented did not allow for the development of a true cost-benefit comparison for the use of private collectors as compared with IRS collectors at the front-end of the process. The IRS has never certified the types of functions being performed by private collectors as commercial, and the IRS acknowledges that its employees can perform those functions more efficiently than private collectors. Accordingly, it does not appear to us that the PDC initiative would have been implemented if it were subject to the competitive sourcing rules under Circular A-76.

We must also be mindful of the hidden costs of using private collectors, notably potential erosion of customer service, lack of transparency of private collection operations, potential failure to provide consistent treatment for all taxpayers, and potential erosion of tax compliance. We do not believe that these principles should be compromised for the revenue gain, if any, this program may produce. For the reasons described, the

<sup>93</sup> IRS, *Private Collection Agency Policies and Procedures Guide* 28.

National Taxpayer Advocate believes the PDC concept is fatally flawed and should be terminated. Moreover, regardless of whether the PDC initiative continues, the National Taxpayer Advocate believes the IRS should conduct a “proof of concept” test to determine the potential revenue benefits of using lower-graded IRS employees with limited collection authorities to locate and contact taxpayers with “potentially collectible” accounts.

### IRS COMMENTS

We view the Taxpayer Advocate Service (TAS) and the National Taxpayer Advocate as our partners in the PDC initiative and appreciate their hard work in helping reach our shared goal of providing taxpayers with a high level of service. Since the start of the project, we have worked with TAS at each stage, listening and responding to their suggestions, and making appropriate adjustments. The National Taxpayer Advocate is one of the many stakeholders, both within and outside the IRS, whose input we have actively sought for this project on issues such as IRS and PCA policies, procedures, letters, publications, scripts, and training. We shared PCA procedures, operational and training plans, letters, and other documents with trusted stakeholders, including Congressional staffs, the National Taxpayer Advocate, the Government Accountability Office and the Treasury Inspector General for Tax Administration. For example, the PCA Policy and Procedures Guide contains all the IRS-required procedures to be followed by the PCAs; 90 percent of TAS’s suggestions resulted in changes to this document, and a majority of suggestions received from all stakeholders were fully adopted.

This initiative strives to make certain that PCA employees adhere to the same guidelines and restrictions as IRS employees. Where possible, the documents governing this effort have been made available to all necessary parties. That includes certain PCA documents that are proprietary and not immediately subject to public release under procurement regulations. As soon as we learned the National Taxpayer Advocate wanted to publish the PCA scripts, we took steps to have all three firms approve their release. Additionally, we have begun the process of releasing other appropriate information.

### Cost Benefit Analysis

The PDC project has started off well, due in no small part to the involvement of a full spectrum of stakeholders. In the 10 weeks from the project’s inception through November 16th, the IRS placed nearly \$90 million in outstanding accounts, and collected \$8.43 million. This yield exceeds the conservative target of 6 percent set for this initial year and is on target for achieving the business case assumption of 10 to 15 percent annually, depending on case type. This assumption is comparable to the Automated Collection System (ACS) collection rate for the IRS during FY 2006, which was 14 percent.

The proportion of commissionable to non-commissionable payments received in the first month is an anomaly and that rate has risen steadily. While commissionable

revenue in September was 46 percent, the cumulative percentage through November is 85 percent. The total compensation is significantly below the 25 percent legislative cap. Commissions paid to the PCAs from the project's inception through November 16<sup>th</sup> amounted to \$1.55 million, calculated on \$7.15 million in commissionable payments. The effective rate of commissions paid is 21.68 percent of commissionable payments, and 18.38 percent of all payments received in the PDC program.

During FY 2007, gross revenue received as a result of the project is expected to range from \$33.8 million to \$62.3 million, with costs ranging from \$23 million to \$29.3 million. Going forward, we expect improved margins as investments in automation allow us to expand the number of case assignments with little additional IRS support. We expect to recoup all PDC sunk investment costs during FY 2008 providing for growth in the return on investment (ROI) as the program continues. The new system for managing PCA caseload was developed as a foundation for all future PCA casework. The costs of this program should be viewed in that context.

As noted by the National Taxpayer Advocate, we are in the process of conducting the first portion of a cost effectiveness study. Our original design for this study compared PCA and IRS effectiveness in working the same type of inventory. After consultation with the GAO, we changed the design to better respond to the following recommendation in the May 2004 GAO report:

*"...the IRS Commissioner should ensure that a study is completed that compares the use of PCAs to a collection strategy that officials determine to be the most effective and efficient overall way of achieving collection goals."*

In response to GAO's recent report, we again adjusted our methodology to include commissions paid to PCAs as a separately stated expense item. Our revised plan will compare PCA results on working PDC inventory with IRS results at working the next best case available. We will also define the full cost benefit of PDC and its ROI. It is important to note that PDC cost comparisons to IRS costs should be made cautiously, using similar types of collection cases worked by phone or letter, not through field contact.

The comparison data, which will be provided to Congress in 2007 as part of the biennial report required under the American Jobs Creation Act of 2004, will be used to assure that we are applying our resources in the most effective manner. The National Taxpayer Advocate recommended a straight IRS cost to PCA cost comparison of like inventory. However, if PDC resources were diverted to hire additional IRS collectors, they likely would not work PDC inventory, as implied by the National Taxpayer Advocate's study design, since IRS has other priorities that will need to be weighed. On November 14, 2006, we briefed the National Taxpayer Advocate on the study and we proposed that we work with the National Taxpayer Advocate to further refine our study to address cost-to-cost comparison questions raised by the National Taxpayer Advocate.

### Service to Taxpayers

Service levels to taxpayers assigned to PCAs will meet or exceed the standards set for IRS customer service and quality. PCA quality, measured the same way as IRS quality, has ranged from 97 to 100 percent across various quality dimensions. This compares favorably with the ACS average range of 89.5 to 99.5 percent along the same dimensions for FY 2006. Of the nearly 19,000 cases assigned to PCAs, only 108 taxpayers have requested that their accounts be handled by the IRS. At any time, taxpayers may avail themselves of IRS services, including the assistance of TAS. There have been 31 reported contractual complaints, all of which have been reviewed in depth. The majority of these complaints deal with taxpayer questions about identity authentication procedures intended to protect taxpayer privacy. There have been no instances of fraud or misuse of taxpayer information.

IRS staff use several methodologies to review and monitor PCA activity with taxpayers. Live calls and cases are reviewed as well as continuous discussions on relevant procedures, as contained in and required by the PCA Policy and Procedures Guide and as outlined in evolving operational plans submitted by each contractor. Under procurement regulations, their operational plans are proprietary and can be made public when permitted by the PCAs. We have begun the process of releasing to the public pertinent portions of the PCA documents.

Each of the private collection agencies is working with the IRS continuously to update and improve their procedures. The successful initialization of the new IRS support groups for this effort ensure that taxpayers may always avail themselves of direct IRS service if they so choose. Furthermore, the taxpayer can contact the IRS to resolve the liability or provide information to determine the collectibility of their unpaid tax liability at any point during the collection process.

The overall success of this project is predicated on placing the *right cases* with PCAs at the *right time* from the *right universe* of inventory. We stage PDC cases in a way that allows us to ensure quality case work, the protection of taxpayer rights, and the delivery of the appropriate level of training to the PCAs. Inventory perfection is an ongoing and evolutionary process. Decisions to bring forward or push back the placement of various types of inventory reflect our efforts to identify the best possible universe of cases for assignment to PCAs during the initial build-up of this program. At times, we have slowed the pace of assignment to ensure proper program delivery at the lowest possible risk; there has never been a shortage of inventory or any pressure to deliver an arbitrary number of assignments. There is no contractual guarantee to the PCA firms of any volume of placements, dollar value of cases, or age of receivables. Future inventory decisions will be based on analysis of PCA performance on cases placed at this time.

As an example of this process, we have always considered placing Tax Delinquent Investigations (TDIs), as clearly stated in the February 2003 Request for Quotations (RFQ), but had reserved them for later placement because the timing was not right in the

initiative's initial phase. To prepare for TDI placement, we plan on testing assignment of Tax Delinquent Accounts (TDAs) with associated TDIs to PCAs during the third quarter of FY 2007. The test will help determine which of these cases are appropriate inventory, and it will include additional training of PCA employees on how to ask taxpayers to file their returns. PCA procedures currently include similar instructions for requesting outstanding returns on the inventory already assigned to PCAs, since returns may be due while the case is being handled by a PCA. We agree with the National Taxpayer Advocate that a determination of a filing requirement is inherently governmental. Under PDC procedures, this decision is made by IRS employees supporting the PCAs.

Our position on the Federal Payment Levy Program (FPLP) cases in PCA inventories is consistent with how these cases are treated within the IRS and not the result of inventory placement decisions. Involuntary levy cases such as those in the FPLP are removed from potential PCA inventory as part of the normal inventory selection process. After assignment, if a FPLP match occurs on a PCA case, the taxpayer has immediate access to work with someone to resolve the delinquency. If the taxpayer wishes to resolve the account using installment payments, the FPLP levy would be prevented or released and the contractor would monitor the agreement. Taxpayers who are unable to pay their balance due will be recalled from the PCA and placed in currently not collectible status when those requirements are met, and the FPLP levy would be prevented or released. Since the PCAs have the ability to resolve the account, there is no need to automatically recall accounts subject to an FPLP levy from the PCA inventory. If the facts of the case warrant a recall from the PCA, then the account will be recalled. Under no circumstance will commissions be paid on levy payments, as outlined in the Task Orders issued to the three firms.

All PCAs have taken actions to provide service for non-English speaking taxpayers. These experienced firms all service non-English speaking customers as part of their normal business. Two PCAs have bilingual staff to handle non-English calls. The third PCA is in the process of making arrangements to provide increased assistance to non-English speaking taxpayers. At all three PCAs, when the language spoken by the taxpayer prevents the PCA employee from assisting the taxpayer, IRS Referral Unit employees provide the necessary assistance. This allows us to provide the same level of service to all taxpayers.

The PCA procedures for collecting financial information directly align with IRS procedures and ensure protection of taxpayer rights. The PCA Policy and Procedures Guide, which the PCAs are contractually required to follow, prohibits the PCAs from obtaining financial information from a taxpayer unless directed to do so by the Guide. As an example, Section 11 of the PCA Policies and Procedures Guide states: "Under no circumstances will a PCA secure financial information from a taxpayer unless specifically directed to do so by the procedures contained in the guide." The instructions provided to the PCAs in the Policy and Procedures Guide on securing financial information do not differ from the procedures used by the IRS when collecting balance due accounts. No PCA is permitted to supersede IRS procedures; they are precluded from doing so by

task order. The PCA Policy and Procedure Guide emphasizes the appropriate time to collect financial information and we verified the PCAs' understanding of this requirement in face-to-face meetings. PCA operational plans are evolving documents, and the IRS is continually working with the PCAs to perfect these documents and to ensure they conform to IRS procedures. We have begun the process of releasing portions of these plans for public review.

### Consistent Taxpayer Treatment

All taxpayer delinquencies are taken seriously by the IRS, regardless of their size, and none is considered "trivial." We notify all taxpayers immediately if we discover they are delinquent, explain the consequences of non-compliance, and offer assistance to help them meet their tax obligations. We customize further treatment based on case characteristics to ensure taxpayers receive the appropriate level of service and to make best use of limited IRS resources. The PDC initiative is a way to provide a higher level of personal assistance to taxpayers within IRS' appropriated resource levels.

All taxpayers with representation whose cases meet the criteria for assignment to PCAs are included in available inventory. No determination of taxpayer ability to afford representation is being used to select inventory. PCA cases with taxpayer representation are currently being worked by PCAs. However, cases where a Power of Attorney (POA) is already on file are being reserved for later assignment in Release 1.2. We expect to assign them in January 2007 when all disclosure systemic concerns will have been resolved to ensure, for example, that updated information is provided to the PCAs when a taxpayer ceases to use a POA and/or obtains a new POA.

We have completed comprehensive procedural and legal reviews on talking scripts used by the PCAs. All taxpayer rights and protections are in force throughout all PCA scripts. The National Taxpayer Advocate expressed concern about a PCA script regarding the pacing of collector dialogues with taxpayers. The PCA assistor was offering the taxpayer an opportunity to engage in conversation and not being asked to enter into a full payment schedule prematurely. We have begun the process of releasing the scripts for public review. We also have a rigorous process in place to ensure PCA employees working on this program are fully trained in critical topics such as taxpayer rights, privacy, disclosure, and TAS-related procedures. PCA employees working on this program are also required to execute the same certifications of training required by IRS employees on critical topics.

### Compliance Impact

While the determination of the full cost benefit and cost effectiveness of the project will be known when the studies in progress are completed, the compliance benefit of the project continues to lie firmly on the leverage PCAs provide. For the one-time cost of setting up the project, we are experiencing the benefits of the efforts of PCA employees and the thousands of contacts made on outstanding accounts. PCA assistors working



on the IRS contract work exclusively on IRS cases. During FY 2007, we project that the IRS will spend 31 FTEs in direct support of PCA activities, delivered by a headcount of 65 IRS employees who work on this program as needed. The total leverage provided by using PCAs allows currently unassigned cases to be worked with more personal interaction than would be achievable otherwise, given the IRS's appropriated level of resources. The IRS already uses its resources to make as many outcalls as possible on priority collection inventory. In FY 2006, the IRS attempted more than 1.3 million predictive dialer calls on Automated Collection System cases.

We also know that collection programs such as PDC have compliance benefits that range far beyond revenue collected. As Commissioner Everson testified in March 2006 on IRS's FY2007 Budget regarding the indirect effect of increased enforcement activities in deterring non-compliant behavior, "[e]conometric estimates of the indirect effects indicate that they may be 10 times the size of the direct effects, or larger." The impact of merely informing taxpayers that they have been selected for this project is evident in the success of both the IRS and PCA initial taxpayer contact letter in generating payments, equal to approximately half of all payments in the first month. When a taxpayer is selected for PDC, he or she has already received multiple balance due and reminder notices from the IRS requesting payment. During the contractually specified non-commissionable period after PCA assignment, many taxpayers responded to the one letter that does not request payment, but informs them of the PCA assignment. Taxpayers are also informed of their right to opt-out of the program in the initial contact letter. The initial taxpayer reaction experienced is clearly the result of PDC activity and substantiates the anticipated compliance benefit of the PDC initiative.

Part of the reason the IRS sought legislative approval to use PCAs was the successful experience of other federal agencies. Section 6306(a) of the Internal Revenue Code exempts the IRS PDC initiative from coverage under the FAIR Act or OMB Circular A-76 by providing: "Nothing in any provision of law shall be construed to prevent the [IRS] from entering into a qualified tax collection contract" with a PCA. Moreover, IRS is not outsourcing but contracting for assistance in delivering a small portion of the overall collection function. No reductions in force were made due to this initiative.

Since 1982, PCAs have been used to assist the government in collecting debt. In FY 2005, the federal government referred \$13.7 billion to PCAs, resulting in collections of \$693.5 million. The Departments of Education, Health and Human Services, and Treasury all use PCAs to collect outstanding debt. More specifically, the Department of the Treasury's Financial Management Services (FMS) currently has 25 FTEs committed to support five PCAs who have roughly 400 employees. The FMS contracted agencies to handle cases after they have been through the FMS debt collection process, similar to previous IRS activity on PCA cases. During FY 2006, FMS placed nearly 300,000 cases valued at \$3.5B with the five PCAs and collected approximately \$71M. The PDC commission fees of 21 to 24 percent are within the norm of what other federal agencies are paying for collecting similar federal debt.

### Conclusion

Given the backlog of IRS receivables and our limited collection resources, the PDC initiative allows the IRS to ensure that more delinquent taxpayers are personally assisted with meeting their obligations. Oversight of this initiative is a role that we take very seriously, and we will continue to make program decisions to protect the privacy and security of taxpayers while collecting outstanding government debt.

### TAXPAYER ADVOCATE SERVICE COMMENTS

By the IRS's calculation, the initiative to date has cost approximately \$56 million in direct costs, with additional planned expenditures of at least \$23 million in FY 2007, \$21 million in FY 2008 and another \$32 million in 2009.<sup>94</sup> These figures do not include a projection of the opportunity cost of the initiative to date or a projected opportunity cost through FY 2009, which the IRS has not yet calculated; nor does the IRS include the downstream (hidden) costs of the initiative.<sup>95</sup> As part of the 1996 PDC initiative, however, the IRS estimated a \$17 million opportunity cost based on direct expenditures of approximately \$3 million.<sup>96</sup> In other words, the 1996 initiative incurred over \$5 in opportunity cost for every dollar of direct costs spent on the initiative. The 1996 initiative, which was terminated as a failure, collected \$3 million in revenue in its only year in existence; thus, the 1996 initiative paid for its direct costs after only one year. In comparison, the IRS does not project that the current initiative will break even until sometime in FY 2008, and this projection does not consider the opportunity costs of the initiative. Even if the current initiative has less of an opportunity cost, for example \$3 per dollar invested (resulting in \$168 million of opportunity costs on expenditures to date and \$396 million through 2009), the opportunity costs are significant.<sup>97</sup> Thus, when the IRS indicates above that the initiative has started off

<sup>94</sup> The Filing & Payment Compliance unit provided information for this report indicating that \$38.18 million was expended in FY 2004 and FY 2005 and \$15.83 million was expended in 2006, plus an additional \$1.9 million (from IRS information provided above) in commissions is added. IRS, *Filing and Payment Compliance Briefing Document* 10 (Dec. 5, 2006).

<sup>95</sup> We note that the IRS has not conducted any studies to determine if PCAs incur more or less downstream costs – such as TAS involvement in cases – than IRS employees doing the same work.

<sup>96</sup> General Accounting Office, GAO/GGD-97-129R, *IRS: Issues Affecting IRS's Private Debt Collection Pilot*, 5 (Jul. 18, 1997).

<sup>97</sup> The opportunity cost reflects the loss of revenue from diverting funds from the best or next best investment opportunity. Because of the return on investment for enforcement dollars in general is high, we believe the PDC initiative has a high opportunity cost. As the Government Accountability Office recently noted in testimony on the tax gap:

As part of an effort to make the best use of its enforcement resources, IRS has developed rough measures of return on investment in terms of tax revenue that it assesses from uncovering noncompliance. Generally, IRS cites an average return on investment for enforcement of 4:1, that is, IRS estimates that it collects \$4 in revenue for every \$1 of funding. Where IRS has developed return on investment estimates for specific programs, it finds substantial variation depending on the type of enforcement action. For instance, the ratio of estimated tax revenue gains to additional spending for pursuing known individual tax debts through phone calls is 13:1 versus a ratio of 32:1 for matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns.

Testimony of Michael Brostek, Director, Government Accountability Office, before the Senate Finance Committee, Tax Gap (July 26, 2006).

well, we feel compelled to ask: *In comparison to what?* At best, the initiative will break even in two years on its direct costs, which is a long time to wait for a zero return on investment of taxpayer dollars.

The stated reason for the PDC initiative was that the IRS did not have the resources to work its inventory backlog of potentially collectible cases. The initiative was presented as a cost efficient way to address the types of cases that could be resolved with a phone call, as evidenced by the success of other federal agencies. Over the last year, we have learned that: the IRS is more efficient at collecting these accounts than private collectors, the backlog of inventory was more complex than originally believed, and the IRS plans to increase the complexity of assigned cases with the next phase of the initiative, Release 1.2.

The analogy of the IRS collection effort with other federal agencies is a poor one, as the IRS has within it a vast collection agency funded at nearly \$2 billion dollars annually and a mission unlike any other federal agency, in essence, to function as the government's Accounts Receivable department, collecting today's delinquent tax dollars and ensuring tomorrow's tax compliance. In this report, we have juxtaposed two different processes for contracting out federal work: the Circular A-76 process and the process used in the PDC initiative. The Circular A-76 process addresses many important questions before proceeding with contracting out, including such threshold questions as whether the function is commercial or inherently governmental and whether the private sector can perform the work more efficiently. The language cited by the IRS from the FAIR Act does not bar the IRS from conducting a study to determine whether PCAs are cost effective. The National Taxpayer Advocate does not understand the IRS's resistance to testing its assumptions of cost-effectiveness *before* implementation, given that taxpayer privacy and taxpayer dollars are at risk.

The IRS indicates that its Collection function has not actually suffered a reduction in force as a result of the PDC initiative, and thus, it should not be held to the standards of the government's competitive sourcing process. This may be true, so far; however, we are aware of reductions in force that are occurring throughout the IRS of low-graded employees, capable of being trained to interact with taxpayers. Thus, we have asked the IRS to compare the performance of private collectors with IRS personnel on the same types of cases so that decision-makers can decide who should be making these calls. To date, the IRS has declined, indicating that even with additional resources it will not work these low priority cases. In light of the fact that part of the initiative was for the IRS to learn best collection practices from private industry,<sup>98</sup> this may be the one salvageable lesson learned from this PDC experiment: no case is too insignificant

<sup>98</sup> The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004), providing in pertinent part:

(7) a measurement plan which includes a comparison of the best practices used by the private collectors with the Internal Revenue Service's own collection techniques and mechanisms to identify and capture information on successful collection techniques used by the contractors which could be adopted by the Internal Revenue Service.

so as not to warrant the expense of a phone call. The problem, of course, is that the IRS wants the private industry to make the calls.

We should not allow the private industry to make these calls. The costs to our tax administration system are too high. These costs, *i.e.*, the cost to customer service, consistency, transparency, and tax compliance, will never show up on the IRS's projected financial statements. The talented IRS professionals working on this initiative may be able to extract some concessions towards customer service; however, the concessions appear to fall far short of the mark. For example, the IRS gives credit for two of the three contractors for having bilingual staff (though we are not sure how many staff members are bilingual, in what languages they are bilingual, and whether their employment is happenstance or by design); however, the IRS would not honor TAS's request to address multilingual services to taxpayers as part of the operational plans so that the contractors could be held accountable.

#### *Lack of Transparency*

The issues surrounding the initiative's lack of transparency have continued to evolve even as we complete this report. The lack of transparency of the operational aspects of the private contractors is another significant cost to our tax administration system. In an initial draft of this report, we cited sections of a collection script used by one of the contractors which used psychological tricks during the conversation to get the taxpayers to commit to a payment, which is then followed by a belated Fair Debt Collection Practices Act warning at the end of the conversation. The IRS informed us that private collection agencies had designated the "collection scripts" and operational plans as proprietary and that we could not cite specific portions of the scripts. Following Federal Acquisition Regulations, the IRS requested the agencies to release the information to the public. To date, one agency has agreed to disclosing portions of its operational plan, one gave a qualified response about releasing portions of its plan, and the third contractor refused.

Thus, this initiative has placed into the hands of private collectors the power to determine the extent to which the public will know about their collection practices, as they go about doing the government's work. This is a very significant cost to our tax administration system, which, like the other hidden costs described above, will only increase as the IRS begins dramatically expanding this initiative with its Release 1.2, beginning in January of 2007.

#### RECOMMENDATIONS

Congress should repeal the private debt collection authority granted to the IRS through the American Jobs Creation Act for the reasons set out above.<sup>99</sup> The initiative risks too much for too little.

<sup>99</sup> Since this recommendation is in essence a legislative recommendation, we have also included the proposal as a Key Legislative Recommendation, *Repeal Private Debt Collection Provisions, infra*.

If Congress does not terminate the initiative, the IRS should be required as part of its biennial reporting process<sup>100</sup> to take steps that will assist decision makers in determining who should be working these cases, *i.e.*, the IRS or the private sector, rather than simply assuming that private collectors should be working these cases since they are “unproductive” for the IRS. To answer this question, the IRS should compare the performance of its own employees with private collectors on the same types of cases. The IRS should also utilize the cost analysis procedures used by its Office of Competitive Sourcing to see how such determinations are made by professionals trained in that area.

If Congress does not terminate the initiative, the IRS should revise its second Request for Quotations (RFQ) process to incorporate some of the important lessons learned in the first RFQ. For example:

- ◆ The IRS should mandate public disclosure of operational plans, scripts and training materials of contractors as a condition of competing in the process.
- ◆ The IRS should require that the contractors contain operational plans for dealing with taxpayers who speak English as a second language.
- ◆ The IRS should require that Fair Debt Collection Practice Act warnings be given at the beginning of each contact and prohibit the use of trickery or device.
- ◆ The IRS should hence forth provide direct training on issues relating to taxpayer rights, the Office of Appeals, levies and other topics essential to the collection process, as well as training as to who has an obligation to file tax returns.

<sup>100</sup>The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881(e), 118 Stat. 1418 (2004).

**PROBLEM****TOPIC #5****EARLY INTERVENTION IN IRS COLLECTION CASES****RESPONSIBLE OFFICIALS**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

The lack of early, meaningful interventions by the IRS on delinquent tax accounts contributes to long-term financial problems for many taxpayers and costs the government billions of dollars in lost revenue.

**ANALYSIS OF PROBLEM****Background**

The IRS Collection function, which is responsible for collecting delinquent unpaid tax assessments and pursuing tax returns that have not been timely filed, is an essential component of our voluntary compliance tax system. In addition to collecting billions of delinquent tax dollars for the U.S. Treasury, a fair and effective tax collection operation is necessary to ensure every citizen pays a fair share of his or her government's expenses. For millions of American taxpayers, the Collection operation is the face and voice of the IRS.

In the 2004 Annual Report to Congress, the National Taxpayer Advocate identified several essential elements for a collection strategy that would balance the goals of tax collection, taxpayer service, and tax compliance. These elements included the need for prompt human contact with delinquent taxpayers, understanding the reasons for their noncompliance, and identifying the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs.<sup>1</sup> Over the last several years, the IRS has stressed that tax enforcement plus taxpayer service equates to tax compliance.<sup>2</sup> The National Taxpayer Advocate has consistently emphasized that while enforcement and taxpayer service are critical components of the voluntary compliance tax system, they are not mutually exclusive. In fact, to maximize the effectiveness of its collection program, the IRS must recognize the role of taxpayer service within the context of enforcement and broaden its understanding of all that falls under the tax enforcement umbrella.<sup>3</sup>

<sup>1</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

<sup>2</sup> IRS, *Strategic Plan 2005-2009* 3 (Jun. 2004).

<sup>3</sup> Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies (Apr. 27, 2006); Nina E. Olson, National Taxpayer Advocate, Keynote Address, American Bar Association Tax Section (May 5, 2006); Statement of Nina E. Olson, National Taxpayer Advocate, before the United State Senate Committee on Finance on The Tax Gap (Jul. 26, 2006).

While federal tax liens, levies, and seizures are certainly IRS collection tools, so are collection notices, personal contacts by collection personnel, installment agreements, and offers in compromise. For those taxpayers who do not resolve their tax delinquency problems through responses to collection notices, we believe a timely personal contact from an IRS collection employee is a vital action for bringing about compliance. Timely, personal interventions on collection accounts are powerful motivations for taxpayers to resolve tax problems. They are excellent opportunities to ensure that delinquent taxpayers understand the serious financial consequences that can develop if tax debts are not resolved timely. These interventions also represent the appropriate point in the collecting process to identify and resolve issues that have caused the taxpayers to become delinquent, thereby preventing future noncompliance, and to explore meaningful payment options.

**IRS case assignment practices do not promote early intervention in collection cases.**

IRS methods for establishing the priority of collection cases have traditionally placed primary emphasis on the aggregate dollar amounts of the delinquencies.<sup>4</sup> For example, a taxpayer owing \$100,000 will typically receive higher priority than one owing \$10,000, while the latter taxpayer will generally be considered a much higher priority than one owing \$1,000. While the type of tax at issue may affect the priority of a case – for example, a case involving employment taxes may receive more priority consideration than one involving income taxes – generally the age of the account does not receive appropriate weight in determining its priority, which in turn plays a critical role in deciding which cases receive personal contacts from IRS collection personnel. As a result, many collection accounts do not receive adequate attention because the taxpayer does not owe “enough” delinquent taxes, at least not yet.

**Aggregate dollar amounts of tax delinquencies do not accurately reflect the nature of most IRS collection cases.**

Most IRS collection cases originate as relatively small balances due on recent tax periods. In fiscal year 2006, for example, of the collection cases in which the IRS issued a final collection notice,<sup>5</sup> 87.2 percent of individual (Individual Master File or IMF) and 91.5 percent of business (Business Master File or BMF) cases involved delinquencies of less than \$10,000.<sup>6</sup> Additionally, 62.9 percent of IMF cases and 76.2 percent of the

<sup>4</sup> IRS, SBSE, *Risk Based Collection* (Mar. 2006), available at [http://sbse.web.irs.gov/ACS/Risk\\_Based/Risk\\_Based\\_Collection.htm](http://sbse.web.irs.gov/ACS/Risk_Based/Risk_Based_Collection.htm).

<sup>5</sup> When a tax return is filed and a taxpayer does not fully pay all assessed amounts due, a series of notices are mailed to the taxpayer. The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account up to three additional collection notices will be sent at five-week intervals. Business taxpayers will receive the first notice and in five weeks, the final collection notice. The final collection notice advises taxpayers of the Intent to Levy and is the last notice required before a federal tax lien may be filed. See IRM § 5.19.1-3.

<sup>6</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

BMF cases involved less than \$3,000.<sup>7</sup> The IRS's emphasis on considering aggregate dollar amounts of collection cases, *i.e.*, the cumulative total of several delinquent tax periods, as a prime factor in establishing case assignment priorities contributes to a lack of meaningful personal contacts with these taxpayers until the delinquency problems "grow" into a pre-defined priority status.

Because of this approach, IRS collection cases often are not given priority consideration, *i.e.*, personal contacts from employees working in the Automated Collection System (ACS) or revenue officers in the field, until the taxpayers accumulate debts on multiple tax periods, a condition commonly known as the "pyramiding of liabilities." The IRS's routine methods for prioritizing and assigning collection accounts in this manner appear to have essentially "institutionalized" the pyramiding of liabilities. At the conclusion of FY 2006, taxpayers with delinquencies whose accounts were assigned to ACS for collection had an average of 1.9 delinquent tax periods, taxpayers whose accounts were waiting in the so-called collection "queue"<sup>8</sup> to be assigned to field personnel had an average of 3.1 delinquent tax periods, and taxpayers whose accounts were assigned to a revenue officer in the collection field operation had an average of 4.2 delinquent tax periods.<sup>9</sup> In the collection field program, 58.2 percent of the BMF taxpayer cases involved three or more delinquent tax periods and 69.3 percent of the IMF cases involved two or more delinquent periods.<sup>10</sup> These conditions not only reflect a problem with pyramiding liabilities, which seems to be built into collection case assignments, but also indicate a considerable passage of time between the origination of the initial debt and the point at which the IRS determines the case requires personal, priority treatment.

**Timely, meaningful contacts are critically important in collecting accounts receivable.**

It is understood in the business community that accounts receivable become much more difficult to collect the longer they remain delinquent. According to a study by Dun & Bradstreet, the probability of collecting a payment 90 days past due declines by 12 percent for each additional 30-day period.<sup>11</sup> A survey of members of the Commercial Collection Agency Section of the Commercial Law League of America, completed in June 2001, indicates that generally, if an account is 90 days delinquent, only 73 percent of the debt will be collected; at six months only 50 percent will be collected; at 12 months the figure falls to 25 percent; and at 24 months, only 10.5 percent will be collected.<sup>12</sup> In fact, the IRS has also recognized and validated this "collectibility curve" in

<sup>7</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

<sup>8</sup> The IRS collection queue is an inventory of cases awaiting assignment to the Collection Field operation. While these cases are considered to be "open" collection accounts, they remain inactive until assigned to a revenue officer. A case assigned to the collection queue will ultimately be reported as currently not collectible (CNC) if not actually assigned to a revenue officer within a prescribed period of time.

<sup>9</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

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

<sup>11</sup> David Shor and Martin Shor, *How to Collect Debts and Still Keep Your Customers* at 51 (1999).

<sup>12</sup> *Collection Trends* at [www.proconsvr.com/colltrends.htm](http://www.proconsvr.com/colltrends.htm).



a number of studies.<sup>13</sup> These studies acknowledge that on tax debts that are 24 months past due, the IRS typically collects approximately 13 cents on the dollar, and these debts become practically uncollectible after three years.

### **IRS collection program measures do not accurately reflect the true age of delinquent accounts.**

IRS measures designed to track the age of collection accounts generally are not based on the due date of the tax return, but instead track the length of time the account has been assigned to a particular status in the collecting process, *i.e.*, ACS, offer in compromise (OIC), or the Collection Field function (Cff). These measures appear to be designed more to measure the program efficiency of the operation to which the accounts are assigned than to accurately reflect the ages of the delinquent accounts themselves. For example, as of September 2006, IRS reports reflect 18.1 percent of open balance due collection accounts had been assigned to the current collection function for 16 months or longer.<sup>14</sup> However, 65.4 percent of these accounts involved tax periods in 2002 or prior tax years.<sup>15</sup> Consequently, although the IRS acknowledges the “collectibility curve” and the impact of time on the ultimate collectibility of accounts receivable, there is a noteworthy absence of program measures that reflect the age of collection cases from the taxpayer’s perspective, *i.e.*, the due date of the tax return.

For example, assume a taxpayer filed a balance due delinquent income tax return for the 1995 tax year in early 2002. Further, assume the case spent several months working its way through the routine collection notice process, a year in ACS, and two years in the collection queue before being assigned to a revenue officer in the collection field operation in early 2006. At the point the account is assigned to a field collection status, traditional IRS measures of “overaged” accounts do not recognize it as an aged account receivable, even though from the taxpayer’s perspective the balance has been due for almost ten years. Although the collection potential of this account is likely to be negligible, IRS cycle time measures will indicate the account is not aged.

### **The accumulation of interest and penalties significantly exacerbates the taxpayer’s delinquency problem.**

Interest accrues on delinquent tax accounts at a rate of eight percent annually, *compounded daily*,<sup>16</sup> and applies to penalties and interest as well as the outstanding tax

<sup>13</sup> IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 30 (Mar. 27, 2001); IRS, *Automated Collection System Operating Model Team, Collectibility Curve* (Aug. 5, 2002).

<sup>14</sup> IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006). The Collection function uses the term “balance due” to describe open collection accounts. In this report, the term is used to describe IRS collection accounts that remained delinquent after issuance of the routine IRS collection notices. In the past, these accounts were called Taxpayer Delinquency Accounts (TDAs).

<sup>15</sup> IRS, *Collection Activity Report, Taxpayer Delinquency Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>16</sup> IRC §§ 6601 and 6621(a)(2). Rev. Rul. 2006-49, 2006 WL 2590501. Interest generally accrues on delinquent tax accounts at the federal short-term rate plus three percentage points.

balance itself. Failure to pay penalties accrue at 0.5 percent per month up to 25 percent of the delinquent balance.<sup>17</sup> When balance due accounts are not addressed and resolved timely, it is not uncommon for penalties and interest to equal or exceed the original delinquencies. Such additional liabilities can make it very difficult for taxpayers to pay both their delinquent taxes and their current liabilities.

Unlike other financial institutions, the IRS does not clearly communicate to taxpayers the true cost of owing money to the government. While the Truth in Lending Act<sup>18</sup> requires lending institutions to inform borrowers of the annual percentage rate (APR) representing the *total* finance charges associated with a loan, no such requirement exists for outstanding federal tax debts. We do not suggest that penalties and interest on tax debt are synonymous with finance charges on consumer loans. However, taxpayers are often stunned by the cumulative impact of penalties and interest (P&I) on their balances due. Taxpayers might be more motivated to seek alternative financing sources if they knew the true cost of “borrowing” from the IRS.

**Delayed contacts and insufficient use of alternative payment options result in thousands of IRS collection cases remaining unresolved for prolonged periods of time.**

Delayed interventions by IRS collection personnel and insufficient use of reasonable payment options result in many collection cases ultimately being reported as currently not collectible (CNC), or remaining inactive in the collection queue. In either situation, the taxpayers’ problems remain unresolved while penalties and interest accrue. For these taxpayers, “no news” is not necessarily “good news.” Frequently, the taxpayer must also contend with the impact of the federal tax lien.<sup>19</sup> Aside from the economic burden, lingering financial problems often carry a psychological burden, including a sense of shame, humiliation, and a loss of independence and control over a very important aspect of one’s life.<sup>20</sup>

The IRS reports a substantial number of collection cases as CNC each year. In FY 2006, the IRS reported over 750,000 taxpayer accounts as currently not collectible, including more than 1.7 million tax periods and approximately \$16.2 billion in revenue.<sup>21</sup> *More delinquent tax dollars were reported as CNC than were actually collected on open taxpayer*

<sup>17</sup> IRC § 6651(a)(2).

<sup>18</sup> Truth in Lending Act, 15 U.S.C.A. 1601 et. seq. (West, 2006).

<sup>19</sup> IRM 5.16.1.1(4) (Sept. 19, 2005), which specifies that “Liens should be filed when the unpaid balance of assessments exceeds the amount in LEM 5.16.1.1(4).”

<sup>20</sup> John Bachman, Ph.D, *The Psychology of Debt*, Credit & Collections World (April 2001), available at <http://www.creditcollectionsworld.com/04paper01.htm>.

<sup>21</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

*delinquent accounts (TDAs), installment agreement accounts, and offers in compromise combined.*<sup>22</sup> Of those accounts reported as CNC, approximately 63.2 percent involved situations in which the IRS decided not to actively pursue collection due to their relative low priority.<sup>23</sup> While technically the IRS may continue to collect delinquent revenue in CNC accounts, historically it has not succeeded in doing so, and data indicates that the IRS actually collects less than two percent of the revenue dollars reported as not collectible.<sup>24</sup> IRS data for FY 2006 reflects over \$53 billion of delinquent revenue in the cumulative inventory of accounts reported as CNC.<sup>25</sup> This situation is not one that has recently developed. From fiscal years 2001 through 2006, the IRS averaged \$14.6 billion per year in revenue dollars reported as CNC and annually collected less than two percent of the CNC dollar inventory.<sup>26</sup>

As of September 2006, over 779,000 taxpayer cases with balance due accounts resided in the IRS collection queue, and 27.1 percent of the related delinquent tax modules were assigned to the queue for 16 months or longer.<sup>27</sup> Over \$27 billion in delinquent tax revenue was associated with these accounts.<sup>28</sup> While theoretically these accounts are inactive and awaiting assignment to the collection field operation, they often remain unassigned and ultimately are systemically reported as CNC once they have been in the queue for a predetermined time.<sup>29</sup> Collection accounts closed in this manner are commonly referred to as “surveyed” or “shelved.” According to a report by the Treasury Inspector General for Tax Administration (TIGTA), from FY 2001 through FY 2004 the IRS “shelved” 1.8 million balance due tax modules involving 934,000 taxpayers and

<sup>22</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006); IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2005). In FY 2006, approximately \$16.2 billion in balance due accounts were reported as CNC; approximately \$7.2 billion was collected on balance due accounts that remained open after the routine collection notice process, *i.e.*, Taxpayer Delinquent Accounts (TDAs) and \$7.4 billion was collected through installment agreements, *i.e.*, formal agreements between taxpayers and the IRS to pay delinquent taxes through regularly scheduled periodic payments, usually monthly. Approximately \$284 million was accepted in offers in compromise.

<sup>23</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006). Of the accounts reported as CNC in FY 2006, 40.1 percent were closed as “surveyed,” meaning the IRS decided to curtail further collection activity due to the perceived relative low priority of the collection accounts. Another 23.1 percent were closed as “toleranced,” meaning the IRS did not pursue collection activity beyond the collection notice stream. Again, these decisions are based on the relative low priority of the collection accounts.

<sup>24</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

<sup>25</sup> *Id.*

<sup>26</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY-2001 - 2005).

<sup>27</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>28</sup> *Id.*

<sup>29</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-030, *High Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management’s Attention 4* (Feb. 2006).

balances due of \$7.8 billion.”<sup>30</sup> The report indicates that the IRS will probably never personally contact a significant number of these taxpayers to resolve their collection-related issues, unless or until their accounts grow into a high priority status.<sup>31</sup>

**The IRS often cites limited resources to justify collection inventory delivery practices, yet while current, self-reported accounts are ignored, collection resources are directed to other, less productive cases.**

We have already discussed the critical impact of elapsed time on the collectibility of accounts receivable. In light of this very real consideration, it would be natural to expect the IRS to place top priority on addressing current, self-reported delinquent accounts as expeditiously as possible. There is little question that the assessments in these cases are valid, and recognized business practices as well as IRS data indicate that early, timely intervention will recover a high percentage of delinquent revenue. The IRS usually cites a lack of available collection resources as a barrier to providing personal attention to many of these cases.<sup>32</sup> However, we have identified a number of situations where the IRS routinely employs collection resources and achieves questionable results.

We recognize and appreciate the need for the IRS to also pursue compliance cases where the taxpayers have not voluntarily reported their tax liabilities. However, IRS data indicate that the manner in which these “compliance-oriented investigations” are generated and processed often leads to unproductive investigations and wasted collection resources. For example, in addition to recovering delinquent revenue on assessed taxes, the Collection operation also pursues and secures delinquent tax returns. The primary instrument for this purpose is the Delinquent Return (Del Ret) investigation. In FY 2006, the IRS issued approximately 2.4 million Del Ret investigations.<sup>33</sup>

IRS data indicates that during FY 2006, only 38.4 percent of the Delinquency Return modules closed in the field and 42.4 percent in ACS were resolved by actually obtaining delinquent returns.<sup>34</sup> On the other hand, a substantial number of Delinquent Return modules were closed because the taxpayers were determined not to be liable for the returns in question (49.7 percent in the field and 43.5 percent in ACS).<sup>35</sup> The identification and pursuit of delinquent tax returns is an important component of a tax system based on voluntary compliance. However, the methods used to generate delinquent return investigations should be based on reliable indicators that the identified returns

<sup>30</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-030, *High Risk Work Is Selected From the Unassigned Delinquent Account Inventory, but Some Unassigned Accounts Need Management’s Attention 2* (Feb. 2006).

<sup>31</sup> *Id.*

<sup>32</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006).

<sup>33</sup> IRS, *Collection Activity Report, Taxpayer Delinquency Investigation Cumulative Report, NO-5000-4* (Oct. 2, 2006).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

are legally required and delinquent. Otherwise, the IRS will continue to waste resources that it could apply to servicing the inventory of current, self-identified balance due accounts.

Another means of securing delinquent income tax returns is the Substitute for Return (SFR) program, which uses income reported by third parties, usually via Forms 1099, U.S. Information Return, and W-2, Employee's Wage and Earnings Statement, to establish potential income tax liabilities for taxpayers who have not voluntarily filed returns for the years in question. In theory, the SFR program, particularly the automated version of the program (ASFR), is an efficient method of addressing non-filing. In practice, this compliance program appears to generate a great deal of unproductive work for the IRS. In FY 2006, only about 21.4 percent of SFR dollars assessed were "resolved" during the collection notice process through the collection of revenue dollars. *The IRS abated approximately 3.7 times more SFR tax dollars than were collected on these accounts.*<sup>36</sup>

Another collection tool is the Trust Fund Recovery Penalty (TFRP), which the IRS uses to collect the trust fund portion of employment tax delinquencies in situations involving business entities, usually corporations, which are delinquent in their employment tax obligations. In situations where the corporation cannot pay the employment tax debt, the corporate officers or other responsible parties may be held personally liable for the trust fund portion of the debt.

TFRP investigations, in a manner similar to business-related seizures, represent failure conditions for the IRS. That is, the IRS can generally avoid TFRP situations through early interventions with businesses at the first indication of an employment tax problem. However, the IRS typically makes TFRP assessments long after the underlying employment tax problems have materialized. Although the TFRP provides something of a "safety net" for the IRS in situations where corporate employment tax liabilities are not addressed timely, it does not appear to be an *effective net*. The overall collection results of TFRP investigations underscore the importance of early intervention in employment tax cases. Of the TFRP balance due assessments reported as dispositions in FY 2006, only 18.9 percent were full paid, with another 16.7 percent approved for installment agreements. However, 28.5 percent of these assessments were reported as not collectible *and the IRS abated or reported as CNC over six times as many TFRP assessed dollars as it ultimately collected.*<sup>37</sup> These results should not surprise collection managers. They closely reflect the impact of time and the "collectibility curve."

### The "downstream" costs related to delayed collection contacts are significant.

As previously mentioned, there are firm indications in IRS data that delayed meaningful contacts on delinquent collection cases actually contribute to wasted resources by focusing them on inventories that are inflated by multiple delinquent tax periods per taxpayer

<sup>36</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

<sup>37</sup> *Id.*

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entity. Routine “assembly line” processing of cases and increased emphasis on automated, “bulk-processing” collection treatments in lieu of personal contacts with taxpayers do not appear to be effective in fully resolving tax delinquency problems, and may actually increase the overall costs involved.

For example, since FY 2000 TAS has observed a marked increase in the volume of levies the IRS has issued, with the vast majority originating from accounts assigned to ACS.<sup>38</sup> We have also noted a corresponding increase in levy-related taxpayer problems referred to TAS.<sup>39</sup> IRS management has confirmed that many of these levies are now issued “systemically,” *i.e.*, as cases are assigned to ACS at the conclusion of the collection notice process, the system will generate levies on identified sources before attempting any personal contact with the taxpayers.

While on the surface this practice may appear to be cost efficient, prior IRS studies have concluded that the IRS costs associated with servicing responses to “bad” levies (the taxpayer is no longer employed by the levy source or no longer maintains an account with the identified source) are considerable, not to mention the burden these levies place on the third parties who are required to respond.<sup>40</sup> In addition, several IRS studies have concluded that taxpayers respond to “call me” letters from ACS at a rate comparable to those subjected to levy action.<sup>41</sup>

*Levies are powerful collection tools, not “calling cards.”* Private sector collection operations must secure court orders to effect garnishments of this nature. Levies should not be confused with legitimate attempts to establish personal contact with delinquent taxpayers. Systemic levies bypass the personal communication process completely, move immediately to enforcement, and produce dubious results.<sup>42</sup> Ironically, although the IRS does not emphasize the use of telephonic outcalls as a primary method of establishing contact with delinquent taxpayers, it has recently contracted with several private debt collection (PDC) agencies, who will take precisely that approach to collect delinquent taxes.<sup>43</sup>

We have already discussed the high percentage of abated tax assessments in the ASFR and TFRP programs. Overall, in FY 2006 the IRS abated \$7.1 billion on balance due collection cases.<sup>44</sup> Of this amount, \$3.9 billion was abated in the Collection Field

<sup>38</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 4 (Mar. 2006).

<sup>39</sup> Taxpayer Advocate Service, *Business Performance Review* 49 (Mar. 16, 2006).

<sup>40</sup> IRS, *Automated Collection System Redesign Project*, 9 (Jun. 1998).

<sup>41</sup> *Id.*

<sup>42</sup> See Most Serious Problem, *Levies*, *infra*.

<sup>43</sup> IRS, *Private Debt Collection Talk Points*, available at [http://sbse.web.irs.gov/collection/programs/pdc/docs/PDC\\_talkpoints.doc](http://sbse.web.irs.gov/collection/programs/pdc/docs/PDC_talkpoints.doc). See also, Most Serious Problem, *True Cost and Benefits of Private Debt Collection*, *supra*.

<sup>44</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

operation and over \$1.6 billion was abated in ACS.<sup>45</sup> Abatements often involve time-consuming, manually generated case actions. Would it not be more practical to apply these resources to early intervention efforts designed to resolve the thousands of collection cases that currently are overlooked each year?

**The IRS has already demonstrated the effectiveness of early intervention, yet has not embraced the lessons learned.**

The IRS's treatment of employment tax delinquencies is a particularly noteworthy example of how the right treatments applied by the right personnel at the right time can profoundly affect taxpayer service, revenue collection, and compliance. Employment taxes, as reported quarterly on Form 941, Employer's Quarterly Federal Tax Return, are withheld in trust by employers for their employees and paid over to the IRS via federal tax deposits. Because employment tax liabilities accrue rapidly, it is imperative that the IRS react to early indicators that a business is delinquent. Otherwise, employment tax debts can pyramid very quickly, often to a point where the accumulated debt is very difficult for the business to resolve. Employment tax delinquencies tend to start with small quarterly balances. Of the cases in which a final collection notice was issued in FY 2006, 71.1 percent of the business (BMF) employment tax cases involved delinquencies of less than \$3,000.<sup>46</sup> Based on dollar amount alone, these early indicators of employment tax problems may not appear to warrant priority attention. However, a focus on dollar amounts alone does not fully capture the impact of delayed contacts in these cases.

In 2001, an IRS collection reengineering team, with assistance from external consultants, studied the processing of employment tax cases. The team confirmed that collectibility on employment tax cases diminishes with age.<sup>47</sup> The team also confirmed that due to limitations built into the ACS system, routine processing of these accounts through assignment to ACS did not fully resolve the majority of the accounts, which led to further aging and pyramiding of liabilities.<sup>48</sup> The study concluded that delayed IRS intervention in employment tax delinquencies creates situations where taxpayers are less likely to resolve tax problems without going out of business or filing bankruptcy.<sup>49</sup>

The team recommended that employment tax delinquencies be handled on a "last due, first worked" basis with highest priority based on the age and type of case rather than the dollar amount.<sup>50</sup> In fact, the team recommended that recently assessed employment tax cases with relatively low delinquent balances due be given the highest priority for

<sup>45</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>46</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

<sup>47</sup> IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings 4*. (Mar. 27, 2001).

<sup>48</sup> *Id.* at 24.

<sup>49</sup> *Id.* at 19-21.

<sup>50</sup> *Id.* at 5.

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expedited assignment to the Collection Field operation.<sup>51</sup> The team projected that such early intervention on trust fund cases would significantly improve revenue collected and protect against further lost revenue by preventing the pyramiding of additional liabilities.<sup>52</sup> Taxpayer service would improve by providing more time and opportunities to resolve tax problems. Further, the team concluded that early intervention would also improve IRS employee satisfaction by allowing revenue officers to intervene in settings that are less confrontational because taxpayers would have a greater capacity to resolve their problems without escalated enforcement.<sup>53</sup> The IRS accepted the team's recommendations in 2001 and implemented them in FY 2002.

The positive results from this effort were almost immediate. By the close of FY 2005, revenue collected by the Collection Field operation had risen by 42.2 percent, contributing significantly to an overall increase in collections of 44.8 percent in IRS balance due cases.<sup>54</sup> Focus group interviews with Collection Field personnel confirmed that "accelerating contact on cases with more current liabilities and less owed has put the Service and the taxpayer in a much better position to reach an amicable resolution. It was also felt that the accelerated contact decreased the likelihood of future liabilities, fostered taxpayer compliance and prevented businesses from failing."<sup>55</sup> Indeed, the impact on compliance was evidenced by more than anecdotal accounts from field personnel. After implementing the new inventory delivery methods, the IRS witnessed a significant decline in the receipt of new employment tax balance due cases from FY 2003 to FY 2005.<sup>56</sup>

A new collection strategy, based on recognizing specific taxpayer needs and characteristics, had been developed and implemented and was generating very positive results. This new approach could have served as the model for similar improvements for other segments of the IRS collection inventory, including those involving individual master file (IMF) cases. Unfortunately, it appears that the IRS has not applied these lessons to other collection cases.

Even more disturbing, in FY 2005 the IRS resumed its practice of assigning more employment tax cases to ACS. It is our understanding that the driving factor behind this change was the perception that small dollar delinquencies are not priority assignments, and should not be assigned to the Collection Field operation until ACS has had an opportunity to resolve them. As a result of the reengineering inventory delivery

<sup>51</sup> IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 4 (Mar. 27, 2001).

<sup>52</sup> *Id.* at 21.

<sup>53</sup> *Id.* at 8-12.

<sup>54</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (2001 – 2005).

<sup>55</sup> IRS, *Collection Reengineering Phase I, Joint Implementation Monitoring Committee* (Final Report) 15 (Aug. 2002).

<sup>56</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (2003 – 2005) The IRS reported 1,107,046 balance due module receipts involving employment tax delinquencies (Forms 941) in FY 2003 and 958,179 receipts in FY 2005 – a reduction of 148,867 modules (14 percent).



changes, by FY 2004 only 26.6 percent of the new balance due cases involving trust fund taxes (Form 941) were assigned to ACS. Through September 2006, 36.7 percent of these cases have been assigned to ACS.<sup>57</sup> The inventory delivery impact of the 2001 reengineering recommendations is almost completely reversed. Further, IRS data indicate that the issuance of Failure to Deposit (FTD) alerts, another tool for early identification of employment tax delinquencies, also has been curtailed significantly.<sup>58</sup> Interestingly, IRS data for 2006 indicate that BMF case receipts are again increasing while BMF revenue collections have significantly declined.<sup>59</sup>

**Meaningful early interventions in IRS collection cases represent a key element of the “social contract” that serves as a prerequisite for a voluntary tax system.**

Tax enforcement and taxpayer service are not mutually exclusive. The concept of voluntary compliance that serves as the foundation of our nation’s tax system has at its core an understanding that compliance with the tax laws is based on more than a simple business relationship between each taxpayer and the U.S. government. In a typical business relationship, each party has the clear option to terminate the transaction and take its business elsewhere. If a collection issue becomes too difficult to resolve, a business entity can refuse to provide further goods or services to the customer. In turn, an unsatisfied customer may turn to a competitor who may offer more realistic and convenient payment options.

The taxpayer and the government have no such options. Taxpayers who are delinquent in tax filing and payment obligations are not cut off from receiving federal services and protections. Taxpayers who fall behind in their tax obligations and cannot reach mutually agreeable payment arrangements with the IRS do not have the option of “taking their business elsewhere” and escaping their tax obligations. Within this context, an important outcome of any IRS effort to collect delinquent taxes is the need to bring the delinquent taxpayer back into the ranks of those who voluntarily comply. On the other hand, compliant taxpayers also have an interest in their government consistently addressing problems with noncompliance in a fair and equitable manner.

In their book “How to Collect Debts and Still Keep Your Customers,” David and Martin Shor write:

If the debt collection effort is handled properly, both parties to that process should also remain friends. Remember, your obligation should be to collect the most

<sup>57</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>58</sup> IRS, *Collection Activity Report, Collection Workload Indicators, NO-5000-23* (Sept. 6, 2006). Through August 2006, only 0.4 percent of staff hours devoted to IRS collection operations were spent on FTD Alerts. This is a 68 percent reduction from the number of staff hours used to work FTD Alerts in FY 2003. IRM 5.7.1.1 (Apr. 1, 2005). The FTD Alert process identifies, at an early stage (*i.e.* before the return is due), taxpayers who have fallen behind in their deposits.

<sup>59</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2005 and FY 2006).

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money as fast as you can, net of expenses, while maintaining the goodwill of the debtor. Keep in mind that most people are honest and intend to pay. On average, 80 percent of the people who owe you money will pay on time; 18 percent intend to pay as promised, but are unable to do so for one reason or another; and 2 percent are “credit criminals” who never intended to pay. Forget the “credit criminals” – you aren’t going to collect your money from them anyway. And, you certainly don’t have to worry about the 80 percent who are going to pay as agreed. So, almost all of your collection effort will be directed at the 18 percent who have good intentions, but who are unable to pay on time.<sup>60</sup>

The authors’ numbers in this passage closely parallel the voluntary compliance rate figures published by the IRS. Most American taxpayers voluntarily file and pay their taxes on time – approximately 83.7 percent, according to the most recent IRS analysis.<sup>61</sup> We do not suggest that the IRS would or should ever “forget the credit criminals” who intentionally engage in fraudulent tax avoidance schemes.<sup>62</sup> Tax debts are very different from other debts, in that taxes are the revenue stream for government. However, the observation that most delinquent accounts represent people with basically good intentions who are struggling to meet their financial obligations in a timely manner is also pertinent to IRS collection accounts. In our routine casework, TAS’s experience with taxpayers attempting to resolve problems indicates that most tax collection cases do not involve individuals who set out to deliberately defraud the government. The need to “maintain the goodwill of the debtor” is even more important within the context of good government and tax administration. The concept of voluntary compliance is based on this goodwill.

However, an emphasis on maintaining the goodwill of the debtor does not routinely surface in an objective review of the IRS’s traditional policies and procedures designed to collect delinquent taxes, as published in the Internal Revenue Manual. Nor is this concern evident in the IRS’s previously described collection inventory delivery system. The traditional IRS “enforcement model” seems to be based on the assumption that collection cases routinely involve taxpayers who are attempting to intentionally avoid their tax obligations.<sup>63</sup> This bias is clearly evident in procedures established for determining the availability of collection payment alternatives, which appear to be designed to ensure

<sup>60</sup> David Shor and Martin Shor, *How to Collect Debts and Still Keep Your Customers* 42 (1999).

<sup>61</sup> Government Accountability Office, GAO-06-453T, *Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions* 6 (Feb. 15, 2006).

<sup>62</sup> The IRS does not have a reliable system of tracking taxpayers who have a history of abusive filing behavior or chronic tax delinquency problems. The IRS uses an “R code” to systemically identify taxpayers who have accumulated repeat delinquencies within a specified period of time. However, the IRS applies this systemic coding to any taxpayer with more than one delinquent tax period. Because a single incident can lead to delinquencies in multiple periods, the “R code” does not accurately reflect taxpayers with multiple, distinct episodes of delinquent filing and paying behavior. As a result, this indicator provides limited useful information to assist IRS management in the early identification of high risk collection accounts.

<sup>63</sup> IRS, *Automated Substitute for Return (ASFR) Program, An Analysis from the Customer’s Perspective*, (Nov. 1998); *Automated Collection System (ACS) Redesign Project* (Jun. 1998).

that delinquent taxpayers aren't "getting away" with noncompliance.<sup>64</sup> If such options are to be considered, they must represent the taxpayer's *maximum* ability to pay, even though this approach more often than not will result in the denial or failure of such payment options to actually resolve the delinquency problems.<sup>65</sup> In essence, taxpayers who do not resolve their delinquency problems during the routine collection notice process are perceived as potential "credit criminals" and are set up to fail.

The National Taxpayer Advocate believes that the underlying social contract between the federal government and American taxpayers requires that the collection process should routinely set the stage for taxpayers to succeed in resolving their debts. A new model should assume that the majority of taxpayers would sincerely like to resolve their problems and move forward with their lives. Prior IRS studies have supported this assumption,<sup>66</sup> and we have yet to see a study that indicates the majority of IRS collection cases involve "credit criminals." The new model should assume that fear and uncertainty about the IRS may impede many taxpayers' inclination to contact the IRS or respond to routine collection notices. The media attention focused on the IRS's renewed emphasis on tax enforcement in recent years may not lead many of these taxpayers to conclude that the IRS is an agency that will listen to their problems and look for "win-win" solutions. Consequently, recognition of the social contract requires that the IRS more effectively identify those taxpayers who will not likely resolve their own problems through the notice process, and initiate meaningful, personal contacts to address and resolve tax problems when they are most likely to be successful.

We again emphasize that an efficient and effective tax collection operation should be characterized by prompt human contact with delinquent taxpayers, an understanding of the reasons for their noncompliance, and identification of the appropriate collection treatment for each taxpayer based on his or her individual characteristics and needs. This type of taxpayer service within the context of IRS enforcement actions is absolutely essential to maximize the recovery of unpaid revenue while also maintaining the goodwill of the taxpaying public and effectively promote voluntary compliance.

### IRS COMMENTS

We agree that the IRS Collection function is an essential component of the tax system and that we must balance the goals of tax collection, taxpayer service, and tax compliance. We also agree that early intervention in collection cases is critical and that personal contact is an important tool for helping taxpayers return to compliance. In striving to contact the greatest number of taxpayers as early as possible in the collection process, we consider the entire Collection system, including our notice process and our campus operations. We have designed our treatments to direct as many taxpayers

<sup>64</sup> See Most Serious Problem, *IRS Collection Payment Alternatives*, *infra*.

<sup>65</sup> *Id.*

<sup>66</sup> IRS, *Automated Substitute for Return (ASFR) Program, An Analysis from the Customer's Perspective*, (Nov. 1998); IRS, *Automated Collection System (ACS) Redesign Project* (June 1998).

as possible to the least invasive and least burdensome option possible. We believe that a balance between prompt attention and appropriate treatment streams will ultimately secure payment of as much of the delinquent tax as possible.

#### *Case Selection and Assignment*

It is axiomatic that the IRS will never have sufficient resources to work every balance due case. Therefore, there must be a process to select and prioritize cases. The three major components of our selection process are business rules, compliance risk codes, and modeling. Business rules are used to identify areas of special emphasis or policy decisions. The practice of prioritizing or scoring cases by compliance risk began in 1999 and was substantially modified in 2001. The reengineering effort placed additional emphasis on the type of tax and dollar values to stress earlier intervention, especially for employment tax liabilities. The third component of our case assignment uses computer modeling to determine the cases with the highest potential yield. Contrary to the National Taxpayer Advocate report's conclusion, age and tax type are the primary determinates of priority, not the amount of the liability. For example, a new employment tax liability is generally more likely to be selected for assignment than an older income tax liability regardless of the amount owed.

While we contend that our current process strikes an appropriate balance among these factors, we acknowledge that further refinement of this process based on improved technology and better data is a desirable goal. We are currently engaged in an IRS-wide effort to revisit these rules so as to better route cases to the appropriate IRS function. Known as the Corporate Approach to Collection Inventory (CACI), the project expects to match cases to the appropriate treatment stream by supplementing the aforementioned rules with information on the source of assessment (*i.e.*, self-reported or compliance assessments) and the various functions' historical success in resolving different types of cases. Ultimately, we hope this project will result in routing cases in a manner that achieves a better match between case characteristics and employee skill set.

Even the CACI project is somewhat limited in its potential effect because it continues to focus on the characteristics of the tax liabilities. The next, more sophisticated level of analysis is to make case selection decisions based on the characteristics of the taxpayer. The long-term effort to achieve this next level has already begun in the form of Consolidated Decision Analytics (CDA). This will use internal and external data on taxpayer characteristics to better match taxpayers to the treatment stream that will most likely result in meaningful contact and timely resolution of the case.

#### *Currently Not Collectible (CNC)*

The statement that “[m]ore delinquent tax dollars were reported as CNC than were actually collected on open balance due accounts and installment agreement accounts combined” is misleading because it fails to recognize significant parts of the collection process. This comparison does not include delinquent notice accounts where the IRS is actively pursuing collection through the notice stream. In FY 2006, the IRS collected \$8.9 billion on balance

due notice status accounts.<sup>67</sup> The comparison also fails to include dollars collected with returns secured as part of non-filer cases. In FY 2006, an additional \$3.9 billion was collected with secured returns.<sup>68</sup>

It is important to note that reporting a case “currently” not collectible does not represent an irreversible decision to write off that case. Cases shelved due to resource constraints can be reactivated as resources permit, and a case placed in CNC status due to hardship may be reactivated if there are systemic indications that the taxpayer’s financial condition has improved. In FY 2006, the IRS collected over \$400 million on cases in CNC status. That said, we are actively studying CNC rates to see if either case selection processes or the manner in which we work cases can be improved. In spite of a changing mix of work in the field, CNCs as a percentage of dispositions have remained relatively constant—even as CNC rates have declined markedly in ACS. A recent study revealed that over 35 percent of field CNC closures were defunct corporations. This points to a need for better case creation and selection so that scarce field resources are used in a productive manner. We intend to delve deeper into this issue and to continue to refine our business practices accordingly.

#### *Collection Program Measures – Age of Accounts*

We acknowledge that, because the reports cited are tactical in nature, they reflect the age of the account within each function, not the total age of the account since date of assessment. Since not all accounts flow through all parts of the process, these reports are specifically designed to reflect the efficiency of each discrete process and are not considered IRS-wide indicators. Potentially Collectible Inventory (PCI) is a corporate-level indicator that tracks the subset of the Unpaid Assessment Inventory that is either actively being worked in Automated Collection, Field, or Notice, or backlogged in the queue. Analysis of active PCI shows that corporate inventory is declining in overall age. The proportion of the inventory that is less than two years old has increased from 43 percent at the close of FY05 to 51 percent at the close of FY06.

#### *Balancing Inventory and Self-Reported Accounts Versus Compliance Assessments*

The IRS is focused on reducing the tax gap. An analysis of the most recent tax gap data shows that of the \$310.6 billion total tax gap only \$31.7 billion, or roughly 10 percent, is attributable to underpayments. We therefore attempt to engage taxpayers who have not filed or who have underreported. We acknowledge that compliance assessments are more difficult to collect and often result in adjustments, but these adjustments represent successfully determining the tax owed from taxpayers who previously failed to file. In

<sup>67</sup> Source: Sept. FY06 CAR 5000-2/242 BDN Report: ALL: National: IMF line 3.1 column G plus IRAF line 3.1 column R plus BMF line 3.1 column N.

<sup>68</sup> Source: Sept. FY06 5000-139 C139 Report, ALL, National, Summary page.

FY 2006 we secured 897,288 returns through our ASFR program. Also in FY 2006, a total of \$3.8 billion was collected through active compliance assessments.<sup>69</sup>

#### *Downstream Costs of Delayed Contacts*

Regarding concerns about the downstream costs of delayed contact, a large number of the references cited in the footnotes are aged reengineering studies that were published between 1998 and 2001. Subsequently, we made changes in technology and procedures that were not referenced in the National Taxpayer Advocate's report. Examples include increased use of locator sources, modeling for case selection, and the increased use of technology in call routing and predictive dialing for processing ACS accounts. Notably, approximately 90 percent of so called "bad" levies are now resolved through an automated process with no direct employee intervention. We agree that the apparent effectiveness of the "call me" letter in gaining a response warrants considering broader use of this tool when new contact information becomes available.

All of our processes are designed to reduce personal burden by directing taxpayers to the right treatment at the fastest possible time. While a programming error in FY06 artificially inflated the number of business accounts assigned to ACS, we continue to examine our business rules and are committed to ongoing improvement in our ability to intervene early in collection cases.

#### **TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate is pleased that the IRS acknowledges that early intervention is a critical component of an effective collection program, and also recognizes that personal contact in collection cases is an important tool for helping these taxpayers return to compliance. We are also encouraged by the IRS's current efforts to improve its performance in these areas, most notably the Corporate Approach to Collection Inventory (CACI) project. We acknowledge the IRS's candor in recognizing that much more work is needed to develop and implement a collection "treatment stream" that better ensures meaningful contacts and timely resolutions of IRS collection cases. However, the IRS appears not to recognize the severity of the problems created by the delayed interventions that characterize the current collection inventory delivery system. The IRS contends that it is "axiomatic that the IRS will never have sufficient resources to work every balance due case," and implies that only "refinements" are needed to improve its collection inventory delivery system. We respectfully disagree.

The IRS reports that because it has insufficient resources to work every delinquent tax account, it has developed a process to prioritize collection cases, which is based on "business rules," an assessment of "compliance risk," and a projection of "revenue yield." We believe the time has arrived when the "limited resource" issue must be

<sup>69</sup> The IRS did not provide reference sources to substantiate that "\$3.8 billion was collected through compliance assessments." Our review of the IRS Collection Activity Reports does not confirm the accuracy of this statistic.

considered in relation to the IRS's inventory delivery system, along with its policies and procedures for handling the collection workload.<sup>70</sup> In other words, we believe the inability to provide timely and effective taxpayer service on IRS collection cases has as much to do with the *manner in which the IRS chooses to process the workload* as it does the size of the workload itself. We are concerned that the taxpayer service concerns raised in this report are hardly acknowledged in the IRS comments. While the IRS does acknowledge the significant impact of the aging of accounts receivable, the IRS continues to track the aging of collection accounts with measures that are not taxpayer-centric. When the “business rules” factored into the current inventory prioritization model result in a situation where taxpayer service issues and concerns cannot be handled as a priority, it is time to change the model.

The IRS comments note that in FY 2006, \$8.9 billion was collected on balance due notice status accounts, and an additional \$3.9 billion was collected with secured returns. (It should be noted that of the \$3.9 billion secured with delinquent returns, over \$3 billion – 78 percent – was collected through the routine collection notice stream.<sup>71</sup>) We agree with these observations. Many taxpayers successfully address and resolve their tax debts through the routine collection notice process. However, *some do not*. Collections secured via the routine notice process do not require a significant amount of IRS resources. We again emphasize that of the *post-notice* collection cases closed in FY 2006, more delinquent tax dollars were reported as currently not collectible than were collected on post-notice TDA accounts, installment agreement accounts, *and* offers in compromise *combined*. The IRS's observation that over \$400 million collected during FY 2006 on cases in CNC status is hardly a noteworthy accomplishment, in light of the \$53 billion in delinquent revenue that was reported in the inventory of CNC cases as of September 2006.<sup>72</sup> When an inventory prioritization model based on revenue “yield” produces these types of results, it is time to change the model.

The IRS claims that “compliance assessments” are important in its efforts to reduce the tax gap, and therefore the investments of collection resources needed to produce them are appropriate. The IRS reports it secured 897,288 returns through the ASFR program in FY 2006. However, as we have already disclosed in this report, only 21.4 percent of the SFR assessments resolved during the collection notice process in FY 2006 were actually collected revenue dollars.<sup>73</sup> The IRS either abated the rest of these assessments or reported them as not collectible. Further, of the delinquent returns secured during FY 2006 through the SFR program, the IRS actually collected only 2.5 percent of the net

<sup>70</sup> National Taxpayer Advocate 2004 Annual Report to Congress 244. In the 2004 Annual Report, the National Taxpayer Advocate stated “the problem of scarce resources does not mean that the IRS should not address the strategic and structural flaws in its collection strategy. In fact, resource limitations may make the need to address those flaws more acute.”

<sup>71</sup> IRS, *Collection Activity Report, National Delinquent Return Activity Report, NO-5000-139* (Sept. 29, 2006).

<sup>72</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

<sup>73</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (October 2, 2005).

assessments.<sup>74</sup> We have already noted that the vast majority of revenue dollars collected during FY 2006 with delinquent tax returns was secured through the collection notice process. It should also be noted that of the delinquent returns secured outside of the routine notice process, only 5.3 percent of the assessed dollars were actually collected.<sup>75</sup> When an inventory prioritization model based on “compliance risk” produces these types of results, it is time to change the model.

The IRS states in its comments that “All of our processes are designed to reduce personal burden by directing taxpayers to the right treatment at the fastest possible time.” Based on the issues identified in this report, we continue to believe the IRS’s lack of timely and meaningful contacts with delinquent taxpayers leads to unsatisfactory revenue collections and taxpayer service. Delayed interventions in IRS collection cases set the taxpayers up to fail in their efforts to resolve their debts. These failures are clearly evident in the IRS’s collection program results.

#### RECOMMENDATIONS

We believe the IRS will need to significantly overhaul current practices in this area to improve the benefits generated by its collection programs, and develop taxpayer-centric as well as IRS-centered measures, thereby ensuring the proper of treatment of taxpayers and protecting the public interest. Moreover, Congress needs to provide the IRS collection function with funding for the proper tools, systems, and research that Collection needs to accomplish its job in an effective manner.

1. The IRS needs to revise the methods used to prioritize and assign collection cases to fully recognize the impact of elapsed time on collectibility and taxpayer service. In particular, top priority should be placed on initiating personal contacts on *current* accounts, *i.e.*, tax delinquencies on recently due tax periods involving taxpayers who have not resolved their tax delinquencies through the collection notice process.
2. The IRS needs to tailor the delivery of collection inventory to recognize the differing needs and characteristics of different types of taxpayer cases. The IRS should conduct additional studies to identify opportunities to expedite personal contacts on collection cases, where it is evident such actions are needed for mutually successful resolutions. Are there common characteristics for taxpayers who do not self-correct during the collection notice process? Does it make sense to repeat the collection notice cycle for taxpayers who have had prior delinquencies assigned to ACS or the Collection Field operation? The IRS needs to ask and answer such questions to ensure that collection resources are used in the most efficient and effective manner.

<sup>74</sup> IRS, *Collection Activity Report, National Delinquent Return Activity Report, NO-5000-139* (Sept. 29, 2006).

<sup>75</sup> *Id.*



3. The IRS should expand the practice in employment tax cases of making prompt, face-to-face contact as early in the collection delinquency cycle as possible. This contact will ensure the maximum collection of revenue, prevent future delinquencies, and engage business taxpayers at a point when they have the best opportunity to resolve their tax problems while salvaging their businesses.
4. The IRS needs to more actively incorporate the reality of the “collectibility curve” into the consideration of reasonable collection alternatives, particularly installment agreements (IA) and offers in compromise (OIC), in the resolution of collection cases. IRS data indicate that most tax collection cases age because the lack of meaningful, early IRS interventions allow them to age. While this unfortunate condition continues in collection cases involving tax delinquencies in excess of 24 months, the IRS should establish liberal and flexible IA and OIC acceptance policies.<sup>76</sup> The IRS not only needs to recognize that any recovery of revenue on these accounts “beats the odds” recognized by most business authorities in the area of collection, but must also acknowledge that reasonable payment arrangements are the best opportunity to bring these taxpayers back into the ranks of those who comply with the tax laws.
5. The IRS needs to revise or develop collection program measures that accurately reflect the true age of its accounts receivable. These measures should reflect the age of collection accounts from the taxpayer’s perspective, *i.e.*, the due date of the tax return.
6. The IRS needs to develop a more realistic measure of collection “yield” that accurately reflects the recovery of potentially lost revenue. This measure should provide the net revenue collected on accounts that were not resolved through the routine collection notice process, *i.e.*, Taxpayer Delinquent Accounts (TDAs). A measure that reflects TDA dollars collected (including offsets) minus revenue dollars reported as not collectible (CNC) and revenue dollars abated would provide a more accurate assessment of the effectiveness of the IRS collection program, as well as promote case dispositions that provide resolution and closure to taxpayers seeking to resolve their tax debts.
7. The IRS should improve its communications with delinquent taxpayers regarding the accruals of penalties and interest on collection cases. Better communication regarding this issue, delivered early in the IRS collection notice process, may not only reduce the element of surprise for the typical taxpayer regarding the rapid accumulation of penalties and interest on IRS collection

<sup>76</sup> Congress has already made this observation. The conference committee report for the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) states, the Committee believes that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the Committee believes that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.

## PROBLEMS

SECTION  
ONE

accounts, but might also encourage many taxpayers to more vigorously pursue other financing alternatives, with substantially more favorable finance charges.<sup>77</sup>

8. The National Taxpayer Advocate acknowledges and supports the IRS's efforts to review and revise its collection inventory delivery systems, *i.e.*, the Consolidated Decision Analytics (CDA) and the Corporate Approach to Collection Inventory (CACI) projects. In order to ensure that taxpayer interests and rights are fully incorporated into future plans materializing from these efforts, we recommend that the IRS include the National Taxpayer Advocate in the planning and analysis stages of these projects as soon as possible. We recommend that the issues and suggestions made in this report be incorporated into the development of these projects in a timely and meaningful manner.

Finally, the National Taxpayer Advocate stresses the critical importance of the need for Congress to fully fund these efforts by the IRS to modernize its collection programs. Congress needs to ensure that those who collect revenue for the United States government have the proper tools to perform their jobs effectively. Without adequate resources, the IRS will have a much more difficult time ensuring that all taxpayers receive the most effective collection treatments at the most appropriate times, to allow for the optimum resolution of their cases.

<sup>77</sup> See also Additional Legislative Recommendation, *Amend IRC 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error*, *infra*.

**PROBLEM****TOPIC #6 IRS COLLECTION PAYMENT ALTERNATIVES****RESPONSIBLE OFFICIALS**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Richard J. Morgante, Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

The IRS does not fully utilize collection payment alternatives, such as installment agreements and offers in compromise, to resolve delinquent tax accounts. This approach means that many account problems are not addressed timely, fostering additional liabilities for the taxpayer and substantial amounts of lost revenue for the IRS.

**ANALYSIS OF PROBLEM****Background**

The IRS is authorized to use a variety of collection payment alternatives to address and resolve tax delinquency problems. For those taxpayers who are financially unable to immediately pay their tax balances in full, the most important options are installment agreements and offers in compromise (OICs). The IRS collects billions of delinquent tax dollars each year through these collection alternatives.<sup>1</sup> Particularly when emerging tax delinquency problems are identified and addressed in a timely manner, alternative payment options can provide solutions that are in the best interests of both the taxpayers and the government.

In the 2005 Annual Report to Congress, the National Taxpayer Advocate raised concerns that the IRS's methods of determining the potential for utilizing payment alternatives in many situations are overly restrictive and clearly not designed to deliver positive solutions for taxpayers trying to resolve debts.<sup>2</sup> We remain concerned that IRS policies and procedures unduly restrict the use of available collection alternatives, and the IRS's overall approach to evaluating collection potential in delinquent accounts too often fails to provide productive resolutions for many taxpayers' problems.

**Installment Agreements – Effective combination of service and enforcement**

In general, the IRS has ten years from the date of assessment of a tax to collect the debt.<sup>3</sup> The Internal Revenue Code (IRC) authorizes the IRS to enter into an installment

<sup>1</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006). In FY 2006, approximately \$7.4 billion was collected via installment agreements. See also *IRS Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2005). In FY 2005, the IRS accepted approximately \$326 million in offers in compromise.

<sup>2</sup> National Taxpayer Advocate 2005 Annual Report to Congress 270-291.

<sup>3</sup> IRC § 6502 provides that the length of period for collection after assessment of a tax liability is ten years. The collection statute expiration ends the government's right to pursue collection of a liability. Each tax assessment has a Collection Statute Expiration Date (CSED) which is the time period established to collect the delinquent taxes.

agreement (IA), whereby a taxpayer is permitted to pay a liability over time through payment schedules approved by the IRS.<sup>4</sup> If the taxpayer cannot fully pay the outstanding balance by the end of the period when the IRS could legally collect the debt (called the Collection Statute Expiration Date or CSED), but has some ability to make regular payments, the IRS may allow the taxpayer to enter into an agreement based on his or her ability to pay, even though the agreement may not fully satisfy the liability. These agreements are known as Partial Payment Installment Agreements (PPIA).<sup>5</sup> Although penalties and interest continue to accrue, the IRS cannot issue levies while a taxpayer's account is in installment agreement status.<sup>6</sup>

IRS data indicates that installment agreements lead to the collection of nearly as much delinquent revenue on balance due accounts which remain delinquent after completion of the collection notice process as all other collection treatments combined.<sup>7</sup> In fiscal year 2006, the IRS collected \$7.4 billion through installment agreements,<sup>8</sup> while collections on all other active Taxpayer Delinquent Accounts (TDA) tax modules amounted to \$7.2 billion.<sup>9</sup> These results indicate that the installment agreement is perhaps the most efficient and effective enforcement tool for collecting delinquent taxes. Particularly when a taxpayer does not have the ability to fully pay a tax liability when due, the IA provides him or her an opportunity to voluntarily resolve the debt and removes the need for the IRS to pursue more costly and time-consuming enforcement procedures.

**Streamlined Installment Agreements are particularly useful and successful in the collection of delinquent accounts.**

The IRS may approve streamlined installment agreements where the aggregate unpaid balance of tax liabilities is \$25,000 or less, and can be fully paid within 60 months or prior to the CSED, whichever comes first.<sup>10</sup> These agreements do not require detailed financial statements or approval by IRS managers, and may be granted even though the taxpayer may be able to fully pay the tax balance sooner.<sup>11</sup> In certain situations, the availability of a streamlined IA is guaranteed by statute. The IRC requires the IRS to accept proposals of installment agreements where taxpayers owe \$10,000 or less, have

<sup>4</sup> IRC § 6159(a).

<sup>5</sup> IRC § 6159 was amended by the American Jobs Creations Act 2004 to allow the IRS to enter into installment agreements with taxpayers that do not provide for full payment of the outstanding tax delinquencies.

<sup>6</sup> IRC § 6331.

<sup>7</sup> When a tax return is filed and a taxpayer does not fully pay all assessed amounts due, the IRS mails a series of notices to the taxpayer. The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account up to three additional collection notices will be sent at five-week intervals. Business taxpayers will receive the first notice, and in five weeks the final collection notice. The final collection notice advises taxpayers of the intent to levy and is the last notice required before a Federal Tax Lien may be filed. See IRM § 5.19.1-3.

<sup>8</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

<sup>9</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>10</sup> IRM 5.14.5.2 (Jul. 12, 2005).

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

filed and paid all tax returns during the five years prior to the year of the liability; have not had installment agreements during those five years, and can fully pay the tax liabilities within three years.<sup>12</sup>

The “streamlined” approach is designed to allow taxpayers and the IRS to quickly agree on a payment schedule that is reasonable, realistic, and does not require an in-depth analysis of the taxpayer’s finances, as in the case of traditional installment agreements and offers in compromise. As such, the streamlined IA represents a realistic and attainable payment option for many taxpayers. Streamlined agreements accounted for 96.7 percent of all IAs granted in FY 2006, and 96.2 percent of the open IA inventory at the close of the fiscal year.<sup>13</sup> Of the accounts that the IRS closed as full paid during FY 2006 using the installment agreement option, 98 percent involved streamlined IAs.<sup>14</sup> In September 2006, the IRS announced plans to implement a new system that will allow taxpayers to request streamlined agreements online via the IRS’s main internet site.<sup>15</sup> While this initiative does not expand the criteria to allow for more streamlined IAs, it will improve taxpayer access to this important collection option and appears to be a positive step toward improving its availability to the public.

### **Lack of early intervention makes streamlined installment agreements unavailable for many taxpayers**

The National Taxpayer Advocate is concerned that despite the successful track record of the streamlined IA, the IRS does not appear to be making optimum use of this collection alternative. In FY 2006, the IRS used installment agreements to resolve only 32.4 percent of balance due accounts<sup>16</sup> and 14.9 percent of field collection cases.<sup>17</sup> At the same time, the IRS closed 31.6 percent of balance due accounts as not collectible.<sup>18</sup> A key factor in the IRS’s ability to maximize the benefits of the streamlined IA option is the concept of early intervention. For taxpayers who do not successfully resolve their delinquencies through the routine notice process, prompt personal contacts are critical to starting the problem-solving dialogue at the point where taxpayers can actually qualify for streamlined IAs.

Most IRS collection cases begin as relatively small balances due on recent tax periods, but over time, penalties and interest accrue and additional delinquencies may develop. Of the collection cases in which the IRS issued a final collection notice in FY 2006,

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<sup>12</sup> IRC § 6159(c).

<sup>13</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

<sup>14</sup> *Id.*

<sup>15</sup> Daily Tax Report, *Tax Collection: IRS to Launch Online Tax Payment Procedure For Use By Individual and Business Taxpayers* (Sept. 13, 2006).

<sup>16</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>17</sup> *Id.*

<sup>18</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006), IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Oct. 2006).

87.2 percent of individual (IMF) and 91.5 percent of business (BMF) collection cases involved delinquent balances due of less than \$10,000.<sup>19</sup> In theory, most of these taxpayers would qualify for streamlined IAs. In practice, delays by the IRS in making meaningful contacts with these taxpayers increase the likelihood that many will not be eligible for streamlined IAs by the time the delinquencies are actually addressed.<sup>20</sup>

### Partial Payment Installment Agreements – A new collection alternative

In April 1998, IRS Counsel determined that the IRS did not have authority to enter into IAs that would not provide for full payment of the taxpayer’s liability before the collection statute expired.<sup>21</sup> According to IRS officials, this policy change created a situation in which some taxpayers who were willing to pay some amount would not qualify for either an installment agreement or an OIC.<sup>22</sup> Instead, the only option was to put the account into inactive status, creating a new group of cases for which there was no apparent resolution.<sup>23</sup> In the 2001 Annual Report to Congress, the National Taxpayer Advocate recommended a legislative change to amend the IRC to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the IRS.<sup>24</sup> The IRS drafted another legislative proposal requesting the same change in the law.<sup>25</sup>

The authority to enter into PPIAs was enacted in the American Jobs Creation Act of 2004,<sup>26</sup> and the IRS implemented procedures to allow for these agreements in January 2005. These IAs are intended to provide a collection payment alternative to taxpayers who have the ability to make monthly installment payments but cannot fully pay their liabilities prior to the expiration of the CSED. The PPIA option is intended to bridge the “gaps” between those taxpayers who can fully pay their debts through traditional installment agreements, those who may qualify for offers in compromise, or those with financial conditions that warrant consideration for reporting their accounts as currently not collectible (CNC). The underlying premise behind the PPIA option makes good business sense, *i.e.*, allowing taxpayers who clearly cannot fully pay their debts or qualify for an OIC to pay what they reasonably can over the CSED period.

<sup>19</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2/242* (Oct. 2, 2006).

<sup>20</sup> See Most Serious Problem, *Early Intervention in IRS Collection Cases, supra*.

<sup>21</sup> General Accounting Office, GAO-02-311, *IRS Should Evaluate the Changes to Its Offer in Compromise Program* 33 (Mar. 2002).

<sup>22</sup> *Id.*

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

<sup>24</sup> National Taxpayer Advocate 2001 Annual Report to Congress 210-214.

<sup>25</sup> General Accounting Office, GAO-02-311, *IRS Should Evaluate the Changes to Its Offer in Compromise Program* 33 (Mar. 2002).

<sup>26</sup> American Jobs Creation Act of 2004, H.R. 4520, Pub. L. No. 108-357, 118 STAT. 1418 (2004).

**The IRS is making limited use of partial payment installment agreements.**

The National Taxpayer Advocate is concerned that the IRS's implementation of the PPIA option may have overly restricted its use. Internal Revenue Manual (IRM) procedures and IRS training material regarding the PPIA place a great deal of emphasis on determining the taxpayer's *maximum* ability to pay. For example, the training materials specify that to qualify for a PPIA the "taxpayer must agree to pay the *maximum* monthly payment" (emphasis in original).<sup>27</sup> The IRS will consider only reasonable and necessary living expenses, as defined by the IRS's allowable living expense standards, in determining a taxpayer's potential to qualify for a PPIA, and will allow no transition period for the taxpayer to retire expenses that the IRS finds excessive.<sup>28</sup> The IRM also gives this direction and states, "In most cases, taxpayers will be required to use equity in assets to pay liabilities."<sup>29</sup>

We acknowledge that IRM procedures go to some length to discuss situations in which PPIAs "may be granted even if a taxpayer does not sell or cannot borrow against assets with equity."<sup>30</sup> However, these procedures do not recognize or acknowledge that in many of these cases, the taxpayers will have a very limited ability to access equity in assets without creating an economic burden or hardship. Poor credit histories or a lack of funds to service financial instruments such as home equity loans often restrict a delinquent taxpayer's ability to "cash in" on equity in assets. Moreover, legal restrictions may bar the liquidation of assets. In these cases, it makes sense that the IRS enter into agreements to collect at least those payments immediately available. Nevertheless, the overall tone of the training and procedures used to implement the PPIA seem designed to discourage its use as a viable collection alternative. In fact, the IRS approved only 11,186 PPIAs in FY 2005, representing approximately 0.5 percent of all IAs granted.<sup>31</sup> It is important to remember that *the IRS specifically requested this authority*. Yet to date, it does not appear to be using this collection alternative to anywhere near the degree intended.

**Offers in Compromise – IRS public policy not supported by Internal Revenue Manual procedures.**

An offer in compromise (OIC) is an agreement between a taxpayer and the government that settles a tax liability for payment of less than the full amount owed.<sup>32</sup> It is the

<sup>27</sup> IRS training document, *Partial Payment Installment Agreements (PPIA), Implementation of Section 843, American Jobs Creation Act of 2004* 12 (Jan. 17, 2005).

<sup>28</sup> *Id.*

<sup>29</sup> IRM 5.14.2.2(2) (Jul. 12, 2005).

<sup>30</sup> IRM 5.14.2.2(2) (Jul. 12, 2005).

<sup>31</sup> Data provided by SBSE Collection Policy. The IRS does not routinely track PPIA activity through systematically generated reports, but plans to have this capability in 2007.

<sup>32</sup> IRC § 7122.

IRS's stated policy to accept an offer when it is unlikely that the IRS can collect the tax liability in full and the amount offered reasonably reflects collection potential.<sup>33</sup>

Congress has long viewed the OIC as a viable and reasonable collection alternative. This view is evidenced in the conference report for the IRS Restructuring and Reform Act of 1998 (RRA 98):

The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.<sup>34</sup>

Despite the clear congressional intent that the IRS more effectively use the OIC as a viable collection payment alternative, the IRS has actually moved the program in the opposite direction. The IRS has significantly tightened its policies and procedures regarding the availability and use of the OIC as a collection alternative since the implementation of RRA 98.

In arriving at this conclusion, we conducted a historical analysis of OIC procedures set forth in the IRM. Our analysis confirms that in 1992, the IRS significantly altered its approach to the use of the OIC as a collection tool. The IRS formally articulated these changes in Policy Statement P-5-100, which was approved on January 30, 1992, and emphasized that

[t]he Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.<sup>35</sup>

The IRS also revised IRM procedures to support the new policy and enable the acceptance of OICs in a broader range of situations. For example, consider the following IRM section:

Rejection of an offer solely based on narrow asset and income evaluations should be avoided. The Service should attempt to *negotiate* (emphasis added) offer agreements which are in the best interests of all parties. Included in determining the government's interests are the costs of collection. If an offer is rejected because

<sup>33</sup> IRM 5.8.1.1.3 (Sept. 1, 2005). This section includes IRS Policy Statement P-5-100.

<sup>34</sup> IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998).

<sup>35</sup> IRM 1.2.1.5.18 (Jan. 30, 1992). This reference provides the IRS's official policy regarding the OIC program, including the full text of IRS policy statement P-5-100.



more can be collected than is offered, it is generally expected that the amount determined to be collectible *will actually be collected*.<sup>36</sup> (Emphasis added)

Although this 1992 direction seems to reflect the actual intent of the IRS's then new policy, as well as that of RRA 98 six years later, the IRS eliminated it from the IRM in the mid-90's and did not reinstate and reinforce it after RRA 98 became law.

### OIC program results do not reflect IRS public policy.

Not surprisingly, a recent IRS study of the OIC program revealed that the majority of delinquent tax dollars in cases involving rejected OICs tend *not* to be collected. The study indicates that over 40 percent of tax modules associated with rejected and withdrawn OICs are ultimately reported as not collectible,<sup>37</sup> with many more remaining unresolved for years in “active” collection status.<sup>38</sup> Of the modules in rejected or withdrawn OICs that were in CNC status, 27 percent of those involving individual taxpayers were *in CNC status while the OIC was being considered*.<sup>39</sup> That is, the IRS *rejected* offers from taxpayers who the IRS had already determined were uncollectible! From calendar years 1998 through 2003, in 44 percent of cases involving rejected OICs from individual taxpayers, the IRS had collected less than 50 percent of the amounts the taxpayers had *offered* to pay.<sup>40</sup> In 31 percent of these cases, the IRS collected less than 10 percent of the offered amounts and in 21 percent the IRS collected nothing at all.<sup>41</sup> These results certainly call into question the degree to which current IRS procedures are aligned with its publicly articulated policy regarding OICs.

Shortly after the implementation of RRA 98, the IRS also revised IRM procedures for determining the valuation of future income in computing each taxpayer's reasonable collection potential. The “present value of future collections” concept, which had been implemented in 1992, was eliminated. This concept, as described in the IRM, stated

[i]n cases where it is determined that the taxpayer can make installment payments, the Service normally considers that any agreement that requires more than five years to complete has a high probability of not being completed. The Service must then decide the “present value” of those five years of payment. . . . Generally, if the taxpayer can now pay us “present value”, we will give serious consideration to accepting the offer.<sup>42</sup>

<sup>36</sup> IRM 57.10.10.1 (Feb. 26, 1992).

<sup>37</sup> IRS Offer in Compromise Program, *Analysis of Various Aspects of the OIC Program* 10 (Sept. 2004).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 9.

<sup>40</sup> *Id.* at 11.

<sup>41</sup> *Id.*

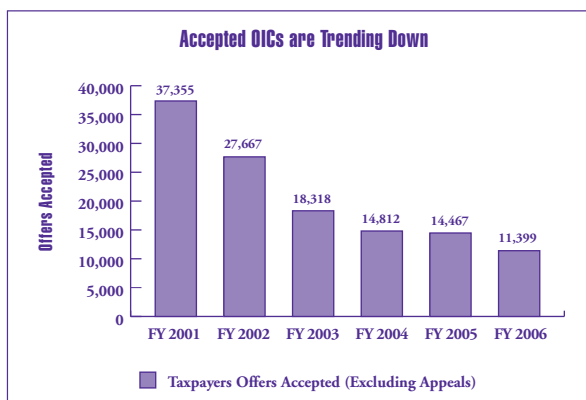
<sup>42</sup> IRM 57.10.10.11 (Feb. 26, 1992).

This pro-taxpayer method of determining the value of potential future tax payments was supplanted by a less taxpayer-friendly change in policy. In early 2000, the IRS revised OIC policy to state that it would not accept offers when the taxpayers could potentially fully pay the liabilities through installment agreements.<sup>43</sup> This change essentially eliminated the “present value of future collections” concept.

Although the IRS has recently clarified its definition of a “protracted installment agreement” as one that will remain in force beyond the collection statute expiration date (CSED), the revised position remains an unrealistic indicator of true collection potential. IRS data indicate the average installment agreement either fully pays or defaults within a year.<sup>44</sup> Within this context, even the projected five-year analysis in the IRS’s earlier policy seems overly optimistic. Clearly, however, the approach of extending the likelihood of future collections beyond the five-year period is not based on any realistic analysis of actual results in these types of cases.

The cumulative effect of the aforementioned policy changes has been a significant reduction in the number of OICs accepted as collection alternatives. From FY 2001 through FY 2006, the number of OICs accepted by the IRS Collection operation (excluding those accepted by Appeals) *declined* by over 69 percent.<sup>45</sup>

**TABLE 1.6.1, OICS ACCEPTED BY IRS COLLECTIONS FY 01-06**<sup>46</sup>



<sup>43</sup> IRM 5.8.1.1.1 (Feb. 4, 2000).

<sup>44</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

<sup>45</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. In FY 2001, 37,355 OICs were accepted. In FY 2006, 11,399 were accepted. The numbers do not include OICs rejected by IRS Collection and subsequently accepted by Appeals.

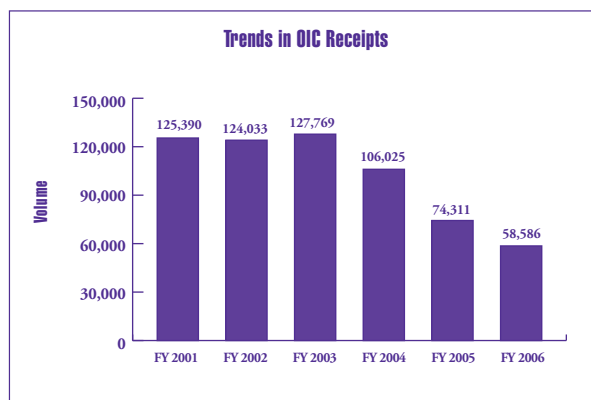
<sup>46</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. (FY 2001 – FY 2006).

**External stakeholders agree: OIC no longer a viable collection alternative.**

The significant reduction in cases where the OIC has been a successful alternative has contributed to a growing perception in the tax practitioner community that the IRS no longer perceives the OIC as a viable collection option. These perceptions were recently reported to the IRS in a series of OIC-related focus groups conducted during the 2005 IRS Nationwide Tax Forums.<sup>47</sup> The IRS received consistently negative feedback in these focus groups, particularly about the IRS’s general approach to considering the merits of an OIC as a viable collection alternative. The focus group report concluded that participants mainly felt that the IRS’s first task was to find a reason – any reason -- to reject the offer, and the mindset of the (OIC) specialist was “I’m not going to make this work or be viable.”<sup>48</sup> Most participants reported they have not had positive experiences negotiating with the IRS. Overall, the participants agreed that offers are not receiving fair consideration. Many felt that the IRS looks for anything to cause an offer to be rejected, and all agreed that, in their opinion, offers are being worked by people who are predisposed to reject them. The practitioners in the focus groups raised a concern that the IRS has “another agenda” that influences the consideration of OICs to resolve tax debts.<sup>49</sup>

More than mere anecdotal reports, the perceptions expressed by practitioners in these focus groups appear to be manifesting themselves in actual taxpayer behavior. The table below indicates that new OIC receipts for FY 2006 will be less than half the number for FY 2003.<sup>50</sup>

**TABLE 1.6.2, OIC RECEIPT TRENDS FY 01-06**<sup>51</sup>



<sup>47</sup> 2005 IRS Nationwide Tax Forums, *Offer in Compromise Focus Group Report* (Nov. 2005).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108*. The IRS reported 127,769 OIC receipts in FY 2003. OIC receipts for FY 2006 were 58,586.

<sup>51</sup> *Id.*

In a 2006 report on the OIC program, the Government Accountability Office (GAO) observed that from 2000 to 2004, the number of accepted offers declined by more than half while the number of delinquent taxpayer accounts remained roughly constant. According to the GAO, this fact raises the question as to whether something has happened to reduce the program’s “accessibility.”<sup>52</sup> In addition to confirming and supporting the observations of tax practitioners, the GAO analysis underscores the concerns of the National Taxpayer Advocate that the IRS does not employ the OIC option as a viable collection alternative in many situations where it is in the best interests of the government and the taxpayer to accept a reasonable offer.

**OIC procedures and program results do not reflect the intent of Congress.**

We again refer to the conference report associated with the IRS Restructuring and Reform Act of 1998:

The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.<sup>53</sup>

Clearly, the IRS did not embrace the intent of Congress. In fact, through a series of policy changes implemented post-RRA 98, the IRS actually appears to have restricted the use of the OIC as a viable collection tool. While the impact of each of these policy changes has been significant, it does not appear that any of them were widely communicated or even discussed outside of Collection prior to implementation. Congress recently passed the Tax Increase Prevention and Reconciliation Act of 2005, which contains provisions with potentially significant impact on the OIC program and the use of OICs as a collection alternative.<sup>54</sup> This legislation requires taxpayers to submit substantial partial payments for offers that will be paid in a lump sum and immediately begin to make the proposed scheduled payments on deferred payment offers.<sup>55</sup> Congress has indicated that these changes will raise an additional \$699 million in revenue over five years and \$1.911 billion over 10 years.<sup>56</sup> These estimates again indicate the intent of the legislation is for the IRS to make more and better use of the OIC as a collection alternative. However, unless the IRS implements these changes within the spirit of RRA 98 and the IRS’s own policy statement regarding the use of offers, which we have

<sup>52</sup> Government Accountability Office, GAO-06-525, *IRS Offers in Compromise* 20 (Apr. 2006).

<sup>53</sup> IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2nd Sess., 288-289 (1998).

<sup>54</sup> Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, Pub. L. No. 109-222, 120 STAT. 345 (2006).

<sup>55</sup> *Id.*

<sup>56</sup> Daily Tax Report, *Senate Finance Committee Summary of Conference Report on Tax Increase Prevention and Reconciliation Act of 2005* (May 10, 2006).

not found to be the case to date, this new legislation has the potential to substantially curtail the availability of the OIC as a viable collection tool. The National Taxpayer Advocate, along with other stakeholders such as the American Bar Association and the American Institute of Certified Public Accountants, has expressed strong concerns that the implementation of this new legislation will create new barriers to taxpayers applying for acceptance into the OIC program while decreasing revenue to the federal treasury.<sup>57</sup>

### **IRS financial analysis techniques: Allowable Living Expenses (ALE) and “maximum ability to pay.”**

In 1995, the IRS developed and implemented the allowable living expenses (ALE) approach to determining a taxpayer’s financial ability to pay delinquent taxes. This system was designed to provide more consistency in the financial analysis determinations that serve as the basis for various collection alternatives, including IAs, OICs, CNC determinations, and enforced collection actions. The IRS believed then, as it does today, that without standardized criteria, financial determinations among taxpayers will be inconsistent and lead to taxpayers with similar financial conditions being treated differently.<sup>58</sup> RRA 98 requires the IRS to prescribe guidelines to determine whether to accept an offer in compromise, which in essence codified the Service’s use of the ALE.<sup>59</sup>

In the 2005 Annual Report to Congress, the National Taxpayer Advocate raised concerns over the IRS’s use of the ALE standards and the wide perception among tax practitioners that the standards are unreasonable and much too rigidly applied.<sup>60</sup> Unfortunately, rather than exploring the outcomes of cases involving the ALE approach to determine the basis for these criticisms, the IRS response to the report focused on reiterating confidence in the data used to formulate the standards. While the IRS asserts that the ALE standards were “formulated to be a reliable indicator of typical individual living expenses” and the “data sources” used in the development of these standards are “impeccable,”<sup>61</sup> the National Taxpayer Advocate remains concerned that the actual application of these standards to *individual* taxpayer cases often leads to erroneous conclusions regarding the appropriate use of reasonable collection payment alternatives.

### **Allowable Living Expenses (ALE) – “standards” do not reflect reality for many taxpayers.**

The ALE standards are based on the average or median expenditures derived from U.S. government data sources, *e.g.*, U.S. Census Bureau or the Bureau of Labor Statistics

<sup>57</sup> Daily Tax Report, *Tax Compliance: Value and Effect of New OIC Requirements Under Debate As Effective Date Approaches* (Jun. 20, 2006).

<sup>58</sup> IRS Office of Research and Analysis, *Evaluation of Current Allowable Living Expense Standards* 1 (Oct.1996).

<sup>59</sup> IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3462(a) (1998) (codified at IRC § 7122(c)).

<sup>60</sup> National Taxpayer Advocate 2005 Annual Report to Congress 270-291.

<sup>61</sup> *Id.* at 281.

## PROBLEMS

(BLS), representing broad segments of the population. The IRS contends that the “data contained in the ALE is formulated from statistically valid core data that is 100 percent accurate at the time the information is collected.”<sup>62</sup> However, as discussed in the 2005 Annual Report to Congress, the Bureau of Labor Statistics, which is a primary source for the ALE data, advises caution in interpreting its consumer expenditure data when relating averages to individual circumstances.<sup>63</sup> The BLS warns that “expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the individual consumer unit.”<sup>64</sup> Accordingly, the National Taxpayer Advocate remains very concerned with the manner in which the ALE standards are *applied to individual taxpayer cases*. “Standards” based on averages derived from large samples of the population simply cannot be consistently translated directly to *individuals* in a realistic manner.

Moreover, shortly after implementing the ALE standards in 1995, the IRS recognized that the standards did not accurately reflect the actual expenses of many taxpayers, particularly in the key areas of housing and transportation.<sup>65</sup> A study conducted in 1996 by the IRS National Office of Research and Analysis determined that 37.3 percent of all taxpayers had housing expenses that exceeded the allowable standards, and over 65 percent of those with mortgages exceeded the allowable standards by a mean of \$938 and a median of \$477 per month.<sup>66</sup> The study also concluded that the percentage of taxpayers exceeding the housing standards increased with family size. The majority of taxpayers *with children* exceeded the allowable housing standards – 51.3 percent of taxpayers with families of three exceeded the standards; 60.7 percent with families of five or more exceeded the standards.<sup>67</sup> In transportation, actual operating costs for taxpayers with one vehicle exceeded the standards in 31.3 percent of the study’s sample of cases, and 42.6 percent of taxpayers with two vehicles exceeded the transportation operating expense allowance.<sup>68</sup>

These numbers indicate that the ALE standards *frequently* do not reflect reasonable living expenses when applied to individual taxpayer cases. The study also lends credence to feedback routinely received by TAS from practitioners regarding unrealistic ALE allowances for housing and transportation. While the ALE standards are periodically updated to reflect more current data, we are not aware of any significant changes to the

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<sup>62</sup> National Taxpayer Advocate 2005 Annual Report to Congress 282.

<sup>63</sup> *Id.* at 286.

<sup>64</sup> See <http://www.bls.gov/cex/csxfaqs.htm#q13> (last visited Aug. 23, 2006). The U.S. Census Bureau provides similar cautionary statements about its data. See <http://www.census.gov/prod/cen2000/doc/sf3chap8.pdf> (last visited Aug. 23, 2006).

<sup>65</sup> IRS Office of Research and Analysis, *Evaluation of Current Allowable Living Expense Standards* 8-9 National (Oct.1996).

<sup>66</sup> *Id.* at 8.

<sup>67</sup> *Id.* at 9.

<sup>68</sup> *Id.* at 12.

methodology used in computing the standards since the 1996 report.<sup>69</sup> Clearly, the ALE standard allowances for housing and transportation expenses frequently underestimate reasonable expenses for many taxpayers in key areas of their financial lives. Further, the disconnect appears to be growing even worse. The ALE standards published for use in 2006 actually reflected *reductions* in expense allowances for taxpayers in many parts of the United States.<sup>70</sup>

### Allowable Living Expenses (ALE) – “standards” or “guidelines”?

The Internal Revenue Code specifies that application of the ALE guidelines should be based on an analysis of the facts and circumstances of each taxpayer, to ensure that use of the ALE will not result in the taxpayer having less than adequate means to provide for basic living expenses.<sup>71</sup> The usual response from the IRS to concerns regarding ALE standards has been that collection employees are permitted to deviate from the standards in situations where taxpayers can document reasonable and necessary actual expenses in excess of the standards. We acknowledge that several IRM references indicate that the ALE “standards” are actually meant to be used as guidelines, and deviations are allowed when a standard amount is inadequate to provide for a specific taxpayer’s basic living expenses.<sup>72</sup> However, these references are buried within IRM sections that indicate collection payment alternative decisions should reflect the taxpayer’s maximum ability to pay. IRM direction regarding the correct use of the ALE standards acknowledges that the underlying philosophy behind the ALE approach is to allow only “necessary expenses” that “establish the *minimum* a taxpayer and family need to live.”<sup>73</sup> (Emphasis added) Further direction in this area specifies that a deviation from an ALE standard is not allowed merely because it is inconvenient for a taxpayer to dispose of valued assets<sup>74</sup> and “a taxpayer who claims more than the total allowed by the national standards must substantiate and justify *each separate expense* of the total national standard amounts.”<sup>75</sup> Is it any wonder that feedback from the public consistently indicates collection employees are reluctant to deviate from the ALE allowances? We are concerned

<sup>69</sup> Subsequent to the 1996 IRS Research study, the IRS revised the standards for housing and utilities to adjust for family size. Effective October 1, 2000, separate housing and utility expenses were provided for families of one or two members, families of three, and families of four or more. However, examination of these new allowances indicate that these adjustments were not adequate to remedy the significant concerns raised in the 1996 study, particularly in regard to taxpayers with mortgage payments.

<sup>70</sup> SB/SE Operating Division Research (Brooklyn/Hartford), *2006 Allowable Living Expenses Project* (Feb. 2006).

<sup>71</sup> IRC § 7122(c)(2).

<sup>72</sup> IRM 5.15.1.7(7) (May 1, 2004). This guidance also appears in the OIC IRM 5.8.5.5.1 (Sept. 1, 2005) and IRM 5.14.1.5 (Jul. 12, 2005).

<sup>73</sup> IRM 5.15.1.7(1) (May 1, 2004).

<sup>74</sup> IRM 5.15.1.7(9) (May 1, 2004).

<sup>75</sup> IRM 5.15.1.8(3) (May 1, 2004). The “national standards” define reasonable amounts for five necessary expenses. Four of them come from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey: food, housekeeping supplies, apparel and services, and personal care products and services. The fifth category, miscellaneous, is a discretionary amount established by the IRS. It is \$100 for one person and \$25 for each additional person in the taxpayer’s household.

that the few IRM references permitting deviations from the ALE standards are lost within the overall context of the manual, which focuses on determining maximum ability to pay. This approach drives employee perceptions that collection payment alternatives, or any other resolutions that do not require full payment, are to be avoided.

**IRS financial analysis often includes unrealistic determinations of realizable equity in assets.**

Another component of the financial analysis techniques the IRS employs to determine a taxpayer's capacity to pay a debt is the consideration of equity in the taxpayer's assets. Generally, IRM direction requires that employees use the "quick sale value" (QSV) to determine the portion of a taxpayer's equity in assets available for full or partial payment of delinquent taxes.<sup>76</sup> QSV is defined as an estimate of the price a seller could obtain for the asset in a situation where financial pressures motivate him or her to sell in a short time, usually 90 days or less.<sup>77</sup> The IRM specifically mentions equity in real estate as a means to fully pay or reduce the tax liability.<sup>78</sup> The manual requires that if such equity exists, the taxpayer should be asked to secure a loan or liquidate the asset, further stating that refusal will be considered refusal to pay and appropriate enforcement actions should be pursued.<sup>79</sup>

The IRM does acknowledge that consideration should be given to factors that could prevent the taxpayer from liquidating the asset, such as illness, advanced age, or "other special circumstances."<sup>80</sup> However, this direction does not provide enough guidance to ensure a realistic determination of a taxpayer's reasonable collection potential. Issues such as the taxpayer's credit history, the relative percentage of equity in the property, and the taxpayer's financial capability to repay a loan are essential to the taxpayer's ability to refinance a mortgage or qualify for a home-equity loan. In TAS's experience with these types of cases, many taxpayers with significant tax delinquencies do not have the ability to tap into home equity. In most cases, if the taxpayer does not have the capacity to borrow, liquidating the home will likely create an economic hardship. The ambiguity of the IRM in this area appears to contribute to situations where collection alternatives such as IAs and OICs are denied, and the accounts either remain inactive or are reported as CNC.

**The IRS focus on determining maximum ability to pay seems to minimize the actual collection of revenue.**

IRS financial analysis techniques do not appear to assist in actually collecting much revenue or resolving many taxpayer collection accounts. IRS data indicates that relatively

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<sup>76</sup> IRM 5.15.1.16 (May 1, 2004).

<sup>77</sup> IRM 5.15.1.16(2) (May 1, 2004).

<sup>78</sup> IRM 5.15.1.26 (3) (May 1, 2004).

<sup>79</sup> IRM 5.15.1.26 (3) (May 1, 2004); IRM 5.14.1.5(6) (Jul. 12, 2005).

<sup>80</sup> IRM 5.14.1.5(7) (Jul. 12, 2005); IRM 5.8.11.2.1 (Sept. 1, 2005).



few collection cases are resolved with alternative payment options in situations where these traditional techniques are used. For example, the IRS uses the ALE standards and equity determinations in evaluating the potential for installment agreements in non-streamlined IA situations. However, only approximately 3.3 percent of all installment agreements granted in FY 2006 were not of the “streamlined” variety.<sup>81</sup> Additionally, there are solid indications that IAs based on the ALE analysis tend to default at a much higher rate, *i.e., maximum ability to pay tends to produce payment expectations that are unrealistic and exceptionally difficult to maintain.*

Consider the following: While approximately 96.7 percent of all installment agreements approved by the IRS in FY 2005 were of the streamlined variety, only 27.2 percent of those approved in the Collection Field operation were streamlined.<sup>82</sup> The rest involved the use of the ALE standards. However, 65.1 percent of the field-based accounts removed from IA status in FY 2006 were defaulted agreements, while the servicewide figure was 38.9 percent.<sup>83</sup> ALE standards and equity determinations also are routinely used in evaluating requests for offers in compromise. However, only 17.8 percent of the OIC dispositions made in FY 2006 were accepted offers (excluding those accepted by Appeals).<sup>84</sup>

We have already noted in this report that a significant number of cases involving rejected OICs are ultimately reported as not collectible. These situations represent lost opportunities for the IRS, not only to collect additional delinquent revenue but also to improve taxpayer service and voluntary compliance. As the following table makes clear, the dollars collected through OICs compared to those reported as CNC or assigned to the collection queue inventory seem remarkably few.

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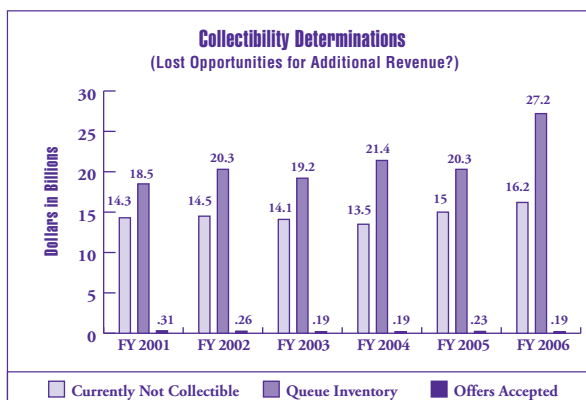
<sup>81</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

TABLE 1.6.3, COLLECTIBILITY DETERMINATIONS 2001-2006<sup>85</sup>



In a similar manner, IRS data indicates that during fiscal years 2004 and 2005, in those cases where taxpayers requested installment agreements and the requests were denied, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the request for an IA was made.<sup>86</sup>

It seems apparent that any process requiring taxpayers to submit detailed, multi-page financial statements, with reams of supporting documentation, to collectors trained to meticulously scrutinize each asset and expense item to determine “maximum ability to pay” is not designed to actually *collect* delinquent accounts. When compared to the positive results the IRS routinely achieves through its streamlined approach to evaluating installment agreements, the traditional, labor-intensive ALE approach seems inefficient and ineffective. In light of the characteristics of cases where the ALE approach is generally applied, *i.e.*, aged accounts with higher tax balances due, and the fact that the likely outcome of the ALE analysis will be reporting the accounts as not collectible or allowing them to remain unresolved in “active” collection status for prolonged periods, the traditional, more costly approach seems even more questionable. Moreover, this traditional, resource-intensive approach to tax administration fails to provide any type of resolution or relief whatsoever to thousands of taxpayers seeking to resolve their tax debt

<sup>85</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (FY 2001 – FY 2006). Data reflects the cumulative amount of revenue dollars reported as CNC during each fiscal year, the amount of revenue dollars reported as assigned to the collection queue as of the end of each fiscal year, and the cumulative amount of revenue dollars accepted in OICs during each fiscal year.

<sup>86</sup> IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005). As described in IRM 5.14.1.3, IDRS transaction code TC 971 with action code 043 should be input on tax modules involving taxpayers who have requested installment agreements, and the requests are pending review and approval. Our analysis identified those accounts reflecting the input of TC 971-43 with no subsequent indication of an approved installment agreement, *i.e.*, IDRS status code 60.

problems. The most significant question regarding this issue remains – why has the IRS not revised its methods for determining the collectibility of delinquent tax accounts?

### Reasonable Collection Alternatives – Is there “another agenda”?

In our interactions with the IRS regarding reasonable collection alternatives, the Taxpayer Advocate Service has also encountered what practitioners have described to us as “another agenda:”

- ◆ The IRS appears very concerned that any increase in the use of collection payment alternatives will hurt voluntary compliance;
- ◆ The IRS does not want to appear to be a “lending institution” in the installment loan business; and
- ◆ The IRS does not want to settle tax debts through the OIC program in a manner that may encourage abusive use of this alternative.

The National Taxpayer Advocate acknowledges these concerns, but questions the degree to which they are valid in practice. The current rate of interest and penalties, along with the considerable impact of the federal tax lien, do not make an IRS installment agreement an attractive option in any realistic financial plan. Moreover, we are not aware of any study or research indicating that a significant number of taxpayers have deliberately avoided paying their taxes in hopes that they might be able to compromise with the IRS on the amount due.

On the other hand, as of September 2006, over 779,000 taxpayer cases with balance due accounts resided in the IRS collection queue.<sup>87</sup> Over \$27 billion in delinquent taxes was associated with these accounts, and almost 27.1 percent of the accounts had been assigned to the queue for 16 months or longer.<sup>88</sup> In FY 2006, over 750,000 taxpayer accounts were reported as currently not collectible (CNC).<sup>89</sup> Of these, approximately two-thirds involved accounts that the IRS decided not to actively pursue due to their relative low priority in the IRS’s inventory distribution system rather than a determination of hardship.<sup>90</sup> In light of these conditions, we find it extremely difficult to believe that a more reasonable and flexible approach to using collection payment alternatives would not represent a viable, appropriate resolution for many taxpayers and additional revenue for public use. Table 1.6.4 below reflects the wide disparity between the number of taxpayers who have been successful in resolving tax debt problems through the use of the OIC and those whose problems remain unresolved as accounts reported as CNC or assigned to the collection queue inventory.

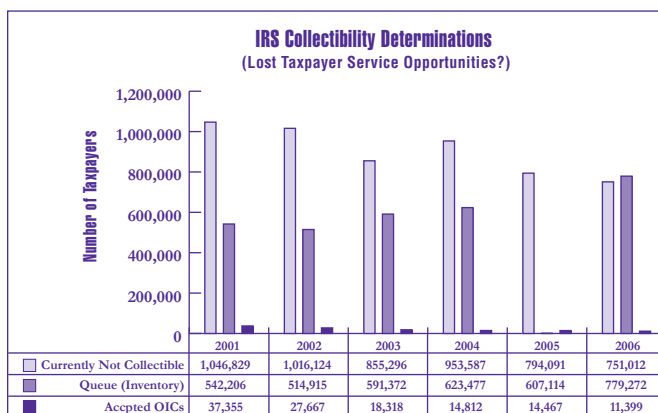
<sup>87</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Apr. 2, 2006).

<sup>88</sup> *Id.*

<sup>89</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149*. (Sept. 29, 2006).

<sup>90</sup> *Id.*

TABLE 1.6.4, COLLECTIBILITY DETERMINATIONS FY 2001-2006<sup>91</sup>



In the 2004 Annual Report to Congress, the National Taxpayer Advocate noted “the IRS collection strategy too often employs a one-size-fits-all approach that does not prioritize person-to-person contacts with taxpayers.”<sup>92</sup> In that report, we urged the IRS to place more priority on prompt person-to-person contact with delinquent taxpayers and utilize collection treatments designed to address the needs of these taxpayers. As mentioned elsewhere in this report, we are concerned that delays in the IRS’s efforts to provide early, meaningful interventions contribute to long-term financial problems for taxpayers, and ultimately cost the government a significant amount of lost revenue.<sup>93</sup> IRS data indicate that these delays play a critical role in allowing tax debts of many taxpayers to grow into financial problems that are exceptionally difficult to overcome.

Virtually any debt-collection operation, including the IRS, acknowledges that as delinquent accounts receivable grow older, their potential to be collected declines. Yet, it appears that as IRS collection tax cases age, with corresponding increases in balances due, IRS policies and procedures become *more* rigid and make it very difficult for taxpayers to obtain reasonable collection alternatives. The IRS cannot have it both ways. We continue to believe prompt personal contact with delinquent taxpayers, particularly those who remain delinquent after the routine collection notice process, should be the top priority for IRS collection operation. In regard to the hundreds of thousands of IRS collection cases that remain unresolved because this has not occurred, the IRS

<sup>91</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (FY 2001 – FY 2006), IRS, *Collection Activity Report, Monthly Report of Offer in Compromise Activity, NO-5000-108* (FY 2001 – FY 2006). Data reflects the cumulative number of taxpayer cases reported as CNC during each fiscal year, the number of taxpayer cases reported as assigned to the collection queue as of the end of each fiscal year, and the cumulative number of accepted OICs during each fiscal year.

<sup>92</sup> National Taxpayer Advocate 2004 Annual Report to Congress 226-245.

<sup>93</sup> See Most Serious Problem, *Early Intervention in IRS Collection Cases, supra*.

needs to provide flexible and realistic collection alternatives to afford taxpayers the opportunities to resolve tax problems in a reasonable manner.

### IRS COMMENTS

Consistent with our mission of applying the tax laws with integrity and fairness to all, the IRS generally expects that all taxpayers will pay the total amount due, regardless of amount. When attempting to resolve a tax delinquency, the IRS works with taxpayers to achieve full payment of all tax, penalty, and interest imposed by Congress. Where payment in full cannot immediately be achieved, the IRS may, and often does, allow taxpayers to pay over time through an installment agreement. If full payment cannot be achieved even over time, or would cause the taxpayer economic hardship, the IRS recognizes that it is both sound business practice and good tax policy to settle some cases for less than the total amount due. The IRS actively continues to increase taxpayer access to appropriate alternative payment options such as installment agreements and offers in compromise, but it is committed to doing so within this overall collection framework.

#### *Installment Agreements and Currently Not Collectible Determinations*

The IRS used installment agreements in over 2.77 million cases in fiscal year 2006, an increase of nearly five percent over the number of agreements granted in FY05. Almost 97 percent were streamlined installment agreements. Over 1.52 million taxpayers paid their agreement balances in full within 60 months in FY06. Although our resources do not permit us to make personal contact in every case as soon as a tax delinquency arises, the Form 1040 package advises taxpayers how to request an installment agreement if they cannot pay the tax in full when they file their return. Instructions on how to apply for an installment agreement are provided in every balance due statement the IRS issues, on the IRS.gov website, and in various publications. The IRS recently made available the Online Payment Agreement internet application to allow qualifying taxpayers to submit streamlined installment agreement requests online. Many smaller accounts comprise the inventory that will receive personal contact through our Private Debt Collection initiative. The IRS initiated a test to explore having telephone assistants attempt collection of cases of liabilities up to \$100,000 that otherwise might not be prioritized in field inventory. In field collection operations, we recently expanded the field authority for granting In-business Trust Fund Express agreements from \$1,500 to \$10,000, to increase the availability of this alternative resolution.

While the IRS clearly prefers to receive payment rather than suspend collection on accounts, the Currently Not Collectible (CNC) figures cited by the National Taxpayer Advocate do not represent the refusal to consider alternative payment options. The designation of CNC refers to a broad range of cases the IRS decided to remove from active inventory for a variety of reasons. CNC includes lower priority cases shelved for lack of resources, either after being worked extensively in ACS or being modeled as low-yield. This number is declining both in real terms and as a percentage of total cases reported CNC. In FY06, the number of shelved cases declined 21 percent in terms of

modules and 32 percent in terms of total dollars. More than 30 percent of the remaining modules reported in FY06 were determinations that collection action, including use of payment alternatives, would impose a hardship on the taxpayer.

The Partial Payment Installment Agreement allows a taxpayer to make payments against a tax debt when the payment schedule will not fully pay the liability prior to the expiration of the collection statute and compromise is not a viable alternative. In FY06, the IRS granted 13,328 partial payment agreements. While a recent review indicates that these agreements are being granted in exactly the circumstances that were intended, it is difficult to determine whether additional opportunities were missed, and, more importantly, whether more effective use of this tool would have resulted in more collected. This authority is relatively new and we will continue to explore appropriate uses for this type of agreement.

#### *Financial Analysis and Allowable Living Expenses*

The IRS agrees that it is important to accurately analyze individuals' ability to pay delinquent tax debts. Only slightly over 18 percent of installment agreements granted after financial analysis defaulted, while nearly 23 percent of streamlined agreements defaulted during the same period. As the National Taxpayer Advocate states, field cases in which IRS applied rigorous financial analysis resulted in the granting of only 3.3 percent of all IRS installment agreements concluded in FY06. The small number of installment agreements granted after a financial analysis was performed in the field reflects the focused application of professional resources on the minority of collection cases most resistant to resolution. Application of IRS financial analysis techniques to this select inventory results in a variety of resolutions that include installment agreements as only one possible option.

In determining the ability to pay in a consistent manner, the IRS uses a calculation based on what average citizens in a given income bracket spend on basic necessary living expenses, established using government survey data. While no set of standards can be expected to fit every individual circumstance, our procedures allow employees the flexibility to deviate from the standards to provide taxpayers adequate means to meet living expenses. We recently undertook a research project to explore whether the methodology used to develop allowable living expenses should be changed. Research conducted into application of the standards found that IRS employees will deviate from the standards when considering necessary living expenses. For example, IRS employees allowed housing and utility expenses that exceeded the applicable standard in 41 percent of 10,864 cases sampled. In fact, 50 percent of the taxpayers in this sample actually claimed less than the current allowable housing standard. We continue to focus our efforts on both improving the accuracy of the standards themselves and improving use of the standards so that they are not applied in an overly rigid manner.

*Offers in Compromise as a Collection Alternative*

The offer in compromise program is an important alternative for taxpayers that are not able to pay in full. The policy and procedures that the IRS has in place are intended to make the program accessible to those taxpayers that qualify. We have made continuous improvement to our procedures to ensure that taxpayers receive a decision on their offer in compromise in a timely manner. A recent GAO study positively acknowledged the changes we have made to the program such as improved forms, instructions, policies, and procedures. The offer program is not a viable resolution for all taxpayers and, as a result, we have adopted a number of communication strategies to educate the public about the offer program. Through education and public outreach, taxpayers now have a better understanding of who qualifies for an offer and are less likely to submit an offer that is not processable as evidenced by a 26 percent reduction in not processable offers since FY05.

We measure compromise program results against a variety of indicators, not just the number of offers received or the number accepted. We are concerned that focusing on the number of offers accepted does not adequately address our objectives of timeliness, quality, and efficiency. We believe acceptances should be based on a quality analysis of each case. A recent TIGTA study found that in 187 cases reviewed, the final decision on rejected or withdrawn offers was correct in 100 percent of the cases. The acceptance rate that is used by the National Taxpayer Advocate to calculate the percentage of offers accepted (17.8 percent) is not reflective of how the program measures acceptances. The acceptance rate has actually increased from 21 percent in FY05 to 23 percent in FY06. More importantly, when a taxpayer provides all the information that the IRS needs to fully investigate the offer, our acceptance rate in FY06 was 42 percent.

*Offer in Compromise - Collection When an Offer Has Been Rejected*

In many instances, rejected or withdrawn offers are placed in a currently not collectible status. The National Taxpayer Advocate is concerned about the number of rejected, returned, or withdrawn offers that are reported as not collectible. The IRS is also concerned about this issue and is exploring ways to address this concern.

We continue to disagree, however, with the National Taxpayer Advocate's analysis of the number of tax modules associated with rejected and withdrawn offers that are ultimately reported as not collectible. To reach 40 percent, the National Taxpayer Advocate looked at the CNC rate of one year's worth of data (1998) at the six year mark. In other words, of all of the modules that were rejected/withdrawn in 1998, 40 percent were closed as CNC in 2003. This data does not support the argument that it is unfair for the IRS to reject an offer that we ultimately determine is not collectible because it does not consider collection activities that may have occurred after the OIC was rejected or withdrawn and before the CNC closing.

The Office of Program Evaluation, Research and Analysis (OPERA) September 2004 analysis of the compromise program indicated that the IRS does succeed in collecting

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a significant portion of rejected, withdrawn or returned offers. The OPERA data looks not just at the CNC for one year's worth of data, but at a snapshot of the CNC rate of all rejected/withdrawn OICs over the entire six-year period. In other words, of all of the modules that were rejected/withdrawn *between 1998 and 2003*, 20 percent were closed as CNC in 2003. This methodology better reflects the disposition method subsequent to rejected/withdrawn OICs. Further, a more recent TIGTA report validated that the IRS does act to collect when attempts to reach a compromise are not successful. TIGTA found that in a sample of 100 rejected offers, subsequent collections exceeded the offer amounts by approximately \$272,000.

We do, however, agree that more can be done to address those cases where an offer is rejected because more can be collected than offered. To this end, we have piloted a Special Case Unit or "Hand-off" unit in the Brookhaven COIC site. The unit was designed to evaluate and recommend a process that will help the IRS maximize the financial information gained during the offer in compromise process.

#### *Offer in Compromise – Program Accessibility*

We are concerned about the perception among taxpayers and practitioners that the offer program is not "accessible." In response to declining receipts, we conducted a test of whether letters targeted to taxpayers with older liabilities and a recent history of compliance would lead those taxpayers to enter into installment agreements or make reasonable offers. Results of that test are pending and should help us to be pro-active in identifying appropriate installment agreement and compromise candidates in the future.

Information received in the Nationwide Tax Forum shows that tax practitioners value timeliness in the offer process, and timeliness encourages participation in the program. We have taken numerous actions to improve the processing of offers to ensure that taxpayers receive a prompt and quality decision on all offers submitted. For example, we revised the Form 656 to include detailed step-by-step instructions on how to complete an offer, a processability check sheet, a worksheet to determine an acceptable offer amount, and what the IRS needs to fully evaluate the offer. Subsequent to the Form 656 revision, processing time and age of inventory has been reduced. In FY04, 35 percent of the total inventory was more than six months old with 13 percent of the inventory over 12 months old. In FY06 only 20 percent of the year-end inventory was over six months old and only five percent of the inventory was over 12 months old. Cycle time has improved as well with 70 percent of the investigations being resolved within zero to nine months.

The Nationwide Tax Forum coupled with our recent Customer Satisfaction Survey has given us valuable feedback. We have made several changes as a result of this feedback and will continue to make improvements going forward.



**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate recognizes that the IRS has utilized the installment agreement (IA) collection tool to assist millions of taxpayers in resolving delinquent tax debts. Specifically, the “streamlined” installment agreement process seems to be a particularly effective mechanism that allows taxpayers and the IRS to quickly “get to yes” on fair, mutually agreeable payment plans. We applaud the IRS’s recent actions designed to increase the availability of this payment option to more taxpayers, *i.e.*, the Internet-based Online Payment Agreement and the increased availability of the Trust Fund Express agreements for business taxpayers. However, while the IRS acknowledges that it is good tax policy to “settle *some* cases for less than the total amount due (emphasis added),” we continue to be concerned that current IRS policies and procedures are designed with a frequently unrealistic “full payment or nothing” perspective that is clearly evident in IRS collection program results. Consequently, the use of collection options such as the offer in compromise and partial payment installment agreement are becoming practically non-existent.

We have noted that of the approximately 2.7 million streamlined IAs granted by the IRS in FY 2006, only 25 percent involved Taxpayer Delinquent Accounts (TDAs) assigned to Collection’s public contact employees, *i.e.*, the Collection Field function or the Automated Collection System (ACS).<sup>94</sup> In fact, only 0.4 percent of all streamlined IAs granted in FY 2006 involved accounts in the Collection Field status.<sup>95</sup> Although the streamlined IA appears to be one of the IRS’s most effective methods for collecting delinquent revenue, its use outside of the routine collection notice process appears to be limited. The IRS reports it granted 13,328 partial payment installment agreements in FY 2006.<sup>96</sup> This represents less than 0.5 percent of all IAs granted during the fiscal year, which is approximately the same rate as in FY 2005.<sup>97</sup> The IRS specifically petitioned the Congress to pass legislation that granted the authority to accept PPIAs, yet, in practice, the use of this collection tool has been negligible.

<sup>94</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006). Of the 2,678,897 streamlined IAs granted in FY 2006, 9,801 were taken by the Collection Field function, 630,342 by ACS (excluding the ACS VRU automated system), and 32,103 involved accounts assigned to the Collection queue inventory. For the purposes of this report, it was assumed the IAs involving queue accounts were taken by Field or ACS employees. On the other hand, 1,017,433 streamlined IAs were granted by Customer Account Services employees via toll-free telephone contacts, 881,878 were granted on collection notice accounts by collection employees working at campus locations, and 56,371 were granted by Walk-In and W&I Field Assistance employees. We also note that the IRS walk-in and field assistance operations granted 64 percent more *total* IAs in FY 2006 than were given by revenue officers in the Collection Field operation.

<sup>95</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report, NO-5000-6* (Oct. 2, 2006).

<sup>96</sup> We note that the IRS comments to this section of the Annual Report to Congress did not cite any reports or supporting documentation. Consequently, in most instances, we were not able to validate the data provided by the IRS to support its positions.

<sup>97</sup> Data provided by SB/SE Collection Policy. The IRS does not routinely track PPIA activity through systematically generated reports, but plans to have this capability in 2007.

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While the IRS publicly states that the offer in compromise is “an important alternative for taxpayers that are not able to pay in full,” and that the “policy and procedures that the IRS has in place are intended to make the program accessible to those taxpayers that qualify,” the fact remains that these very policies and procedures have reduced the productive use of this important collection option almost to the point of extinction. The IRS Collection operation accepted only 11,399 OICs during FY 2006.<sup>98</sup> This represents a 69 percent reduction since FY 2001, with the number of accepted OICs declining in every fiscal year since FY 2001.<sup>99</sup>

The IRS contends that reviews by internal quality review staff, as well as TIGTA, have confirmed that final decisions on rejected and returned OICs have been “correct.” We note that these types of reviews generally focus on the correct application of IRS policies and procedures, *i.e.*, did the taxpayers meet the “qualifications” established by the IRS that govern the acceptability of the offers? These reviews do not typically reveal whether the OIC case decisions were in the long-term best interest of the taxpayers and the U.S. government. In consideration of the more than 750,000 taxpayers whose accounts were reported as uncollectible in FY 2006,<sup>100</sup> as well as the more than 779,000 taxpayers whose accounts remained inactive in the collection queue inventory at the close of the fiscal year,<sup>101</sup> we must question the reasoning behind the current set of rules that determine “taxpayers that qualify” for an accepted OIC.

We respectfully disagree with the IRS’s interpretation of the 2004 SB/SE - OPERA analysis of OIC results, which was based on data representing all OICs closed from October 1998 through July 2003. In fact, this analysis did not involve a sample; it included every closed OIC during this six-year period. The data indicates that over time, more than 40 percent of rejected and withdrawn OICs will ultimately be closed as CNC.<sup>102</sup> Also, the study revealed that of the tax modules in rejected or withdrawn OICs that were in CNC status, 27 percent of those involving individual taxpayers were in CNC status *while the OIC was being considered*.<sup>103</sup> Contrary to the IRS’s comments, these results are clearly indicative of the IRS’s refusal to consider alternative payment options in appropriate situations.

The IRS’s reading of the 2004 study, as reflected in the IRS comments to this report, evidences a failure to acknowledge the significantly negative impact the passage of time has on the successful collection of accounts receivable. We note, however, that

<sup>98</sup> IRS, *Collection Activity Report, Report of Offer in Compromise Activity, NO-5000-108* (Oct. 2, 2006).

<sup>99</sup> *Id.*

<sup>100</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006).

<sup>101</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>102</sup> IRS *Offers in Compromise Program, Analysis of Various Aspects of the OIC Program 10* (Sept. 2004). This analysis includes modules reported as currently not collectible (CNC), modules that became not collectible due to the expiration of the 10-year collection statute (CSED), and modules that became not collectible because they involved taxes that were discharged in bankruptcy proceedings.

<sup>103</sup> IRS *Offers in Compromise Program, Analysis of Various Aspects of the OIC Program 9* (Sept. 2004).

the IRS places a great deal of emphasis on the improvements in the overall age of the OIC inventories and on the reduction in length of time needed to complete OIC investigations. While we agree that timeliness matters to both taxpayers and their representatives, taxpayers also want a positive resolution of their tax problems. As it stands today, the IRS's "timeliness" means "getting to no" on OICs much quicker than it has in the past.

As IRS collection accounts age, the agency's collection policies and procedures make it much more difficult for taxpayers to work with IRS collectors to reach mutually agreeable and beneficial payment solutions. Rather than recognize taxpayers who do not successfully resolve tax debt problems through the collection notice process as a market segment most in need of personal contacts and flexible payment options to get back into compliance, the IRS categorizes these taxpayers as "cases most resistant to resolution." We believe this approach contributes to collection program results that should concern policymakers and taxpayers alike. Consider the following: in FY 2006, the IRS collected a total of \$7.2 billion on open TDA accounts, excluding payments from installment agreements.<sup>104</sup> However, during this same fiscal year, the IRS reported \$16.2 billion as CNC, and abated \$7.1 billion in open TDAs.<sup>105</sup> At least on the surface, it appears the IRS's "overall collection framework" is losing money.

The aforementioned 2004 OIC study also identified a very significant aspect of the program that the IRS rarely mentions – namely, the taxpayer's promise to remain in compliance. Approximately 80 percent of the taxpayers who had their offers accepted remained in compliance with their filing and paying compliance requirements during the five-year post-OIC monitoring period.<sup>106</sup> A subsequent review by TIGTA confirmed that "taxpayers generally do remain in compliance when offers are accepted." In fact, of the sample of cases included in the TIGTA review, 96 percent of the taxpayers were in compliance with the OIC payment terms and the five-year post-OIC compliance requirements.<sup>107</sup> TIGTA's review also indicates that these taxpayers tend to remain in compliance after the five-year monitoring period has concluded.<sup>108</sup> The IRS continues to undervalue the significant compliance benefits achieved through OICs and installment agreements.

<sup>104</sup> IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>105</sup> IRS, *Collection Activity Report, Recap of Accounts Currently Not Collectible Report, NO-5000-149* (Sept. 29, 2006); IRS, *Collection Activity Report, Taxpayer Delinquent Account Cumulative Report, NO-5000-2* (Oct. 2, 2006).

<sup>106</sup> IRS Offers in Compromise Program, *Analysis of Various Aspects of the OIC Program 6* (Sept. 2004).

<sup>107</sup> Treasury Inspector General for Tax Administration, Ref. Number: 2006-30-100, *The Offer in Compromise Program is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes 7* (Jul. 2006).

<sup>108</sup> *Id.*

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ONE**RECOMMENDATIONS**

We believe the underutilization of available collection payment options results in lost opportunities for the IRS to improve revenue collections and compliance through improvements in taxpayer service. In order to correct this situation, the IRS needs to revise the policies and procedures governing the use of these options with more realistic and reasonable expectations regarding their use.

1. The IRS should revise its current policies regarding the use of reasonable payment alternatives, *i.e.*, installment agreements, partial payment installment agreements, and offers in compromise. Policy guidance should clearly set expectations that in situations involving interactions with taxpayers seeking payment resolutions for tax delinquencies, the IRS will approve a payment option that is reasonable and realistic, unless the taxpayer represents a “won’t pay” situation where enforcement actions are necessary to collect the appropriate amount of revenue. Moreover, taxpayers who are engaging in discussions of payment options should be viewed as individuals who are “trying to pay,” but need the assistance of their government to return to the ranks of the compliant.
2. IRS policy should clearly state that a determination of reasonable collection potential (RCP) in any given collection case represents the amount the IRS actually and realistically expects to collect. IRS program results, including quality reviews of collection casework, should be evaluated on a regular basis to validate that case outcomes are based on reasonable and realistic RCP determinations.
3. In recognition of the negative impact of elapsed time on the collectibility of delinquent accounts receivable, the IRS should establish liberal and flexible installment agreement and offer in compromise acceptance policies for collection cases involving tax delinquencies that have aged more than 24 months from the due date of the tax liabilities.
4. The IRS needs to review and revise Part V of the Internal Revenue Manual and collection training materials to ensure that IRM procedural direction clearly reflects and supports IRS policy regarding reasonable payment alternatives, with particular emphasis on the sections involving offers in compromise (IRM 5.8), installment agreements (IRM 5.14), and financial analysis (IRM 5.15).
5. In consideration of OICs, the IRS should redefine “protracted installment agreement” as one that extends beyond five years, or the time remaining on the CSED, whichever is shorter. The IRS should reinstitute prior IRM direction regarding the “current value of future payments” in considering the reasonable collection potential of future installment payments for cash OICs.
6. The IRM should provide revised guidance involving the consideration of equity in assets in determining reasonable collection potential. The consideration of equity should realistically reflect the true potential for the taxpayer to secure

funds based on available equity, without creating undue economic hardship. The new IRM should provide sufficient guidance to ensure the determination of a taxpayer's realizable equity in assets is realistic, and address such issues as the taxpayer's credit history, the relative percentage of equity in the property, and the taxpayer's financial capability to qualify for and repay a loan.

7. The IRS needs to provide more clarity and direction in IRM procedures and collection training materials regarding the use of the allowable living expense (ALE) allowances as guidelines to be used as the starting point for determining a taxpayer's reasonable living expenses, and that deviations from the ALE allowances will commonly be required to reflect a realistic determination of individual taxpayer's ability to full pay a tax liability or to qualify for a collection payment alternative.
8. The IRS should develop reliable, systemic indicators for collection cases that more accurately identify "repeat delinquent" taxpayers who repeatedly seek to resolve delinquent tax accounts via collection alternatives such as offers in compromise and partial payment installment agreements, or who repeatedly default on installment agreements. IRS concerns about misuse of collection payment alternatives would be better addressed through more reliable methods of identifying taxpayers who have actually demonstrated these "high risk" tendencies.
9. The IRS should develop and implement a new "compliance" measure that routinely and accurately tracks taxpayer filing and paying compliance behaviors subsequent to entering into collection payment alternative agreements. Particularly in situations where the agreements will not result in the full payment of the outstanding tax liabilities, *e.g.*, OICs and PPIAs, the post-treatment compliance behavior of these taxpayers is a critically important component of the agreement. Any meaningful discussion regarding the use of OICs and PPIAs is incomplete without addressing the impact these agreements have on future taxpayer filing and payment compliance.
10. The IRS should reevaluate its current policies and procedures governing the use of collateral agreements in conjunction with accepted OICs. Properly designed collateral agreements can mitigate concerns that the IRS may have in entering into collection payment alternative agreements that will not result in full payment of the outstanding tax liabilities. We understand that the IRS has resisted the idea of expanded use of collateral agreements primarily due to costs associated with monitoring the agreements. In consideration of the large number of delinquent tax accounts currently reported as not collectible, which could potentially be resolved through improved utilization of the OIC, we believe these concerns are "penny wise and dollar foolish." However, we believe the costs associated with monitoring collateral agreements could be at least partially offset by implementing an additional OIC user fee for accepted offers that include collateral agreements.

**PROBLEM****TOPIC #7****LEVIES****RESPONSIBLE OFFICIALS**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage & Investment Division

**DEFINITION OF PROBLEM**

In fiscal year (FY) 2006, the IRS served 3.74 million notices of levy upon third parties, an increase of over 36 percent from FY 2005.<sup>1</sup> The IRS issues these levies while making minimal efforts to personally contact taxpayers or identify those who might face the greatest risk of economic hardship. The IRS does not apply adequate screening procedures or filters, or require its employees to diligently research existing and future hardship indicators. Instead, the IRS has heightened its emphasis on systemic acceleration of the levy process, which reduces personal contact with the taxpayer before and after the levy is imposed.

The National Taxpayer Advocate recognizes the IRS's need to utilize automation to perform enforcement activities more efficiently. However, we are concerned that this automation comes at the expense of quality taxpayer service. We have identified four main issues that the IRS levy program must address to maintain the proper balance of service and enforcement:

- ◆ Accelerated issuance of levies without an attempt at personal contact;
- ◆ Systemic issuance of levies without an appropriate screening filter;
- ◆ Reliance on ineffective levy release and refund mechanisms and procedures; and
- ◆ Downstream consequences of levy actions.

**ANALYSIS OF PROBLEM****Background**

A levy is a legal seizure of property to satisfy a tax debt.<sup>2</sup> The IRS levy program is a necessary means of collection, and when used appropriately is a fundamental component of tax enforcement. Per IRC § 6331(a), if a taxpayer does not pay a tax liability in full or otherwise come to an agreement to resolve the matter, the IRS may levy against

<sup>1</sup> IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006); IRS, *Statistics of Income (SOI), Tax Stats 2005*; Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006). FY 2005 data shows that 2,743,577 levies were served while FY 2006 data shows 3,742,276. There are two levy notices issued by the IRS to third parties: Form 668-W, Notice of Levy on Salary, Wages, and Other Income and Form 668-A, Notice of Levy. Form 668-W is used to levy an individual's wages, salary or other income (including income owed the taxpayer as a result of personal services in a work relationship). Form 668-A is used to levy other property that a third party is holding for an individual or business (e.g., bank accounts and business accounts receivable).

<sup>2</sup> IRC § 6331 provides the IRS with statutory authority to levy funds held by a third party.

any property (or right to property) that belongs to the taxpayer or is subject to a federal tax lien, unless it is exempt.<sup>3</sup>

To protect taxpayers from unnecessary hardship, Congress instructed the IRS to ensure that when appropriate, a supervisor reviews a determination to issue a levy prior to the action. Section 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98) outlines the steps the IRS must take.<sup>4</sup> An employee must:

- ◆ Review the taxpayer's information;
- ◆ Verify that a balance is due and owing; and
- ◆ Affirm that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.<sup>5</sup>

Despite this congressional mandate, the number of notices of levy served on third parties rose by 1,603 percent from FY 2000 to FY 2006.<sup>6</sup> The IRS processed 93 percent of the levies it issued in FY 2006 through the Automated Collection System (ACS), which, as its name implies, operates systemically, and requires minimal if any attempted contact with taxpayers before issuing levies.<sup>7</sup>

<sup>3</sup> See IRC § 6334 for an enumeration of property exempt from levy.

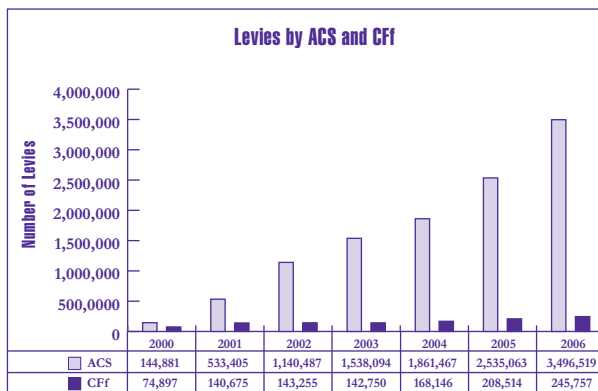
<sup>4</sup> IRS Reform and Restructuring Act of 1998, Pub. L. No. 105-206 § 3421(b) (1998).

<sup>5</sup> *Id.*

<sup>6</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 4 (Mar. 2006); IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006). The number of levies issued by the IRS increased from 219,778 in FY 2000 to 3,742,276 in FY 2006.

<sup>7</sup> IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006). [3,496,519 (number of levies issued by ACS in 2006) divided by 3,742,276 (total number of levies issued in 2006) = 93 percent].

**TABLE 1.7.1, LEVIES ISSUED BY ACS AND COLLECTION FIELD FUNCTION FY 2000-2006<sup>8</sup>**



**Levies Issued Without an Attempt at Personal Contact**

*The Notice Stream*

Generally, the IRS collection process consists of three stages: the notice stream, the ACS, and the Collection Field function (CFF).<sup>9</sup> In the notice stream, the IRS typically sends a series of notices – four to individual taxpayers and two to businesses – to the taxpayer’s last address of record.<sup>10</sup> Up to six months may lapse from the first notice to the last notice in the current process, with the IRS generally making no attempt to contact the taxpayer by phone or in person during that period.<sup>11</sup>

IRC § 6331(d)(2)(C) requires the IRS to issue these notices to the last known address, but does not prohibit the IRS from conducting research to obtain more current addresses during the notice process. The IRS currently has such a process, the Address Research System (ADR), but only employs ADR for letters issued beyond the final notice.<sup>12</sup> The ADR process is designed to systemically check existing IRS databases (e.g., Integrated Data Retrieval System, or IDRS) but more importantly has the ability to retrieve data from external sources such as the U.S. Postal Service (USPS) and Choice Point. Private

<sup>8</sup> IRS, *Statistics of Income (SOI), Tax Stats 2000 through 2005*; IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies- NO-5000-23-240* (Oct. 2, 2006).

<sup>9</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 230-235 for a more detailed analysis of the IRS collection strategy.

<sup>10</sup> The first is a settlement notice advising of a balance due. For individual accounts, when a balance remains on the account, up to three additional collection notices will be sent at five week intervals. Business taxpayers will receive the first notice and in five weeks, the final collection notice. The final collection notice advises taxpayers of the Intent to Levy and is the last notice required before a Federal Tax Lien may be filed. See IRM 5.19.1-3 (Dec. 31, 2003) for a complete description of the notice stream.

<sup>11</sup> Government Accountability Office, GAO-07-26, *Internal Revenue Service: Procedural Changes Could Enhance Tax Collections* 4 (Nov. 2006).

<sup>12</sup> IRS, Wage & Investment Division flowchart titled “ADR” (Jun. 26, 2006). Information was provided in response to TAS Research Request.



debt collectors have experienced great success using these outside services as well as searching the Internet and looking at Department of Motor Vehicles (DMV) and voting records. ADR processing can take up to 111 days depending on the number of sources researched, the number of letters sent, and the receipt of the response.<sup>13</sup> Even so, the IRS should conduct a study to further explore use of the ADR system, including ways to speed up the research, and evaluate the merits of initiating this beneficial process much earlier in the notice stream.

### *The Automated Approach to Collection*

If the taxpayer does not pay the liability in full or otherwise respond to the notices, the IRS assigns the account to the ACS or CFf, depending on the type of tax and taxpayer. The ACS typically handles most individual taxpayer accounts and collects delinquent taxes through a combination of human and automated processes. ACS systemically searches internal databases for levy sources to allow the IRS to take levy action quickly if the taxpayer does not contact the IRS.<sup>14</sup> IRS systems immediately issue a final notice (LT11) if none has been previously issued or certain conditions do not exist (e.g., a pending Collection Due Process (CDP) hearing, installment agreement, offer in compromise or bankruptcy proceeding). While the IRS does use systemic filters to ensure these taxpayer rights provisions are protected, the filters are monitored electronically, with no human intervention in the preliminary stages.

Similarly, when the IRS identifies levy sources, it does little else to contact the taxpayer or research the account while the final notice (LT11) is pending. IRS procedures do allow for a telephone contact prior to issuing a levy. However, the caveat to this option is “this is a management decision based on known backlogs in outcalls, quality of levy sources available and lengthy levy time frame.”<sup>15</sup> If the IRS attempts a contact, it does so via the “predictive dialer” process in which, if the taxpayer answers, the call is quickly redirected to the next available IRS assistor.<sup>16</sup> If no one answers, a message is left requesting a return call. The IRS also uses this process for situations in which there are no known sources of levy but there is a valid telephone number. If the attempted contact is unsuccessful, the IRS sends these cases, along with others lacking both a valid levy source and telephone number, to an investigation inventory where internal sources are checked to identify leads.

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<sup>13</sup> IRM 5.19.10.4.2(2) (Dec. 23, 2002).

<sup>14</sup> IRC § 6331(d). Before a levy action is taken, the IRS must send a notice of its intent to levy to the taxpayer. IRC § 6330(c)(2). Before the first levy, with respect to any tax liability, the IRS must also provide to the taxpayer a notice of the taxpayer’s right to a Collection Due Process hearing with the IRS Office of Appeals in which the taxpayer can raise a number of issues, including collection alternatives such as installment agreements or offers in compromise. IRC § 6331(d)(2).

<sup>15</sup> IRM 5.19.4.3.12(12) (Dec. 22, 2005).

<sup>16</sup> The predictive dialer system is outbound calling technology in which calls are placed without an attending agent on the originating telephone line. If the dialer makes contact, it transfers the call along with the other pertinent case data to a waiting IRS representative. See IRM 5.19.5.3.11 (Nov. 7, 2005) for a more detailed explanation of the process.

*Issuance of Multiple Levies*

The IRS adds further potential burden for the taxpayer by issuing ACS levies in a wholesale manner to all known sources of income, including situations where joint liabilities exist or community property law governs collection rights among spouses. While procedures do specify the maximum number of levies the IRS can issue at any given time, the IRS can simultaneously serve levies on both the taxpayer's bank account and wages. The levy determination process fails to consider and screen for the potentially devastating effect of this action on a taxpayer's financial condition.

**FPLP Levies Without an Appropriate Screening Filter***Background of Federal Payment Levy Program*

The Taxpayer Relief Act of 1997 (TRA 97) authorized the IRS to issue continuous levies for up to 15 percent of federal payments due to taxpayers who have an unpaid federal tax liability.<sup>17</sup> This process is known as the Federal Payment Levy Program (FPLP), an automated system that matches IRS records against those of the government's Financial Management Service (FMS) to locate federal payment recipients who have delinquent income tax debts.<sup>18</sup> Once a match occurs, the IRS attempts to notify the recipient of the potential levy by sending a letter with information about the liability and the taxpayer's appeal rights.<sup>19</sup> As an additional precaution for taxpayers who receive benefits paid by the Social Security Administration (SSA), the IRS sends a second notice before transmitting the levy to the FMS.<sup>20</sup> When the FMS generates a levy payment, it sends a notice to the taxpayer's address of record on file with the appropriate federal agency.<sup>21</sup>

*Inadequate Exclusionary Safeguards Remain for Low Income Taxpayers*

In January 2002, the IRS began using an income filter to systemically exclude from the FPLP those taxpayers with income below a specified threshold. This filter was implemented at the request of the National Taxpayer Advocate and was based on the amount of income reported on the taxpayer's last filed return (known as the Total Positive Income (TPI) indicator).<sup>22</sup> The General Accounting Office (GAO, now the Government

<sup>17</sup> IRC § 6331(h)(2)(A). Payments subject to the Federal Payment Levy Program include any federal payments other than those for which eligibility is based on the income or assets of the recipients.

<sup>18</sup> The Financial Management Service is the Department of the Treasury agency that processes payments for various federal agencies.

<sup>19</sup> IRM 5.19.9.3.3.2.7 (Jul. 14, 2005); CP 90/297, *Notice of Intent to Levy and Notice of Your Right to a Hearing*.

<sup>20</sup> IRM 5.19.9.3.2.7(5) (Jul. 14, 2005); CP 91/298, *Final Notice Before Levy on Social Security Benefits*.

<sup>21</sup> IRM 5.19.9.3.2.8(2) (Jul. 14, 2005).

<sup>22</sup> TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero. IRM Exhibit 4.1.7-1(33) (May 19, 1999). For a more detailed discussion of this filter, see National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; and National Taxpayer Advocate 2005 Annual Report to Congress 123-135.

Accountability Office) concluded in a 2003 study that the TPI criterion was “an inaccurate indicator of a taxpayer’s ability to pay.”<sup>23</sup> In response, the IRS gradually phased out all TPI levels and in January 2006 eliminated the filter altogether.

### *Social Security Payments Represent the Bulk of all FPLP Levies*

While we agree that the income filter used prior to 2006 was imperfect, we also believe there is an inherent need for some type of screening mechanism to protect taxpayers who depend on Social Security benefits for their health and welfare. From FY 2002 through the first quarter of FY 2006, 84 percent of all FPLP levies involved SSA payments to the elderly or disabled.<sup>24</sup> Although the law limits FPLP levies to only 15 percent of each Social Security payment, the remainder may not be enough to avoid a financial hardship, considering that:

- ◆ Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 or over, and is the *only* source of income for more than 20 percent of this population;<sup>25</sup> and
- ◆ As of August 2006, Social Security recipients received an average monthly benefit of \$923.30. An FPLP levy would reduce the amount to \$784.80 per month.<sup>26</sup>

Many of these taxpayers have come to TAS for assistance with FPLP levies. Three typical examples follow:<sup>27</sup>

**Example 1:** The taxpayer was 48 years old and living in a nursing home with SSA as his only source of income (a total of \$8,834 for 2005). The IRS attached FPLP levies to \$101.70 of these SSA payments for three months. Since all of these funds were earmarked to cover the taxpayer’s nursing home rent, he was unable to make the full payment and was facing eviction when he came to TAS for assistance. TAS got the IRS to release the FPLP levy, refund all of the levied funds, and place the taxpayer’s account into a Currently Not Collectible status due to his inability to pay.

**Example 2:** The taxpayer was 75 years old, had suffered a stroke and was bedridden. Her only source of income was SSA (a total of \$10,850 for 2005), which she relied on for her living expenses and multiple medications. When the IRS attached FPLP levies to \$127.95 of these SSA payments for two months, the taxpayer could no longer pay for her monthly medications and came to TAS for help. TAS got the

<sup>23</sup> General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (Mar. 6, 2003).

<sup>24</sup> IRS, W&I Operating Division spreadsheet titled “FPLP Monthly Counts CUM” (May 5, 2006). [Total number of SSA levies from FY 2002 through Dec. 2005 (2,572,299) divided by total number of FPLP levies from FY 2002 through Dec. 2005 (3,044,824) = 84 percent].

<sup>25</sup> Social Security Administration, *Fast Facts & Figures About Social Security*, 2005 (Sept. 2005).

<sup>26</sup> Social Security Administration, Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot*, Table 2, Social Security Benefits (Oct. 2006). [ $\$923.30 \times .15 = \$138.50$  and  $\$923.30 - 138.50 = \$784.80$ ].

<sup>27</sup> Examples are taken from the Taxpayer Advocate Management Information System (TAMIS).

IRS to release the FPLP levy, refund all of the levied funds and place the taxpayer's account into a Currently Not Collectible (CNC) status due to her inability to pay.

**Example 3:** The taxpayer was 58 years old and received monthly federal assistance in the following amounts: \$531 from SSA, \$91 from disability payments, \$200 from welfare, and \$10 in food stamps. She was supporting two children and could not work due to a back injury. FPLP levies had attached to \$79.65 of her SSA payments for three months, prompting her to come to TAS for assistance. TAS secured the release of the FPLP levy and a refund of one of the levy payments, but is still attempting to help the taxpayer recover the rest. The IRS also put this taxpayer's account in CNC status due to her inability to pay.

These examples demonstrate how imperative it is that the IRS develop an effective screen to eliminate the need for these low income individuals to contact the IRS and seek relief from a levy after the fact. The National Taxpayer Advocate is troubled that despite two IRS task forces, a GAO audit, and multiple Annual Reports to Congress (with specific recommendations) over the past five years, the IRS has been unable to devise a feasible method of screening out low income taxpayers from this automated process.<sup>28</sup>

Interestingly, the IRS identified the aging U.S. population as an emerging trend and an issue essential to its strategic planning efforts. The Wage and Investment (W&I) division's most recent Strategy and Program Plan projected that "70 million people, or one-fifth of the U.S. population, will be age 65 or older by 2030."<sup>29</sup> The IRS also expects a growing number of grandparents to raise their grandchildren because the middle generation cannot.<sup>30</sup> Still, in spite of these forecasts, the IRS conducts business as usual. There is little doubt that FPLP practices will significantly impact future generations unless the IRS changes the program considerably.

#### *Recent FPLP Developments and Trends*

In the spring of 2006, TAS and the IRS formed a task force to identify and resolve levy-related systemic issues. Although the National Taxpayer Advocate's highest priority for this project was to develop a viable income filter for the FPLP, the IRS has not yet devised one. Ironically, the most notable developments in the FPLP program for 2006 were not the exploration of a proactive screening mechanism, but the IRS's desire to expand the scope of the FPLP.

The IRS's first such action came in January 2006, when it enhanced the FPLP to enable FMS to attach to federal payments under the secondary Taxpayer Identification Number

<sup>28</sup> National Taxpayer Advocate 2001 Annual Report to Congress 202-209; National Taxpayer Advocate 2003 Annual Report to Congress 206-212; National Taxpayer Advocate 2004 Annual Report to Congress 246-263; National Taxpayer Advocate 2005 Annual Report to Congress 123-135.

<sup>29</sup> IRS, *Wage & Investment Division, Strategy and Program Plan ('06-'07)* Document 11622 13-16 (Oct. 2005).

<sup>30</sup> *Id.*

(TIN) of a joint income tax liability.<sup>31</sup> While the IRS has a legal right to collect from both liable parties, the systemic limitations within FPLP present great concerns to the National Taxpayer Advocate.<sup>32</sup> For example, IRS guidance states that the FPLP levy cannot be used to levy only on one of the taxpayers since all matched TINs will be levied for their appropriate matched payments.<sup>33</sup> Thus, if both taxpayers receive federal payments, an FPLP levy will attach to 15 percent of each of their monthly payments. This levy will place an increasingly tighter strain on the taxpayer's household income. This system also becomes an issue when both taxpayers are eligible for FPLP but are divorced. Since the primary account controls all FPLP activities, a compliant secondary former spouse may still be subject to an FPLP levy if the IRS takes enforcement action against the primary former spouse. The IRS has no written procedures to address this potentially harmful scenario.

The second development dealt with guidance from a Wage and Investment division (W&I) Compliance operational review in May 2006 in which the IRS cited plans to add Railroad Retirement Benefits to the FPLP.<sup>34</sup> At the request of the National Taxpayer Advocate, the IRS placed this decision on hold until it develops a suitable filter for the entire FPLP process. We note that this type of directive, coming in the wake of long-standing and significant systemic issues, underscores the National Taxpayer Advocate's concern that the IRS's sole focus for this program is bringing in more revenue.

Finally, another related development concerning FPLP stems from the implementation of the IRS's Private Debt Collection (PDC) initiative. As part of this initiative, the IRS decided not to assign cases with active FPLP levies and cases subject to automated levy programs to private collection agencies because the Commissioner acknowledged that it would be inappropriate to do so.<sup>35</sup> However, the IRS has refused to recall cases back from private collectors when a taxpayer becomes subject to the levy after the case has been assigned to the private collectors. While the IRS acknowledges that cases with active FPLP levies are the wrong type for assignment to private collectors, the IRS continues to assert that taxpayers under an FPLP levy of their Social Security income will benefit from interaction from private collectors.<sup>36</sup> For reasons previously stated, we do not believe it is appropriate for private collectors to pursue taxpayers in these situations and have accordingly asked the IRS to reconsider its position.

<sup>31</sup> IRS, Wage & Investment Division, *Federal Payment Levy Program (FPLP) Matching Process Enhancements* (Feb. 3, 2006).

<sup>32</sup> IRC § 6013(d)(3).

<sup>33</sup> IRM 5.19.9.3.9.2(3) (Aug. 18, 2006).

<sup>34</sup> IRS, Wage & Investment Division, *Compliance (F&PC) Operational Review* (May 2006).

<sup>35</sup> *Private Debt Collection: Hearing Before the Subcommittee on Oversight, House Committee on Ways and Means*, 109th Cong, 2nd Sess. (May 13, 2006) (Testimony of Mark W. Everson, Commissioner of Internal Revenue).

<sup>36</sup> For a more detailed discussion, see Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *supra*.

## Ineffective Levy Release Mechanisms and Procedures

### *Timeliness of Levy Releases*

In the 2005 Annual Report to Congress, we stated that the most common levy release problem reported to TAS by taxpayers involved processing time.<sup>37</sup> The Internal Revenue Code and accompanying Treasury Regulations require prompt release of any existing levies on the taxpayer's property when a taxpayer is suffering an economic hardship or agrees to certain collection alternatives (e.g., an installment agreement or offer in compromise).<sup>38</sup> We noted, and continue to observe, that this situation may be a result of ambiguity over the term *prompt*, which ordinarily means "performed readily, or immediately."<sup>39</sup>

The IRS normally inputs levy releases daily but does not actually mail them to the levy source (i.e., the employer or other source of taxpayer income) until the end of a processing cycle, i.e., one week. IRS guidance states that "generally, levy releases are mailed to save resources" and "the levy source should receive the levy release in about a week."<sup>40</sup> Thus, standard levy releases can routinely take ten days, including mailing time. This delay can lead to additional levy actions in the interim week cycle, causing harm to taxpayers.

### *Lack of Communication Regarding Expedited Procedures*

While the IRS can expedite levy releases to prevent over-collection or relieve hardship, it does not adequately or effectively communicate this message to its employees or taxpayers. For example, to expedite a levy release, an IRS employee must generate a manual release and fax it to the source. Historically, the IRS has interpreted this exception to mean the taxpayer must suggest an imminent need and prove the expedited relief is warranted. Only those taxpayers who are knowledgeable about IRS procedures and persistent in their requests will achieve a favorable outcome, while others who do not know about (or fear to ask for) expedited treatment will be left to endure their hardship until the levy source is officially notified.

The IRS's response to this issue in the 2005 Annual Report to Congress was that its employees "are aware of these procedures and make use of its capability where appropriate."<sup>41</sup> However, the IRS seems to be sending a mixed message to its employees when it comes to making these expedited determinations. Internal Revenue Manual (IRM) 5.19.4.4.10 advises the employee that when a return call is needed to provide the correct fax number, justification for the expedited release must be documented.<sup>42</sup> The IRM further states, "Sites will need to reevaluate the taxpayer's request for a faxed levy release"

<sup>37</sup> National Taxpayer Advocate 2005 Annual Report to Congress 215.

<sup>38</sup> See IRC § 6343(a); Treas. Reg. § 301.6343-1(a).

<sup>39</sup> *Webster's Third New International Dictionary* 1816 (1991).

<sup>40</sup> IRM 5.11.2.2.3(1) (May 5, 1998); IRM 5.19.4.4.10(7) (Dec. 22, 2005).

<sup>41</sup> National Taxpayer Advocate 2005 Annual Report to Congress 220.

<sup>42</sup> IRM 5.19.4.4.10(1) (Dec. 22, 2005).

if there is not adequate justification.<sup>43</sup> This suggests that the taxpayer must continue to bear the burden of substantiating the need for an imminent release should a later call be necessary to provide the missing fax information. Since the taxpayer has already met the conditions for a levy release, the IRS has an obligation to timely release the levy and help the taxpayer, or at least not continue to burden him or her. The same systemic approach and technology used to issue levies should be utilized to more efficiently release them as well.

Without clear and specific written guidance *requiring* employees to discuss expeditious options with taxpayers, such as speaking directly to the third party levy recipient or requesting a fax number during the taxpayer contact, the IRS will allow inequitable and disparate treatment of taxpayers. Proactively advising the taxpayer of the right to expedited treatment would signify that enforcement and taxpayer service can co-exist, as RRA 98 intended.

### Systemic Failures in Releasing Levies and Applying Levy Proceeds

As previously stated, when the IRS has levied an account but the liability is subsequently satisfied or becomes unenforceable due to lapse of time, the IRS is required to promptly release the levy to prevent over-collection.<sup>44</sup> In its response to the 2005 Annual Report, the IRS explained its due diligence efforts to reduce the instances of full paid accounts that continue to receive payments from the source, and referenced a systems update that could generate transcripts in these situations.<sup>45</sup> The IRS stated this process would enable employees to use a feature called Remittance Transaction Research to help identify the source of the payment and send levy releases.

The IRS also updated the IRM to give specific instructions for employees working these levy payment transcripts.<sup>46</sup> This guidance provides that employees must release levies “promptly” and fully research accounts to resolve any accounts where credits exist. The IRS also added information requiring contact with the taxpayer or levy source as well as resolution of all credit modules. We applaud the IRS’s efforts to establish much-needed controls for this fundamental process. However, these controls do not address some potentially harmful situations. The following example illustrates one taxpayer’s experience as a result of the IRS’s lack of adequate safeguards.

**Example:** A taxpayer in North Carolina owed several years of delinquent taxes, which eventually led to enforced collection via a levy on her retirement income. This levy attached to approximately \$600 per month and subsequently paid all of the balance due on the original levy. Although this full payment occurred in 1997, the IRS received monthly payments until the levy was released in June 2005.

<sup>43</sup> IRM 5.19.4.4.10(1) (Dec. 22, 2005).

<sup>44</sup> IRC § 6343(a)(1)(A).

<sup>45</sup> National Taxpayer Advocate 2005 Annual Report to Congress 220.

<sup>46</sup> IRM 5.19.6.21 (Jan. 25, 2005).

Rather than refunding the overpayments to the taxpayer, the IRS applied the funds to these fully paid tax modules as well as to several unassessed modules (those where a return was either not filed or there was no valid assessment of taxes). As a result, approximately \$39,000 in overpayments sit stagnant on the taxpayer's account with no observable plan to provide the taxpayer any relief she may be entitled to receive.

While the revised guidance will serve to alleviate *future* cases of this nature, it fails to address the underlying issues of this and other similar cases in which taxpayers were left without adequate protection or possible relief. Based on our analysis of cases where the IRS misapplied levied funds or later moved them to the IRS's Excess Collections File (XSF), the IRS still has some significant "clean up" work to do.<sup>47</sup> We identified four scenarios where IRS procedures or systems apparently failed to release levies or correctly apply levy proceeds. These situations involve levy payments that were:

- ◆ Applied to accounts that have already been full paid;
- ◆ Applied to accounts not included on the original levy;
- ◆ Applied to accounts without a valid assessment of taxes; or
- ◆ Applied to accounts after the collection statute expiration date (CSED) had lapsed (under the doctrine of "fixed and determinable rights").<sup>48</sup>

We also identified situations where taxpayers were prevented from obtaining refunds of levy proceeds because the refund statute expiration date (RSED) had lapsed, even though the IRS was negligent in its initial and subsequent application of said funds.

#### *Levy Payments Applied to Accounts That Have Already Been Full Paid*

IRS systems are designed to generate transcripts for IRS personnel to research and determine where the funds should be applied when payments are posted to full paid modules.<sup>49</sup> While the IRS updated these guidelines in April 2006 to re-emphasize the need for prompt and full account research to properly resolve these situations, we continue to find credit balances that are not applied or refunded when overpayments exist. In many cases, these credits remain on the taxpayer's account indefinitely or are

<sup>47</sup> The IRS's Excess Collections File (XSF) is primarily used to hold payments sent to the IRS that cannot be associated with a tax liability. IRM 3.17.220 explains that funds are only to be moved to XSF after completing the necessary research to establish that the funds could not be applied to a specific account or could not be refunded to the taxpayer. For a more detailed discussion of XSF, see Most Serious Problem, *Excess Collections*, *infra*.

<sup>48</sup> Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future and will not be released under this condition unless the liability is satisfied. Certain streams of payments (*e.g.*, retirement and Social Security benefits, pensions, royalties, etc.) can be seized by a single levy and according to the IRS, that levy attaches to all future payments to which the taxpayer is entitled to, so long as there is a fixed and determinable right at the time of levy. Thus, the IRS can collect these payments long after the expiration of the statutory period for collecting the tax.

<sup>49</sup> IRM 5.19.6.21 (Jan. 25, 2005).



finally moved to the Excess Collections File. In others, the IRS continues to post levy proceeds to fully satisfied periods, and as a result incurs significant costs by generating refund checks for the overpayments. One such case involved the continual posting of \$20 payments and issuance of refund checks ranging from \$20.02 to \$20.16 over a period of two years (25 such payments were eventually refunded). While the IRS does not publish the cost of processing a refund check, given the time an IRS or TAS employee must expend in dealing with the taxpayer and researching the request, the inefficiency speaks for itself.

#### *Levy Payments Applied to Accounts Not Included on the Original Levy*

As previously stated, in situations where the tax liabilities listed on the levy have been satisfied, it is the IRS's policy to promptly release the levy to avoid overcollection.<sup>50</sup> IRC § 6402(a) permits the IRS to offset these overpayments against any liability of the taxpayer.<sup>51</sup> IRS guidelines do advise that

Although this is legal and we will retain funds already received, we do not intentionally allow levies to remain in effect once we are aware that the modules listed on it have been resolved. We must either release the levy, or if CDP criteria are met, reissue a new levy to include the additional modules.<sup>52</sup>

Additional guidance speaks to this same type of situation and reiterates that “where a taxpayer has had a wage levy, which is now full paid and is being misapplied to other tax periods,” a release must be prepared.<sup>53</sup>

Even so, TAS has identified situations where the IRS did not follow its published guidance and continued to offset overpayments against liabilities without issuing additional levies. These offsets were not one-time occurrences but were situations where the IRS applied levy payments for two to three years or longer. In many cases, the taxpayer may not have been notified of the application since current procedures require no personal contact or correspondence. The application of such payments to a module not listed on the original levy is of particular concern to the National Taxpayer Advocate because the taxpayer may not have received a CDP notice or other recent notice for this additional collection activity.

#### *Levy Payments Applied to Accounts Without a Valid Assessment of Taxes*

Similar to the situation where proceeds are applied to an account not originally listed on the levy, we have also observed instances where the IRS posted levy payments to accounts without a valid assessment of taxes. This is disturbing because the IRS has no legal authority to collect or apply funds to an account where it has not assessed taxes.

<sup>50</sup> See IRM 5.19.6.21 (Jan. 25, 2005); IRM 5.19.4.4.10(4)(d) (Aug. 14, 2006).

<sup>51</sup> IRC § 6402(a).

<sup>52</sup> IRM 5.19.4.4.10(4)(d) (Aug. 14, 2006).

<sup>53</sup> IRM 5.19.2.6.8(10) (Jun. 1, 2006).

IRC §§ 6331(a) and (d) clearly require the IRS is to advise a taxpayer of the balance due and further notify the taxpayer of the proposed levy action before issuing the levy itself.<sup>54</sup> Section 3421 of RRA 98 further requires employees to verify that a balance is due before issuing a levy. By posting levy payments to accounts without a valid assessment, the IRS has failed to provide important taxpayer protections.

*Levy Payments Applied to Accounts After the CSED (Doctrine of “Fixed and Determinable Rights”)*

Treas. Reg. § 301.6343-1(b)(1)(B)(ii) provides that a levy reaches all property rights at the time the levy is made, including the right to receive payments at some point in the future, and will not be released under this condition unless the liability is satisfied. Certain streams of payments (e.g., retirement and Social Security benefits, pensions, royalties, etc.) can be seized by a single levy and according to the IRS, that levy attaches to all future payments to which the taxpayer is entitled to, so long as there is a fixed and determinable right at the time of levy. The IRS can collect these payments long after the expiration of the statutory period for collecting the tax.<sup>55</sup>

*Refund of Erroneously Applied Levy Proceeds After the RSED*

In the 2001 Annual Report to Congress, we noted several instances where IRS errors in the course of collecting a tax liability negatively affected taxpayers.<sup>56</sup> As we pointed out, the IRS was prevented from providing relief to taxpayers because of statutory limitation periods for requesting the return of proceeds, even though some of these IRS errors were deemed to be flagrant or egregious.<sup>57</sup> Accordingly, we recommended that the IRS be given authority to correct such errors.<sup>58</sup>

Five years later, we are still witnessing situations where the taxpayer was not (and is still not) aware of the fact that any levied funds were misapplied and may be available for recovery. In many instances, the IRS continued to post levy payments and failed to release the levy, exacerbating the original problem while not alerting the taxpayer to possible relief. Here, the levy release mechanism clearly failed. Therefore, we reiterate our recommendation that Congress amend the Internal Revenue Code to grant the IRS the authority to remedy harm to taxpayers brought about by improper IRS actions. This authority would extend to those errors that are flagrant or egregious in nature and would shock the conscience of taxpayers if not corrected.<sup>59</sup>

<sup>54</sup> There is an exception for situations where the Secretary makes a finding that the collection of tax is in jeopardy. See IRC § 6331(d)(3).

<sup>55</sup> For a more detailed discussion, see Key Legislative Recommendation, *Post-CSED Levies on Fixed and Determinable Rights*, *infra*.

<sup>56</sup> National Taxpayer Advocate 2001 Annual Report to Congress 206.

<sup>57</sup> *Id.* at 202.

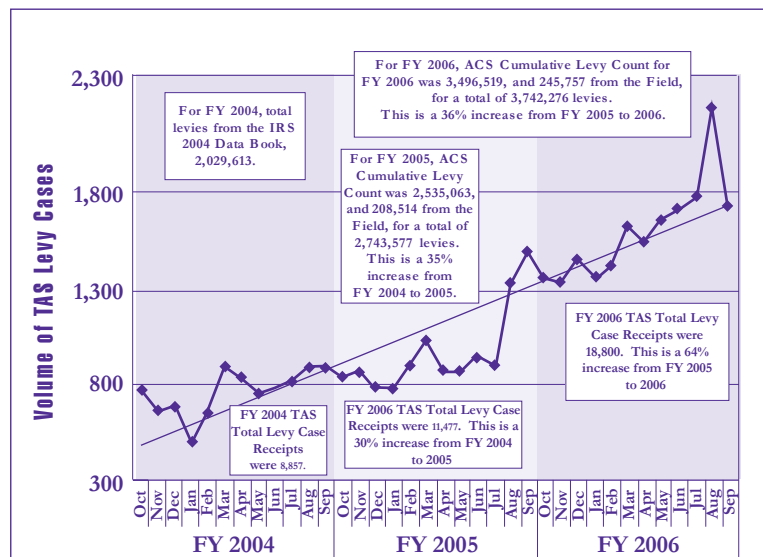
<sup>58</sup> See *id.* at 202-209 for a more detailed analysis of the return of levy or sale proceeds.

<sup>59</sup> The term “flagrant” is defined as “conspicuously bad” or “offensive”. Webster’s II New Riverside University Dictionary, 1st Ed., The Riverside Publishing Company, Massachusetts, 1984. For a more detailed discussion, see Additional Legislative Recommendation, *Amend IRC § 6511 to Allow Refund Claims Past the RSED When Excess Collection Is Due to IRS Error*, *infra*.

### Downstream Consequences of Levy Activities

By not trying to proactively weed out its own defined categories of “will pay” and “can’t pay” taxpayers from those who are unwilling or “won’t pay” before imposing levies, the IRS creates additional work and undue hardship for itself and taxpayers alike.<sup>60</sup> As a result, functions such as TAS and the IRS’s Office of Appeals must often deal with disgruntled or burdened taxpayers. For example, levy-related cases in TAS have risen by 64 percent from FY 2005 to FY 2006.<sup>61</sup> More specifically, TAS cases regarding FPLP/Social Security benefits issues have increased at a rate of 143 percent from FY 2005 to FY 2006.<sup>62</sup> Nearly 65 percent of the levy cases closed by TAS in FY 2006 have received some type of relief from their hardship, with almost 56 percent being given full relief (*i.e.*, release or removal from the FPLP process).<sup>63</sup> As the graph below indicates, the steady rise of IRS levies to third parties has resulted in a significant increase in TAS levy case receipts. It also provides an accurate depiction of the current state of IRS collection efforts and underscores our growing apprehension as to where these actions may ultimately lead.

**TABLE 1.7.2, IRS LEVIES AND TAS MONTHLY LEVY CASE RECEIPTS, FISCAL YEAR 2004-2006<sup>64</sup>**



<sup>60</sup> See IRM 5.10.1.4 (Oct. 1, 2004) for a detailed description of these three categories.  
<sup>61</sup> Taxpayer Advocate Service, *Business Performance Management System* (as of Sept. 30, 2006). For FY 2005, there were 11,477 levy-related cases in TAS and 18,800 such cases in FY 2006.  
<sup>62</sup> Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security benefit-related cases in TAS and 4,147 for FY 2006.  
<sup>63</sup> Taxpayer Advocate Service, *Business Performance Management System* (Sept. 30, 2006).  
<sup>64</sup> Chart data was gathered from a variety of sources: Taxpayer Advocate Service, *Business Performance Management System* (FY 2004 through FY 2006); IRS, *Statistics of Income (SOI), Tax Stats 2004 and 2005*; IRS, *Automated Collection System (ACS) Customer Service Activity Reports (CSAR) FY 2006 BOD Report* (Oct. 2, 2006); IRS, *Collection Account Report, Field Collection Levies-NO-5000-23-240* (Oct. 2, 2006).

## CONCLUSION

The National Taxpayer Advocate is concerned that based on current collection enforcement initiatives, the IRS is slowly returning to the way it did business prior to RRA 98. In fact, contrary to RRA 98 and IRC § 3422's directive to utilize better discretion in its levy processes, the IRS has now embarked on an even more narrow path towards impersonal and rigid collection procedures. The IRS should continue to use automation to perform its enforcement activities but it should do so wisely and appropriately. By employing more proactive approaches, such as the removal of potential hardship cases from FPLP and a requirement for meaningful personal contact in pre-levy activities, as well as more efficient processes for levy releases and the application of levy proceeds, the IRS can achieve the appropriate balance of enforcement and taxpayer service.

## IRS COMMENTS

The IRS understands the sensitive nature of levying taxpayer assets and respects all taxpayer rights in using its levy power. The IRS enforces the tax laws through levy only after we attempt to notify the taxpayer of the tax liability and the taxpayer does not work with the IRS to resolve the outstanding balance.

Automation is an important component of IRS enforcement activities. In the wake of the IRS Restructuring and Reform Act of 1998, the IRS severely curtailed levy activity as we rewrote and refined our levy procedures. Under our new procedures and processes, as well as the systemic levy programs that have been developed in recent years, we have increased the number of levies we initiate each year and are confident we are meeting existing legal requirements. As we continue to refine our levy processes and procedures, we continue to take steps to mitigate any negative consequences that may result from our levy programs.

## Contacting Taxpayer Prior to Levy Action

The IRS uses several resources to ensure our records reflect a taxpayer's most current address. We receive National Change of Address files from the United States Postal Service (USPS) and upload that information weekly to the master file. This information comes from address changes taxpayers report to the USPS. Before assigning an account to a Collection function, the IRS also uses the Address Research System (ADR) in an attempt to locate a taxpayer. Our ACS and the CFF utilize additional locator services for taxpayers whose notice was returned to the IRS as undeliverable. If we find a taxpayer's telephone number for a taxpayer whose notice was returned as undeliverable, ACS employees attempt to telephone that taxpayer prior to any enforcement action. In the Collection Field function, a revenue officer may attempt an in-person contact with the taxpayer prior to enforcement action. In any instance, the IRS issues a final notice of intent to levy and notice of a right to a collection due process hearing before taking

enforcement action. The notice must be given to the taxpayer, left at the residence or place of business, or sent by certified mail.

The IRS does not issue multiple levies systemically. We issue multiple levies on a case-by-case basis and only after an authorized Collection employee has reviewed the case and determined that issuing multiple levies is the next appropriate action. Again, we emphasize that the taxpayer can contact the IRS to resolve the liability or provide information to determine the collectibility of their unpaid tax liability at any point during the collection process.

### **Federal Payment Levy Program (FPLP)**

The IRS disagrees that its sole focus for the FPLP is bringing in more revenue. The IRS implements the laws it is given, including the Taxpayer Relief Act of 1997 and the Railroad Retirement Act. The receipt of benefit income from the Social Security Administration (SSA) does not, in and of itself, indicate that a taxpayer is experiencing a hardship situation. To assist the IRS in identifying taxpayers who are experiencing a hardship because of the FPLP, the IRS plans to begin a research project to determine whether we can create and implement an effective income filter. As stated in the National Taxpayer Advocate's report, the GAO determined that the IRS' previous filter did not accurately reflect a taxpayer's ability to pay. We agreed with GAO and followed their recommendation to eliminate the exclusion criteria and rely on the additional final notice process to resolve taxpayer cases.

Social Security payments, levied at 15 percent, represent the majority of the FPLP levy proceeds. In addition to the general final notice issued to all taxpayers prior to enforcement action, the IRS issues an additional notice to Social Security beneficiaries prior to the FPLP levy. Every notice sent to the taxpayer provides information on how to contact the IRS if he or she cannot pay the balance. We also advise taxpayers to submit information to substantiate their inability to pay and analyze that information in determining whether a taxpayer is suffering a hardship.

The IRS is working with the SSA to improve the program. In an effort to identify Social Security recipients who could be experiencing a hardship, the IRS and SSA are working on blocking a Federal Payment Levy (FPL) on benefit payments going directly to a health care facility. Although the IRS does not receive many levy payments on these taxpayers, excluding the payments will eliminate the possibility of hardship caused by the FPLP for these taxpayers. In another instance, the IRS helped perfect SSA's records so that SSA could ensure it was honoring only appropriate paper levies.

With regard to the Private Debt Collection (PDC) program, the IRS excludes taxpayers with a FPL in place from the PDC inventory mix. Additionally, taxpayers subject to a FPL can exclude themselves from future FPLP action by resolving their tax liabilities or by substantiating their financial hardships.

**Timely Release of Levy**

We agree that levies must be released promptly. In non-hardship situations, levy releases are input daily, but are subject to current systemic capabilities for printing and mailing. As noted, we expedite levy releases in hardship situations. To maintain a high level of customer service for all taxpayers, we normally fax a levy release only when it is necessary to prevent a hardship situation. To advise every taxpayer of the “right to expedited treatment” could decrease our overall level of service and adversely impact our ability to assist those truly experiencing a hardship. We agree that we need to pursue other technological alternatives to improve our efficiency in releasing levies and plan to study these options in FY 2007.

The IRS has made programming changes to more quickly and efficiently identify cases where levy releases are necessary. Some payments had been sent to Excess Collections rather than being refunded to the taxpayer. To address this issue, we developed a transcript to identify levy payment of full paid accounts. As a result, levies are released earlier, eliminating the potential of surplus levy funds being remitted to Excess Collections. In addition, we developed a procedure by which our cashiers identify levy overpayment situations and share the list with ACS on a daily basis. ACS researches the account, releases levies in appropriate situations and refunds excess monies to taxpayers. Finally, we generate a transcript to identify payments misapplied to an account without a valid assessment so that we may quickly identify these types of situations and properly resolve them.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate is pleased the IRS understands the sensitive nature of levying taxpayer assets and strives to respect taxpayer rights when using its levy authority. We agree that the IRS levy program is a necessary means of collection and a fundamental component of tax enforcement, but we believe such a powerful collection tool must be used with appropriate safeguards. Moreover, while automation is an important means of performing enforcement activities more efficiently, this efficiency should not come at the expense of taxpayer service.

*Contacting Taxpayers Prior to Levy Action*

With respect to contacting taxpayers prior to levy action, the IRS mentions several resources utilized to reflect a taxpayer’s most current address – USPS, ADR, and additional locator sources. These are all excellent resources, and we see no reason for the IRS to wait until all notices have been sent before using the ADR or additional locator sources. We realize that IRC § 6331(d)(2)(C) requires the IRS to issue these notices to the last known address, but this does not prevent the IRS from conducting research to obtain more current addresses during the notice process.

Further, the IRS should utilize all available resources in its address search. Many taxpayers do not update their address changes through the Postal Service, and for those

who do, forwarding orders may expire before the IRS attempts to contact the taxpayer. As we have pointed out, private debt collectors have experienced great success expanding their search tools to include such sources as the Internet, Department of Motor Vehicles records, and voting registries.

We also remain concerned over the practice of multiple levies, particularly in situations involving a joint liability where both taxpayers are employed. We continue to see examples in our TAS casework where the IRS simultaneously issued levies on both the husband's and wife's income and a pressing economic hardship has quickly ensued. The IRS should consider multiple levies only in situations where the IRS has performed adequate research of the taxpayer's address and the taxpayer has remained unresponsive or uncooperative.

#### *Federal Payment Levy Program (FPLP)*

We applaud the IRS for its continued efforts to work with SSA to improve this highly sensitive program, particularly for benefit payments going directly to a health care facility. We are also pleased to hear of the upcoming research project to determine the effectiveness of an income filter and we have offered to partner with IRS in designing and conducting that research. These steps were both suggested in the 2005 Annual Report to Congress.<sup>65</sup> We urge the IRS to conduct this research with all due speed, given the vulnerable nature of the population subject to FPLP social security levies.

Finally, we are extremely disappointed by the IRS's failure to exclude FPLP taxpayers from the Private Debt Collection (PDC) inventory mix, regardless of when the levy was initiated (pre- or post-PDC assignment). As we have discussed elsewhere in this report, these taxpayers are not only subject to a social security levy but also to private debt collectors utilizing "proprietary" methods of collection.<sup>66</sup> The IRS should ensure these cases are removed from FPLP.

#### *Timely Release of Levy*

We are pleased that the IRS agrees levies must be released promptly. However, this issue finds itself established as a most serious problem in the Annual Report to Congress for the second year in a row. The IRS states that "we normally fax a release only when it is necessary to prevent a financial hardship" and "to advise every taxpayer of the right to expedited treatment could decrease our overall level of service and adversely impact our ability to assist truly experiencing a hardship." To not advise all taxpayers of their right to secure an expeditious release is not fair or equitable. We have continually

<sup>65</sup> Problems associated with the IRS's use of the "last known address" in delivering the notices of intent to issue FPLP levies were also discussed in the 2005 Annual Report to Congress, *Most Serious Problem: Levies on Social Security Payments*. In general, the IRS's last known address is based on the address provided by the taxpayer on the last tax return filed. This practice is particularly problematic when applied to taxpayers who are retired or disabled, and who may not have had a legal requirement to file an income tax return for several years prior to the FPLP notice.

<sup>66</sup> See Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, *supra*.

## PROBLEMS

SECTION  
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recommended that IRS employees be given additional training as to what constitutes “economic hardship.” Given the wide variance of interpretation seen in our TAS cases, it appears there is still significant room for improvement.

We applaud the IRS’s efforts to more quickly and efficiently identify cases where levy releases are necessary and the IRS’s development of a transcript to identify levy payment of full paid accounts. The additional procedures involving the cashiers and ACS are also noteworthy. These efforts should greatly minimize future errors or lapses, and we urge the IRS to provide managerial oversight of the transcript process to ensure it provides the intended protections.

To summarize, while the IRS has the legal right to serve a notice of levy upon third parties, it should only do so after it has taken the necessary steps to ensure that taxpayers will not be needlessly harmed. It should also take full responsibility for the downstream consequences stemming from such actions and provide fair and equitable treatment when administering the entire levy process. The IRS should continue to utilize automation to perform its enforcement activities, but only with appropriate systemic safeguards in place.

**RECOMMENDATIONS**

The National Taxpayer Advocate recommends that the IRS:

- ◆ Conduct a study to determine the effectiveness of telephone contact versus mailed correspondence prior to issuance of a levy. If this study shows telephone contact to be more effective, the IRS should consider mandating that telephone contact be attempted prior to issuance of a levy, at least in certain situations.
- ◆ Discontinue the practice of “wholesale” or multiple levies, except in situations where the IRS has performed appropriate research of the taxpayer’s address and the taxpayer has remained unresponsive or uncooperative.
- ◆ Conduct the research necessary to implement an effective filter to screen out taxpayers from the FPLP who are unable to pay.
- ◆ Remove all FPLP cases from its Private Debt Collection initiative.
- ◆ Treat all levy releases expeditiously and provide clearer guidance to ensure taxpayers are properly apprised of the levy release timeframes. A possible solution is to include such language in a notice or “stuffer” which could accompany the taxpayer’s copy of levy that the IRS is required to send. Additional training may also be warranted to ensure that all employees with taxpayer contact requirements are fully aware of these guidelines.
- ◆ Implement tighter management and quality controls to ensure the levy payment transcript process is effectively working to protect taxpayer rights. A quality or diagnostic measure should be developed and utilized to ensure the transcript process provides the intended protections. The IRS should also form a task force



(with TAS as a participant) to look into the various misapplied levy proceeds situations. At any rate, the IRS must notify taxpayers as soon as it learns it has been overcollecting on an account.

- ◆ Send a detailed annual notice (much like the CP 89 notice it currently sends to all accounts with installment agreement activity) to notify taxpayers of continuous levy activity. This notice should provide a detailed accounting of the payments received, including the application of such payments, all interest and penalty charges and the remaining balance due of any existing liabilities.

**PROBLEM**

TOPIC #8

**CENTRALIZED LIEN PROCESSING****RESPONSIBLE OFFICIAL**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**DEFINITION OF PROBLEM**

In 2005, the IRS consolidated its geographically dispersed lien units into the Centralized Case Processing Lien Unit (CCP-LU) at its Cincinnati campus. This centralization was designed to reduce operating costs, increase efficiency, and improve customer service. More than a year into the centralized process, the IRS has not achieved its goals.

The National Taxpayer Advocate is concerned that the new system has greatly increased taxpayer burden and encroached on taxpayer rights. Problems with the centralized lien process include:

- ◆ Failure to provide taxpayers with written notice of lien filings within five days;
- ◆ Failure to release liens in a timely manner;
- ◆ Inability of internal and external customers to reach the IRS; and
- ◆ Increased burden to taxpayers and IRS employees.

**ANALYSIS OF PROBLEM****Background**

Internal Revenue Code (IRC) § 6321 provides the IRS with a statutory lien that attaches to “all property and rights to property, whether real or personal” of taxpayers who do not pay all of their assessed federal taxes after demand. A lien imposed by IRC § 6321 arises at the time the assessment is made; however, priority over other creditors is not established until the IRS files a notice of federal tax lien (NFTL).<sup>1</sup>

This NFTL is one of the most effective tools for collecting outstanding taxes because it protects the interest of the federal government by serving notice to current and potential creditors of the government’s priority interest in the taxpayer’s current and future assets. The IRS filed approximately 522,000 liens against taxpayer property in fiscal year (FY) 2005.<sup>2</sup> Lien filings for FY 2006 have increased by 20 percent from the FY05 level, to slightly over 629,800.<sup>3</sup>

*Collection Due Process (CDP) Notice*

IRC § 6320 requires the IRS to notify taxpayers within five business days of the filing of an NFTL upon the initial filing for each tax period. The IRS issues a notice, which

<sup>1</sup> IRC §§ 6322 and 6323.

<sup>2</sup> IRS, *Data Book 2005*, Publication 55B, Table 16 (Mar. 2006). The IRS filed 522,887 tax liens in FY 2005.

<sup>3</sup> IRS, *Business Measures Data Mart*, Measure 183 ACS Liens and Measure 239 Field Collection Liens Filed. The IRS filed 629,813 tax liens in FY 2006.

is known as the Collection Due Process (CDP) notice, explaining the taxes due and the options for an administrative appeal.<sup>4</sup> The notice advises taxpayers of the date by which the CDP hearing request must be filed. The date provided assumes that the NFTL is filed within five business days after the date the NFTL was mailed, and reflects a date that is 30 calendar days after that five-business-day period.

### *Lien Filing*

Liens become effective when the IRS provides legal notice of its lien interest by filing, or perfecting, the lien with the appropriate office. For liens against real property, an NFTL is generally filed where the property is physically located in the office designated by each state.<sup>5</sup> For liens against personal property, the lien is generally filed either where the taxpayer resides or where the property is located in the office designated by each state.<sup>6</sup> In business entity situations, the NFTL is filed in the office designated by each state, such as the office of the secretary of state.<sup>7</sup>

### *Lien Release*

IRC § 6325 generally requires the IRS to release liens within 30 days after the tax debt is paid. IRC § 7432 provides taxpayers a statutory right to civil damages for the IRS's failure to release a lien. The dollar amount of damages is unlimited, but must be actual, direct economic damages sustained by the taxpayer, plus the costs of bringing the action.<sup>8</sup>

## **Historical Structure of IRS Lien Units**

Before the IRS centralized the lien process in 2005, lien operations were handled by geographically dispersed lien units at 33 sites.<sup>9</sup> Each unit offered "Lien Desk" service, with direct telephone and walk-in assistance to taxpayers seeking payoff balances, lien subordinations, and other lien-related services. Under the Lien Desk structure, each local IRS office followed specific recording office procedures and local lien filing rules. The Lien Desks also assisted other IRS personnel, lenders, escrow agents, and mortgage companies with lien issues, including requests for release, discharge, and subordination.

## **Centralization of Lien Processing**

In 2005, the IRS consolidated the lien processing function into a Centralized Case Processing Lien Unit (CCP-LU) at the Cincinnati campus.<sup>10</sup> The Small Business/Self-

<sup>4</sup> IRS Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320* (Nov. 2004).

<sup>5</sup> IRC § 6323.

<sup>6</sup> *Id.*

<sup>7</sup> Treas. Reg. § 301.6323(f)-1.

<sup>8</sup> Treas. Reg. § 301.7432-1(a).

<sup>9</sup> Government Accountability Office, GAO 05-26R, *Opportunities to Improve Timeliness of IRS Lien Releases* (Jan. 10, 2005).

<sup>10</sup> Centralization began in August 2004 and was completed by July of 2005.

Employed (SB/SE) division's Campus Compliance Services Operations now oversees all lien processing. The IRS envisioned that it would improve its overall performance by redesigning the case processing function, which included lien processing.

### Problems with Centralized Lien Processing

As noted above, by centralizing its lien operations, the IRS hoped to improve business results by reducing operating costs, increasing efficiency, and improving customer service.<sup>11</sup> However, the IRS has not achieved these objectives. With centralization, existing lien processing problems have become more apparent.

#### *Failure to Provide Written Notice of Filing within Five Days*

The CDP notice provides an opportunity for the taxpayer to request an Appeals hearing within 30 days of the day after the five-business-day period for sending notice of the filing of the NFTL with respect to that tax.<sup>12</sup> Any delay in providing this notice can erode taxpayer rights by reducing the number of days allowed for the taxpayer to request a hearing.

Despite the importance of the CDP process, the IRS fails to notify taxpayers of lien filing in a timely manner. The Treasury Inspector General for Tax Administration (TIGTA) estimates the IRS failed to mail the CDP notice timely in nearly five percent of liens from August 1, 2004, through July 31, 2005.<sup>13</sup> TIGTA estimates the delay could have adversely impacted more than 23,000 taxpayers in FY 2005 by potentially limiting the number of days the taxpayers had to appeal.<sup>14</sup>

#### *Failure to Release Liens in a Timely Manner*

Failing to timely release liens can cause undue burden to the taxpayer. A filed lien appears in the taxpayer's credit history, and may cause a lender to charge a higher interest rate or deny financing to purchase a home or car. Taxpayers may be unable to sell their homes or creditors may refuse financing to businesses, resulting in the loss of financial opportunities. Moreover, some taxpayers may be denied employment based on the existence of an NFTL.

The Government Accountability Office (GAO, formerly the General Accounting Office) has reported each year, beginning with an FY 1999 audit of IRS financial statements, that the IRS remains noncompliant in releasing liens timely as IRC § 6325 requires.<sup>15</sup>

<sup>11</sup> See IRS, *Implementation Plan – Case Processing*, Slide 10, 03-SBSE-CS-4Q-24 (Oct. 30, 2003); Government Accountability Office, GAO-05-26R, *Opportunities to Improve Timeliness of IRS Lien Releases* (Jan. 10, 2005).

<sup>12</sup> IRS Letter 3172, *Notice of Federal Tax Lien Filing and your Rights to a Hearing Under IRC 6320* (Sept. 2006).

<sup>13</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-094, *Fiscal Year 2006 Statutory Review of Compliance with Lien Due Process Procedures* (Jun. 2006).

<sup>14</sup> *Id.*

<sup>15</sup> Government Accountability Office, GAO-06-137, Report to the Secretary of the Treasury, *IRS's Fiscal Years 2005 and 2004 Financial Statements* (Nov. 2005).

The GAO noted that as of 2006, the IRS had not addressed the following recommendations regarding management reviews of lien processing information controls:

- ◆ Implement procedures to closely monitor the release of tax liens to ensure that they are released within 30 days of the date the related tax liability is fully satisfied. As part of these procedures, IRS should carefully analyze the causes of the delays in releasing tax liens identified by GAO's work and prior work by IRS's former internal audit function and ensure that such procedures effectively address these issues.
- ◆ Research and resolve the current backlog of unresolved unmatched exception reports.<sup>16</sup>
- ◆ Research and resolve unmatched exception reports weekly.
- ◆ Research and resolve the current backlog of unresolved manual interest or penalties reports.
- ◆ Research and resolve exception reports containing liens with manually calculated interest or penalties weekly, as called for in the Internal Revenue Manual and the ALS (Automated Lien System) User Guide.
- ◆ Improve the current unmatched exception report by including a cumulative list of all unmatched taxpayer accounts that have not been resolved to date.<sup>17</sup>

The National Taxpayer Advocate recommends that the IRS design its systems to automatically release liens when accounts are satisfied. Because ALS can systemically generate an NFTL, the IRS should be able to systemically generate a certificate of lien release. The Accounts Management Services (AMS) is exploring ways to improve existing IRS information systems as a part of the Customer Account Data Engine (CADE) project.<sup>18</sup> SB/SE should ensure that CADE includes programming to allow the systemic release of liens.

#### *Inability of Internal and External Customers to Reach the IRS*

Centralization has compromised customer service. The IRS did not have management information systems data to establish call patterns and develop the phone system for the centralized lien unit. Without this data, the IRS could not adequately plan for the number of taxpayers who would seek assistance from the CCP-LU (and the times when they would call) or anticipate the increase in filings and releases. The initial centralization design

<sup>16</sup> Exception reports contain data that do not match, including names or taxpayer identification numbers, and accounts which have manually calculated interest or penalties.

<sup>17</sup> Government Accountability Office, GAO-06-560, *Status of Recommendations from Financial Audits and Related Financial Management Reports* 38, 58-61 (Jun. 2006).

<sup>18</sup> The Customer Account Data Engine (CADE) project is incrementally designing, developing, and implementing the data foundation for a modernized IRS. CADE will eventually replace the Individual Master File (IMF) and enable the replacement of the related Integrated Data Retrieval System (IDRS) components. See <http://www.irs.gov/privacy/article/0,,id=130899,00.html>.

estimated that 74 full time employees would answer 3,000 calls per week.<sup>19</sup> However, the calls from taxpayers, recorders, lenders, mortgage companies, and IRS employees have greatly exceeded the IRS's projection.<sup>20</sup> Taxpayers have consequently experienced difficulty reaching the centralized lien unit on IRS toll-free telephone numbers.

The volume of calls answered by the CCP-LU more than doubled from January 2005 (when the unit began taking calls) through FY 2006.<sup>21</sup> *Assistors answered approximately one-third of the approximately 717,000 call attempts to the CCP-LU in FY 2006.*<sup>22</sup> Taxpayers waited an average of approximately 18 minutes before reaching an assistor.<sup>23</sup> Although the IRS answered about twice as many calls in FY 2006 as in FY 2005, 74 percent more callers received a "courtesy disconnect" while they were waiting in queue because staffing was insufficient.<sup>24</sup> Another 250,000 taxpayers abandoned their calls in FY 2006 before reaching an assistor.<sup>25</sup> The IRS must do better at staffing its phone lines so that customers get through to employees.

#### *Increased Burden on Taxpayers and IRS Employees*

The centralized process requires third parties to provide written requests for lien payoffs, with a completed Form 8821, Tax Information Authorization, to accompany the request.<sup>26</sup> Taxpayers frequently make errors completing Form 8821, requiring further contacts by the lien unit and delaying receipt of a payoff from the unit. SB/SE reviewed a sample of payoff requests and determined both taxpayers and their representatives found the form was confusing and thus frequently omitted necessary information.<sup>27</sup> SB/SE recommended revising Form 8821 to reduce confusion or

<sup>19</sup> IRS, *Implementation Plan – Case Processing*, Slide 129, 03-SBSE-CS-4Q-24 (Oct. 30, 2003); SB/SE, *Cincinnati Centralized Case Processing Lien Review* 17 (Oct. 31 – Nov. 4, 2005).

<sup>20</sup> The volume of weekly calls answered in FY 2005 ranged from a low of slightly over 1,100 to a high of over 6,200. See SB/SE FY 2005 Lien Processing Snapshot Report. Weekly calls answered for FY 2006 ranged from a low of slightly less than 3,000 to a high of over 5,300 callers. See SB/SE FY 2006 Lien Processing Snapshot Report; *see also* Joint Operating Center (JOC) Enterprise Telephone Data Warehouse Product Line Detail Reports.

<sup>21</sup> IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports*.

<sup>22</sup> Assistors answered 226,863 of the 716,873 call attempts to the CCP-LU. IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports*.

<sup>23</sup> IRS, *JOC Enterprise Telephone Data Warehouse Product Line Detail Reports*.

<sup>24</sup> SB/SE, *Internal vs. External LOS Computations*. "Courtesy disconnects" occur when callers receive a message stating to call back at another time due to high call volume. 133,849 callers received a courtesy disconnect in FY 2005 while 232,502 callers received courtesy disconnects in FY 2006.

<sup>25</sup> *Id.* Primary abandoned calls are where a taxpayer reaches IRS prior to being in the queue and disconnects for whatever reason at the onset of their call. Secondary abandoned calls are those where the taxpayer gets into the phone system and is waiting in the queue for an assistor, but for whatever reason does not complete the call. 250,179 calls were abandoned in FY 2006.

<sup>26</sup> IRS Pub. 1450, *Instructions on How to Request a Certificate of Release of Federal Tax Lien* (Dec. 2005).

<sup>27</sup> SB/SE, *Cincinnati Centralized Case Processing Lien Review* (Oct. 31 – Nov. 4, 2005).

developing another form for third parties.<sup>28</sup> To our knowledge, the form is not currently scheduled for revision.

Prior to centralization, each individual lien unit processed liens for taxpayers, and lien employees dealt regularly with the appropriate authorities in their local jurisdictions. By centralizing the process, the IRS now requires each CCP-LU employee to become familiar with the procedures and contact information for every locality. This places an extraordinary burden on the employees, since there are over 4,600 possible filing localities across the United States.<sup>29</sup> An operational review by SB/SE indicates various county requirements for filing liens and releases are causing difficulty for the staff.<sup>30</sup> For example, one county requires special wording in red lettering on the top of the lien release requests, while other counties want cover sheets. Delays and duplication of work occur when employees are not aware of a particular county's requirements and the county sends back the entire package without the necessary filing or release.

The IRS has also experienced problems paying filing fees on time, prompting some recording offices to refuse additional filings until the IRS satisfies its bill.<sup>31</sup> The IRS generally pays recording fees when the office submits a voucher certifying that it has recorded the lien. Some recording entities require payment when lien recordation is done, and each entity has its own requirements for filing liens and releases. For example, some counties impose a charge for additional name lines and pages. The ALS database may not include all such billing idiosyncrasies, as recording offices do not always notify the CCP-LU of fee changes. The specific payment procedures used by various localities have proved to be burdensome for the centralized unit.<sup>32</sup>

### Downstream Consequences

When taxpayers are unable to contact the lien unit, or experience delays in lien releases, other IRS units, including TAS, spend additional time and resources resolving those cases. These downstream consequences must be taken into account when assessing the true cost of centralized lien processing. In FY 2006, TAS received 6,065 lien-related cases, an increase of 13 percent from FY 2005, suggesting that a growing number of taxpayers are experiencing difficulties.<sup>33</sup>

<sup>28</sup> SB/SE, *Cincinnati Centralized Case Processing Lien Review* (Oct. 31 – Nov. 4, 2005).

<sup>29</sup> IRS, *Implementation Plan – Case Processing*, Slide 132, 03-SBSE-CS-4Q-24 (Oct. 30, 2003).

<sup>30</sup> SB/SE, *Cincinnati Centralized Case Processing Lien Review* 14 (Oct. 31 – Nov. 4, 2005).

<sup>31</sup> Telephone interview with personnel in Beckley Finance Center (Sept. 24, 2006).

<sup>32</sup> SB/SE, *Cincinnati Centralized Case Processing Lien Review* 9 (Oct. 31 – Nov. 4, 2005).

<sup>33</sup> The number of lien-related TAS cases increased by 693 from FY 2005 to FY 2006. Total FY 2006 lien-related receipts were 6,065. Primary Issue Codes 720, 721, 722, 723, 724, and 729 were extracted from the Taxpayer Advocate Management Information System (TAMIS). However, many TAS cases involved complex issues (such as offer in compromise and injured spouse).

## PROBLEMS

**IRS COMMENTS**

The IRS concurs with the importance and necessity of timely lien filing, timely notification, timely lien releases and accessibility for our customers and believes that the Centralized Lien Unit (CLU) can deliver those functions. The IRS completed its implementation of the CLU in late August 2005 and stood up the unit in October 2005. Consolidating lien operations into a single site has helped us to better identify program inconsistencies and inefficiencies in our customer service that were not obvious in the decentralized environment. We detected, and have taken steps to address, many of the issues that arose early on and we will continue to take the steps necessary to improve our service. We believe the National Taxpayer Advocate has prematurely concluded that the program is not achieving the goals of centralization.

*Efforts Since Stand Up*

To ensure that the CLU continued to improve after implementation and stand up, a Collection executive was assigned for over six months beginning in November 2005 to oversee the CLU and a team of stakeholders to fine tune the process and build additional efficiencies into the program. The team included functions from across the IRS and input from the Taxpayer Advocate Service. The team developed a comprehensive action plan to mitigate the various processing, systemic and accessibility issues identified by many different prior reviews.

As a result, we have taken many actions to improve service and address concerns, such as:

- ◆ Reconfiguring our teams to provide dedicated telephone support;
- ◆ Establishing a specialized billing team to provide direct coordination with county recording offices;
- ◆ Partnering with Governmental Liaisons (GLs) to solicit feedback from the more than 4000 county recording offices and correct identified payment or process discrepancies;
- ◆ Updating our automated telephone messages to provide additional customer service for incoming calls;
- ◆ Updating the Automated Lien System (ALS) to provide nationwide access for each assistor ensuring any agent can provide assistance on an incoming call; and
- ◆ Bringing all lien filing and release requests current.

Although we have completed a majority of the actions, we continue to discuss additional actions in monthly team conferences to ensure progress continues on remaining issues.



*Specific Points***Failure to provide taxpayers with written notice of lien filings within five business days of the NFTL filing.**

We concur on the importance of timely notification of lien filings and will continue to make efforts to improve notification processes. We do note that TIGTA conducted the review cited by the National Taxpayer Advocate during the implementation phase of the CLU. Implementation was not completed until late August 2005 – after the period reviewed and cited as evidence of the CLU’s failure to notify taxpayers.

In our own reviews we found that, although the CLU sent proper notification, we needed to modify the record keeping process because the site could not always produce certifiable lists of mailing. TIGTA’s FY 2006 audit showed improvement – only three of 74 certified mail lists were not locatable and one was not date stamped. Since that time, the IRS has purchased additional scanning equipment to better monitor mailing lists and the unit began scanning Form 3877, Certified Mail Listings, to ensure all mail listings are recorded and available.

**Failure to release liens in a timely manner.**

Timely release of liens has always been a paramount concern in the lien process. The CLU has improved customer service and accessibility with respect to lien release. Under the decentralized structure, taxpayer assistance was limited in several of the 33 sites and only some of those locations provided Walk-In assistance. Centralization enables the Walk-In service to provide immediate lien release and payoff information in over 400 sites using an internal phone line.

When the CLU stood up in October 2005, we identified processing issues that we had to address, one of which was working exception reports. Since that time, we have addressed the backlogs, identified systemic problems, and developed work processes. We are current and will remain current with the exception reports.

The ALS automatically generates lien releases when accounts are satisfied. Exceptions to this process are cases with freeze codes, credits, and zero balances. Programming these scenarios for Individual Master File was completed in January 2006. Programming for Business Master File and Non Master File will be completed in January 2007 for Business Master File and Non Master File. Programming systemic partial releases for mirror accounts, such as bankruptcy and OIC, will be completed in January 2008.

**Inability of internal and external customers to reach the IRS.**

The IRS initially underestimated the volume of incoming calls the centralized telephone operation would receive and acknowledges that taxpayers experienced difficulties in contacting the site in the months immediately following the full transition to the centralized site. We have improved our operations throughout the year and continue to take steps to improve the level of service for our internal and external customers. Changes in telephone routing by implementing scripts/messaging and staffing

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requirements at the Centralized Case Processing – Line Unit (CCP-LU) site dramatically improved service by the product line. Although the Level of Service (LOS) for the full year was 33 percent as noted, the LOS for the last four months of the FY2006 (June 4th through September 30, 2006) was 77.5 percent. This compares favorably with the LOS delivered by most of the other IRS toll-free operations. After analyzing incoming call patterns, automated phone scripts were updated to better address the needs of our customers and provide improved routing service based on taxpayer needs.

While we will continue to improve our service through the CCP-LU, other data lends additional perspective to that cited by the National Taxpayer Advocate:

- ◆ 88 percent of the 232,502 “Courtesy Disconnect” messages referenced occurred during the first four months of the fiscal year.
- ◆ Of the 250,000 callers cited as abandoning before reaching an assistor, more than 136,000 were PRIMARY abandons. These are callers who hang up while navigating through the initial telephone scripts, *after* they hear various informational messages about the type of assistance available from the CCP-LU operation.
- ◆ Although the Average Speed of Answer (ASA) for the full fiscal year was 17½ minutes per call, the ASA for the last quarter of the year was less than nine minutes. We are continuing to focus on this area.

**Increased burden to taxpayers and IRS employees.**

Together with the Governmental Liaison Division, the CLU created and sent an information booklet to recording offices explaining how lien documents will be submitted. We are identifying special requirements and making contacts with recording offices to explain the Federal Lien Registration Act and how the IRS determines the format and content of lien documents.

With regard to paying recording fees, we have updated the ALS database to include the specific requirements of the recording offices and to identify which recording offices are paid by imprest and which are billing counties. We also have requested additional programming to enable all employees to have accurate county recorder information at their fingertips.

Under revised procedures, the CLU will continue to date stamp Billing Support Vouchers (BSV) used to pay recording fees and will verify that employees are timely and accurately following revised procedures through semiannual reviews during FY 2006 & FY 2007. Further, we have enhanced the ALS to allow employees to edit BSVs and plan to upgrade ALS to allow systemic monitoring of BSVs.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate appreciates that migrating to a centralized system is a challenging endeavor, and commends the IRS for its efforts during the transition period. However, the National Taxpayer Advocate also recognizes that much work remains to be done, and is concerned that the centralized approach to lien processing may be detrimental to taxpayer service.

*Timely notification*

The FY 2006 TIGTA report referenced in the IRS response covered approximately six months of centralized lien processing and identified a continued lack of improvement in timely mailing lien notices. TIGTA did note the improved procedural control of certified mail listings over the five prior years. The National Taxpayer Advocate is hopeful that the improvement in management controls over the certified listings, and the purchase of additional scanning equipment, will help the IRS eliminate the problem of missing listings.

*Failure to release liens in a timely manner*

Despite the IRS's claim that taxpayer accessibility to customer service has expanded, the National Taxpayer Advocate remains concerned about the ability of the IRS to timely release NFTLs. The GAO recently identified the failure to timely release NFTLs after centralization as a continuing weakness for the IRS.<sup>34</sup>

The National Taxpayer Advocate continues to receive complaints from practitioners that the IRS has not immediately released liens when taxpayers have presented certified checks to cover the outstanding liability. Although IRS guidance specifies that "accounts satisfied by cash, postal money order, certified check, cashiers check, official bank check or guaranteed draft drawn on any federally chartered or state licensed financial institution, may be released immediately upon payment," it appears that this guidance is not always being followed.<sup>35</sup> Employees must understand this provision and sense the urgency in releasing the lien.

Addressing exception reports in a timely manner is also critical to resolving release discrepancies. The CCP-LU needs to resolve discrepancies as soon as possible, with adequate monitoring in place to ensure releases are generated. We applaud the IRS for scheduling the necessary programming changes, and encourage the IRS to ensure that these changes are implemented in a timely manner.

*Inability of internal and external customers to reach the IRS*

The National Taxpayer Advocate is encouraged by the significant increase in the level of service provided by the centralized telephone operation, and hopes this high level of

<sup>34</sup> Government Accountability Office, GAO-07-136, *IRS's Fiscal Years 2006 and 2005 Financial Statements* 12, 124, 142 (Nov. 2006).

<sup>35</sup> IRM 5.12.2.3.1.

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customer service continues in FY 2007 and beyond. However, the National Taxpayer Advocate remains concerned about the ability of taxpayers to contact the CCP-LU in the first place.

During FY 2006, 54 percent of the abandoned calls fell into the “primary abandon” category, which means these callers abandoned their calls while trying to navigate telephone messaging prompts. The other 46 percent of the abandoned calls were “secondary abandons,” meaning the caller gave up after successfully navigating telephone prompts and was on hold awaiting an assistor. The IRS needs to pay close attention to the abandoned call rates and ensure that its messaging prompts adequately address taxpayer needs.

**RECOMMENDATIONS**

The National Taxpayer Advocate recommends that the IRS:

- ◆ Program its systems to automatically release liens when the account is satisfied.
- ◆ Work proactively with Governmental Liaisons to contact recording entities yearly to identify fee schedule changes and update ALS accordingly.
- ◆ Propose revisions to Form 8821, Tax Information Authorization, and the accompanying instructions, or develop a new form to reduce confusion.
- ◆ Reexamine whether centralization is more cost effective and provides better service to taxpayers than the previous local lien desk structure, and conduct a comprehensive cost analysis, including downstream costs such as TAS cases and Taxpayer Assistance Center contacts.
- ◆ Examine primary disconnect rates to determine if additional staffing is necessary or if menu items need to be revisited for ease of taxpayer use.
- ◆ Issue additional guidance or training regarding IRS authority to issue an immediate lien release when a taxpayer satisfies an account by cash or cash equivalents, including certified check, cashiers check, official bank check, or guaranteed draft drawn on any federally chartered or state licensed financial institution.

**PROBLEM****TOPIC #9****COLLECTION ISSUES OF LOW INCOME TAXPAYERS****RESPONSIBLE OFFICIALS**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
Richard J. Morgante, Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

The IRS's collection operations fail to provide the meaningful services that low income taxpayers need to meet their obligations regarding federal tax delinquencies. In handling routine collection cases involving low income taxpayers, the IRS frequently fails to offer personal contacts and flexible payment options, even though many low income taxpayers require this type of service to fully resolve problems in a timely manner. While low income taxpayers generally incur relatively small debts, which the IRS considers low priority collection cases, these balances still cause serious financial problems for the individual taxpayers.

**ANALYSIS OF PROBLEM****IRS Collection Practices:****Low Income = Small Balances Due = Low Priority = Little or No Personal Attention**

Collection cases involving income tax liabilities of low income taxpayers are affected in a particularly negative manner by IRS case assignment practices, which are designed to treat relatively small balances due as low priority cases. As a result, these taxpayers will likely never receive personal contacts from IRS collection representatives if their cases are not successfully resolved through the routine collection notice process. These accounts carry a high probability of being "surveyed," *i.e.*, systemically reported as not collectible. If cases go unresolved, penalties and interest will continue to accrue on these accounts, and taxpayers who are already struggling to make ends meet will quickly see their tax debts grow even larger.<sup>1</sup> Further, without meaningful intervention early in these cases, the IRS creates the appearance of being an unconcerned creditor. This perception may lead to the accrual of additional liabilities and larger tax debt problems that are exceptionally difficult for the low income taxpayer to resolve.

**IRS collection practices do not encourage or support efforts by low income taxpayers to resolve tax debts.**

Even when low income taxpayers proactively attempt to resolve their delinquency problems, IRS collection practices often serve as barriers to mutually beneficial solutions. User fees for installment agreements (IA), offers in compromise (OIC) application

<sup>1</sup> See Most Serious Problem, *Early Intervention in IRS Collection Cases*, *supra*.

fees, and the new OIC payment requirements mandated by the TIPRA legislation<sup>2</sup> make alternative payment arrangements even less attainable for struggling low income taxpayers. Rather than reaching out and encouraging these taxpayers to seek positive resolutions for their tax debt problems, these requirements may very well act as disincentives to even make the attempt. For example, in a recent review of the OIC program, the Treasury Inspector General for Tax Administration (TIGTA) noted that the decline in OIC receipts attributable to the implementation of the OIC application fee was notably higher among low income taxpayers, including those who would qualify for the low income waiver.<sup>3</sup>

### IRS Installment Agreement User Fee – One Size Fits All?

The IRS recently announced plans to raise the IA user fee from \$43 to \$105 for taxpayers entering into new IAs. However, taxpayers who opt to make payments via direct debits from their bank accounts will only pay a \$52 fee.<sup>4</sup> Some responses to the IRS's notice of the proposed changes have noted that the changes appear to discriminate against low income taxpayers, particularly those too poor or financially unsophisticated to maintain bank accounts.<sup>5</sup> While those taxpayers with the financial capacity to make their IA payments via direct debit will pay only \$9 more than the current fee, the “unbanked” poor will have to pay almost 150 percent more than the current amount.<sup>6</sup>

Further, the IA fee does not appear to be directly related to the size of the delinquent tax balance, the income level of the taxpayer, or even the amount of effort required by the IRS to establish and monitor the agreement. For example, a taxpayer with a six figure income owing \$50,000 in delinquent taxes who agrees to have the IA payments automatically drawn from a bank account would pay a fee of \$52, even if the IRS had to assign the case to a field-based revenue officer for resolution. On the other hand, an unbanked low income taxpayer seeking a monthly payment plan to resolve a \$500 tax debt would be charged \$105 – over 20 percent of the balance due – even if the IA

<sup>2</sup> Tax Increase Prevention and Reconciliation Act of 2005, H.R. 4297, Pub. L. No. 109-222, 120 STAT. 345. A taxpayer is now required to submit with the OIC application an initial payment of 20 percent of the amount offered with a cash OIC, or immediately begin to make the proposed scheduled payments in a deferred payment OIC. Otherwise, the OIC request will not be processed by the IRS.

<sup>3</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-100, *The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes* 11 (Jul. 2006).

<sup>4</sup> Daily Tax Report, *User Fees: IRS Proposes Increased User Fees for Direct Debit Installment Agreements* (Aug. 30, 2006).

<sup>5</sup> “The proposal to increase the user fee fails to meet the requirements of the Independent Offices Appropriations Act (IOAA), codified at 31 USC section 9701 and cited in the Notice of Proposed Rulemaking. Quite simply, the proposed fee increase is not fair and represents poor public policy because it discriminates against low income taxpayers – more specifically, those too poor to be able to maintain bank accounts.” Tax Analysts Tax Notes Today, *Legal Aid Group Says Proposed Regs To Increase Installment Agreement Fees Would Discriminate Against Poor*, Oct. 4, 2006, at 2.

<sup>6</sup> A recent survey indicates that 91.6 percent of households that do not maintain a bank account have annual incomes of less than \$25,000. The Center for Financial Services Innovation, *A Financial Services Survey of Low- and Moderate-Income Households* 6 (Jul. 2005).

was established in a streamlined manner during the collection notice process.<sup>7</sup> It seems impossible not to notice the inequity of this situation. While the IA fee represents a relatively small amount for most taxpayers, it could be a significant amount for those already financially burdened. The IRS does not provide a low income waiver for the installment agreement user fee.

**IRS collection practices do not realistically determine the reasonable collection potential of cases involving low income taxpayers.**

Elsewhere in this report, we discuss in detail concerns with the manner in which the IRS applies the national standards for allowable living expenses (ALE) to individual taxpayer cases to determine reasonable collection potential.<sup>8</sup> These concerns are clearly illustrated by the manner in which the IRS employs these standards in evaluating the collection potential of cases involving low income taxpayers. Because ALE standards are based on actual expenditures at differing income levels, rather than cost of living estimates, the use of these standards in evaluating the collection potential of low income taxpayers provides unrealistic results. For example, the IRS provides current ALE “national standards,” which primarily represent allowances for food and clothing, for taxpayers at eight income stratifications.<sup>9</sup> For a family of four, the stratifications representing the lowest three income levels are actually *below the poverty income level* as defined by the U.S. Department of Health and Human Services.<sup>10</sup> The six lowest income levels represented in the standards are below 250 percent of the poverty level. As defined by the ALE, a family of four living at the lowest defined income level is only entitled to \$11 more per month for food than a family of three! Further, the ALE national standards fail to recognize evidence that low income taxpayers often face higher food prices because they tend to live in urban or rural parts of the country, where prices tend to be higher than in the suburbs.<sup>11</sup>

We believe that assigning “allowable” expenses to taxpayers at these income levels is highly impractical and unrealistic. This methodology fails to recognize that these taxpayers may be hard pressed to simply meet basic living expenses. The IRS should not confuse actual expenditures with realistic cost of living allowances. As we recommended in the 2005 Annual Report to Congress, the IRS should develop reasonable allowable expense standards that recognize the need for taxpayers to retain sufficient net income to rise above the poverty level, as measured by federal poverty guidelines (or some reasonable

<sup>7</sup> See Most Serious Problem, *IRS Collection Payment Alternatives*, *supra*, for a more detailed discussion of the streamlined installment agreement process.

<sup>8</sup> *Id.*

<sup>9</sup> IRS, *National Standards for Allowable Living Expenses*, at <http://www.irs.gov/businesses/small/article/0,,id=104627,00.html>.

<sup>10</sup> United States Department of Health and Human Services, *Poverty Guidelines Research and Measurement* at <http://aspe.hhs.gov/poverty>.

<sup>11</sup> Phil Kaufman and Steven M. Lutz, Food and Rural Economics Division, U.S. Department of Agriculture, *Competing Forces Affect Food Prices for Low Income Households*, Food Review (May-Aug. 1997).

percentage above them). The IRS should also apply these standards without documentation.<sup>12</sup> A fair and reasonable application of the ALE concept must acknowledge and account for the taxpayer's ability to meet basic living expenses. ALE allowances that drop below this level, or "floor," simply do not reflect realistic allowances.

### Collection options for low income taxpayers tend to have a narrow focus – "full pay" or "not collectible."

Typically, the IRS response to concerns in this area indicate the IRS does not require payments from taxpayers at or below the poverty level, *i.e.*, it usually reports these accounts as currently not collectible (CNC).<sup>13</sup> We acknowledge the CNC option can represent a reasonable and realistic collection decision for taxpayers who do not have the financial capacity to make payments on delinquent taxes. However, the CNC status is not the optimal solution for the problems of many taxpayers, particularly those who have not been personally contacted by the IRS, or have actually offered alternative payment options which the IRS has denied. As discussed elsewhere in this report, a significant number of rejected OICs are subsequently reported as CNC.<sup>14</sup> In a recent IRS study, of those rejected OICs subsequently reported as CNC, 27 percent of the cases involving individuals (Individual Master File) and 49 percent of those involving businesses (Business Master File) were already in CNC status *at the time the OICs were rejected*.<sup>15</sup> Additional IRS data indicates that during fiscal years 2004 and 2005, in cases where taxpayers requested installment agreements and the requests were denied, 31 percent were later reported as not collectible. Of those, 52 percent were in CNC status at the time the taxpayer requested an IA.<sup>16</sup>

In a recent focus group conducted by TAS with professionals considered to be experts in matters involving low income taxpayers, it was reported that the IRS seems very reluctant to accept low-dollar OICs, even though these offer amounts may realistically reflect the taxpayers' reasonable collection potential.<sup>17</sup> The focus group comments included observations that IRS employees seem to believe the IRS is doing the low income taxpayer "a favor" by reporting the account as CNC, with no recognition that these taxpayers are looking for a sense of closure to their debt problems, which the CNC decisions do not provide. This group also reported that because accepted OICs are a matter of public record, it appears the IRS is reluctant to accept and disclose low-dollar offer amounts. Members of the group stated that it was their experience that low-dollar offers from low income taxpayers bring "automatic" rejections from the IRS's centralized OIC

<sup>12</sup> National Taxpayer Advocate 2005 Annual Report to Congress 291.

<sup>13</sup> *Id.* at 284.

<sup>14</sup> See Most Serious Problem, *IRS Collection Payment Alternatives*, *supra*.

<sup>15</sup> IRS, *Analysis of Various Aspects of the OIC Program* 9 (Sept. 2004).

<sup>16</sup> IRS, *Accounts Receivable Inventory Report* (FY 2004 and FY 2005).

<sup>17</sup> Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers*. (Aug. 29, 2006).



operations in Brookhaven, New York and Memphis, Tennessee.<sup>18</sup> It should be noted that these perceptions exist despite the specific direction of the Internal Revenue Code that the IRS shall not reject OICs from low income taxpayers solely on the basis of the amounts offered.<sup>19</sup>

The concerns of the focus group may have received some validation from the proceedings in *Oman v. Commissioner*, a recent case before the United States Tax Court.<sup>20</sup> In this case, a low income taxpayer intermittently failed to file and pay his income taxes timely from 1990 through 2001, accruing a \$169,146 delinquency. Although the IRS determined it would be unlikely to collect anything from the taxpayer (*i.e.*, his “reasonable collection potential” was zero) because he had no assets and his income, which was below poverty level, did not cover his allowable expenses each month, the IRS did not accept his \$1,000 offer.<sup>21</sup> The IRS rejected the taxpayer’s offer as not in the “best interest of the government” because of his “egregious history of past non-compliance” and because the IRS’s analysis of the taxpayer’s current finances gave rise to concerns that he could not “remain in compliance during the offer terms.”<sup>22</sup> The court remanded the case back to the IRS because the IRS had not adequately explained the reason for its decision.

The circumstances in this case clearly illustrate how the lack of early IRS intervention in a collection case can lead to a tax debt that may be impossible for the taxpayer to fully resolve, as well as the reluctance of the IRS to use collection tools, such as the offer in compromise, as reasonable alternative solutions. This case is a classic example of how IRS collection practices harm low income taxpayers, and waste considerable resources – including tax court litigation expenses – to deny relief in cases where the only other realistic alternative is to report the account as not collectible.

### Tax delinquencies represent more than “dollars and cents” problems for the low income individuals involved.

The focus group also reported that the psychological harm associated with the inability to resolve lingering tax problems with the IRS should not be discounted.<sup>23</sup> Tax debts, particularly if the IRS has filed a notice of federal tax lien, can have serious consequenc-

<sup>18</sup> Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers*. (Aug. 29, 2006).

<sup>19</sup> IRC § 7122(c)(3).

<sup>20</sup> *Oman v. Comm’r*, TC Memo 2006-231.

<sup>21</sup> The taxpayer’s allowable expenses of \$1,012 per month exceeded his monthly income of \$653 (or \$7,836 per year) by \$359 per month. Since the early 1990s he had held a series of seasonal and odd jobs relied on friends and family for necessities. He entered a rehabilitation program for alcohol, drugs, and depression in 2003. At the time he submitted an offer to the IRS, he was unemployed, lived with friends, and received money from his parents from time to time.

<sup>22</sup> *Oman v. Comm’r*, TC Memo 2006-231.

<sup>23</sup> Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers* (Aug. 29, 2006).

es in various aspects of these taxpayers' lives. Tax debts can negatively impact taxpayers' credit ratings, which may in turn result in higher rents, steeper automobile insurance rates, and generally higher interest rates for individuals classified as poor credit risks.<sup>24</sup> Further, employers increasingly use credit scores in screening job applicants, and there is evidence that negative credit ratings can adversely affect job offers.<sup>25</sup> Other studies indicate that stress related to financial difficulties can lead to decreased productivity in the workplace and a variety of additional costs for employers.<sup>26</sup>

Automatic refund offsets associated with taxpayer accounts in CNC status may encourage non-compliant behavior, *i.e.*, inadequate withholding from wages or failure to make estimated tax payments, which in turn lead to additional tax delinquencies. In some instances, failure to successfully negotiate a mutually agreeable payment alternative could lead taxpayers to drop out of the tax system altogether and become part of the non-compliant cash economy. The focus group participants also emphasized that for many taxpayers whose debts are reported as CNC, the tax problems are not resolved and the lingering, growing debts are significant psychological weights. The group reported many of these taxpayers sincerely want to solve their tax problems and have a good sense of what they can realistically pay, but need the IRS to be more flexible and help them solve their problems in a reasonable and realistic manner.<sup>27</sup>

**While personal contacts and flexible payment alternatives are often not available to low income taxpayers, automated enforcement actions on these accounts are becoming much more common.**

Elsewhere in this report, we discuss in detail concerns with the manner in which the IRS is increasingly utilizing its authority to levy on the assets of taxpayers to collect delinquent taxes, even in situations where there has been no meaningful attempt at personal contact, *i.e.*, “systemic levies.”<sup>28</sup> These concerns are most clearly evident in the Federal Payment Levy Program (FPLP), an automated system that matches IRS records against those of the government’s Financial Management Service (FMS) to locate recipients of federal payments who have delinquent tax debts. The IRS is authorized to use the FPLP program to issue continuous levies on these income sources to capture up to 15 percent of these payments.<sup>29</sup>

<sup>24</sup> State of Washington, Office of Insurance Commissioner, *A Report to the Legislature: Effect of Credit Scoring on Auto Insurance Underwriting and Pricing 2* (Jan. 2003); State of Missouri, Department of Insurance, *Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri 1-2* (Jan. 2004).

<sup>25</sup> Better Business Bureau, *The Wise Consumer News Letter*, available at <http://www.bbb.org/wise/issues/0604.asp> (Jun. 2004).

<sup>26</sup> Association for Financial Counseling and Planning Education, “*The Negative Impact of Employee Poor Personal Financial Behaviors On Employers*,” E. Thomas Garman, Irene E. Leech, John E. Grable, 157 (Vol. 7, 1996).

<sup>27</sup> Taxpayer Advocate Service, *Focus Group Discussion: Negative Impact of IRS Collection Practices on Low Income Taxpayers* (Aug. 29, 2006).

<sup>28</sup> See Most Serious Problem, *Levies, supra*.

<sup>29</sup> IRC § 6331(h)(2)(A).

While it is our understanding that the FPLP program was originally developed as a collection tool to address delinquent taxpayers who were also the beneficiaries of contracts with the federal government, in recent years approximately 84 percent of all FPLP levies have involved payments from the Social Security Administration (SSA) to taxpayers who are elderly and/or disabled.<sup>30</sup> The IRS makes no attempt to identify and exclude from the FPLP those taxpayers with income below a specified threshold.<sup>31</sup> Although current law limits FPLP levies to only 15 percent of each Social Security payment, this reduction in income can be highly significant for low income taxpayers already surviving on income at or near the poverty level.

### FPLP Particularly Harmful to Low income Taxpayers

Recently, Professor Scott A. Schumacher, Director of the University of Washington's low income taxpayer clinic (LITC), published an insightful discussion of the harmful effects of the FPLP program on low income taxpayers. In his article, Schumacher explains that "many elderly and disabled taxpayers rely on Social Security as their sole source of income, with the average amount of Social Security benefits paid to those taxpayers being \$900 per month."<sup>32</sup> Many of these taxpayers have had their benefits levied by the IRS, often without actual prior contact or notice, "rendering them unable to pay their living expenses."<sup>33</sup>

Because IRS procedures only require notices of intent to levy be mailed to the taxpayer's "last known address," these taxpayers frequently do not receive actual notice until the IRS has already levied upon their benefits.<sup>34</sup> These levies invariably result in economic harm when retired or disabled low income taxpayers are involved. However, without actual notice, these taxpayers have no opportunity to exercise their collection due process (CDP) rights to prevent the issuance of these levies.<sup>35</sup> Schumacher reports that once the FPLP levy is issued, it can take a month if not longer for the IRS to agree to release it. The IRS may levy upon some taxpayers' benefits for several months before the matter is resolved. The University of Washington LITC has "seen a dramatic increase in FPLP levies over the past year. Without exception, the IRS has released those

<sup>30</sup> IRS, Wage & Investment Operating Division, *FPLP Monthly Counts CUM* (May 2006).

<sup>31</sup> See Most Serious Problem, *Levies*, *supra*.

<sup>32</sup> Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 2. As of October 2006, Social Security recipients received an average monthly benefit of \$923.30. Social Security Administration, *Office of Policy Research, Evaluation and Statistics, Monthly Statistical Snapshot*, Table 2, Social Security Benefits (Oct. 2006).

<sup>33</sup> Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 2.

<sup>34</sup> Problems associated with the IRS's use of the "last known address" in delivering the notices of intent to issue FPLP levies were also discussed in the NTA's 2005 Annual Report to Congress, *Most Serious Problem: Levies on Social Security Payments*. In general, the IRS's last known address is based on the address provided by the taxpayer on the last tax return filed. This practice is particularly problematic when applied to taxpayers who are retired or disabled, and may not have had a legal requirement to file an income tax return for several years prior to the FPLP notice.

<sup>35</sup> See IRC § 6330.

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levies because it determined the levy was causing financial hardship, but not before it had wrecked havoc on the taxpayer.”<sup>36</sup>

In the 2005 Annual Report to Congress, the National Taxpayer Advocate identified levies on Social Security benefits as one of the most serious problems encountered by taxpayers.<sup>37</sup> We reported concerns that taxpayers subject to FPLP may not receive adequate prior notification of the intent to levy, and the IRS lacked adequate safeguards to prevent harm to low income taxpayers in these situations. The IRS response to this report has done little to reduce these concerns. In fact, the problem appears to be growing worse. TAS cases involving the IRS levy program have increased by 69 percent from FY 2005 to FY 2006.<sup>38</sup> TAS cases regarding FPLP levies on Social Security benefits have increased by 143 percent from FY 2005 to FY 2006.<sup>39</sup> Cases involving the FPLP program have been particularly disturbing. Consider the following taxpayers upon whom this levy was systemically imposed:<sup>40</sup>

- ◆ Taxpayer is 70 years old, paralyzed and confined to a wheelchair, and has resided in a nursing home since 1994. SSA income for 2005 was just under \$13,000, which was supplemented by a pension of approximately \$10,500. All income is paid to the nursing home to cover necessary living expenses.
- ◆ Taxpayer is 75 years old and bedridden as a result of a stroke. The only income is Social Security, which provides for medicine and necessary living expenses. SSA income for 2005 was just under \$11,000. The taxpayer’s last tax return filed was 1995.
- ◆ Taxpayer is 72 years old, suffers from heart disease that resulted in triple bypass surgery, and is now working part-time to help pay for medications. SSA income for 2005 was approximately \$6,700, supplemented by wages of approximately \$4,600. The taxpayer has had individual income tax liabilities already reported as not collectible by the IRS. The FPLP levy involved taxes incurred by a business that has been closed since 1999.
- ◆ Taxpayer is 58 years old and relies on Social Security benefits, along with welfare payments and food stamps, to meet basic living expenses. The total monthly income was \$832. TAS involvement led to release of the FPLP levy. The IRS initially refused to refund any levy payments because the taxpayer had “no apparent hardship.”

<sup>36</sup> Tax Analysts Tax Notes Today, *Unnecessary Harm: IRS Levies On Social Security Benefits*, Oct. 17, 2006, at 4. See Most Serious Problem, *Levies*, *supra* for a more detailed discussion of problems with IRS policies and procedures regarding the release of IRS levies.

<sup>37</sup> National Taxpayer Advocate 2005 Annual Report to Congress 123-135. See also Most Serious Problem, *Levies*, *supra*.

<sup>38</sup> Taxpayer Advocate Service, *Business Performance Review* 50 (Oct. 11, 2006).

<sup>39</sup> Taxpayer Advocate Service, *Business Performance Review* (Sept. 30, 2006). For FY 2005, there were 1,707 FPLP/Social Security-benefit related cases in TAS and 4,147 for FY 2006.

<sup>40</sup> Taxpayer Advocate Management Information System (TAMIS).

TAS has many, many more examples of situations where the FPLP program has created financial and emotional harm to low income taxpayers. During FY 2006, we have noted that 56 percent of the TAS cases involving FPLP levies on Social Security benefits were given full relief, *i.e.*, the levies were released.<sup>41</sup> It is very difficult to believe that anyone reviewing these cases would conclude that IRS levy activity was appropriate. However, the basic underlying problem with the systemically generated FPLP levies is that they were not reviewed by anyone prior to issuance.

### **FPLP Levies Require the Use of Good Judgment and Proper Discretion.**

In the 2005 Annual Report, the National Taxpayer Advocate expressed concern with the lack of managerial approval required by the FPLP levy process.<sup>42</sup> The report noted that to protect taxpayers from unnecessary hardship, Congress has instructed the IRS to develop procedures to ensure a determination to file a levy would, where appropriate, be reviewed and approved by a supervisor before levy action was taken. Section 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98) requires that a supervisor, where the Secretary deems appropriate, take the following steps prior to the issuance of a levy: (1) review the taxpayer's information; (2) verify that a balance is due; and (3) affirm that the action proposed to be taken is *appropriate given the taxpayer's circumstances*.<sup>43</sup>

The RRA 98 language implies that this review was intended to be more than a measure to ensure the technical accuracy of levies. Rather, this part of the legislation was designed to ensure the IRS exercised proper judgment and discretion in the application of its considerable levy authority. The IRS response to concerns regarding the application of this requirement to the FPLP program has been that the Taxpayer Relief Act of 1997 (TRA 97) allows for the use of continuous automated FPLP levies. However, we do not agree that TRA 97 authorizes the use of systemic levies without adequate research and screening to prevent unintended economic harm on vulnerable segments of the population.

<sup>41</sup> Taxpayer Advocate Management Information System (TAMIS).

<sup>42</sup> National Taxpayer Advocate 2005 Annual Report to Congress 127-128. *See also* Most Serious Problem, *Levies*, *supra*.

<sup>43</sup> Section 3421 of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998) provides as follows:

- (a) IN GENERAL.—The Commissioner of Internal Revenue shall develop and implement procedures under which—
- (1) a determination by an employee to file a notice of lien or levy with respect to, or to levy or seize, any property or right to property would, where appropriate, be required to be reviewed by a supervisor of the employee before the action was taken; and
  - (2) appropriate disciplinary action would be taken against the employee or supervisor where the procedures under paragraph (1) were not followed.
- (b) REVIEW PROCESS.—The review process under subsection (a)(1) may include a certification that the employee has—
- (1) reviewed the taxpayer's information;
  - (2) verified that a balance is due; and
  - (3) affirmed that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.

We believe the IRS's legal right to take an action does not automatically mean it is the right action to take. Although the systemic issuance of FPLP levies is technically legal, we believe that without proper research, analysis, and screening mechanisms in place to protect taxpayers from economic harm and undue burden, the IRS's current practices in this area are intolerable. While RRA 98 permits the Commissioner to exercise discretion regarding the application of Section 3421, we believe levies involving Social Security benefits clearly fall within the category of levy actions for which this legislation was intended.

**Conclusion: Quality customer service should not be dependent on the taxpayer's level of income**

For a voluntary tax system to work, it is important that it work well for *all* taxpayers. RRA 98 required the IRS to develop and implement a system of "balanced measures" to gauge the organization's effectiveness in delivering business results, customer satisfaction, and employee satisfaction. With regard to the service provided to low income taxpayers, the National Taxpayer Advocate believes the IRS collection operations are failing in all three areas.

The IRS routinely gives very low priority to collection cases involving low income taxpayers, and generally provides "service" on these accounts through computer-generated collection notices and automated levies. As a result, collection employees have relatively few opportunities to offer these taxpayers the services needed to help them fully resolve their problems. Frequently, cases involving low income taxpayers are simply set aside as "not collectible" even if the taxpayers are seeking alternative payment options. The taxpayers may also be subjected to automated levies on retirement and disability income sources, often without actual prior notice, even in situations where the taxpayers are surviving on incomes below or near the poverty level. Without the financial means to secure adequate representation, low income taxpayers can easily find themselves lost in a tax system that appears to be indifferent, uncaring, and sometimes actually hostile. Nevertheless, these taxpayers are part of the federal government's voluntary tax system. The IRS *must* do a better job in treating them accordingly.

**IRS COMMENTS**

We disagree with the National Taxpayer Advocate's assessment that the IRS is not providing the services low income taxpayers need to resolve their Federal tax delinquencies. The IRS generally expects that all taxpayers will try to pay the total amount due, regardless of that amount and whether it is solely tax or includes penalties and interest. Within an overall Collection framework, we assist taxpayers in fulfilling their obligations regardless of income levels.

The IRS' collection strategy places priority on rapidly working the largest number of cases with the highest potential risk to future compliance. All new cases above a minimum liability receive some form of collection treatment and we provide contact options

in Campus, Field, and electronic environments to maximize opportunities for early resolution for all taxpayers.

To optimize enterprise efficiency and effective collection practices across our entire accounts receivable inventory, we recently chartered a working group to review our current case routing practices to assess whether we can use recent technological improvements to develop alternative treatment streams, including those for small debts owed by low income taxpayers. Also, while the IRS does not have the resources to personally contact every low income taxpayer regarding a delinquent account, our Private Debt Collection initiative uses contractors to attempt personal contact on many smaller debts that might otherwise go unaddressed because of higher priority work.

### Offer in Compromise

An offer in compromise (OIC) remains a viable payment alternative for low income taxpayers. Regardless of economic bracket, the OIC program is not an option for all taxpayers. We evaluate each case individually. The OIC application fee and payments imposed by § 509 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) are currently waived for individuals whose income falls at or below IRS Low Income Guidelines. The upcoming revision of Form 656 will define “low income” to include those taxpayers with incomes at or below 250 percent of the federal poverty level as defined by the Department of Health and Human Services. To address the Treasury Inspector General for Tax Administration’s concerns, as noted in the National Taxpayer Advocate’s report, the IRS conducted a media campaign to educate the public about the OIC eligibility requirements and exemptions. Further, the IRS recently piloted the “OIC Candidate” program under which the IRS sends OIC outreach information to compliant taxpayers already identified as a Currently Not Collectible (CNC) “hardship.”

### Installment Agreements

The IRS grants streamlined installment agreements (IAs), where taxpayers choose their own repayment schedule within certain guidelines, for liabilities up to \$25,000. In fiscal year 2006, streamlined IAs accounted for ninety-seven percent of all IAs granted. When applying for a streamlined IA, taxpayers do not have to submit financial analysis or other documents for review; they simply sign up and choose a repayment schedule. In other words, it is unlikely that the IRS will have cause to apply the Allowable Living Expense (ALE) standards in low-dollar tax cases. In the unlikely situation that the ALE would be applied to a taxpayer with an income at or near the poverty level, however, recent IRS research shows that, almost invariably, we would place the taxpayer in CNC status. If we determine that we should not take further collection action because of the risk of hardship, but the taxpayer chooses to pay, the IRS accepts the payments and may place the account in a “backup” CNC status to prevent enforcement if the taxpayer fails to make the voluntary payments.

The amount of liability paid through an IA does not impact the cost of granting the agreement. In Notice of Proposed Rulemaking, 71 Fed. Reg. 51538 (Aug. 30, 2006), the Office of Management and Budget (OMB) directed federal agencies to charge user fees that reflect the full cost of services. The proposed increase in user fees for IAs will bring the IRS's fees in line with actual processing costs. The IRS charges the user fee upon accepting the IA, not upon application for the IA. Further, we do not require the taxpayer to pay the user fee "up front", but rather deduct the fee from the initial installment payments so that taxpayers may pay the fee in increments. In addition, the IRS will study the possibility of being able to either waive or reduce the IA user fees for individuals with incomes less than 250 percent of federally established poverty levels.

### Federal Payment Levy Program

The National Taxpayer Advocate states that the Federal Payment Levy Program was originally developed to collect debts from beneficiaries of contracts with the Federal government. The Taxpayer Relief Act of 1997 specifically authorized the IRS to use the FPLP to levy up to 15 percent of Social Security payments. The House of Representatives Committee Report on P.L. 105-34 states, in part,

"...the provision amends the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are not subject to levy under present law, would become subject to continuous levy."

In addition to the general final notice issued to all taxpayers prior to enforcement action, the IRS issues an additional notice to Social Security beneficiaries prior to the FPLP levy. Every notice sent to the taxpayer provides information on how to contact the IRS if he or she cannot pay the balance. We also advise taxpayers to submit information to substantiate their inability to pay and analyze that information in determining whether a taxpayer is suffering a hardship.

As stated in the National Taxpayer Advocate's report, the Government Accountability Office determined that the IRS's previous filter to pre-screen FPLP levies for hardship situations did not accurately reflect a taxpayer's ability to pay. We agreed with GAO and followed their recommendation to eliminate the exclusion criteria and rely on the additional final notice process to resolve taxpayer cases. A subsequent IRS task force, including TAS representatives, was unable to design a valid replacement filter. In an effort to identify Social Security recipients who could be experiencing a hardship, the IRS and SSA are working on blocking a FPL on benefit payments going directly to a health care facility. Although the IRS does not receive many levy payments on these taxpayers, excluding the payments will eliminate the possibility of hardship caused by the FPLP for these taxpayers. In another instance, the IRS helped perfect SSA's records so that SSA could ensure it was honoring only appropriate paper levies.



We agree, however, that the FPLP should be used in a manner that causes the minimum amount of financial hardship. Therefore, we will begin a new research project to create and implement an effective income filter to assist the IRS in identifying taxpayers who may experience a hardship because of the FPLP. We also agree that levies must be released promptly in hardship situations, and we do expedite levy releases in those cases. We plan to study options for improving our efficiency in releasing levies during FY 2007.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes and acknowledges current and past efforts by the IRS to mitigate the negative impact collection activity may have on low income taxpayers. Most notably, we are pleased with recent decisions to modify the new payment requirements for OICs that were implemented this past year as part of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The decision to waive these requirements for taxpayers with income at or below 250 percent of the poverty level as defined by the Department of Health and Human Services is a very significant step in the right direction. Also, we view the decision to apply the same low income definition to the requirement for the OIC application fee as a significant accomplishment, which not only mitigates the economic impact these requirements have on low income taxpayers, but also simplifies the OIC application process for these individuals. We are also pleased to note that the application for OIC consideration, Form 656, has been revised to include instructions for taxpayers regarding these issues. We look forward to seeing the new revision in the near future.

We have worked closely with the IRS on these issues during the past year, and have found IRS management to be genuinely concerned about integrating fair and reasonable expectations into the practical application of these requirements. The IRS is to be commended for its efforts in this area. Further, we are encouraged by current discussions between the IRS and the Treasury Department regarding the implementation of a similar “low income” waiver for the installment agreement user fees. We view this decision as a logical, realistic extension of the concepts now embedded in the OIC process, and optimistically look forward to these proposed changes to the IA fee becoming reality in the near future.

We remain concerned, however, that the “overall Collection framework” mentioned in the IRS comments to this report does not reflect a true commitment to provide adequate service to the low income segment of the taxpayer population. As discussed in this report, the IRS collection framework takes a very rudimentary approach to servicing low income taxpayers with tax debts, *i.e.*, collection notices sent to the taxpayer’s last known address, systemically generated levies, and what appears to be an almost automatic default position of reporting the accounts as CNC if the notice or levy processes fail to resolve the delinquencies. We continue to believe that these methods

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clearly do not provide a service-oriented approach to helping these taxpayers resolve their collection problems.

As we have discussed at length in this year's report to Congress, timely, meaningful interventions are critical to the successful collection of delinquent accounts.<sup>44</sup> Probably more than any other taxpayer group, low income taxpayers will likely have problems with the IRS collection notice process, particularly if those notices are sent to incorrect addresses. Low income taxpayers are the least likely to have the financial ability to obtain professional representation to assist them in navigating the IRS collection process. Additionally, the practice of issuing notices to the last known address, which is typically the address of the last tax return filed, will likely fail to reach many of these taxpayers, particularly if their line of employment makes them transient, or if their levels of income do not require them to file returns for a period of time.

Further, low income taxpayers are the segment of the population most in need of flexible, realistic payment options. While the IRS is quick to acknowledge that many collection accounts involving low income taxpayers are reported as CNC, we continue to question the reasoning behind the significant number of cases involving taxpayer requests for OICs and installment agreements that are rejected by the IRS and subsequently reported as CNC.<sup>45</sup> Many of these taxpayers sincerely wish to resolve their tax debts, but have been unable to do so because IRS policies and procedures restrict the availability of realistic payment options. In fact, we find it interesting to note that in FY 2006, more installment agreements were granted by the IRS taxpayer assistance offices, *i.e.*, those servicing "walk-in" taxpayers, than were approved by the entire Collection Field operation.<sup>46</sup>

We continue to be very concerned about the negative impact of the IRS Federal Payment Levy Program (FPLP) on low income taxpayers. We strongly disagree that the additional notice issued by the IRS to Social Security beneficiaries prior to the FPLP levies provides an adequate safeguard for taxpayers in these situations. These pre-levy notices are issued to the last known address, which is generally the address on the last return filed. Many of these taxpayers have not had filing requirements for years. We understand that the collection workload of the IRS is considerable. We also appreciate that with limited resources, the IRS must address this workload as efficiently as possible. However, we do not believe that the IRS levy program is the appropriate place for cost-cutting initiatives. We are concerned that because FPLP levies collect delinquent revenue at relatively low cost, the efforts to identify and implement a suitable replacement for the income filter, which had previously been used to screen out potential hardship situations, may have been abandoned prematurely. Levies are very significant enforcement actions with the potential to create considerable economic and

<sup>44</sup> See Most Serious Problem, *Early Intervention in IRS Collection Cases*, *supra*.

<sup>45</sup> See Most Serious Problems, *IRS Collection Payment Alternatives*, *supra*.

<sup>46</sup> IRS, *Collection Activity Report, Installment Agreement Cumulative Report*, NO-5000-6 (Oct. 2, 2006).

emotional harm for the affected taxpayers. As discussed elsewhere in this report, TAS cases involving imprudent levy actions have increased substantially in recent years.<sup>47</sup>

We do not agree with the IRS that assigning the collection accounts of low income taxpayers to private collection agencies is an acceptable substitute for the quality taxpayer service many of these individuals need to fully resolve their tax debts. We believe the interests of these taxpayers are best served through meaningful interactions with IRS employees, who have the ability to exercise judgment and discretion, including access to the full range of collection payment alternatives needed to meet the needs of the low income population.

We are pleased to note that the IRS recognizes the need to use the FPLP in a manner that does not create undue hardship for low income taxpayers, and plans to renew its efforts to develop an effective income filter, work with the Social Security Administration to block FPLP levies in situations where benefits are paid directly to a health care facility, and study options that will ensure levy releases are issued promptly in hardship situations. We urge the IRS to complete its work to improve the FPLP program with a sense of urgency, and we offer the continued assistance of TAS to further these efforts.

### RECOMMENDATIONS

While the National Taxpayer Advocate recognizes and appreciates a number of significant actions recently taken by the IRS to address the collection concerns of low income taxpayers, much work remains to be done in this area. We recommend that the following actions be considered, and implemented, as soon as possible:

- 1) The IRS should continue its efforts to develop and implement a low income waiver for the installment agreement user fee, similar to what is currently used in administering the OIC application fee. Also, we recommend that the IRS establish a graduated scale of IA user fees that reflect the amount of work required, i.e, lower fees should be required for streamlined IAs than those that require more financial analysis and extended periods of monitoring by the IRS.
- 2) The IRS needs to develop an alternative to the Allowable Living Expenses (ALE) methodology for determining the reasonable collection potential (RCP) of collection cases involving low income taxpayers. The ALE standards, as currently applied, are neither reasonable nor realistic in analyzing the RCP of taxpayers with incomes below or near the poverty level. Use of the ALE standards should constitute a reasonable “floor” in these situations, and the IRS should be flexible in accepting documentation of basic living expenses that exceed that “floor.”
- 3) In recognition of the limited collection potential of delinquent collection accounts involving low income taxpayers, the IRS should establish liberal and

<sup>47</sup> See Most Serious Problem, *Levies*, *supra*.

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flexible installment agreement and offer in compromise acceptance policies for taxpayers in this segment of the population who are seeking resolution and closure for their tax debt problems.

- 4) The IRS needs to expand its current procedures to ensure that notices of intent to levy on Social Security benefits via the FPLP program are mailed to the best addresses available, and not simply the last known addresses. At a minimum, the IRS should utilize address research resources that are readily available via the Internet, and coordinate with the SSA to determine if the IRS's "last known address" for the taxpayer is the most recent one available.
- 5) The IRS should develop and implement a realistic screening process to eliminate low income taxpayers from FPLP levies on Social Security benefits. Also, the IRS should incorporate procedures into the FPLP process that require legitimate attempts at personal contacts prior to the issuances of these levies.
- 6) The IRS should develop and implement procedures to require managerial review and approval of any levy involving retirement and/or disability income from the Social Security Administration, within the spirit of § 3421 of RRA 98.
- 7) The IRS should develop procedures in conjunction with the SSA to ensure FPLP levies are released in an expedited manner in situations where failure to do so will cause financial hardship for the taxpayer. Designated points of contact, designated fax numbers, and similar measures should be developed and implemented to ensure expedited resolution for problems involving FPLP levies.
- 8) The National Taxpayer Advocate acknowledges and supports the IRS's efforts to review and revise its methods of addressing the collection problems faced by low income taxpayers, particularly those seeking to ensure timely, meaningful contacts for these taxpayers in regard to their collection accounts, and those designed to improve the administration of the FPLP program in situations involving low income individuals. In order to ensure that the interests of the low income taxpayer population are adequately represented and considered in these efforts, we recommend that the IRS include the National Taxpayer Advocate in the planning and analysis stages of these efforts as soon as possible. We recommend that the IRS also include the participation of the Low Income Taxpayer Clinics (LITC) and the Taxpayer Advocacy Panels (TAP) for their improvement efforts in this area. These groups have significant experience with the needs of this population and can offer valuable perspective about how to effectively communicate with these taxpayers.
- 9) Finally, 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 legislative recommendation was also included in 2005 Annual Report to Congress. We believe this action continues to be needed to protect the rights of low income taxpayers.

## PROBLEM

## TOPIC #10

## EXCESS COLLECTIONS

## RESPONSIBLE OFFICIALS

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

Nancy J. Jardini, Chief, Criminal Investigation

Steven T. Miller, Commissioner, Tax Exempt and Government Entities

Richard J. Morgante, Commissioner, Wage & Investment Division

Deborah M. Nolan, Commissioner, Large & Mid-Size Business Division

## DEFINITION OF PROBLEM

The Excess Collections File (XSF) is a cumulative file within the IRS's Integrated Data Retrieval System (IDRS), which reflects payments that either cannot be identified or cannot be applied to a specific taxpayer account.<sup>1</sup> Taxpayers pay in excess of \$2 trillion dollars to the IRS each year,<sup>2</sup> so it is not surprising that the IRS needs a temporary account to house payments until they are associated with the correct taxpayer or the correct tax return. However, because a transfer to the XSF signifies that a taxpayer's payment may not have been credited as intended, clear and consistent guidelines should govern these transfers. In approximately four and one half years (from March 1999 to October 2003), the XSF grew at a rate of 65 percent, from approximately \$2.3 billion to \$3.8 billion.<sup>3</sup> Although the IRS has since made progress in reducing the size and volume of the XSF, as of May 31, 2006 the file still contained nearly \$3.5 billion in unapplied credits.<sup>4</sup>

IRS procedures require the IRS to correspond with the taxpayer in an effort to determine the proper disposition of the credits before transferring them to the XSF.<sup>5</sup> However, despite the guidance established to assist IRS personnel in handling these issues, both the Taxpayer Advocate Service (TAS) and the Treasury Inspector General for Tax Administration (TIGTA) have found the IRS routinely moves funds into the XSF with very little research or personal contact with the taxpayer to correctly ascertain if a

<sup>1</sup> IRM 3.17.220.2(1) (Jan. 1, 2006). IDRS is a computer system with the capability to instantaneously retrieve or update stored information which works in harmony with the Master File system of taxpayer accounts. A non-revenue receipt is defined as a payment received for items other than taxes (*i.e.*, bulk forms, photocopy fees, court fees, installment agreement user fees, erroneous refund payments, etc.).

<sup>2</sup> Statistics of Income, *IRS Data Book, 2004-2005*, available at: <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>.

<sup>3</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution 1* (Jan. 2005). TIGTA reviewed 88 taxpayer accounts with at least one tax module totaling \$1 million or more in at least one tax period.

<sup>4</sup> IRS spreadsheet, *XSF National Totals FY 2003-2007* (using volumes taken from URF6040 Reports, (Oct. 2005 through May 2006). A credit can be an amount paid directly to the IRS by the taxpayer (*e.g.*, payment with a tax return), an amount withheld by an employer to be credited to a taxpayer's account upon filing of a tax return (*e.g.*, credit for withholding taxes) or statutory entitlements based on facts and circumstances (*e.g.*, earned income tax credits or child tax credit).

<sup>5</sup> IRM 3.17.220.1.5 (Jan. 1, 2006) and numerous related IRM sections. See IRM 3.17.220.1.6 for a comprehensive listing.

taxable return should be filed, and if not, where such funds should be applied.<sup>6</sup> Thus, the IRS cannot properly determine whether it has collected the correct amount of tax or it owes the taxpayer a refund.

Inadequate management of the XSF can lead to negative consequences for taxpayers. Our analysis focuses on three concerns that should be addressed to ensure proper governance of taxpayer funds:

- ◆ The need for meaningful personal contact at the earliest possible opportunity;
- ◆ The need for substantive research and clear procedural guidance to more efficiently resolve the credit issues; and
- ◆ The potential disparate treatment of taxpayers that results from placing a \$100,000 credit balance limit on the proposed XSF enhancements.

## ANALYSIS OF PROBLEM

### Background

#### *What is Excess Collections?*

Within the IRS, the term excess collections is somewhat of a misnomer. It does not actually relate to “extra” or “surplus” funds, but rather to monies received by the IRS which, for a variety of reasons, the IRS cannot apply to a specific tax liability. All money received by the IRS initially goes to the Treasury General Fund, broken down by a specific tax class or type of payment received.<sup>7</sup> If a payment cannot be associated with a taxpayer’s account or a tax return is not filed, the IRS will, after following prescribed procedures, transfer the payment to the XSF for more research.<sup>8</sup>

#### *How Are These Funds Maintained?*

The IRS maintains payments and credits transferred to the XSF within two separate accounts on the IDRS database.<sup>9</sup> The funds in these two accounts are mainly comprised of taxpayers’ payments or “credits” for which the taxpayers can no longer seek refunds due to the expiration of the applicable statutory period for claiming a refund (statute-

<sup>6</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collection Accounts Could Be Credited to Taxpayers* (Jun. 2000) and Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service’s Excess Collections File Could Improve Case Resolution* (Jan. 2005).

<sup>7</sup> IRM 3.8.44.2 (Jan. 1, 2005).

<sup>8</sup> See IRM 3.17.10 (Jan. 1, 2006) and 3.17.220 (Jan. 1, 2006).

<sup>9</sup> IRM 3.17.10 (Jan. 1, 2006) and 3.17.220 (Jan. 1, 2006). These accounts are Account 6800 (Excess Collections) and Account 9999 (Revenue Clearance Accountability). Credits may remain in Account 6800 for up to one year, at which point they are automatically transferred to Account 9999. Any unapplied credits will remain on IDRS in the XSF for seven years after the initial entry date of the payment, and then appear on a dropped listing.

expired credits).<sup>10</sup> These credits include payments for withholding taxes and earned income tax credits (EITC) for which a return has been filed, and other payments that appear to be intended for association with a tax return but for which no return has been filed (credits/no return). The IRS systemically transfers the statute-expired credits from the Individual Master File (IMF) to the XSF each week but must manually move the other payments on an as-needed basis.<sup>11</sup>

#### *Who is Involved in the XSF Process?*

The Submission Processing organization in the IRS's Wage and Investment (W&I) division exercises line authority over the XSF process and is responsible for completing the necessary research and administering the file's daily operations. These functions serve as the primary processing arm of the XSF as well as the clearinghouse when other IRS business units request credit applications be moved into or out of the file. Accounts Management also contains a statutory function that is responsible for addressing any situations related to credits that are either imminent or beyond the statutory period for refunds.<sup>12</sup> However, at least eight other IRS operating divisions or functions have direct ties to the XSF process.<sup>13</sup> Eight IRS campuses maintain XSF activities, with each retaining a separate Account 6800 and Account 9999.<sup>14</sup> These campuses generate reports to show the monthly national inventory activity of both accounts.<sup>15</sup>

<sup>10</sup> IRC § 6511(b) provides that if the claim is filed within the three-year period prescribed in IRC § 6511(a), the amount of the credit or refund may not exceed the portion of the tax paid during the period immediately preceding the filing of the claim equal to three years plus the period of any extension of the time to file the return. If no return is filed by the taxpayer, the amount of the refund or credit may not exceed the portion of tax paid within two years from the filing of the claim.

<sup>11</sup> IRM 3.17.220.2.1(2) (Jan. 1, 2006).

<sup>12</sup> IRC § 6511(a).

<sup>13</sup> These organizations and their XSF relationships are:

- ◆ *Collection Field Function (CFf)* – This function is responsible for face-to-face collection activities related to filing and payment compliance. When investigating delinquent tax returns, field personnel (e.g., revenue officer) initiate contact with the taxpayer to determine the nature of any liability to resolve the specific account.
- ◆ *Compliance Services Campus Operation (CSCO) and Automated Collection System (ACS)* – These functions attempt to resolve credit balance accounts through correspondence, telephone contacts, or letters and notices. Credit balance accounts are worked by verifying whether the credit was properly applied.
- ◆ *Automated Underreporter (AUR)* – This function is responsible for corresponding with taxpayers when a previous notice proposed an adjustment to the taxpayer's account.
- ◆ *Examination and Centralized Case Closing* – These functions research instances where credits may reside on an account that was originally flagged for an examination.
- ◆ *Tax Exempt and Government Entities (TE/GE)* – This operating division is responsible for addressing compliance issues involving tax exempt organization or government agencies. Like CFf, it identifies and resolves situations where a taxpayer fails to file a return.
- ◆ *Criminal investigation (CI)* – This function is responsible for investigation of potential criminal violations of the Internal Revenue Code and related financial crimes.

<sup>14</sup> IRS, W&I Operating Division Response to TAS Research Request (Jun. 14, 2006).

<sup>15</sup> A campus is a facility that processes paper and electronic submissions, corrects errors and forwards the data on for analysis and posting to taxpayer accounts. The following IRS campuses conduct XSF activities: Andover, Atlanta, Austin, Cincinnati, Fresno, Kansas City, Ogden and Philadelphia (with Cincinnati maintaining Memphis and Brookhaven Campus XSF activities on separate reporting systems).

### Problems Signify Need for XSF Reform

TIGTA first raised concerns over the IRS's administration of the XSF process in 2000 and re-addressed those same issues in a follow up review in 2005.<sup>16</sup> TIGTA noted that too many XSF transfers resulted from insufficient IRS employee research, lack of employee contact with the taxpayer, or improper adjustments to taxpayer accounts. The report concluded that if IRS controls had been adequate, 25 percent of the dollars in the XSF could have been credited to those accounts.<sup>17</sup>

TIGTA's findings ultimately led to the creation in February 2005 of the Excess Collections Task Group (XSFTG), with representation from all IRS business units, including TAS. The group's objective was to analyze TIGTA's findings, evaluate procedures for working unresolved credit accounts and develop suitable recommendations.

The group identified proposals to improve the XSF process, including an allowance for additional employee research and taxpayer contact to obtain needed information, mandatory approval of XSF credit transfers and establishment of points of contact at each campus for each business unit to facilitate resolution of large dollar credit balances, *i.e.*, balances \$100,000 and over.<sup>18</sup> However, because these proposals were limited to credits involving high dollar amounts, they would not benefit low or middle income taxpayers.

A recent TAS case demonstrates how the lack of specific guidelines for proper research and contact with the taxpayer leads to taxpayer burden and IRS re-work.<sup>19</sup>

**Example:** The taxpayer made two estimated tax payments in October 2001 but failed to file a 2001 return until February 25, 2005. Although the return showed the 2001 payments, the IRS had erroneously moved these credits to XSF prior to the statutory limitation period for a refund and did so without additional research. The taxpayer came to TAS for assistance. After TAS completed its research and located the payments in XSF, the IRS agreed to return the funds to the tax year in question and reduced the liability to a minimal balance due, which the taxpayer paid.

Transferring payments to the XSF without sufficient research and taxpayer contact can cause serious downstream effects for both the taxpayer and the IRS. As noted in the above example, this impact can take the form of unwarranted or incorrect billing notices when credits are misapplied and a subsequent return is filed. Further, some IRS

<sup>16</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-30-088, *Millions of Dollars in Internal Revenue Service Excess Collection Accounts Could Be Credited to Taxpayers* (Jun. 2000) and Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution* (Jan. 2005).

<sup>17</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution 3* (Jan. 2005). TIGTA reviewed 88 taxpayer accounts with at least one tax module totaling \$1 million or more in at least one tax period.

<sup>18</sup> IRS Excess Collections Task Group Report 2, 3 (Mar. 6, 2006). The XSFTG conducted a statistically valid sample of credit balance accounts equal to or greater than \$100,000. Thus, the group's report defines large dollar credit balances as \$100,000 and over.

<sup>19</sup> Examples are taken from the Taxpayer Advocate Management Information System (TAMIS).



functions that transfer funds into the XSF lack any written guidance as to when it is appropriate to make such transfers. The Criminal Investigation Division's operation of the Questionable Refund Program provides one such example.

#### *Criminal Investigation's Use of XSF*

Criminal Investigation (CI) operates the IRS's Questionable Refund Program (QRP), which uses data mining techniques to identify suspicious refund claims and subject those claims to further investigation.<sup>20</sup> In the 2005 Annual Report to Congress, we identified serious problems within the QRP, such as the high rate of TAS QRP cases that resulted in full or partial relief, and the IRS's failure to provide taxpayers with notice of their frozen refunds or an opportunity to provide exculpatory evidence.<sup>21</sup> We have also learned that in fiscal years 2005 and 2006, CI transferred some of the EITC payments and withholding payments associated with these frozen refunds into the XSF.<sup>22</sup> By taking this step, CI was moving payments belonging to taxpayers out of the taxpayers' accounts *before* the taxpayers even knew the IRS suspected fraudulent activity and *before* the expiration of the period in which the taxpayers could file suit to recover the refunds.<sup>23</sup> Thus, an innocent taxpayer with a frozen refund who contacted the IRS about the status of the refund would have been told the IRS had no record of a credit balance.

CI has advised TAS it has no written policies or procedures regarding transfer of payments to the XSF but would adopt appropriate written guidance for its employees as part of the overall reorganization of the QRP. It is imperative that the IRS implement these procedures prior to the start of the 2007 filing season.

#### *Misapplication of Levy Proceeds and Transfer to XSF*

We have also uncovered instances where the IRS inappropriately moved credits to the XSF during the application of levy proceeds without properly notifying the taxpayer. In these situations, the IRS has initiated enforcement action against a taxpayer, served a notice of levy to collect the delinquent liabilities, and then either posted the proceeds to

<sup>20</sup> For discussion of CI's QRP program, see National Taxpayer Advocate 2005 Annual Report to Congress 25. See also Most Serious Problem, *Criminal Investigation's QRP*, *infra*.

<sup>21</sup> In a study of Taxpayer Advocate Service QRP frozen refund cases, TAS found that in 66 percent of the decided cases taxpayers were innocent of fraud and were fully entitled to their refunds; nearly three-quarters (74 percent) of the affected taxpayers had claimed the Earned Income Tax Credit (EITC) and a majority of those taxpayers ultimately received the EITC. National Taxpayer Advocate 2005 Annual Report to Congress Vol. II, at 10-12.

<sup>22</sup> Data provided by CI shows that for CY 2005, 336 accounts totaling \$981,586 moved to XSF. For CY 2006, these figures rose to 1133 accounts and \$2.15 million. IRS, Criminal Investigation Response to TAS Research Request (Aug. 23, 2006).

<sup>23</sup> IRC § 6532 provides that taxpayers cannot file suit for refund until the expiration of six months from the filing of a claim and must file the suit within two years of a notice from the IRS disallowing the claim. Because taxpayers whose refunds were frozen in the QRP did not receive claim disallowances, or at the earliest, received them in FY 2006 following the 2005 Annual Report to Congress review, their rights to file suit to recover the funds would not have expired.

tax periods which were already satisfied or were not listed on the original levy.<sup>24</sup> Instead of conducting research to determine if these funds should be refunded, the IRS simply transferred them to the XSF, and in many cases never notified the taxpayer. Some of these payments have now passed the two-year statutory period for the taxpayers to file a claim for the return of these proceeds.<sup>25</sup>

Although W&I exercises ultimate line authority for the XSF, the actions of the other interrelated parties still significantly impact the process and are not subject to clear checks and balances.<sup>26</sup> Thus, the IRS must closely administer and follow the guidance and expectations associated with the XSF process to ensure taxpayers are protected at all stages.

### Need for Meaningful Personal Contact

Current IRS guidance allows employees to attempt personal contact with taxpayers only rarely, and then only with management approval.<sup>27</sup> Accordingly, in its final report to IRS management, the XSFTG acknowledged that the “primary weakness is [that] the current process relies almost exclusively on notices and letters with relatively few instances in which personal contact is made with the taxpayer.”<sup>28</sup>

The XSFTG reached this conclusion by reviewing a Large and Mid-Size Business (LMSB) division initiative to deal with unresolved credit balances on cases inside the division’s purview. LMSB conducted research to determine if a taxpayer was actually liable to file the return in question, and after culling out those who were not required to file, attempted to personally contact the remainder using Internet resources if IRS databases did not yield a contact name or phone number. *This approach enabled LMSB to secure several hundred delinquent tax returns and shrink the division’s initial unresolved credit balance from \$3.1 billion to \$240 million.*<sup>29</sup>

The task group then developed and tested a hypothesis that Internet research and telephone contact with the taxpayer would not only resolve a vast number of credit balance accounts but would do so faster than the current processes, thus reducing the credits moving to XSF.<sup>30</sup> The task group’s conclusions were:

<sup>24</sup> A levy is a legal seizure of property to satisfy a tax debt. IRC § 6331 provides the IRS with statutory authority to levy funds held by a third party.

<sup>25</sup> For a related and more detailed discussion of levies, specifically situations involving the erroneous application of levy proceeds after expiration of the statutory period for claiming a refund, see Most Serious Problem, *Levies, supra*.

<sup>26</sup> The XSFTG report did recommend new research procedures in IRM 3.17.220.2 which will be effective in January 2007. These procedures specify what will cause the rejection of the Form 8758 if the submitting function does not take the required action.

<sup>27</sup> IRM 3.17.220(8)(5) (Jan. 1, 2006).

<sup>28</sup> IRS, *Excess Collections Task Group Report 4* (Mar. 6, 2006).

<sup>29</sup> *Id.* at 7.

<sup>30</sup> *Id.*

- ◆ Internet and telephone contact provided the IRS with updated taxpayer information for its internal systems;
- ◆ Approximately half of the taxpayer phone contacts resulted in returns secured or credit balances resolved; and
- ◆ The process allowed credit resolution on first contact, which ultimately decreases the need to repeatedly handle cases.<sup>31</sup>

#### *Early Intervention Yields Positive Results*

By virtue of these findings the XSFTG concluded that, “IRS processes would improve considerably if personal contact with the taxpayer is made.”<sup>32</sup> The group also recognized that the earlier these actions could be taken, the better for all involved. We agree with the task group recommendation for meaningful personal contact with the taxpayer and the need for earlier intervention. In its second review TIGTA noted (and we concur) that studies have shown “taxpayers do not send payments to the IRS unless they anticipate incurring a tax liability.”<sup>33</sup> In fact, an LMSB study of income tax non-filers concluded, “The presence of a credit balance is indicative that the taxpayer expects to file a return which shows tax due.”<sup>34</sup> Many cases reviewed by TIGTA, the XSFTG and TAS contain clear indications that the IRS does not always follow procedural guidelines before transferring the associated credit balance to XSF.<sup>35</sup> Such failure to follow existing guidance compounds the harm to these taxpayers.

#### *Time Sensitivity of “Statute-Expired Credits” Issues*

The IRS needs to attempt more personal contact with taxpayers who file delinquent returns or claim for credits close to or beyond the applicable statutory timeframes. Taxpayers filed nearly 270,000 refund due returns with statutory expiration dates of April 15, 2005 in calendar year 2005.<sup>36</sup> While not all were filed after April 15, 2005, the sheer volume indicates the IRS missed many opportunities to contact taxpayers and address the credit issues much earlier in the process. Currently, the IRS sends a systemic notice to the taxpayer every six months until the refund limitation period expires, and makes little or no attempt at personal contact. A personal contact with the taxpayer at the earliest possible interval would enable the IRS to better educate him or her about the credit issue and statutory limitations associated with these payments.

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<sup>31</sup> IRS, *Excess Collections Task Group Report 4* (Mar. 6, 2006).

<sup>32</sup> *Id.* at 8.

<sup>33</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service’s Excess Collections File Could Improve Case Resolution 1* (Jan. 2005).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 5,6 (Jan. 2005); IRS, *Excess Collections Task Group Report 9* (Mar. 6, 2006).

<sup>36</sup> IRS Compliance Data Warehouse, *Individual Returns Transaction File (Processing Year 2005 for Tax Year 2001)*.

### Need for Substantive Research

In addition to the need for personal contact, the XSFTG studies also revealed a need for employees to take their research beyond the normal IRS databases and systems. Currently, this research is limited to internal records, mainly on the IDRS system, and focuses on items such as pending transactions, prior tax return information, or related entities in an attempt to help locate the proper placement of the credit.<sup>37</sup> If the research is inconclusive, the next step is to generate a standardized letter to inquire about proper disposition of the credit. The IRS mails this letter to the last address of record but does not require the employee to first attempt personal contact with the taxpayer or try to identify any other potential addresses.<sup>38</sup> In fact, for situations where the taxpayer's account was previously reported as unable to locate, XSF procedures actually advise the employee not to send any additional correspondence.<sup>39</sup>

### *Current Guidance Lacks Clarity and Consistency*

The majority of IRS guidance associated with XSF research activities lacks the clarity needed to provide the proper level of service to resolve the taxpayer's credit issue. Moreover, several XSF procedures are confusing and contradictory. For example, one Internal Revenue Manual (IRM) section states that certain types of cases require no research at all.<sup>40</sup> This reference applies to "statute-expired" cases and others where the IRS may have "frozen" credits due to pending audits or criminal investigations.<sup>41</sup> However, another IRM section related to statute-expired cases advises the employee to conduct an initial analysis to determine if the credit "meets the legal criteria for expiration of the statute for either assessment or credit/refund and the taxpayer has not been injured through IRS mishandling of his/her case."<sup>42</sup> This same IRM further explains in a later section that "statute-expired credits represent a wide range of situations which may require detailed analysis to determine whether further action [sic] need be taken to protect the taxpayer."<sup>43</sup>

The obvious question is: "*How can an employee determine that further action is necessary if initial guidance dictates there is no need for research?*" Even if the employee does recognize such a situation, the guidance is not clear as to how the other applicable function (Accounts Management Statutes, in this case) becomes involved.

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<sup>37</sup> IRM 3.17.220.2.7 (Jan. 1, 2006).

<sup>38</sup> IRM 3.17.220.8(1) (Jan. 1, 2006).

<sup>39</sup> IRM 3.17.220.2.8(4) (Jan. 1, 2006).

<sup>40</sup> IRM 3.17.220.1.5(2) (Jan. 1, 2006).

<sup>41</sup> *Id.*

<sup>42</sup> IRM 3.17.220.2.2(4) (Jan. 1, 2006).

<sup>43</sup> IRM 3.17.220.2.7.1.1.1(1) (Jan. 1, 2006).

*Research Timeframes are Too Stringent*

The restrictive timeframes allotted for XSF research further compound the inadequacy of that research. TIGTA's second report concluded the IRS took incorrect or insufficient actions in nearly 50 percent of the cases reviewed, and "contributing to this situation are several related sections of the IRM that may be preventing employees from expending additional time to research or contact taxpayers before deciding to transfer payments to the XSF."<sup>44</sup>

For example, IRS procedures provide that when a payment cannot be directly applied to a taxpayer account, the employee must add these credits to the XSF within five workdays, including any action necessary to remove the original credit from its previous location.<sup>45</sup> The guidance further states these credits must be thoroughly researched within two workdays of their addition to the XSF. The rigidity of the research timeframes does not allow employees to properly consider the specific facts of each case and explore all means of resolution before applying these funds to the XSF. It is unreasonable to assume an employee can complete all necessary research, including taxpayer contact (should the need arise) in two days. This timeframe is also inadequate for situations where the taxpayer is contacted but cannot call or write back within these same two days.<sup>46</sup> TIGTA reached a similar conclusion and remarked, "It is highly probable that by transferring these payments so expeditiously, the employee may not be taking sufficient action to ensure the proper resolution."<sup>47</sup> These seemingly abrupt and inflexible parameters can lead to improper application of payments, poor customer service, and additional work.

**Need for Equitable Treatment Regardless of Dollar Amount**

In its final report to IRS management, the XSFTG proposed that the IRS engage in personal contact and additional research on credit balances over \$100,000.<sup>48</sup> While we recognize it is reasonable for the IRS to leverage its resources and define priority work for its employees, this approach will clearly result in disparate treatment for taxpayers with credit balances below the \$100,000 threshold. IRS guidance already understates the importance of cases involving lower credit balances by stating, "Both large and small cases are to receive equal attention but large-dollar cases will be worked first."<sup>49</sup>

<sup>44</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution 7* (Jan. 2005). Of the 57 cases in which TIGTA determined the IRS should have been able to resolve the credit, they found that 28 occurred because the IRS had insufficient research, taxpayer contact or improper adjustments.

<sup>45</sup> IRM 3.17.220.1.3 (Jan. 1, 2006).

<sup>46</sup> IRM 3.17.220.2.7(1) (Jan. 1, 2006).

<sup>47</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-022, *Enhancing Internal Controls for the Internal Revenue Service's Excess Collections File Could Improve Case Resolution 8* (Jan. 2005).

<sup>48</sup> IRS, *Excess Collections Task Group Report 8* (Mar. 6, 2006). The XSFTG conducted a statistically valid sample of credit balance accounts equal to or greater than \$100,000. Thus, the group's report defines large dollar credit balances as \$100,000 and over.

<sup>49</sup> IRM 3.17.220.1.5 (Jan. 1, 2006).

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Also, certain managerial reports are geared to highlight cases with balances greater than \$25,000.<sup>50</sup> Thus, it seems the IRS's focus is not truly on equal attention and service. From a taxpayer-focused point of view, the need for a \$1,000 refund to a low or middle income taxpayer is as great as (and possibly even greater than) a refund of \$100,000 for a Fortune 500 company. Accordingly, we believe the IRS should provide this same service to all taxpayers, regardless of the dollar amount.

*Recent and Noteworthy Procedural Change by IRS*

We are pleased that upon the specific recommendation of the XSFTG, the IRS took steps to ensure proper research on future cases by requiring the input of a transaction code to indicate research has been completed prior to transfer to XSF and making it mandatory to note managerial approval on all required forms.<sup>51</sup> This approach will allow for the maintenance of a clear audit trail, avoid duplicate or inefficient actions, and ensure the adequacy of the XSF transfer given the facts of the case. However, we also note this new change does not include the previously referenced concerns relating to the need for personal contact and clearer guidance of what constitutes "complete" research.

**CONCLUSION**

The Excess Collections File represents an important opportunity for the IRS to help taxpayers meet their filing and payment responsibilities. The IRS has a fiduciary responsibility for these funds and it is critical that the XSF process be improved so as to reinforce voluntary compliance and instill public confidence in the tax system. The IRS can accomplish this goal by establishing meaningful personal contact with taxpayers at the earliest possible stage, and conducting substantive research to assist when such contact is not as forthcoming. The guidance needed to effectively carry out these tasks must be put forth in a clear and specific manner, with proper training given to ensure all IRS employees have the same set of expectations when considering XSF-related decisions. In doing so, not only will the taxpayer's credit balance issues be resolved more efficiently but their level of satisfaction will significantly improve.

**IRS COMMENTS**

The Excess Collections File involves credits and payments that cannot be identified or are for accounts for which returns have not been filed. Since 2000, the IRS has been making steady progress in reducing the number of credits that are moved to the XSF account. Recently, with the support and assistance of the Taxpayer Advocate Service, as many as ten Internal Revenue Manual (IRM) procedural changes and other system changes have been initiated or implemented that involve operations of Accounts Management, Submission Processing, and Compliance. Criminal Investigation is

<sup>50</sup> IRM 3.17.220.2.16(6) (Jan. 1, 2006).

<sup>51</sup> IRM 21.5.8.1(8) (Jun. 30, 2006). However, management approval is needed only on cases of \$100,000 or more.

also working with other IRS functions to develop and implement uniform procedural improvements. These changes affect the way accounts are worked prior to determining whether payments should be moved to XSF and will help us properly identify millions of dollars of unresolved credits. We believe these changes will ensure proper action is taken to resolve most large dollar credit balance accounts as we continue to explore the feasibility of applying similar changes to the resolution of lower dollar credits.

As acknowledged in the National Taxpayer Advocate's assessment of this problem, in 2005, the IRS formed the Excess Collections Task Group (XSFTG) to address concerns cited in a 2005 TIGTA report regarding the growth of large dollar credits in the XSF. That group, with representatives from all business units including TAS (except Criminal Investigation) completed a comprehensive review of the way credits were processed and identified improvements that will significantly reduce large dollar credits of \$100,000 or more moving to the XSF. Many of these changes have already been adopted or are pending implementation beginning in 2007.

One of the major changes initiated by the XSFTG is the requirement for employees to conduct additional research on large dollar credit balance accounts. This primarily involves BMF accounts, which were cited by TIGTA as the major contributing factor to the growth of the XSF. In 2005, the XSFTG sponsored a statistically valid sampling of 822 unresolved IMF and BMF large dollar XSF accounts. In this test, additional research enabled the IRS to resolve approximately 20 percent of the cases, representing \$2.2 billion in previously unapplied credits. However, the employee productivity rate significantly decreased from 7.9 cases closed per hour to 3.1 per hour, or a 60 percent reduction. While these procedures are now mandatory for all large dollar credits, we have not extended these procedures to lower dollar credits pending an analysis of whether we can expect the same positive results from the increased expenditure of our limited staff resources.

Another procedural change initiated by the XSFTG was the development of a better research tracking system for credit balance accounts on IDRS. The existing system generates an Accounts Maintenance Research (AMRH) transcript for virtually all credit balance accounts after 25 to 82 weeks of inactivity, depending on the type of credit and the due date of the return. At that point, the account is reviewed by an Accounts Management employee and notices are generated to the taxpayer's last known address on IDRS. However, previously there was no history on IDRS to verify the issuance of these notices. The XSFTG initiated a requirement for employees to input a new transaction code (TC Code 971 Action Code 296) to show that all research of the primary and related Taxpayer Identification Numbers was completed prior to a transfer of credits to XSF. An additional enhancement that will be effective in January 2007 will create an audit trail to record issuance of the CP 80/81 letters which request the taxpayer to provide information on how they want the IRS to apply the credit balance on their account.

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We agree with the National Taxpayer Advocate that personal contact may improve the resolution of some credits. As previously mentioned, when a taxpayer has an unresolved credit balance on an account, the IRS sends a series of notices to the taxpayer's address of record advising of the credit balance and asking how they want it applied to their account. This notification continues until the statute expires on the account. However, the IRS believes there is a very low response rate to these notices and as a result, the process for working large dollar credits has been changed to require additional research to locate the taxpayer. When this research identifies a telephone number, we also attempt to make telephone contact with the taxpayer to determine the proper disposition of the unapplied credit.

Regarding the National Taxpayer Advocate's commentary regarding the transfer of levy proceeds to the XSF, the IRS fully appreciates the sensitive nature of levying taxpayer assets. Currently, the IRS uses several resources to ensure our records reflect the taxpayer's most current address. We receive National Change of Address (NCOA) files from the United States Postal Service (USPS) and the Address Research System (ADR) as part of the process to locate taxpayers in the notice stream prior to the assignment of an account to a Collection function. In addition to ADR, our Automated Collection System (ACS) and the Collection Field function (Cff) utilize additional locator services on taxpayers whose notice was return to the Service as undeliverable. If a telephone number is located on taxpayers whose notice was returned undeliverable, our ACS policy directs employees to attempt a telephone contact prior to any enforcement action. In Cff, a revenue officer may attempt an in-person contact with the taxpayer prior to enforcement action. In all these instances, a final notice of intent to levy and notice of a right to a collection due process hearing is issued prior to enforcement action. The notice must be given to the taxpayer, left at the residence or place of business or mailed certified. In addition to these taxpayer notification procedures, we have taken other actions specifically aimed at reducing movement of levy proceeds to the XSF. Among these are programming changes to more quickly identify cases where levy releases are necessary, including automatically generating transcripts whenever a levy payment is more than necessary to full pay an account. Prior to these changes, some payments were being sent to the XSF rather than being refunded to the taxpayer. Because we now have a method to identify these situations, levies are released earlier, thereby eliminating a potential for surplus levy funds being transferred to the XSF. Further, the IRM was changed to require cashiers to provide information to ACS Support on any levy proceeds for accounts without a balance. ACS Support then performs research to resolve the credit and immediately release the levy, if appropriate, and initiate a refund.

While we agree that opportunities remain to further improve our management of XSF accounts, we disagree with the National Taxpayer Advocate's position that the majority of IRS guidance associated with XSF research activities is confusing or lacks the clarity needed to resolve unapplied credit issues. We believe that the procedural guidance



provided to our employees are sufficiently clear and that the recent IRM and systems changes implemented or planned for January 2007 will further enhance that guidance.

As previously noted, the specific enhancements being implemented from the XSFTG are aimed at large dollar accounts. We believe that extending these research requirements to substantially lower dollar accounts may not yield significantly better results while substantially increasing IRS costs. However, we will evaluate the possibility of lowering dollar thresholds based on our ability to improve resolution of additional credits through the same or similar methods now in use for large dollar cases.

In summary, the IRS agrees that the movement of payments and credits to Excess Collections were a problem for taxpayers and for the IRS. As a result, an IRS-initiated study has already resulted in significant procedural and systems changes to require enhanced research, additional taxpayer contact, improved levy procedures, and the creation of audit trails to better manage the movement of funds to the XSF. Several additional improvements are scheduled for implementation in 2007. We are also exploring the feasibility and cost-effectiveness of expanding new research and personal contact requirements for credits of less than \$100,000.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the efforts and progress made by the IRS in reducing the number of credits that are moved to the XSF account. However, we express cautious optimism given the fact that as of May 31, 2006 the file still contained nearly \$3.5 billion in unapplied credits.<sup>52</sup> As mentioned, TAS was an active participant in the XSFTG and lent much support and assistance to the numerous IRM procedural changes and systemic enhancements that have recently taken shape. With so many intricacies and players involved, we admit the XSF process is a daunting task to administer. Yet, the IRS's desire to develop and implement uniform procedural improvements to help properly identify millions of dollars of unresolved credits is encouraging.

One of the major changes initiated by the XSFTG was the requirement for employees to conduct additional research on large dollar credit accounts. In the test administered by the XSFTG (and cited in the IRS's response), additional research enabled the IRS to resolve approximately 20 percent of the cases, representing \$2.2 billion in previously unapplied credits. There is no denying the success of this venture; however, we must point out the XSFTG's comprehensive review was limited to identifying improvements that would significantly reduce large dollar credits of \$100,000 or more moving to the XSF. The IRS cited a significant decrease in productivity rates and offered this decrease as one of the main reasons why procedures requiring additional research have not been extended to lower dollar credits (at least until an analysis can be performed to see if the

<sup>52</sup> IRS spreadsheet, *XSF National Totals FY 2003-2007* (using volumes taken from URF6040 Reports (Oct. 2005 through May 2006).

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same positive results can be expected from the increased expenditure of their limited staff resources).

We recognize it is reasonable for the IRS to leverage its resources. However, when the IRS only performs additional treatment on credits satisfying the \$100,000 threshold, it is disparately treating taxpayers with credit balances below the threshold. As we have previously stated, from a taxpayer-focused point of view, the need for a \$1,000 refund can be significant to a low or middle income taxpayer. We believe the IRS should provide the same service to all taxpayers, regardless of the dollar amount and thus, we would welcome participation in a study or task group to explore the feasibility of such a plan. This task group should study ways to automate the additional research, thereby minimizing productivity declines.

The development of a better tracking system and an audit trail to record the issuance of notices are both noteworthy procedural changes. However, if the IRS continually sends notices to the same outdated addresses without conducting research for new information, this process will remain an exercise in futility. The IRS response even acknowledges this futility. It is discouraging to note that although the IRS will admit that its notice process has very little impact, it does not perform additional research or attempt a personal contact unless the balance is \$100,000 or more. It may be that the extra cost for additional research will be recouped by the postage costs no longer expended for multiple letters to wrong addresses.

We also maintain that the majority of IRS guidance associated with XSF research activities is confusing or lacks the clarity needed to resolve unapplied credit issues. We acknowledge that recent and planned IRM changes should help to improve guidance, but it is still difficult to maneuver through the IRM provisions without the benefit of a desk guide or job aid. With at least ten IRS functions conducting XSF activities, it is paramount that each respective IRM clearly define the role and responsibility of each function. A good example is Criminal Investigation, which does not have any written or procedural guidance for the use of XSF, yet placed upwards of \$2.15 million in credits into XSF for FY 2006.<sup>53</sup> The establishment of clear, written procedures as well as training for all functions involved with XSF activities would prove beneficial. The additional guidance would only further enhance the efforts and progress already accomplished toward assisting taxpayers with their filing and payment requirements.

<sup>53</sup> Data provided by CI shows that for CY 2005, 336 accounts totaling \$981,586 moved to XSF. For CY 2006, these figures rose to 1133 accounts and \$2.15 million. IRS, Criminal Investigation Response to TAS Research Request (Aug. 23, 2006).

**RECOMMENDATIONS**

To improve the administration of the Excess Collections File, the National Taxpayer Advocate recommends that the IRS:

- ◆ Evaluate the costs (*e.g.*, postage, downstream resolution, etc.) expended and saved by performing additional research as well as explore other methods to automate this additional research. The IRS should ensure that all employees responsible for the placement and maintenance of funds into XSF have full IRS intranet and Internet access to research internal and external sources for potential addresses and leads. The IRS should clarify the extent of this research, mandate such research on all cases regardless of dollar amount and provide sufficient time for employees to accomplish such duties (preferably a minimum of 14 days to allow for an attempted personal contact and taxpayer response). Furthermore, the IRS should mandate an attempted personal contact be made prior to the manual placement of any funds into XSF, regardless of dollar amount.
- ◆ Provide mandatory training for all employees to reiterate the need to resolve the applicable credit issue at the earliest possible interval. This training should include examples based on actual cases to illustrate the benefits of substantive research and early intervention. The IRS should also develop and implement a desk guide or handbook, similar to the IRS's Reasonable Cause handbook.
- ◆ Require managerial approval on all transfers to XSF, regardless of dollar amount. W&I should conduct quality and operational reviews to ensure all transfers include such documentation.
- ◆ Send a detailed annual notice (much like the CP 89 notice the IRS currently sends to all accounts with installment agreement activity) to notify taxpayers of continuous levy activity. This notice should provide a detailed accounting of the payments received, including the application of such payments, all interest and penalty charges, and the remaining balance due of any existing liabilities.
- ◆ Establish clear, written procedures for Criminal Investigation regarding transfers of payments to the XSF and ensure implementation prior to the conclusion of the 2007 processing year.

**PROBLEM****TOPIC #11****SMALL BUSINESS OUTREACH****RESPONSIBLE OFFICIAL**

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

**DEFINITION OF PROBLEM**

There are 45 million small business or self-employed taxpayers in the United States tax system today.<sup>1</sup> These taxpayers use a wide range of services and products and are increasingly diverse in terms of education, language, and geography. To fulfill their tax obligations, small business taxpayers must deal with tax law complexity, extensive recordkeeping, and regulatory requirements. Many of these taxpayers cannot afford professional tax advice, or see a tax professional only once a year. Still others need face-to-face communication with the IRS.

IRS research indicates that small business and self-employed taxpayers account for about 44 percent<sup>2</sup> of the \$345 billion tax gap,<sup>3</sup> which is the single largest element of the gap.<sup>4</sup> To make any meaningful dent in the tax gap, the IRS must ascertain why small business and self-employed taxpayers have such difficulty in complying with their tax obligations and educate these taxpayers about how to avoid problems.

The IRS's Small Business/Self-Employed division (SB/SE) is not adequately helping its taxpayer base to understand and comply with its tax obligations. Problems with SB/SE's current outreach program include:

- ◆ SB/SE's recent reorganization of its taxpayer education office reduced staffing dedicated to outreach and education, leaving 12 states without a local stakeholder liaison;<sup>5</sup>

<sup>1</sup> Small Business/Self-Employed Division At-a-Glance at <http://www.irs.gov/irs/article/0,,id=149199,00.html>.

<sup>2</sup> One hundred fifty-three billion dollars of the \$345 billion gross tax gap is attributable to SB/SE taxpayers as follows: underreported business income by individuals (*i.e.*, self-employed Schedule C filers): \$109 billion; underreported self-employment tax: \$39 billion; underreported income by small corporations: \$5 billion. The gross tax gap also includes \$15 billion in underreported FICA and unemployment taxes and \$32 billion in overstated adjustments, deductions, exemptions, and credits. A substantial portion of these latter three amounts is likely attributable to SB/SE taxpayers, but the exact amount is not known. *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

<sup>3</sup> The "tax gap" or "gross tax gap" is the gap between the amount of tax imposed by law and the amount voluntarily and timely paid by taxpayers for a given tax year. The "net tax gap" is the portion of the gross tax gap that will remain uncollected after all IRS and taxpayer actions have been completed for a given tax year. Taxpayers who underreport business income on individual returns account for \$109 billion of the gross tax gap and those who underreport self-employment taxes account for another \$39 billion – a yearly total of \$148 billion. *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

<sup>4</sup> *See* IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006) (accompanying charts).

<sup>5</sup> Communications, Liaison, and Disclosure Org Charts, Stakeholder Liaison Field (May 2006). The states without Stakeholder Liaison representatives are: Delaware, Hawaii, Idaho, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Vermont, West Virginia, and Wyoming.

- ◆ SB/SE does not have a five-year plan for addressing the taxpayer service, outreach, and educational needs of small business and self-employed taxpayers, including the needs of the Limited English Proficiency (LEP) and disabled populations;<sup>6</sup>
- ◆ SB/SE does not conduct research or focus groups to obtain information about the characteristics and needs of small business and self-employed taxpayers;
- ◆ SB/SE does not measure or monitor the effectiveness of its outreach activities; and
- ◆ SB/SE focuses its outreach efforts on practitioner and professional organizations, hoping that the information passed on to these organizations will trickle down to actual taxpayers, but this approach presents practical problems.

Because small business and self-employed taxpayer education and outreach are critical to voluntary compliance, the IRS must target, monitor, and measure its education and outreach efforts to ensure that they have the maximum possible impact.

#### ANALYSIS OF PROBLEM

##### Characteristics of SB/SE Taxpayers

Small businesses play an important part in the U.S. economy. Small businesses with less than 500 employees represent 99.7 percent of all employer firms, employ over half of all private sector workers, and pay more than 45 percent of the total U.S. private payroll.<sup>7</sup> In addition, small businesses created 60 to 80 percent of net new jobs annually over the past decade.<sup>8</sup>

Diversity among small businesses is increasing. Hispanic Americans are opening their own businesses at a rate of three times the national average.<sup>9</sup> Immigrants have also increased their share of the self-employed sector, representing 14.7 percent of the total self-employed in 2003 – up from 10.9 percent in 1994.<sup>10</sup>

Information from a 2002 U.S. Census Bureau survey of 20.5 million business owners indicates 28 percent of the owners of non-employer firms have a high school education or less. A bachelor's degree was the highest level completed by over 20 percent of all

<sup>6</sup> For a further discussion of LEP taxpayers see Most Serious Problem, *Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance*, *infra*. For a further discussion of difficulties that taxpayers with disabilities face, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities*, *infra*.

<sup>7</sup> The U.S. Small Business Administration (SBA) defines small businesses as those having less than 500 employees. The IRS defines small businesses as corporations and partnerships with assets of \$10 million or less, and self-employed taxpayers. Small Business/Self-Employed Division At-a-Glance at <http://www.irs.gov/irs/article/0,,id=149199,00.html>.

<sup>8</sup> U.S. Small Business Administration, *Frequently Asked Questions*, at <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24>.

<sup>9</sup> President's address to the Small Business Week Conference at <http://www.whitehouse.gov/infocus/small-business/> (Apr. 13, 2006).

<sup>10</sup> Robert W. Fairlie, *Self-Employed Business Ownership Rates in the United States: 1979-2003 Research Summary 6* (2004) at <http://www.sba.gov/advo/research/rs243tot.pdf>.

owners of both employer and non-employer firms.<sup>11</sup> The survey was not exclusive to small businesses, but almost 15 million of the 20.5 million owners responding represented firms with no employees.

Unfortunately, small businesses bear a disproportionate share of the federal regulatory burden. Small businesses with less than 20 employees pay 67 percent more per employee for tax compliance than large businesses with over 500 employees. Medium size firms, with 20 to 499 employees, pay 21.5 percent more than large firms.<sup>12</sup>

### Small Business Taxpayers and the Tax Gap

The gross federal tax gap, which stands at approximately \$345 billion,<sup>13</sup> is the difference between what taxpayers should have paid and what they actually paid on a timely basis. The “net tax gap,” an estimated \$290 billion, is the portion of the gross tax gap that will remain uncollected after the IRS and the taxpayer complete all actions for a given tax year.<sup>14</sup> Although nonfiling, underreporting, and underpayment all contribute to the tax gap, its single largest component, about 44 percent, is attributable to underreporting by self-employed taxpayers.<sup>15</sup> Because these taxpayers account for the largest portion of the tax gap, the IRS strategy for addressing the gap must include an understanding of non-compliance by small business and self-employed taxpayers.

### The IRS and the Small Business Taxpayer

#### *The Small Business/Self-Employed Division*

Like the other IRS operating divisions, the Small Business/Self-Employed Division (SB/SE) was formed in 2000 as a result of the IRS Restructuring and Reform Act of 1998 (RRA 98). RRA 98 required the IRS to realign its operations around groups of taxpayers with similar needs and place a greater emphasis on serving taxpayers and meeting these needs.<sup>16</sup>

SB/SE has stewardship over seven million small businesses, including corporations and partnerships with assets of \$10 million or less, and approximately 33 million self-employed taxpayers and supplemental income earners.<sup>17</sup> SB/SE is responsible for

<sup>11</sup> U.S. Census Bureau, *Characteristics of Business Owners: 2002*, at <http://www.census.gov/csd/sbo/cbosummaryoffindings.htm>

<sup>12</sup> W. Mark Crain, *The Impact of Regulatory Costs on Small Firms, Small Business Research Summary* at <http://www.sba.gov/advo/research/rs264tot.pdf> (Sept. 2005).

<sup>13</sup> IRS News Release, IRS Updates Tax Gap Estimates (Feb. 14, 2006).

<sup>14</sup> *See id.* (accompanying charts).

<sup>15</sup> *See* footnote 2, *supra*.

<sup>16</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998) §§ 1001-1002.

<sup>17</sup> Small Business/Self-Employed Division At-a-Glance at <http://www.irs.gov/irs/article/0,,id=149199,00.html> (last visited Oct. 24, 2006).

ensuring these taxpayers are compliant, but also for helping them understand and comply with their tax obligations.

### *The Small Business/Self-Employed Taxpayer's Compliance Burden*

Like all taxpayers, SB/SE taxpayers must determine their taxable income and the tax they owe on that income. But unlike most of their wage or salary earning counterparts, SB/SE taxpayers generally must make determinations that can be quite complex. Numerous sets of layered rules dictate which expenses a business can deduct, how many of these expenses are deductible, and even when the business is entitled to take the deductions. To complicate matters even more, the rules governing income and expenses for tax purposes are often different than the rules a business must use to determine its income for internal bookkeeping and financial reporting purposes. Further, determining taxable income and the applicable tax is just the beginning of the complexity that businesses face. SB/SE taxpayers must also navigate the numerous rules governing employment taxes, overlapping filing and deposit requirements, and various factors that govern whether a worker should be classified as an employee or an independent contractor.

Large corporations also face complexities, but they generally have full-time tax experts on staff and can afford the help of outside tax professionals as well. Many SB/SE taxpayers, on the other hand, must deal with comparable tax complexities on their own or with limited professional assistance.<sup>18</sup> There is also evidence suggesting that many taxpayer errors are inadvertent, rather than deliberate attempts at noncompliance.<sup>19</sup> For these reasons, small business and self-employed taxpayers carry a disproportionate share of tax compliance burdens and need additional assistance from the IRS to prevent errors and underreporting.<sup>20</sup>

### **The TEC Vision**

When SB/SE “stood up” after RRA 98, it contained three functional organizations: Compliance, Customer Account Services (CAS), and Taxpayer Education and Communications (TEC). TEC was created to proactively deliver the specialized education and outreach programs that small business taxpayers need to comply with their tax obligations.

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<sup>18</sup> See Russell Marketing Research, Inc, *Findings From Task 149 – The Taxpayer Advocate Service Research Program* (Sept. 2002) (on file with the Taxpayer Advocate Service).

<sup>19</sup> See *A Closer Look at the Size and Sources of the Tax Gap*, Hearing before the Senate Subcommittee on Taxation and IRS Oversight, Committee on Finance (July 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate) (available at <http://finance.senate.gov/hearings/testimony/2005test/072606no.pdf>).

<sup>20</sup> A recent study by the U.S. Small Business Administration Office of Advocacy found that small firms pay 67 percent more to comply with the tax laws than do their counterparts at large firms. See W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2005), available at <http://www.sba.gov/advo/research/rs264tot.pdf>.

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ONE

Taxpayer education was an essential component of the IRS when it restructured under RRA 98.<sup>21</sup> Compliance and CAS existed before then, but TEC was a new unit with new responsibilities. The IRS designed TEC to serve small business and self-employed taxpayers, primarily by educating them about their tax obligations.<sup>22</sup> The IRS believed that providing up-front education and assistance to business taxpayers would reduce the need for future compliance actions, thereby reducing taxpayer burden and IRS operating costs.<sup>23</sup> TEC was to advance its education and outreach programs through partnerships with government agencies, small business organizations, tax practitioner groups, and other stakeholders.

These stakeholders expressed a strong interest in TEC. At a Senate Small Business Committee meeting in May 2000, witnesses stated the creation of TEC was the most important change the IRS was making.<sup>24</sup> One witness testified:

The strategy behind the establishment of TEC, which I think is excellent, is to assist taxpayers initially to avoid or reduce problems and burden in the filing and post-filing phases. Basically, if you solve a problem on the front or educate the taxpayer on the front end, you will not have problems later on.<sup>25</sup>

The IRS planned to start TEC with approximately 329 employees in FY 2001 and increase staffing incrementally.<sup>26</sup> By FY 2002, TEC was to have over 1,200 staff in 15 major field locations and an annual budget of \$60 million.<sup>27</sup> IRS management believed this approach would be consistent with its vision of maintaining program quality while developing new products and work processes.<sup>28</sup> TEC initially appeared to be meeting this challenge, but recent developments have called its effectiveness into question.

<sup>21</sup> National Commission on Restructuring the Internal Revenue Service, *A Vision for a New IRS* 8 (Jun. 25, 1997).

<sup>22</sup> General Accounting Office, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit 2* (May 7, 2003).

<sup>23</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149, *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 6 (Sept. 2000).

<sup>24</sup> *IRS Restructuring: A New Era for Small Business, Hearing before the Senate Comm. on Small Business*, 106th Cong. 2nd Sess. (May 23, 2000) (testimony of Sandra A. Abalos, CPA, President, Abalos & Associates, P.C., Phoenix, Arizona and testimony of Roy M. Quick, Jr., Enrolled Agent, Principal, Quick Tax & Accounting Service, St. Louis, Missouri).

<sup>25</sup> *IRS Restructuring: A New Era for Small Business, Hearing before the Senate Comm. on Small Business*, 106th Cong. 2nd Sess. (May 23, 2000) (testimony of Roy M. Quick, Jr., Enrolled Agent, Principal, Quick Tax & Accounting Service, St. Louis, Missouri).

<sup>26</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149, *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 8 (Sept. 2000).

<sup>27</sup> General Accounting Office, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit 2* (May 7, 2003).

<sup>28</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-30-149, *Management Advisory Report: The Small Business/Self-Employed Division Will Substantially Stand Up on October 1, 2000* 8 (Sept. 2000).



## The TEC Reality

### *Initial Praise for TEC*

At the outset, TEC was generally considered a success by the IRS and external stakeholders alike. Former IRS Commissioner Charles Rossotti stated in his September 2002 report to the IRS Oversight Board that, “Seriously engaging key stakeholders as a regular part of the decision-making process has shown that it improves the final product; shortens the time for decisions and implementation; and strengthens relationships.”<sup>29</sup> TEC was named the Small Business Administration’s (SBA’s) agency of the year in 2002 for what the SBA called its outstanding progress in creating an effective education and compliance assistance program for small businesses and the self-employed.<sup>30</sup>

### *TEC Realignment*

In October 2005, SB/SE merged TEC with other outreach and communications organizations in the division to form the Communication, Liaison, and Disclosure (CLD) function.<sup>31</sup> The new organization includes five program areas:

- ◆ Communications;
- ◆ Stakeholder Liaison – Headquarters (SL – HQ);
- ◆ Stakeholder Liaison (SL – Field);
- ◆ Office of Governmental Liaison and Disclosure (GLD); and
- ◆ Policy and Strategic Planning (PSP).<sup>32</sup>

Upon realignment of TEC into CLD, SB/SE stated, “greater emphasis will be given to using technology to leverage messages and activities, ensuring the level of service will not diminish.”<sup>33</sup> Within CLD, Stakeholder Liaison is the functional unit formerly known as TEC. In February 2005, prior to the realignment, TEC had 536 employees.<sup>34</sup> After the realignment, Stakeholder Liaison staffing included 183 employees in the field and 36 in headquarters.<sup>35</sup> *These 219 employees are fewer than the 329 employees TEC had at its inception and considerably fewer than the 1200 that SB/SE first envisioned for a successful*

<sup>29</sup> IRS Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board Assessment of the IRS and the Tax System* 7 (Sept.2002).

<sup>30</sup> See *Closing the Tax Gap and the Impact on Small Businesses*, Hearing Before the H. Comm. On Small Business, 109th Cong (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, SBLC).

<sup>31</sup> When SB/SE stood up there were three operating divisions, CAS, TEC, and Compliance. Government Liaison and Disclosure (GLD), which was originally aligned with IRS Communications and Liaison, was subsequently realigned under SB/SE in March 2004. SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

<sup>32</sup> SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

<sup>33</sup> “It’s Official: CLD Stands Up” (Oct. 11, 2006) available at [http://sbse.web.irs.gov/dd/NEWCLD\\_Organization.htm](http://sbse.web.irs.gov/dd/NEWCLD_Organization.htm).

<sup>34</sup> SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

<sup>35</sup> *Id.* During FY 2005, prior to the realignment of TEC into CLD, SB/SE offered a voluntary return to compliance positions to TEC employees who were interested and qualified. Approximately 157 employees took advantage of the offer.

*educational and communications organization.*<sup>36</sup> Twelve states have no Stakeholder Liaison representative within the state.<sup>37</sup>

#### *Current Delivery of Education and Outreach*

In its FY 2006 program letter, SB/SE committed that the new CLD unit would:

- ◆ Work with the Taxpayer Burden Reduction (TBR) unit to deliver key messages and products through appropriate stakeholder channels;<sup>38</sup>
- ◆ Ensure effective and timely communications with key stakeholder groups;
- ◆ Collaborate with appropriate business owners to develop outreach products targeted towards sectors of greatest non-compliance;
- ◆ Use this information to develop and implement a strategy to deliver key messages through liaison activities;
- ◆ Determine appropriate liaison channels and activities in order to consistently implement the delivery of key messages targeting identified sectors of non-compliance; and
- ◆ Conduct routine focus groups at the national and local levels with practitioners and stakeholders to ensure the overall effectiveness of communications and delivery channels.<sup>39</sup>

The Taxpayer Advocate Service (TAS) asked SB/SE to provide the number and details of outreach events it has conducted. SB/SE gave us the total number of events but provided only limited information about the different types of outreach within the total.

<sup>36</sup> In FY 2004, 93 TEC FTEs were devoted to compliance. SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006).

<sup>37</sup> CLD Org Charts, SL Field (May 2006). The states without Stakeholder Liaison representatives are: Delaware, Hawaii, Idaho, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Vermont, West Virginia, and Wyoming.

<sup>38</sup> The IRS formed the Office of Taxpayer Burden Reduction (TBR) in 2002 as part of the effort to reduce unnecessary burden on taxpayers. TBR's efforts to reduce taxpayer burden include: simplifying forms and publications, promoting less burdensome rulings and laws, and streamlining internal policies and procedures. TBR Handbook, *Taxpayer Education and Communication* 1-3 (April 2004).

<sup>39</sup> SB/SE Communications, Liaison and Disclosure (CLD) *FY 2006 Program Letter*, provided in SB/SE Response to Taxpayer Advocate Information Request (Oct 5, 2006).

TAS reconstructed the chart below from the CLD calendar of outreach events during 2006.<sup>40</sup>

**TABLE 1.11.1, SB/SE 2006 OUTREACH EVENTS**

Event Type	Number of Events
Payroll and Practitioner Local Liaison Meeting, Seminar or Event	545
Tax Practitioner Institute Classes	22
Leveraged Small Business Tax Workshops	285
Small Business Industry	99
Governmental Liaison	37
Other Event	70
<b>Total Events</b>	<b>1,058</b>

The Leveraged Small Business Tax Workshop is the only type of outreach event that specifically targets small business owners directly.<sup>41</sup> Although SB/SE conducted 285 of these workshops nationwide during this period, it held no workshops at all in 25 of the 50 states.<sup>42</sup> The other types of outreach are delivered to practitioners and small business industry organizations. Of the 545 Payroll and Practitioner Local Liaison Meeting Seminar outreach events, SB/SE delivered more than half by phone forum or “virtual seminar.”<sup>43</sup> Since SB/SE does not measure the effectiveness of outreach activities, the division cannot determine if these efforts were successful and which types of events are more successful than others.<sup>44</sup>

<sup>40</sup> The Calendar of Events reflects information from February through December 2006. It includes details such as type of event (small business workshop or payroll & practitioner liaison meeting, etc) format (phone forum or actual meeting); location; and for some events, estimated number of attendees. This chart includes events conducted from February 2006 through September 30, 2006. CLD Calendar of Events on SB/SE website at [http://sbse.web.irs.gov/cl2/sl/Events\\_Calendar/default.asp](http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp).

Payroll and Practitioner Local Liaison Meeting, Seminar, or Event is a meeting or seminar for the tax professional community. Tax Practitioner Institute Classes are events that qualify for CPE credit and are performed in conjunction with a university, college or other educational institution. Leveraged Small Business Tax Workshops are workshops designed to help the small business owner. Small Business Industry is an event where the audience is a small business or industry stakeholder. Other Events are events that do not fit into the other categories. The CLD Calendar of Events also includes Governmental Liaison which includes events for federal, state, or local government agencies.

<sup>41</sup> *User's Guide Small Business and Self-Employed Communications, Liaison & Disclosure (CLD) Calendar of Events*, Appendix A, Types of Events 7 (Jul. 2006), available at [http://sbse.web.irs.gov/cl2/sl/Events\\_Calendar/default.asp](http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp).

<sup>42</sup> CLD Calendar of Events on SB/SE website at: [http://sbse.web.irs.gov/cl2/sl/Events\\_Calendar/default.asp](http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp) The states that had no Leveraged Small Business Workshops between February 2, 2006 and September 30, 2006 are Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Indiana, Kansas, Kentucky, Maine, Massachusetts, Mississippi, Montana, Nevada, New Hampshire, New Jersey, Rhode Island, Vermont, Washington, West Virginia, and Wyoming.

<sup>43</sup> CLD Calendar of Events on SB/SE website at [http://sbse.web.irs.gov/cl2/sl/Events\\_Calendar/default.asp](http://sbse.web.irs.gov/cl2/sl/Events_Calendar/default.asp). Of the 545 outreach events classified as Payroll and Practitioner Local Liaison, Meeting, Seminar, or Event, 331 were conducted by telephone (either by phone forum or virtual seminar via telephone).

<sup>44</sup> SB/SE response to Taxpayer Advocate Service Request (Sept. 5, 2006). (“There are no measures for outreach activities for any period.”).

*Delivery Methods and Channels*

The Internet has dramatically changed the way the IRS communicates with taxpayers. The IRS website at <http://www.irs.gov> is one of the most frequently visited sites in the world, with 121.9 million “hits” during the 2006 filing season.<sup>45</sup> SB/SE has made commendable efforts to educate small business taxpayers with online resources such as:

- ◆ The Small Business and Self-Employed Online Classroom;
- ◆ The Small Business Resource Guide; and
- ◆ The Virtual Small Business Forum.

Taxpayers can order this information in a number of formats, such as CD-ROM or DVD, directly from the IRS website or by telephone.

While SB/SE has developed impressive products to provide outreach and education to small business taxpayers through electronic channels, the IRS needs to assess the effectiveness of this method of delivery. Some small businesses may be best served by face-to-face meetings with IRS representatives. The IRS website may be difficult to navigate for taxpayers who have little or no computer skill, or may be hard to understand for those who are unfamiliar with tax law and procedures. While surveys show that approximately 73 percent of American adults use the Internet,<sup>46</sup> only 54 percent of these users reported they had sought information from a government website.<sup>47</sup> The effectiveness of SB/SE’s outreach materials on the IRS website is unclear. SB/SE has conducted research to gauge the effectiveness of its web-based outreach materials with respect to tax practitioners, but TAS is unaware of any SB/SE research designed to determine whether actual small business or self-employed taxpayers access the IRS site, and if they do access it, how well they are able to navigate and use the site.<sup>48</sup> Thus, it is possible that a significant number of small business and self-employed taxpayers will not obtain compliance information from the IRS site.

*Tax Practitioners*

In April 2006, then-SB/SE Commissioner Kevin Brown testified that CLD has built an outreach and education program to reach thousands of stakeholders, and through them, millions of small business taxpayers.<sup>49</sup> These stakeholders are “national and local partners, including practitioner organizations, small business and industry associations,

<sup>45</sup> There were 121,859,609 hits to IRS.gov in 2006 as of the week ending April 22, 2006. W&I Strategy & Finance Survey Administration & Analysis, 2006 Filing Season Reports.

<sup>46</sup> Pew Internet & American Life Project, *February 15 – April 6, 2006 Tracking Survey*, available at [http://www.pewinternet.org/trends/User\\_Demo\\_4.26.06.htm](http://www.pewinternet.org/trends/User_Demo_4.26.06.htm).

<sup>47</sup> Pew Internet & American Life Project, *Tracking surveys (March 2000-April 2006)*, available at [http://www.pewinternet.org/trends/Internet\\_Activities\\_7.19.06.htm](http://www.pewinternet.org/trends/Internet_Activities_7.19.06.htm).

<sup>48</sup> SB/SE conducted focus groups in 2003 with practitioners regarding the practitioners’ use of the IRS website. 2003 Nationwide Tax Forums Focus Groups, *Taxpayer Education and Communications* 5-13 (2003).

<sup>49</sup> *IRS’s Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business*, 109th Cong. 2nd Sess. (Apr. 5, 2006) (testimony of Kevin M. Brown, Commissioner, SB/SE).

and federal and state agencies and governments.”<sup>50</sup> SB/SE believes the information provided to these stakeholders will trickle down to taxpayers.<sup>51</sup> Thus, Stakeholder Liaison (SL) has concentrated most of its efforts on these practitioner and trade associations. These efforts can be effective in providing important information to practitioners and trade association representatives, but there are practical problems with attempting to reach the large number of varied and diverse small business and self-employed taxpayers in this manner.

### Concerns with SB/SE Outreach

In addition to concerns with SB/SE’s methods of delivering taxpayer education, services, and outreach, the National Taxpayer Advocate also has concerns about the overall effectiveness of the division’s taxpayer outreach and education programs.

#### *Planning, Focus, and Measures*

While CLD does have a mission statement and issues annual program letters, there is no indication that SB/SE’s Stakeholder Liaison program has developed a five-year strategic plan.<sup>52</sup> CLD’s fiscal year 2007 program letter divides Stakeholder Liaison into Headquarters and Field functions (“SL HQ” and “SL Field,” respectively). SL HQ “focuses on national engagement of the payroll and practitioner community and stakeholder organizations to provide information about IRS policies, practices, and procedures to ensure compliance with the tax laws, both by voluntary means and through enforcement programs; [and] oversees IRS involvement in disaster assistance and emergency relief activities.”<sup>53</sup> SL Field:

Focuses on local engagement of the payroll and practitioner community and stakeholder organizations to provide information about IRS policies, practices and procedures to ensure compliance with the tax laws; aligns SL Field activities with

<sup>50</sup> *IRS’s Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business, 109th Cong. 2nd Sess. (Apr. 5, 2006)* (testimony of Kevin M. Brown, Commissioner, SB/SE) (“Some of these relationships include the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the U.S. Chamber of Commerce, the National Association of the Self-Employed, the National Federation of Independent Businesses, the Small Business Legislative Council, the Small Business Administration, the Federation of Tax Administrators, and the National Association of State Workforce Agencies”).

<sup>51</sup> *See IRS’s Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing before the H. Comm. On Small Business, 109th Cong. 2nd Sess. (Apr. 5, 2006)* (testimony of Kevin M. Brown, Commissioner, SB/SE).

<sup>52</sup> CLD’s mission statement says, “The mission of CLD is to develop and deliver integrated strategic communications and educational products to SB/SE employees and taxpayers and to our key SB/SE partners in tax administration including federal, state and local governmental agencies, practitioners, and industry groups. CLD is responsible for programs and activities in support of both the SB/SE and the IRS Strategic Plans including the administration of IRC §6103, the Freedom of Information and Privacy Act, and coordinates the IRS National Disaster Assistance Program.” SB/SE Communications, Liaison and Disclosure, *Fiscal Year 2007 Program Letter*.

<sup>53</sup> SB/SE Communications, *Liaison and Disclosure Fiscal Year 2007 Program Letter*.

the IRS goals to improve taxpayer service, enhance enforcement of tax law and modernize the IRS through its people, processes and technology.<sup>54</sup>

Neither of these statements indicates that Stakeholder Liaison has developed a plan to ensure that SB/SE taxpayers receive *effective* education and assistance.

Additionally, neither these statements nor the fiscal year 2007 program letter indicate any planned research or focus groups to help the IRS better understand the characteristics and needs of small business and self-employed taxpayers. Without this information, SB/SE cannot tailor its outreach and education efforts to best serve these taxpayers and meet their specific needs.<sup>55</sup>

Further, SB/SE has not implemented a system to determine whether the new Stakeholder Liaison program is providing taxpayers with the same level of service they received under TEC. In fact, SB/SE does not measure its outreach efforts at all and has no measure of what constitutes a success with respect to its outreach and educational activities.<sup>56</sup> Without a measurement system, it is not possible for SB/SE to honor its commitment to provide its customers with the same level of service<sup>57</sup> under the new organization because SB/SE cannot know what “level of service” it is providing. The absence of planning, focus, and measures represents serious deficiencies in the Stakeholder Liaison program.

The Taxpayer Assistance Blueprint (TAB) initiative may serve as a model for SB/SE to correct some of these deficiencies. In July 2005, Congress instructed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to “undertake a comprehensive review of its current portfolio of [IRS] taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers.”<sup>58</sup> The TAB is headed by the IRS Wage and Investment Division (W&I) and is focused on individual taxpayers.<sup>59</sup>

<sup>54</sup> SB/SE Communications, *Liaison and Disclosure Fiscal Year 2007 Program Letter*.

<sup>55</sup> Notably, the fiscal year 2007 program letter does indicate that SB/SE recognizes the increasing Spanish speaking taxpayer population. The program letter says that CLD’s Communication function will partner with SL HQ to “consider minority-based outreach, including multi-lingual products, as appropriate.” Additionally, CLD’s Governmental Liaison and Disclosure arm will partner with SL Field to “provide effective outreach to their government and industry stakeholders, especially on issues related to the small business Spanish Speaking Taxpayer.” SB/SE Communications, Liaison and Disclosure *Fiscal Year 2007 Program Letter*. Because Spanish speaking small business and self-employed taxpayers are the fastest growing segment of SB/SE’s taxpayer base, CLD should make efforts to more clearly define and expedite its outreach and education efforts to these taxpayers.

<sup>56</sup> SB/SE response to Taxpayer Advocate Service Request. (Sept. 5, 2006). (“There are no measures for outreach activities for any period.”).

<sup>57</sup> “Greater emphasis will be given to using technology to leverage messages and activities, ensuring the level of service will not diminish.” “It’s Official: CLD Stands Up” (Oct.11, 2006) available at [http://sbse.web.irs.gov/dd/NEWCLD\\_Organization.htm](http://sbse.web.irs.gov/dd/NEWCLD_Organization.htm).

<sup>58</sup> S. Rep. No. 109-109, 133-34 (2005).

<sup>59</sup> See IRS, *The 2006 Taxpayer Assistance Blueprint: Phase I*, 19.

The TAB is a two-phase process. In Phase I (which has been completed), the TAB team identified and developed numerous research projects to quantify the services individual taxpayers need from the IRS and the channels through which they prefer to receive these services. Based on its preliminary research in Phase I, the team developed specific strategic improvement themes.

Phase II of TAB is now underway, and has the following objectives:

- ◆ Refine the IRS's understanding of taxpayer needs, preferences, and expectations;
- ◆ Identify and prioritize taxpayer services improvement recommendations;
- ◆ Develop customer-centric and efficiency service metrics;
- ◆ Establish an ongoing process to assess customer needs and correlate that assessment with compliance findings from the National Research Program; and
- ◆ Address the challenges of effectively and efficiently aligning service content, delivery, and resources with taxpayers' and partners' expectations.<sup>60</sup>

To meet these objectives, the TAB is conducting 27 major research studies to learn more about general tax services offered, the taxpayers who use the services, and their impact.<sup>61</sup>

Although the TAB is a major undertaking, TAS believes that SB/SE must do the research necessary to understand the characteristics and needs of its taxpayers, and should develop an interactive five-year plan for delivering effective outreach and education to small business taxpayers. It may not be necessary for SB/SE to do all of this work on its own. SB/SE can and should use information available from other IRS functions and other government agencies.<sup>62</sup> But to effectively serve taxpayers, SB/SE must clearly understand its customer base and what these taxpayers need.

### *Outreach Through Practitioners*

As explained above, SB/SE has concentrated its outreach efforts on practitioners, generally through outreach to practitioners and trade associations. While this approach may appear efficient, and in many cases does provide important information to practitioners and trade associations, it presents at least four practical problems:

- ◆ First, some business taxpayers cannot afford the regular advice of tax professionals. Most small business taxpayers hire preparers to prepare their annual returns,

<sup>60</sup> See Taxpayer Assistance Blueprint (TAB) Phase 2 Congressional Status Briefing (Sept. 28, 2006).

<sup>61</sup> *Id.*

<sup>62</sup> Global Hue, *Qualitative Hispanic Market Research* 9 (May 2003); Global Hue, *Hispanic LEP Taxpayer Research Quantitative Report* (June 2003); U.S. Census Bureau News Release, *Growth of Hispanic-Owned Businesses Triples the National Average* (Ma. 21, 2006) [http://www.census.gov/Press-Release/www/releases/archives/business\\_ownership/006577.html](http://www.census.gov/Press-Release/www/releases/archives/business_ownership/006577.html); Robert W. Fairlie, *Self-Employed Business Ownership Rates in the United States: 1979-2003 Research Summary 6* (2004) at <http://www.sba.gov/advo/research/rs243tot.pdf>; U.S. Census Bureau, *Characteristics of Business Owners: 2002*, at <http://www.census.gov/csd/sbo/cbosummaryoffindings.htm>. See also Most Serious Problem, *Limited English Proficiency Taxpayers: Language and Cultural Barriers to Tax Compliance*, *infra*.

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but handle other IRS matters without assistance.<sup>63</sup> Some “mom and pop” type businesses may deal with the IRS by themselves. According to IRS research, approximately 21 percent of small business taxpayers do not use practitioners to prepare their returns.<sup>64</sup> While leveraging IRS resources through practitioners and professional associations may be an economical use of limited resources, the IRS should also consider the needs of business taxpayers who do not use or cannot afford professional tax assistance. The messages delivered through practitioners do not reach these taxpayers. Face-to-face outreach gives taxpayers a chance to address their questions and concerns directly to the IRS and helps the IRS to identify areas of taxpayer confusion and concern.

- ◆ Second, SB/SE does not measure the effectiveness of its outreach to practitioners and trade associations. Without a plan to determine whether the actual small business and self-employed taxpayers are receiving the messages SB/SE communicates with its “partners,” the IRS does not know if conducting outreach through practitioners and industry groups is an effective way to target these taxpayers – or even if these taxpayers are receiving the messages at all.
- ◆ Third, because Stakeholder Liaison has no presence in a dozen states, it may not be able to develop effective relationships with the practitioner community in these areas. Even if SB/SE attempts to provide outreach to practitioners in these states on a regional or even a “traveling” basis, without establishing a permanent, continuing relationship with these stakeholders, practitioners may not know when the substitute outreach events are being held. These practitioners will also be less likely to turn to Stakeholder Liaison when specific issues come up because the practitioners will not know who to contact or may not feel a local connection with the IRS liaison. This arrangement may set the Stakeholder Liaison up for failure, or at best, limit its effectiveness.
- ◆ Fourth, IRS relationships with practitioner and professional organizations can be damaged by miscommunication. For example, we are aware of at least one instance where SB/SE solicited input from a practitioner organization at the organization’s annual IRS liaison meeting, invited representatives to attend a meeting in IRS headquarters to discuss their concerns, received suggestions on how to better administer a particular SB/SE program, and failed to act on these suggestions – or to communicate to the practitioner organization whether it was even considering the suggestions. This organization expressed displeasure and frustration with the IRS at its next liaison meeting. When SB/SE fails to maintain its practitioner and

<sup>63</sup> See Russell Marketing Research, Inc, *Findings From Task 149 – The Taxpayer Advocate Service Research Program* (Sept. 2002).

<sup>64</sup> IRS, *Business Master File, BMF-2006-0039*. The report, which SB/SE requested, analyzed the percentage of forms 1040 Schedule C, Forms 1065, Forms 1120S, and Forms 1120 for corporations with assets less than \$10 million that did not use paid tax preparers. The report used data from processing years 2004 and 2005. Twenty-six percent of 1040 schedule C’s were self-prepared; 14 percent of Forms 1065, five percent of Forms 1120S and 13 percent of the corporate returns were self-prepared. Overall, 21 percent of small business and self-employed tax returns were self-prepared.



professional organization relationships, it loses credibility and decreases the likelihood that these organizations will distribute outreach information to their clients and members.

### *SB/SE Research*

Although it can and must do more to understand the characteristics and needs of its customer base, SB/SE has recently performed some industry specific research to gauge the effectiveness of certain outreach initiatives. SB/SE's research unit looked at the effect of targeted outreach to taxpayers in the restaurant and construction industries (Targeted Research Study) with the goal of finding out whether these targeted programs are effective in general.<sup>65</sup> In the restaurant industry, three out of five tests indicated outreach has a significant effect.<sup>66</sup> However, the study of the construction industry found no evidence that outreach increased compliance in the issuance of Form W2, Employee's Wage and Tax Statement, and Form 1099-MISC, Miscellaneous Income.<sup>67</sup> Although inherent differences between the industries could explain the divergent results, there was also a difference in how the outreach was delivered. SB/SE provided one-on-one, face-to-face outreach to restaurant owners and managers<sup>68</sup> but delivered outreach to the construction sector through industry publications and association meetings.<sup>69</sup> This research project was not designed to test the effectiveness of one outreach program over another and is not conclusive. Still, the results indicate SB/SE needs to measure more closely the effect of particular methods of outreach.

Another SB/SE research project (Construction Study Phase I) sought to measure the effect of TEC outreach on the construction industry's employment tax filing compliance.<sup>70</sup> The survey showed relative improvement in these areas:

<sup>65</sup> SB/SE Research Report, Project No. SEA0004, *The Effect of Targeted Outreach on Compliance 2* (May 2006).

<sup>66</sup> *Id.* at 7. The restaurant industry outreach was delivered during November and December of 2003. The primary measure included the change in proportion of taxpayers or entities in compliance. Specifically, for tip reporting compliance, the measure was the proportion of taxpayers reporting any tip wages on Form 941. The tip reporting outreach appeared to have a significant positive effect on compliance, except among those taxpayers not reporting this before and among taxpayers new to the market segment.

<sup>67</sup> *Id.* The construction industry outreach has been delivered continually since 2003. The effectiveness of the construction industry outreach was tested using three measures: issuance of Form W2, Issuance of Form 1099-MISC (Non Employee Compensation) and filing those forms electronically. Form 1099-MISC is used to report rents, royalties, prizes, awards, and other fixed determinable income including nonemployee compensation. The study also looked at growth in e-filing of these forms which is a compliance issue. An important IRS goal is to increase the number of tax returns e-filed because RRA 98 established the goal for the IRS of having 80 percent of all federal tax and information returns filed electronically by the year 2007.

<sup>68</sup> *Id.* at 16.

<sup>69</sup> *Id.* at 25.

<sup>70</sup> SB/SE Research Report, Project NO. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes 27* (July 2004). The project compared each business's third-quarter 2002 Form 941 against that of the third quarter 2003. The fourth-quarter 2003 Form 941 was also analyzed. This project was a panel study in which the same businesses were tracked each quarter. The market segment of interest was the construction industry. The control groups were retail, transportation, and real estate industries, which were used to determine if the changes in the construction industry's compliance represent random fluctuation or a response to the general outreach.

- ◆ Failure to Deposit (FTD) penalties increased at a slower rate than in the control industries;
- ◆ The percentage of the industry’s Failure to File (FTF) penalties decreased;
- ◆ The average amount of the FTF penalty assessed was reduced;
- ◆ The number of cases ”open beyond First Notice”<sup>71</sup> decreased; and
- ◆ The average balance of cases in “open beyond First Notice” inventory declined.<sup>72</sup>

The conclusions of the report support the hypothesis that TEC general outreach had a measurable impact on compliance.<sup>73</sup> The outcome of this research seems to contradict the previously discussed Targeted Research Study involving the construction industry which showed no evidence that targeted outreach increased compliance.<sup>74</sup> Again, the method of delivery may make a significant difference. The outreach in Construction Study Phase I was delivered through various means. TEC personnel visited local and national trade shows and spoke at industry organization meetings. TEC also delivered part of the outreach through a pair of specialized advertisements provided on a website or in newsletters.<sup>75</sup> The contradiction between the outcomes of the two studies serves to emphasize the need for SB/SE to conduct more research so it can determine what works and why it works.

SB/SE conducted a second study (Construction Study Phase II) on the effect of TEC outreach on the construction industry’s employment tax filing compliance.<sup>76</sup> This subsequent study concluded that general outreach does have a positive effect on the percentage of businesses receiving certain penalties, the average amount of delinquency penalties, and payment compliance.<sup>77</sup> SB/SE found:

<sup>71</sup> In addition to analyzing the frequency and amount of penalties, this report considered the difficulty in collecting accounts receivable. The report examined each industry during the second action taken by the IRS. The first standard action is always a notice. This analysis was based upon accounts receivable during the next action. The next action was found to be a final demand, an installment agreement, a suspension (i.e., payment tracer or credit transfer) or assignment to collection division. The aggregate of these conditions is called ‘open beyond First Notice’ for this report.

<sup>72</sup> SB/SE Research Report, Project No. 06.08.004.03, *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes 29* (Jul. 2004).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 7.

<sup>75</sup> *Id.* at 1.

<sup>76</sup> The study was conducted to measure the ability of general outreach to influence e-filing, penalty, and payment compliance. The project compared the changes in the aspects of e-filing, Federal Tax Deposit (FTD) penalty, Failure to File (FTF) penalty and Balance Due beyond the First Notice. The construction industry was compared with three control groups – retail, transportation and real estate industries, from the base quarter to the end of every test period, starting with the third quarter of 2003 and ending at the fourth quarter of 2004. The measurement requirement was that the construction industry outperform two out of the three control groups. The data represents a panel of taxpayers consisting of one percent of Form 941 filers. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II 23* (January 2006).

<sup>77</sup> SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II 51* (January 2006).

- ◆ General outreach appears to reduce the percentage of filers receiving FTD penalties.<sup>78</sup> The construction industry showed negative improvement during the project but still outperformed the control groups in five of six tests;<sup>79</sup>
- ◆ General outreach appeared to decrease the rate and average amounts of FTF penalties;<sup>80</sup> and
- ◆ Overall, general outreach seemed to reduce accounts receivable in the construction industry.<sup>81</sup>

#### *TIGTA Findings on TEC Performance Measures*

The Treasury Inspector General for Tax Administration (TIGTA) also reviewed TEC outreach to small business taxpayers in 2005 and evaluated TEC's efforts to help small businesses understand and fulfill their tax obligations.<sup>82</sup> TIGTA found many of TEC's performance measures were questionable. For example, TEC used the number of taxpayers reached through practitioner organizations as an indirect measure of outreach impact. TIGTA believed TEC may have been taking credit for the work of these third parties (*i.e.*, practitioners) rather than work done by its own staff. Because SB/SE does not measure the effectiveness of its outreach activities, the accuracy of the measures depended upon the practitioners.<sup>83</sup>

#### *Local Taxpayer Advocate Questionnaire on TEC Realignment*

TAS Local Taxpayer Advocates (LTAs) support TAS's operational priority of increasing public awareness of TAS by partnering with the IRS operating divisions in conducting outreach events in local communities. The LTAs participate in joint outreach activities with CLD's Stakeholder Liaisons in an effort to reach small business owners and tax professionals, inform them of TAS services, and learn about both their case specific

<sup>78</sup> Federal Tax Deposit (FTD) penalties are an excellent indicator of payment compliance. If a business deposits employment taxes properly, there is no penalty.

<sup>79</sup> SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (January 2006).

<sup>80</sup> At the end of the project, the construction industry had a noticeable improvement in the decrease in percentage of filers being assessed the FTF. The project also showed that general outreach reduced the average amount of filing penalties. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (Jan.2006). Due to limitations, we cannot be certain that the effects came entirely from the general outreach program. The limitations are due to environmental factors. Part of the tests involved analyzing e-filing; an increase in e-filing should be highly correlated with a reduction in FTF penalties. The environmental factors affecting e-filing could be e-filing outreach by other parts of the IRS which could affect the measured industry e-filing rates and the improving economy which could affect e-filing rates. The measure of the environmental effects is unknown.

<sup>81</sup> In addition to analyzing the frequency and amount of penalties, the report considered the difficulty in collecting accounts receivable. The project examined each industry during the second action taken by the IRS. The first standard action is always a notice. SB/SE Research Report, Project No. 06.06.005.04. *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes Phase II* 51 (January 2006).

<sup>82</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-30-132, *Opportunities Exist to Improve the Efforts of the Taxpayer Education and Communication Organization to Assist Small Businesses in Understanding and Fulfilling Their Tax Obligations* 1 (Aug. 2005).

<sup>83</sup> *Id.* at 8-9.

and systemic problems with the IRS. TAS's Office of Systemic Advocacy submitted a questionnaire to LTAs to solicit their observations about specific ways the realignment of TEC into CLD has affected outreach in the field.<sup>84</sup> Although some LTAs have not noticed a negative impact, others have seen a decrease in outreach. The impact varies by locality, with LTAs generally reporting a greater impact in states that do not have a Stakeholder Liaison representative. Further, 31 of the 42 LTAs who responded to our survey stated they have noticed a decrease in Stakeholder Liaison representatives since TEC realigned into CLD.<sup>85</sup> Three LTAs reported SB/SE has asked their offices to provide outreach for events that TEC used to cover.

### Small Business Administration Concerns

The Small Business Administration (SBA) has also expressed concern about the lack of an appropriate balance between IRS enforcement and outreach and education to small business taxpayers. In April 2006, Thomas M. Sullivan, the SBA's Chief Counsel for Advocacy, told the House Committee on Small Business that the small business community is concerned that the IRS's plans for closing the tax gap focus primarily on increasing enforcement.<sup>86</sup> Mr. Sullivan expressed his belief that IRS attempts to improve compliance should also include "taxpayer education and compliance assistance ... to balance an appropriate level of enforcement."<sup>87</sup> This statement was based in part on a study showing the connection between enforcement and compliance is not certain, and excessive enforcement may actually lead to decreased compliance.<sup>88</sup>

### Other Stakeholders' Concerns

John Satagaj, President and General Counsel of the Small Business Legislative Council (SBLC), testified before the Small Business Committee of the House of Representatives that:

The message now being delivered to the small business community from the IRS is that education is no longer a priority and that enforcement is the way to increase

<sup>84</sup> The questionnaire to the LTAs provides anecdotal rather than quantitative evidence.

<sup>85</sup> Forty-two LTAs responded to our survey, 31 of them reported a decrease in Stakeholder Liaison (formerly TEC) representatives, two reported no decrease, and nine either did not know or had no response. The survey had a 56.8 percent response rate. Although non-response error is likely, we did not analyze the results for non-response error; therefore, the results may not extend to the whole population of 73 LTAs.

<sup>86</sup> *IRS's Latest Enforcement: Is the Bulls-Eye on Small Businesses? Hearing Before the House Comm. On Small Business*, 109th Cong. (Apr. 5, 2006) (testimony of Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration).

<sup>87</sup> *Id.*

<sup>88</sup> "Important insight on tax compliance and tax evasion can be gained by looking at how the tax authority deals with the taxpayer. Taxpayers respond in a systematic way to how the tax authority treats them. In particular, the taxpayer's willingness to pay their taxes, or *tax morale*, is supported or even raised, when the tax officials treat them with respect. In contrast, when the tax officials consider taxpayers purely as 'subjects' who have to be forced to pay their dues, the taxpayers tend to respond by actively trying to avoid taxation." Frey, Bruno S. and Feld, Lars P., "Deterrence and Morale in Taxation: An Empirical Analysis" 23 (Aug.2002). CESifo Working Paper Series No. 760, available at SSRN, <http://ssrn.com/abstract=341380>.

compliance. One of the great successes of the IRS Restructuring and Reform Act of 1998 was the creation of the Small Business Self Employment Division and its Taxpayer Education and Communication (TEC) section. We at SBLC believe that a greater emphasis on education can have a significant impact by helping to bring in those individuals that want to pay their taxes but for one reason or another are not doing so. That is why we were disheartened recently to learn that TEC is being cut substantially and many of the employees there will be moving into enforcement roles.<sup>89</sup>

### *The SB/SE Perspective*

The former SB/SE Commissioner has stated that enforcement alone will not close the tax gap. At an August 2006 meeting of the National Association of Tax Professionals, then-Commissioner Kevin Brown said that increasing audit rates and selecting better returns for audit can help, but “even if [the IRS] doubles the number of revenue agents [auditors] ... I don’t think that is going to close the gap.” SB/SE Commissioner Brown said that audit coverage rates for individual taxpayers, partnerships, and S corporations are each less than one percent and are only three percent for Schedule C filers. “We are simply not going to close the [tax] gap auditing one individual at a time.”<sup>90</sup>

According to the figures reported by former SB/SE Commissioner Brown, the vast majority of small business and self-employed taxpayers will have little or no interaction with the IRS apart from outreach and education.<sup>91</sup> To accurately comply with their tax obligations, these taxpayers must understand how to navigate the complex landscape of rules, regulations, and procedures that apply to their situations. Many small business and self-employed taxpayers embark on this annual journey with only limited assistance from professional tax advisors, and some have no assistance at all. It is imperative, therefore, that the IRS provide these taxpayers with the instruction and information necessary to make voluntary compliance easier.

### CONCLUSION

To fulfill their tax obligations, small business taxpayers must deal with ever increasing tax law complexity. They also must keep extensive records, comply with regulatory requirements, and meet numerous tax deadlines. Many of these taxpayers cannot afford professional tax advice. Many small business owners also need face-to-face communication with the IRS. We believe that reducing small business education resources is a mistake, particularly since the IRS does not measure the effect of outreach activities

<sup>89</sup> *Closing the Tax Gap and the Impact on Small Businesses, Hearing before the House Comm. On Small Business*, 109th Cong (Apr. 27, 2005) (testimony of John Satagaj, President and General Counsel, SBLC).

<sup>90</sup> Crystal Tandon, *Legislative Fixes Needed to Close Tax Gap, IRS Official Says*, 2006 TNT 162-2, Aug. 21, 2006.

<sup>91</sup> See Crystal Tandon, *Legislative Fixes Needed to Close Tax Gap, IRS Official Says*, 2006 TNT 162-2, Aug. 21, 2006. Because the IRS audits small business and self-employed taxpayers at rates of only three and one percent, respectively, more than 97 percent of these taxpayers will have no contact with the IRS beyond IRS outreach and education efforts.

on small business taxpayers' behavior, including compliance. The downstream consequences of reducing outreach to the small business community may include decreased compliance, and potentially an increase in the tax gap. The IRS needs to provide adequate and effective education to taxpayers who want to comply and need more information and assistance to do so.

### IRS COMMENTS

The IRS disagrees with the National Taxpayer Advocate's conclusions and statements concerning the outreach and education function of the Small Business/Self-Employed (SB/SE) Division. Since its inception, SB/SE has been committed to balancing service and enforcement in order to properly inform SB/SE taxpayers about the tax laws and IRS policy regarding those laws. SB/SE has always employed a leveraged approach through an education and outreach function – currently, the Communication, Liaison & Disclosure Division (CLD). In addition, we regularly perform extensive reviews, and have redesigned our functions when necessary, to maximize the value of our outreach to the small business community.

### Staffing Dedicated to Outreach and Education

The staffing dedicated to outreach and education has not diminished since SB/SE standup. Although the design of the original Taxpayer Education & Communication (TEC) division included approximately 1200 staff, many of those staff equivalents were not going to fully engage in outreach and education. Many of the TEC employees had outreach duties, but also would have supported the filing season – a duty that had fallen to many Compliance employees over the past several years. With TEC employees fulfilling that function, Compliance employees could perform their enforcement duties year round, thereby completing their casework more expeditiously and providing better customer service to those taxpayers in the enforcement process. The number of TEC staff that would have been dedicated fully to outreach is approximately the same as the number of staff in the redesigned Stakeholder Liaison (SL) function, which is fully committed to outreach and education.

### Stakeholder Liaison Placement

The IRS used a strategic approach to placing SL employees. We used research data to determine locations with the highest concentration of SB/SE taxpayers and placed our Stakeholder Liaisons there. External stakeholders in all 50 states and Washington, D.C. have a liaison contact in the SL function, even though the contact may not be physically located within the same state or city.

The IRS efficiently uses advancements in technology to deliver liaison activities so that activities do not diminish when the liaison contact is in a different state than the stakeholder. In FY 2006, there were 283 SL events conducted in the 12 states without the physical presence of a Stakeholder Liaison employee. These ranged from two events in

Hawaii to 90 events in Missouri. During the design of CLD, we also wanted to ensure there was coverage from at least one CLD employee in each state, which we accomplished in all but two states. There are also plans to hire SL employees in states that currently have a vacancy.

We also work through our partners so that small business workshops are now fully leveraged by external stakeholders, such as Small Business Development Centers and SCORE. We support these stakeholders by providing products and approved presentations for key message delivery. We also audit classes to ensure quality and market classes to our stakeholders to inform small business owners regarding class availability. The decision to conduct a workshop is driven by identified demand and the availability of a leveraged stakeholder to deliver the workshop.

### CLD Strategic Planning

SB/SE's planning consists of a Concept of Operations (CONOPS), which provides a three to five year plan; a strategic plan for the next two consecutive fiscal years; and a program letter requirement for each function, which more specifically lays out the mission, strategy and activities for the current fiscal year. The SB/SE Strategic Plan covers two years so it will align with the Treasury and OMB budgetary process. CLD closely follows this process and has a CONOPS and program letter aligned to the SB/SE Strategic Plan.

The CLD plan includes actions to address limited english proficiency. In FY 2006, Stakeholder Liaison launched Hispanic Small Business Forums with the Spanish speaking small business community in states strategically determined to have the highest concentration of Hispanic small business taxpayers. This included California, Florida and New York. We also conducted forums in South Carolina and New Jersey – states that showed significant Hispanic populations. We plan to expand this outreach nationwide. These forums provided us an opportunity to identify specific issues and concerns impacting Spanish speaking small business owners. Also, the new Small Business Workshop DVD provides lessons in English, Spanish and Mandarin Chinese. The disability credits available to small business owners are not currently addressed, as credits like this are geared more toward Wage & Investment outreach activity.

Although strategic planning is important, CLD also feels it is critical to maintain flexibility in its outreach approach to react to emerging issues and provide up-to-the-minute education to taxpayers. One recent example is our outreach to the entertainment industry regarding the taxability of celebrity gift bags. This was not in our outreach plans for FY 2006, but we seized upon the tax compliance issue and quickly rolled out a nationwide strategy to deliver the IRS's message.

### Using Research

CLD partners with SB/SE Research to obtain research data and conduct focus groups to assist in identifying and developing future outreach activities. During FY 2006, for example, SB/SE Research provided a comprehensive library of existing research targeted toward the non-filer community. Stakeholder Liaison Headquarters is currently using this research to develop an outreach strategy aimed at small business taxpayers who are not complying with their filing requirements.

CLD is also currently working with SB/SE Research on a specific project using the Examination Operational Automated Database (EOAD) to determine whether significant portions of the tax gap can be isolated and then addressed by industry and geography. Also, in a tax gap related project, we plan to work with Research, pending the availability of funds, on behavioral methods to influence small business owners in the cash economy to report their income. This study will be on two levels: how practitioners perceive and deal with their “cash economy” clients and how “cash economy” business owners view their income tax responsibility related to reporting cash receipts.

CLD also partners with Research to conduct focus groups with practitioners at the Nationwide Tax Forums. One of this year’s focus group questions concerned expanding communications with practitioners. The Research Summary stated, “Our primary observation is that there is a high level of satisfaction”. The communication products discussed were Tax Talk Today, Headliners, e-News and irs.gov website.

### Effectiveness of Outreach Activities

SB/SE monitors the effectiveness of outreach activities through direct contact with stakeholders. In these “level of service” calls, we directly sample stakeholders and inquire about the effectiveness of outreach activities. We solicit feedback from stakeholders at each hosted event and use the feedback to improve future events. It is true that we do not measure outreach quantitatively; however, we believe that quality content is more important. We also believe that stakeholder satisfaction is a better measurement of our effectiveness. We do not have any specific examples where we have failed to meet the challenge of effectively providing education related to tax obligations and IRS policies to our stakeholders.

### Individual Interaction with SB/SE Taxpayers

The outreach and education arm of SB/SE was never designed to meet one-on-one with small business owners, as there are more than 45 million small business taxpayers. The outreach mission has always been to educate the small business community by leveraging stakeholder relationships and networks. We continue to expand our network each year in order to reach more of the small business community. We believe that this approach is working and have not encountered any practical problems with it.



An example of our expanding network is the “SB/SE Mailing List” that has accumulated 90,000 subscribers over the last five years and includes small business owners as well as other external tax professional and industry stakeholders. Beginning in January 2007, we are renaming this “list” to “e-News for Small Businesses” and will launch regular editions aimed at helping small business owners and self-employed persons voluntarily comply with their tax responsibilities, including:

- ◆ Important upcoming tax dates;
- ◆ What's new for small businesses on the IRS Web site;
- ◆ Reminders and tips to assist small businesses with tax compliance; and
- ◆ IRS News Releases and special announcements.

Finally, we strongly believe in the cohesiveness of CLD with all liaison activities housed within one function - liaison to external stakeholders, business owners within the small business community, state departments of revenue, and governmental liaison and Congressional offices. This one organization with a focused liaison mission affords the small business community with the most consistent outreach and education approach regarding tax compliance responsibilities.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that SB/SE must balance taxpayer service, education and outreach with its responsibility to enforce the tax laws. The National Taxpayer Advocate supports SB/SE's efforts to improve compliance among nonfilers, and the Taxpayer Advocate Service is a partner of SB/SE (and other IRS organizations) on a task force focusing on noncompliance in the cash economy. The National Taxpayer Advocate continues to believe, however, that compliance cannot be achieved without effective outreach and education to small business and self-employed taxpayers.

The IRS's response to our concerns about outreach and education efforts to small business and self-employed taxpayers indicates that the IRS plans to continue its present course in serving these taxpayers. The IRS does not appear to be willing to contemplate additional approaches that may enhance the reach and effectiveness of its outreach and education. While the IRS is doing a lot under the status quo, it can do more. Given the amount of the tax gap attributable to the self-employed, it *must* do more.

The IRS claims that a loss of 157 employees from the TEC organization<sup>92</sup> has not resulted in diminished taxpayer service because during filing season, these employees supported IRS compliance functions. Thus, the IRS argues, this staff reduction has not decreased taxpayer services because the number of employees devoted to full time outreach and education has essentially remained constant during the transition from

<sup>92</sup> In February 2005, prior to the realignment TEC had 536 employees; after the realignment, Stakeholder Liaison staffing included 183 employees in the field and 36 in Headquarters. CLD Org Chart (February 2005) Prior to the realignment, in February 2005, 157 TEC employees voluntarily returned to full-time compliance positions. SB/SE response to TAS request (Sept. 5, 2006).

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TEC to CLD. We, however, fail to see how a loss of 157 employees – even if they only work part-time – *cannot* result in diminished customer service.<sup>93</sup> Moreover, TEC staffing never approached the 1200 employee level that SB/SE envisioned as necessary for a successful small business/self-employed taxpayer education and communications organization.

The IRS also asserts that the absence of Stakeholder Liaison offices in 12 states does not diminish taxpayer service because the IRS used a “strategic approach” when it closed these offices and that “external stakeholders in all 50 states and Washington, D.C. have a liaison contact in the SL function, even though the contact may not be physically located within the same state.” Again, we fail to see how removing IRS small business outreach contacts from nearly a quarter of all states does not diminish taxpayer service.

TAS recognizes that SB/SE has limited resources and must sometimes make difficult staffing decisions. We do not understand, however, why SB/SE refuses to acknowledge that reduced staffing may lead to reduced taxpayer service. SB/SE cannot develop and maintain an effective outreach and education program unless it has an accurate understanding of its own resources.

We recognize that both SB/SE and CLD have created strategic planning documents (such as the Concept of Operations and Program Letter) and commend the IRS for CLD’s plans to address Limited English Proficiency taxpayers.<sup>94</sup> However, we are unaware of any specific five-year plan to develop, deliver, and measure a small business/self-employed taxpayer outreach and education effort through Stakeholder Liaison. The IRS suggests one reason a specific five-year plan does not exist is because such a plan would limit the IRS’s flexibility to “react to emerging issues and provide up-to-the-minute education to taxpayers.” The prospect of limited flexibility is not a valid reason to neglect planning. Strategic plans provide focus and goals, but they are not set in stone and can easily be adapted to changing circumstances. Moreover, they are part of an interactive process. Without specific plans, an organization can lose focus as it attempts to deal with inevitable changes and budgetary limitations. It is precisely for this reason that the IRS cannot provide effective outreach and education to small business and self-employed taxpayers without a specific five-year strategic plan for the SB/SE Stakeholder Liaison function.

The National Taxpayer Advocate commends SB/SE for the behavioral research it plans to do, but it appears that this research may be a postscript to the IRS’s tax gap closure initiatives. Rather than conducting *ad hoc* research studies, we encourage SB/SE to use

<sup>93</sup> We also note that SB/SE reported that 93 TEC FTE’s provided cross-functional support during FY 2004, but 157 TEC employees returned to full-time compliance positions in FY 2005. SB/SE response to TAS Request (Sept. 5, 2006).

<sup>94</sup> We note that the SPEC organization’s CONOPS did not diminish the need for a five-year Taxpayer Assistance Blueprint.

W&I's TAB as a model for research, namely research conducted as part of an integrated strategic approach.

We agree that the IRS should continue to leverage its outreach efforts through practitioners and trade association representatives and through the excellent small business education materials on IRS.gov. In this respect, the National Taxpayer Advocate does not believe that SB/SE should meet "one-on-one" with small business owners, as the IRS suggests. She does believe, however, that the IRS should be aware that it will not reach a significant number of small business and self-employed taxpayers by leveraged outreach alone. As noted in our discussion, most small business and self-employed taxpayers do use tax practitioners, but many of these taxpayers hire practitioners only to prepare their returns. Most tax planning and compliance decisions are made without the advice of a practitioner. A practitioner leveraged outreach program is not the best method of educating these taxpayers. The IRS should find other ways to reach them. Likewise, providing materials to taxpayers through IRS.gov is another good way to leverage resources, but it will not reach small business and self-employed taxpayers who lack Internet access or do not regularly use computers.

The National Taxpayer Advocate believes that rather than dismissing her concerns about small business and self-employed taxpayer outreach, the IRS should use them as a springboard to evaluate its outreach and education programs. If the IRS is willing to engage in this exercise, it will find that it is, in fact, providing excellent information to certain practitioners and trade association representatives, and to those taxpayers who have Internet access and know how to use it. We believe the IRS will also find, however, that it is not reaching a large portion of small business and self-employed taxpayers and its current outreach initiatives to these taxpayers could be revised and improved.

As a final note, the National Taxpayer Advocate is astonished by SB/SE's complete abdication of responsibility for outreach to disabled small business owners or small business owners who hire disabled employees or provide accommodations for those employees. In its response, the IRS claims that SB/SE does not "currently address" outreach to these small businesses because the disability credits available to small business owners are "geared more toward Wage & Investment outreach activity." The IRS provides no legal or administrative authority for this assertion. Outreach to these *small business* owners is not W&I's responsibility. SB/SE must develop a program to educate and serve these taxpayers.

#### RECOMMENDATIONS

- ◆ Undertake an initiative similar to the Taxpayer Assistance Blueprint (TAB) to access needs of the small business taxpayers. Develop a strategic five-year plan that outlines the services the IRS should provide and determines the most effective way to deliver and improve outreach and education to small business taxpayers and provides for an interactive process of assessing and meeting these needs.

## PROBLEMS

- ◆ Conduct research or focus groups to obtain information about the characteristics and needs of small business and self-employed taxpayers, including their usage of computer technology and practitioners.
- ◆ Establish a measure for the effectiveness of outreach activities. At a minimum, the IRS should survey small business owners and self-employed taxpayers to ascertain that outreach delivered through practitioners and small business organizations reaches the taxpayers and remains accurate.
- ◆ Evaluate and reconsider staffing levels in SB/SE's outreach and education division. At a minimum, there should be a Stakeholder Liaison in each and every state.
- ◆ SB/SE must develop a specific outreach and education strategy to serve disabled small business owners and small business owners who hire disabled employees or provide accommodations to these employees. At the very least, SB/SE should include on the IRS website more detailed information regarding the deductions and credits to which small businesses may be entitled, either for hiring employees with a disability, providing accommodations to employees with a disability, or removing architectural barriers for taxpayers with a disability.

**PROBLEM****TOPIC #12****OVERSIGHT OF UNENROLLED RETURN PREPARERS****RESPONSIBLE OFFICIALS**

Kathy Petronchak, Commissioner, Small Business/Self Employed Division  
 Stephen Whitlock, Director, Office of Professional Responsibility

**DEFINITION OF PROBLEM**

Taxpayers are harmed by the absence of a comprehensive federal program to regulate unenrolled return preparers. Over 61 percent of all individual income tax returns received by the IRS during the 2006 filing season (through May 5, 2006) were prepared by paid preparers.<sup>1</sup> Although the exact number is unclear, it is likely that unenrolled preparers handled a large percentage of those returns.

The National Taxpayer Advocate acknowledges that a significant percentage of unenrolled preparers are well trained and maintain high ethical standards. However, as evidenced by the findings of a 2006 limited study performed by the Government Accountability Office (GAO),<sup>2</sup> untrained and unscrupulous preparers present a serious problem. The National Taxpayer Advocate has repeatedly raised concerns about the lack of IRS oversight of unenrolled return preparers<sup>3</sup> and has proposed legislation that would create a system to register and certify these preparers, as well as enhance due diligence and signature requirements, increase preparer penalties, and assess and collect those penalties as appropriate. However, the IRS has declined to support such a system, and none is currently in place.

The following issues exist within IRS guidance and procedures:

- ◆ The National Taxpayer Advocate is concerned about the proposed amendments to Circular 230, which would eliminate the authority of unenrolled preparers to practice on a limited basis on examination issues.<sup>4</sup> Rather than punish all unenrolled preparers and their clients, the way to deal with incompetence is to require unenrolled preparers to learn the tax law and pass a basic exam.
- ◆ The procedures for a taxpayer or IRS employee to file a complaint about preparer misconduct are confusing. Further, a taxpayer's complaint may bounce around within the IRS, the Treasury Inspector General for Tax Administration (TIGTA),

<sup>1</sup> IRS, *Taxpayer Usage Study (TPUS), Weekly Report 14*.

<sup>2</sup> Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, 2 (April 4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

<sup>3</sup> Unenrolled return preparers are return preparers who are not Certified Public Accountants, attorneys, enrolled agents, or enrolled actuaries. See National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; House Committee on Ways and Means, Testimony of Nina. E. Olson, National Taxpayer Advocate (Jul. 20, 2005).

<sup>4</sup> REG-122380-02.

and the Department of Justice, while the preparer continues to practice and potentially harm other taxpayers.

- ◆ The IRS Office of Professional Responsibility (OPR) has proposed a nationwide database to track return preparers, which would contain complete information on reported preparers and would be accessible by all IRS functions with preparer oversight responsibility. The proposed centralized database has inherent benefits and is under development. Before supporting the development of the database, the National Taxpayer Advocate needs assurance that the IRS will not use it as a mere catalogue of complaints. Accordingly, the IRS must carefully design the database and procedures for access and use of the data contained therein to ensure safeguards are in place to prevent IRS employees from unfairly labeling preparers as “bad preparers” without protecting preparers’ due process rights.
- ◆ Over the last five fiscal years, the IRS collected only 13 percent of the net assessed return preparer penalties.<sup>5</sup>
- ◆ The IRS does not require preparer signatures on Form 656, Offer in Compromise, or the accompanying Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals and Form 433-B, Collection Information Statement for Business. As a result, the IRS has no way to track or regulate “offer mills” or the activities of offer preparers who are not authorized to practice before the IRS.
- ◆ The IRS fails to adequately monitor Electronic Return Originators (EROs) from the application process and throughout the period of registration.
- ◆ The IRS has not sufficiently expanded access to its e-Services program to include Circular 230 practitioners regardless of whether they have met a threshold number of *e-filed* returns.
- ◆ IRS regulations under IRC § 7216 need revision to safeguard taxpayers’ privacy in both electronic and paper filing environments.

#### ANALYSIS OF PROBLEM

##### GAO Findings on Limited Study of Chain Preparers

The Government Accountability Office (GAO) recently conducted a limited study of several commercial chain preparers by visiting 19 retail offices in one major metropolitan area.<sup>6</sup> The GAO auditors posed as taxpayers and presented one of two carefully developed but relatively straightforward tax fact patterns. The findings of the study are alarming, and many of the preparers’ errors as well as their consequences are significant.

<sup>5</sup> IRS ERIS Data as of September 2006, IRC 6694 and 6695 Preparer Penalty Data.

<sup>6</sup> Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* (Apr. 4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

All 19 preparers made mistakes, and 17 ultimately computed the wrong refund amount. The most serious problems included the following:

- ◆ Failure to report business income in ten of 19 cases. Several preparers advised the GAO “taxpayers” that reporting business income was discretionary because the IRS would not otherwise discover the income;
- ◆ Failing to ask relevant questions or ignoring GAO responses with respect to the Earned Income Tax Credit (EITC). Preparers claimed an ineligible child for the EITC in five of the ten applicable cases;
- ◆ Failure to take advantage of education tax incentives in three of the nine applicable cases;
- ◆ Failure to properly itemize deductions in seven of nine applicable cases; and
- ◆ Overstated refunds of almost \$2,000 in five cases and understated refunds of over \$1,500 in two cases.<sup>7</sup>

The IRS has stated these preparers could have been subject to penalties for negligence and willful or reckless disregard of tax rules.<sup>8</sup>

### Proposals to Regulate Unenrolled Return Preparers

Since 2002, the National Taxpayer Advocate has advocated the establishment of minimum levels of competency for return preparation by developing a federal system to register, test and certify unenrolled return preparers. She has also proposed to strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.<sup>9</sup> The IRS has declined to support such a proposal to establish a federal system to register, test, and certify preparers on two grounds.

- ◆ First, the IRS claims there is insufficient data to warrant regulation and its related costs; and
- ◆ Second, the IRS asserts that the proposed program would impose burdens on both the IRS and unenrolled preparers.<sup>10</sup>

<sup>7</sup> IRC §§ 6694 and 6695.

<sup>8</sup> Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, 26-27 (April 4, 2006) (Statement of Michael Brostek, Director Strategic Issues, before the Committee on Finance, U.S. Senate).

<sup>9</sup> National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Regulation of Federal Tax Return Preparers*, Hearing Before U.S. House of Representatives Committee on Ways and Means, Subcommittee on Oversight, 108th Cong. (July 20, 2005) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service); *Tax Return Preparation Options for Taxpayers*, Hearing Before the U.S. Senate Committee on Finance, 109th Cong. (April 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

<sup>10</sup> See IRS Comments, National Taxpayer Advocate 2004 Annual Report to Congress 82-85.

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SECTION  
ONE

The National Taxpayer Advocate continues to find these concerns unpersuasive. The GAO audit and other data illustrate that there is a sufficient problem to warrant regulation. The method of administering such a regime in California, which already imposes regulatory requirements on unenrolled return preparers, demonstrates that the program can be run at a low cost to preparers and virtually no cost to the government.<sup>11</sup>

Our proposal to regulate unenrolled return preparers has received a favorable response from the tax-writing committees and from practitioner groups. In the 109th Congress, the Senate Finance Committee approved legislation that would require the Treasury Department to prescribe regulations to establish a system to regulate compensated preparers. The bill, S.1321, the Telephone Excise Tax Repeal Act of 2005, would also require Treasury to establish and administer, through OPR, an eligibility examination designed to test preparers' knowledge of ethical standards as well as their technical knowledge and competence. The bill directs the Secretary to issue regulations that would require unenrolled preparers to renew eligibility every three years, at which time the preparer must show that he or she has completed continuing professional education requirements. The program would include monetary sanctions for failure to meet eligibility or renewal requirements. S.1321 also would increase preparer penalties and authorize OPR to use the collected penalties for a public awareness campaign on preparer eligibility and practice requirements.<sup>12</sup>

In addition to its passage by the Finance Committee, the proposal has received widespread backing from groups representing practitioners. At a hearing held by the House Ways and Means Committee Subcommittee on Oversight in 2005, the American Bar Association, American Institute of Certified Public Accountants, National Association of Enrolled Agents, National Association of Tax Professionals and National Society of Accountants all testified in support of the proposal.<sup>13</sup>

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<sup>11</sup> For more information on the California program, see the California Tax Education Council website at [www.ctec.org](http://www.ctec.org). See also IRS Comments, and the corresponding Taxpayer Advocate Service response, to the Most Serious Problem and the associated Taxpayer Advocate Service Comments in National Taxpayer Advocate 2004 Annual Report to Congress 82-88.

<sup>12</sup> S.1321, §203, Telephone Excise Tax Repeal Act of 2005; Joint Committee on Taxation, Description of the Chairman's Modification to the Provisions of S. 1321, the "Telephone Excise Tax Repeal Act of 2005" and S. 832, the "Taxpayer Protection and Assistance Act of 2005," JCX-28-06 (Jun. 28, 2006).

<sup>13</sup> Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Kenneth W. Gideon, Chair, Section of Taxation, American Bar Association); U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Tom Purcell, Chair, Tax Executive Committee, American Institute of Certified Public Accountants); Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Francis X. Degen, President, National Association of Enrolled Agents); Hearing on Fraud in Income Tax Preparation, U.S. House Committee on Ways and Means, Subcommittee on Oversight, (July 20, 2005) (Statement of Larry Gray, Government Liaison, National Association of Tax Professionals); U.S. House Committee on Ways and Means, Subcommittee on Oversight, (Jul. 20, 2005) (Statement of Robert L. Cross, Chairman, Right to Practice Committee, National Society of Accountants).



### Proposed Revocation of Limited Practice for Unenrolled Preparers in Circular 230

Circular 230 governs the practice of attorneys, certified public accountants, enrolled agents, and enrolled actuaries before the IRS.<sup>14</sup> The regulations detail the duties and restrictions of representatives authorized to practice before the IRS.<sup>15</sup> Sanctions for incompetence, disreputable conduct, and violations of the provisions include censure (public reprimand), suspension, or disbarment of the practitioner from practice before the IRS.<sup>16</sup> Circular 230 does not impose monetary penalties.

Circular 230 currently permits unenrolled preparers to practice before the IRS on a limited basis if they have a valid Form 2848, Power of Attorney and Declaration of Representative, on file with the IRS. As long as the preparer signs the return for the relevant tax period (unless the tax form in question has no place for preparer signatures), the preparer is permitted to represent the taxpayer before customer service representatives, revenue agents, and similar officers and employees during an examination of the return.<sup>17</sup> Unenrolled preparers are not permitted to:

- ◆ Represent taxpayers before the IRS's Collections, Appeals, or Counsel functions;
- ◆ Execute closing agreements, claims for refund, or waivers on restriction on assessment or collection of a deficiency;
- ◆ Extend statutory periods for tax assessment or collection; or
- ◆ Receive refund checks.<sup>18</sup>

In February 2006, the Department of Treasury published proposed regulations, REG-122380-02, which revoke the authorization of unenrolled preparers to engage in limited practice before the IRS. The preamble to the proposed regulations states the revocation is due to the inconsistency of limited practice with the requirement that all individuals practicing before the IRS demonstrate their qualifications to advise and assist persons in presenting their cases to the IRS.<sup>19</sup> Further, the IRS has indicated that unenrolled preparers will still be able to assist their clients in an examination if a taxpayer signs a

<sup>14</sup> 31 C.F.R., Part 10. Practice before the IRS includes the presentation to the IRS of all matters relating to a taxpayer's rights, privileges, or liabilities under laws and regulations administered by the IRS. 31 C.F.R. § 10.2(d).

<sup>15</sup> Such duties and restrictions include diligence as to accuracy; required actions upon learning of client's non-compliance, error or omission; the prompt disposition of pending matters, restrictions on fees, advertising, and the negotiation of taxpayer checks. 31 C.F.R. §§ 10.20-38.

<sup>16</sup> 31 C.F.R. § 10.50.

<sup>17</sup> If a carryback or carryforward is involved in a tax return, an unenrolled preparer will not be recognized as the taxpayer's representative with respect to the taxable year in which the carryback or carryforward arose, unless the preparer also prepared and signed the return for that year or years. IRS Pub 470, *Limited Practice Without Enrollment*, § 4.

<sup>18</sup> 31 C.F.R. § 10.7(c); IRS Pub 470, *Limited Practice Without Enrollment*, § 4

<sup>19</sup> REG-122380-02, I.R.B. 2006-10, available at [http://www.irs.gov/irb/2006-10\\_IRB/ar10.html](http://www.irs.gov/irb/2006-10_IRB/ar10.html). The proposed regulations would still allow unenrolled return preparers to exchange information with the IRS, provided the taxpayer has specifically authorized the preparer to receive confidential information from the IRS by signing a Form 8821, Tax Information Authorization.

Form 8821, Tax Information Authorization, which allows the IRS to exchange confidential information with the preparer. Thus, an unenrolled preparer can still accompany the taxpayer to the exam and assist the taxpayer in responding to questions regarding the return.

The National Taxpayer Advocate does not support the revocation of authority for unenrolled return preparers to engage in limited practice. The correct approach to incompetence is to require unenrolled preparers to demonstrate proficiency in tax law by passing a basic competency exam, and thereby acquiring the ability to represent taxpayers at the earliest administrative level. Treasury and the IRS should not address incompetence by eliminating authorizations for all unenrolled preparers.<sup>20</sup>

In addition, the proposed regulations do not take into account the basic expectations of taxpayers. From a taxpayer perspective, the taxpayer has engaged an individual who has perceived expertise in the tax law. If the IRS challenges a tax return, many taxpayers would reasonably expect the preparer of that return to be able to contact the IRS to answer questions and negotiate on their behalf.

The existing distinction between authorizations granted to unenrolled preparers who have clients with exam issues as opposed to appeals conferences or collection issues is an important one. In an examination, the practitioner must know black letter tax law and produce books and records to substantiate a position taken on the return. An appeal requires the practitioner to weigh hazards of litigation, and conduct settlement negotiations based on the likelihood of success of the taxpayer's position. Collection requires knowledge of valuation, state property and family law, and federal due process rights. An examination case requires totally different skills than an appeal or collection case. The work performed by the unenrolled preparer lends itself to assisting the taxpayer in an exam. This arrangement enables the IRS to determine firsthand the information presented to and relied on by the practitioner in preparing the return. It allows the IRS to correct the preparer's errors and misconceptions so they are not replicated, and to identify negligent or unscrupulous preparers, so they will not continue to harm taxpayers. Thus, taxpayers and tax administration interests are served by permitting unenrolled – but regulated – preparers to represent their return preparation clients before exam. Accordingly, the existing distinction in Circular 230 allowing unenrolled preparers to represent taxpayers on exam issues, but not appeals or collection issues, should stand.

<sup>20</sup> It is important to note that TIGTA recently found that OPR does not adequately perform background checks on enrolled agents. Thus, it is considering punishing unenrolled preparers but does not perform adequate federal tax obligation and criminal background checks on individuals who are granted the complete ability to practice before the IRS on exam, appeals and collection issues. Specifically, TIGTA found that the IRS does not take a proactive approach to monitoring tax compliance for enrolled agent's renewing their authorizations. Furthermore, OPR does not adequately check the criminal backgrounds of both new applicants and agents renewing their authorizations. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-170, *The Office of Professional Responsibility Does Not Always Ensure Enrolled Agents Are Qualified, and System Limitations Prevented Identification of Ineligible Representatives* (Sept. 29, 2006).

## More Outreach and Coordination Necessary in Preparer Complaint Process

### *Process to File Complaints Against Preparers*

Taxpayers and IRS employees have the following venues to file complaints against preparers: the IRS Office of Professional Responsibility (OPR), Area Return Preparer Coordinators within the IRS's Small Business/Self-Employed (SB/SE) Operating Division, and the Treasury Inspector General for Tax Administration.

### *Complaints Filed with the Office of Professional Responsibility*

IRS employees are required to promptly file a Form 8484, Report of Suspected Practitioner Misconduct,<sup>21</sup> with OPR if they have reason to believe a Circular 230 practitioner has violated any provision of regulations governing practice before the IRS.<sup>22</sup> OPR reviews the submissions and determines whether the problems can be addressed by a simple phone call to the practitioner or whether disciplinary proceedings are warranted.

OPR provides instructions for taxpayers who wish to file complaints against Circular 230 practitioners. If the evidence indicates the allegations, taken as true, would constitute a violation of Circular 230, OPR will send a letter informing the practitioner of the charges and affording him or her the right to respond in writing or by requesting a conference.<sup>23</sup>

### *Complaints filed with the Area Return Preparer Coordinators*

IRS employees and taxpayers who suspect misconduct on behalf of a return preparer, whether a Circular 230 practitioner or an unenrolled preparer, are instructed to contact an Area Return Preparer Coordinator (RPC) in SB/SE. The IRS provides its employees with a list of RPC contacts based on localities, while members of the public are encouraged to file complaints by completing and mailing Form 3949-A, Information Referral.<sup>24</sup>

Each RPC maintains a local level database or spreadsheet to track reported return preparers. However, the IRS does not coordinate or consolidate these local tracking systems on a national basis; nor do the local systems include other enforcement information, such as criminal investigations or Lead Development Center promoter

<sup>21</sup> OPR requires management approval for misconduct reports to ensure that reports are based on objective, generally understood standards of practitioner service and professionalism. Form 8484, Part E.

<sup>22</sup> 31 C.F.R. § 10.53.

<sup>23</sup> IRS, *Complaints Against Tax Professionals – Frequently Asked Questions*, available at <http://www.irs.gov/taxpros/agents/article/0,,id=123392,00.html#how>. The complaint should be written in a letter format and include the tax practitioner's name, address, telephone number, designation (*i.e.* attorney, CPA, enrolled agent, etc.), a detailed description of the allegations, and any documents that support those allegations.

<sup>24</sup> IRS, *Complaints Against Tax Professionals – Frequently Asked Questions*, available at <http://www.irs.gov/taxpros/agents/article/0,,id=123392,00.html#how>; Reporting Abusive Shelters, Fraud & Unscrupulous Preparers, available at <http://www.irs.gov/newsroom/article/0,,id=121584,00.html> (Information on filing a complaint is not obvious on the IRS official website and requires several steps to access. The Site Map is also not useful to locate this information); Small Business/Self-Employed Response to Information Request (Aug. 15, 2006).

investigations.<sup>25</sup> The RPCs have discretion to review all available information to determine whether a Program Action Case (PAC) is warranted. The PAC involves selecting for examination 30 randomly sampled returns of the preparer's clients. The PAC's overall goal is to support penalties against the preparer.<sup>26</sup>

National guidelines indicate that RPCs should consider the following information when determining whether to initiate a PAC:

- ◆ The egregious nature of the conduct, which depends on whether the misconduct is widespread or intentional;
- ◆ The number of taxpayer clients affected by the misconduct;
- ◆ The types of returns and the tax years involved;
- ◆ The significance of the questionable issues;
- ◆ The dollar amounts involved; and
- ◆ The examination group's available resources in the geographic area where the preparer is located.<sup>27</sup>

Before developing and proposing a PAC, the RPC must confirm that it will not conflict with another pending enforcement action by contacting the Criminal Investigation function (CI) and the Lead Development Center for promoter investigation. The RPC must also seek the approval of the Penalty Screening Committee (PSC).<sup>28</sup> We note that the EITC Program Office is not currently represented on the PSC, notwithstanding that 79.1 percent of tax year 2004 EITC returns audited by the end of June 2006 and reflecting an audit change were prepared by a paid professional.<sup>29</sup> As of August 15, 2006, SB/SE had approximately 582 open PACs nationwide. Because SB/SE receives referrals from many different sources and only tracks its information locally, it is unclear what percentage of reported preparers are the subject of PACs.<sup>30</sup> It is interesting to note that

<sup>25</sup> Lead Development Centers conduct promoter investigations under IRC §§ 6700 and 6701.

<sup>26</sup> Small Business/Self-Employed Response to Information Request (Aug. 24, 2006).

<sup>27</sup> Draft IRM § 4.1.4.10.3.2 (Aug. 15, 2006).

<sup>28</sup> Draft IRM §§ 4.1.4.10.3.3 (Aug. 15, 2006), 20.1.6.1.6. The multifunctional Penalty Screening Committee (PSC) includes the following representatives: Area Office Electronic Filing Coordinator (DOEFC), Examination Return Preparer (RPC), and a Criminal Investigation (CI) representative. The PSC contacts service center representatives from Criminal Investigation (CI) and Examination as needed. The PSC will be responsible for planning and coordinating the implementation of Area and National Headquarters Return Preparer strategy. The PSC also establishes communication lines between Planning and Special Programs (PSP), the Area Electronic Filing (ELF) Coordinator, the CI Questionable Refund Program Coordinator (QRPC), the Service Center Examination RPC, and the CI RPC. A major goal of the committee is to more effectively identify patterns of preparer abuse and prevent duplication of efforts within the Areas and Service Centers. IRM 20.1.6.1.1.

<sup>29</sup> Information from the Audit Information Management System (AIMS) closed case database (Nov. 20, 2006) showed that the original return of 286,281 of the 361,834 tax year 2004 EITC returns audited through June 30, 2006 reflecting disposal codes other than "no change" were completed by a paid preparer. The determination of whether a return was audited for an EITC issue was based on AIMS Project Codes provided by the EITC Project Office.

<sup>30</sup> Small Business/Self-Employed Response to Information Request (Aug. 15, 2006).

a taxpayer faces fewer hurdles in lodging a complaint against and starting an investigation of a Circular 230 preparer than an unenrolled preparer.

#### *IRS Programs Identifying Problem Preparers*

Both SB/SE and CI have programs to identify potentially problematic preparers. SB/SE identifies preparers through PACs, while CI's Office of Refund Crimes identifies preparers through patterns and schemes detected by Fraud Detection Centers (FDCs). Both offices refer cases to each other. For example, if a PAC identifies a problematic preparer and SB/SE suspects fraudulent behavior, the division will contact CI. In addition, if an FDC identifies a scheme but CI does not work the case for some reason, CI is supposed to recommend that SB/SE open a PAC.<sup>31</sup> Investigations performed by these offices may lead to either civil or criminal penalties imposed on the preparers.

#### *Complaints Filed with the Treasury Inspector General for Tax Administration*

The Treasury Inspector General for Tax Administration (TIGTA) also receives complaints of practitioner misconduct. IRS employees and members of the public are encouraged to contact TIGTA if they suspect practitioners of falsifying their qualifications, theft of IRS tax remittances, or theft of refunds.<sup>32</sup>

#### *More Outreach and Education Necessary on Complaint Process*

The existing preparer misconduct referral procedures are confusing and ineffective. Depending on the type of preparer and misconduct, the complaint can either go to an Area Return Preparer Coordinator (RPC), OPR, or TIGTA. Where and on what grounds to file a complaint are not sufficiently clear to IRS employees, and are even less clear to taxpayers. Taxpayers and preparers need to search the IRS official website to find information on the process of reporting preparers. This search is exponentially more difficult for taxpayers who are unfamiliar with the structure of the IRS. The resulting general lack of awareness of the complaint process is a serious problem. TIGTA has conducted outreach among the preparer community at IRS Nationwide Tax Forums, and the OPR website includes instructions on the process. However, the IRS needs to conduct more outreach and education on this topic to reach IRS employees, the preparer community, and taxpayers.

#### *Example: TAS's Recent Experience with One Complaint*

Our office was recently involved with a case in which preparer misconduct was clearly identified and the IRS and TIGTA investigated the complaint. Specifically, the practitioner falsified qualifications on several submitted Forms 2848, Power of Attorney and Declaration of Representative. The IRS and TIGTA were both aware of the misconduct, and the Department of Justice (DOJ) declined to prosecute. After DOJ declined prosecution, the case was routed to OPR for further investigation, because the preparer

<sup>31</sup> EITC Preparer Meeting (Sept. 20-21, 2006).

<sup>32</sup> See [http://www.treas.gov/tigta/contact\\_report.shtml](http://www.treas.gov/tigta/contact_report.shtml).

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claimed to be a Circular 230 practitioner. At this writing, OPR has taken no formal action against the preparer, the IRS has assessed no preparer penalties, and the Forms 2848 remain on file at the IRS with no indication of a problem. During this entire process, the unscrupulous preparer continues representing taxpayers and misrepresenting qualifications to practice before the IRS.<sup>33</sup>

This case illustrates the need for the IRS to address the preparer complaint process. Once the IRS becomes aware of a potential preparer issue, it needs to thoroughly research the complaint for immediate resolution. The IRS harms taxpayers if it does not promptly and adequately address preparer complaints. The IRS has procedures and programs in place to identify potential problem preparers through patterns and schemes. However, when either a taxpayer or employee identifies an actual case of putative preparer misconduct, the IRS should *not* “shelve it” in some database. The IRS needs to take immediate action to address the issue.

The IRS should also consider developing a formal procedure to temporarily flag potentially problematic Forms 2848 on file. The IRS should clearly delineate what type of behavior warrants placing an internal indicator on the file, such as misrepresenting qualifications or requesting to receive refunds on behalf of the taxpayer. Once this yet-to-be-determined threshold behavior is met, this indicator should not lead the IRS to freeze a taxpayer’s account, but would be maintained for internal informational purposes. In addition, the IRS should delete the temporary indicator automatically after a period of time determined to be reasonable to conduct a thorough preparer investigation, so that preparers are not unfairly flagged. During the entire process, the IRS must take extreme care to provide the preparer with due process rights to defend him or herself and appeal any IRS determination. Information concerning a temporary indicator or alleged preparer misconduct should not be available to the public until a full investigation is concluded, a final determination is made and the preparer is afforded due process rights.

In her 2003 Annual Report to Congress, the National Taxpayer Advocate proposed a legislative recommendation to impose a \$1,000 penalty, per instance, against practitioners who willfully and intentionally misrepresent professional status on a Form 2848, and thus practice before the IRS without proper authorization.<sup>34</sup> If Congress had enacted such legislation, the IRS would have had a meaningful penalty to impose on the practitioner in the TAS case discussed above.

#### TIGTA’S Findings on OPR Oversight

In a 2006 report, TIGTA found serious shortcomings in OPR’s oversight of Circular 230 practitioners, specifically that OPR fails to adequately identify practitioners whose conduct warrants disciplinary action. TIGTA found instances where state authorities

<sup>33</sup> Information provided by Local Taxpayer Advocate (Nov. 8, 2006).

<sup>34</sup> National Taxpayer Advocate 2003 Annual Report to Congress 273.

convicted tax practitioners of tax-related crimes or suspended or revoked their licenses, but the practitioners continued to practice before the IRS. Further, the IRS did not have sufficient procedures in place to notify OPR when a practitioner failed to meet his or her own tax obligations. Finally, TIGTA found OPR did not have written procedures to control and review referrals to the office. While the IRS may have procedures to route referrals to OPR, the function does not maintain a record or list of referrals received. In response, OPR agreed to seek out information on practitioner misconduct from state authorities and other IRS functions. OPR also implemented a new case management system for quality control.<sup>35</sup>

### The Case for a National Preparer Database

The Office of Professional Responsibility has actively promoted the creation of a national database, which would centralize and coordinate complaints made throughout the country to any organization within the IRS. This system would supplant the local databases and spreadsheets kept by SB/SE's RPCs and provide full information to each organization investigating a particular preparer.

Before the National Taxpayer Advocate can support the development of a national preparer database, it is imperative that the IRS commit to instituting safeguards in the program. The IRS must strictly limit access to the database to only those IRS employees who are well-trained on the use of the database and the significance of the data contained therein. The IRS must also set clear guidelines on which types of preparer behavior warrant inclusion in the database. Without these safeguards, data entered by one function may be misinterpreted by another function to the detriment of the preparers and their clients. The database should not enable IRS employees to go on "fishing expeditions" or label practitioners and preparers who are merely taking aggressive, but lawful positions.

Notwithstanding these concerns, a national database makes sense due to the lack of central oversight over IRS employees making determinations regarding preparer misconduct. Keeping many databases in different geographical locations and at different IRS enforcement functions is not feasible. Further, it makes sense that different functions within the IRS coordinate with each other for a complete set of facts pertaining to a preparer in question. The database would also allow the IRS to manage and assess the inventory of preparer complaints/referrals and spot trends. However, the IRS has not developed the database beyond a few initial screens.<sup>36</sup>

<sup>35</sup> In the IRS management response to the draft report, the IRS noted that TIGTA reviewed state level actions against attorneys and CPAs. Because a significant portion of the actions involve attorneys and CPAs who do not practice before the IRS, the Service screens the list for individuals who have represented taxpayers. If there is evidence of tax practice, the IRS stated that OPR records information on the case. If there is no evidence of tax practice, the IRS has no jurisdiction and the information is not tracked. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-066, *The Office of Professional Responsibility Can do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (Mar. 2006).

<sup>36</sup> Office of Professional Responsibility Response to Information Request (Jul. 28, 2006).

### Assessment and Collection of Preparer Penalties

Penalty assertion is the IRS's key enforcement vehicle for punishing noncompliance among preparers. SB/SE is responsible for assessing and collecting monetary penalties.<sup>37</sup> The following table details SB/SE assessment and collection of return preparer penalties under IRC §§ 6694 and 6695.

**TABLE 1.12.1, IRS ASSESSMENT AND COLLECTION OF IRC §§ 6694 AND 6695 RETURN PREPARER PENALTIES FOR FY 2002-2006**

Fiscal Year	Total Return Preparer Penalties Assessed	Total Return Preparer Penalties Abated	Total Return Preparer Penalties Collected
2002	\$1,402,033	\$80,493	\$187,898
2003	\$2,724,248	\$250,000	\$226,586
2004	\$1,142,626	\$50,725	\$245,980
2005	\$960,758	\$65,600	\$224,083
2006	\$1,913,962	\$44,900	\$117,823
<b>Totals</b>	<b>\$8,143,627</b>	<b>\$491,718</b>	<b>\$1,002,370</b>

As illustrated in the table above, the IRS has only collected 13 percent of net assessed return preparer penalties under IRC §§ 6694 and 6695<sup>38</sup> in the last five fiscal years with only six percent collected in fiscal year 2006. However small the assessed penalties may be relative to the IRS's other efforts, they may effectively deter noncompliance by preparers. In assessing but not collecting these penalties, the IRS is sending a mixed message about whether it will tolerate poor performance.<sup>39</sup>

### Regulation of Offer Mills

Late night television is filled with advertisements from businesses that offer to settle IRS debts "for pennies on the dollar." These offer mills are a problem for both taxpayers and the IRS. In calendar year 2002 through September 12, 2006, the IRS received 134,132 offers that were not processable, 61,451 (46 percent) of which have a power of attorney indicator on the record.<sup>40</sup> The Taxpayer Advocate Service has handled many

<sup>37</sup> IRM § 4.10.6.8.2, Return Preparer Penalties. Civil penalties and rights of action are set forth in IRC §§ 6694, 6695, 6713, 7407, and 7408. Criminal penalties are included in IRC § 7216. For a detailed discussion of civil and criminal penalties applicable to preparers and the National Taxpayer Advocate's legislative proposals with respect to preparer penalties, see National Taxpayer Advocate 2003 Annual Report to Congress 270-301. See also Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, 9-11 (Apr. 4, 2006) (Statement of Michael Brostek, Director Strategic Issues before the Committee on Finance, U.S. Senate).

<sup>38</sup> Net penalties assessed are equal to the total amount of preparer penalties assessed, minus the total amount of penalties abated. IRS ERIS Data as of September 2006, IRC 6694 and 6695 Preparer Penalty Data.

<sup>39</sup> For a detailed discussion on the impact of penalty enforcement on compliance, see Joint Committee on Taxation, *Committee Print: Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* 31-37, JCS-3-99 (Jul. 22, 1999).

<sup>40</sup> IRS Response to TAS Information Request (Sept. 29, 2006). In CY 2005, 9,558 (49 percent) out of a total 19,675 "not processable" offer submissions had a POA indicator on record.



cases in which the taxpayer engaged an “offer mill” to preparer an offer submission. The taxpayer believes he or she hired a representative who will resolve a tax problem. Then, although the IRS continues to mail notices to the taxpayer about the problem, the taxpayer thinks the preparer is handling the issue by working with the IRS, and does not respond to the notices.<sup>41</sup>

The IRS has taken the position that the mere act of *preparing* an OIC does not constitute practice before the IRS. Thus, unenrolled return preparers, who are not regulated by Circular 230, can prepare OICs. However, unenrolled preparers are not entitled to represent taxpayers before the IRS in discussions regarding the processing of OICs or any collection matter. The Collection function and the Office of Professional Responsibility have issued guidance to Collection employees clarifying the limited representation authority of unenrolled return preparers, and emphasizing that employees should not honor a Form 2848 designation of an unenrolled preparer as a representation in a collection matter.<sup>42</sup>

The National Taxpayer Advocate believes the IRS should deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS and covered by Circular 230. Accordingly, by allowing unenrolled preparers to prepare these forms, the IRS would be permitting unauthorized practice in violation of Circular 230.

Further, even if the IRS does not deem the mere act of preparation as practice before the IRS, it is reasonable for a taxpayer to expect a preparer to see the submitted offer through and continue representing the taxpayer before IRS Collection, unless the taxpayer and preparer explicitly agree otherwise. However, unenrolled preparers are strictly prohibited from representing taxpayers in offers where Collection has jurisdiction.<sup>43</sup> If an unenrolled preparer attempts to *represent* a taxpayer before Collection, the IRS does not have the authority to impose monetary sanctions for this unauthorized practice. The IRS’s only remedy is to seek an injunction against the preparer under IRC § 7407.<sup>44</sup> The National Taxpayer Advocate has previously identified problems resulting from the lack of a significant monetary sanction in these circumstances and recommended enacting a \$1,000 penalty for unauthorized practice before the IRS by a return preparer or other persons.<sup>45</sup>

<sup>41</sup> Local Taxpayer Advocates’ Response to Information Request (Sept. 2006).

<sup>42</sup> IRS Comments to Draft Most Serious Problem on Regulation of Offer Mills Prepared for 2005 Annual Report to Congress; IRS Response to TAS Information Request (Sept. 29, 2006); IRM 5.1.1.7, Exhibits 5.1.1-1 & 5.1.1-2, Processing Third Party Authorizations.

<sup>43</sup> CCA 200431015 (June 1, 2004).

<sup>44</sup> IRC § 7407 authorizes the U.S. government to bring an action in the District Court to enjoin a preparer from acting as a return preparer or from further engaging in misconduct.

<sup>45</sup> National Taxpayer Advocate 2003 Annual Report to Congress 291.

Individuals who prepare Form 656, Offer in Compromise, or the accompanying Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, and Form 433-B, Collection Information Statement for Business, are not required to sign these forms. The absence of a signature line on Forms 433-A and 433-B and the lack of enforcement of the signature on Form 656 make it difficult for the IRS to determine whether a taxpayer or a paid preparer prepared an offer. Because the IRS cannot track offer mills, it cannot regulate them, which allows negligent or unscrupulous preparers to operate with a complete lack of accountability.

Through routine case advocacy and outreach projects, Local Taxpayer Advocates (LTAs) encounter a significant number of complaints about offer mills. LTAs have reported that some prepare the offers, collect money from the taxpayers, and refuse all subsequent follow-up calls from the taxpayers.<sup>46</sup> Requiring practitioners to sign the offers and enforcing the requirement may alleviate this problem by adding an element of accountability into the transaction.

#### Current IRS Oversight of Electronic Return Originators<sup>47</sup>

To become an Electronic Return Operator (ERO), applicants must submit an application to the IRS Electronic Tax Administration function and pass suitability checks, which also cover the applicant's designated Principals and Responsible Official(s). The checks may include criminal background, credit history, tax compliance, and prior non-compliance with IRS *e-file* requirements.<sup>48</sup>

Once the IRS accepts applicants to participate in IRS *e-file* as Authorized IRS *e-file* Providers, the IRS monitors them in several ways. EROs must comply with Rev. Proc. 2005-60; Publication 3112, IRS *e-file* Application and Participation; Publication 1345, Handbook for Authorized IRS *e-file* Providers of Individual Income Tax Returns; and Publication 1345A, Filing Season Supplement for Authorized IRS *e-file* Providers of Individual Income Tax Returns. The IRS monitors the EROs' compliance with tax regulations and submission of taxpayer signature documents. SB/SE is responsible for all field aspects of the monitoring of ERO operations. Monitoring is generally accomplished through visits to the ERO's operation to verify compliance with IRS *e-file* rules. If an ERO is found to be in noncompliance, the violation(s) may result in a warning, written reprimand, suspension, or expulsion of the ERO, depending on the seriousness of the infraction.<sup>49</sup>

<sup>46</sup> Local Taxpayer Advocates' Response to Information Request (Sept. 2006).

<sup>47</sup> For a detailed discussion of the IRS's regulation of EROs, see National Taxpayer Advocate 2005 Annual Report to Congress 223-237.

<sup>48</sup> For a more detailed discussion of suitability checks, see National Taxpayer Advocate 2005 Annual Report to Congress 223-237.

<sup>49</sup> IRS Publication 3112, IRS *e-file* Application and Participation.

In the 2005 Annual Report, the National Taxpayer Advocate pointed out the inadequacies in both the ERO application process and *e-file* monitoring. The IRS has indicated it does not perform all elements of the suitability check either before authorizing an ERO or during the period of certification.<sup>50</sup> With no stringent procedures in place during the application process or thereafter, the IRS cannot be certain that only qualified individuals are registered.<sup>51</sup>

Further, the IRS continues to inadequately monitor compliance with ERO requirements found in Publication 1345, Handbook for Authorized IRS *e-file* Providers of Individual Income Tax Returns.

**TABLE 1.12.2, IRS ERO SANCTIONS**<sup>52</sup>

Year	Active EROs	Visits	Percentage of visits per active EROs	Warnings	Written Reprimands	Proposed Suspensions	Suspensions
2002	85,194	1,412	1.7%	No Data	117	38	60
2003	99,049	1,062	1.07%	139	124	67	29
2004	89,320	1,294	1.45%	224	154	90	31
2005	105,250	1,104	1.05%	143	124	26	29

Based on the above data, it appears the IRS does not adequately enforce the ERO regulations. Even as the number of EROs has continually risen, the percentage of EROs visited has generally fallen. In addition, the fact that more than 29 percent of ERO visits in 2005 led to either a warning or a sanction indicates the IRS needs to more actively monitor EROs. The IRS has asserted the high rate of ERO noncompliance found during *e-file* monitoring is due to an effective selection methodology. The IRS also claims it found a 7.8 percent noncompliance rate during past random visits.<sup>53</sup> However, without more information regarding the selection process, we cannot apply the random rate of noncompliance to the general population. We invite the IRS to work with TAS regarding the methodology used to select ERO sites at random.

<sup>50</sup> IRS Response to TAS Information Request (Sept. 18, 2006).

<sup>51</sup> TIGTA recently identified the same issues with the Office of Professional Responsibility's enrolled agent program. Specifically, TIGTA found that the IRS does not take a proactive approach to monitoring tax compliance for enrolled agent's renewing their authorizations. Furthermore, OPR does not adequately check the criminal backgrounds of both new applicants and agents renewing their authorizations. Treasury Inspector General for Tax Administration, Ref. No. 2006-10-170, *The Office of Professional Responsibility Does Not Always Ensure Enrolled Agents Are Qualified, and System Limitations Prevented Identification of Ineligible Representatives*, (Sept. 29, 2006).

<sup>52</sup> IRS Responses to TAS Information Request (Sept. 29, 2006, Nov. 30, 2006). As of September 20, 2006, SB/SE planned to complete 1,129 visits in 2006 and 1,270 in 2007. Electronic Tax Administration, IRS *e-file* and *e-file* Monitoring (Presentation on Sept. 20, 2006). Beginning in 2004, active ERO numbers reflect those EFINs filing more than 25 returns.

<sup>53</sup> IRS Comments on Most Serious Problem on Refund Anticipation Loans, National Taxpayer Advocate 2005 Annual Report to Congress 177.

Further, based on the questions included on the ERO Visitation Checksheet used by SB/SE employees, the IRS appears to focus on infractions affecting the quality of the *e-file* program rather than tax administration in general.<sup>54</sup> It is encouraging that the visits now verify compliance with EITC due diligence requirements in IRC § 6659(g). However, the IRS should take advantage of the time spent in the ERO's office to take a broad-based look at whether the provider's activities affect the entire tax system, such as observing the marketing of ancillary tax products, including refund anticipation loans (RALs).<sup>55</sup> In addition, due to the fundamental importance of safeguarding confidential tax return information, the monitoring visits should also include a comprehensive review of the ERO's procedures to comply with IRC § 7216 use and disclosure requirements. The checksheet does not include any questions to determine whether the ERO's procedures to obtain the taxpayers' written consent to use or disclose confidential tax information comply with the requirements of the IRC § 7216 regulations, which are discussed in more detail below.

### Access to E-Services

In the 2005 Annual Report to Congress, the National Taxpayer Advocate stated the IRS should expand access to e-Services to all Circular 230 practitioners regardless of their *e-file* rate.<sup>56</sup> In response, the IRS stated it was pursuing options to add additional groups to e-Services.<sup>57</sup> In November 2006, the IRS announced plans to extend the program to enrolled agents and reporting agents.<sup>58</sup> However, the National Taxpayer Advocate believes the planned expansion is still insufficient. As discussed in her 2005 Most Serious Problem on e-Services, the suite of services included in e-Services, especially the Transcript Delivery System (TDS) and Electronic Account Resolution (EAR), are extremely useful to Circular 230 practitioners who do not meet the current *e-file* threshold but who represent taxpayers in controversies and other dealings with the IRS. There is no legitimate reason to expand access to enrolled agents and reporting agents and continue to exclude other highly qualified Circular 230 practitioners. Moreover, such an approach harms taxpayers who have disagreements and disputes with the IRS by delaying their access to account information.

<sup>54</sup> IRM Exhibit 4.21.1-6, ERO Visitation Checksheet (Jan. 2003). Items monitored during the visits include *e-file* signature authorizations, reviewing compliance with signature requirements, advertising materials, documentation, inspecting acknowledgment files, and very basic RAL items.

<sup>55</sup> For a more detailed discussion of the RAL related practices overlooked during the *e-file* monitoring visits, see National Taxpayer Advocate Fiscal Year 2007 Objectives Report to Congress, Vol. II (Jun. 30, 2006).

<sup>56</sup> E-Services is a suite of web-based products available to practitioners who are active in the IRS *e-file* Program. The following services are available through e-Services: Registration, Preparer Tax Identification Number (PTIN) Application, Online *e-file* Application, Taxpayer Identification Number (TIN) Matching, Disclosure Authorization, Electronic Account Resolution (EAR), and Transcript Delivery System (TDS).

<sup>57</sup> National Taxpayer Advocate 2005 Annual Report to Congress 249-259. The IRS generally limits access to e-Services to practitioners who have *e-filed* five or more accepted individual or business returns.

<sup>58</sup> *CERCA Conference Showcases Controversy Over Potential IRS E-Filing Portal*, Tax Notes (Nov. 3, 2006). Reporting agents are companies that perform payroll services for other businesses and act as a conduit between the employers and the IRS.

### Restrictions on Disclosure of Tax Return Information

Internal Revenue Code § 7216 imposes a criminal penalty on preparers of income tax returns who knowingly or recklessly make unauthorized uses or disclosures of tax return information.<sup>59</sup> The statute and the regulations issued thereunder establish privacy protections by placing limitations on a tax return preparer's ability to use or disclose confidential information. The existing statute and regulations permit a tax return preparer, with the written consent of the taxpayer, to use tax return information to promote non-tax products and services currently offered by the preparer or a member of the preparer's affiliated group.<sup>60</sup> Moreover, with written taxpayer consent, a tax return preparer may disclose tax return information to any third person as directed by the taxpayer.<sup>61</sup> Further, after the initial disclosure of tax return information to a third party, the tax laws and regulations do not place any restrictions on the redisclosure of information by that party.

The IRS and Treasury, after consulting with the National Taxpayer Advocate, have issued proposed regulations and a related draft revenue procedure. The preamble to the proposed regulations states the proposed rules address taxpayers' consent to the disclosure or use of tax return information in an electronic environment. The proposed changes also focus on provisions designed to ensure that taxpayers give knowing, informed, and voluntary consent. The proposed regulations allow preparers to obtain written consents for solicitation of services or facilities furnished by any person rather than limiting solicitations to the services or facilities offered by the preparer or a member of the preparer's "affiliated group." The proposed regulations also include provisions requiring written consent by the taxpayer before the preparer releases information overseas, even when the recipient is with the same firm.<sup>62</sup>

Notice 2005-93 contains the proposed revenue procedure detailing the format and contents of consents to use and disclose tax return information by tax return preparers under IRC § 7216. The proposed revenue procedure contains mandatory language to include in consents addressing the limitations and duration of the consent. It also contains mandatory language detailing contact information for TAS, so taxpayers can learn more about taxpayer rights under IRC § 7216, as well as contact information to report suspected violations to TIGTA.<sup>63</sup>

<sup>59</sup> IRC § 6713 imposes civil penalties on the improper use or disclosure of tax return information by return preparers of income tax returns.

<sup>60</sup> Treas. Reg. § 301.7216-3(a)(1)(i).

<sup>61</sup> Treas. Reg. § 301.7216-3(a)(2).

<sup>62</sup> REG. 137243-02, 2006-3 I.R.B. (containing Prop. Treas. Reg. §§ 301.7216-1 to -3); Notice 2005-93, 2005-52 I.R.B. 1204 (containing Proposed Revenue Procedure 2005-93). For a more detailed discussion of the benefits included in the proposed regulations and revenue procedure, see *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Comm. on Finance*, 109th Cong. 2nd Sess. (Apr. 4, 2006) (Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service).

<sup>63</sup> IRS Notice 2005-93, 2005-52 I.R.B. 1 (Dec. 7, 2005).

## PROBLEMS

After the IRS and Treasury released the proposed regulations and draft revenue procedure for public comment, the proposed rules came under fire for not protecting taxpayers enough. A number of consumer protection groups argued the proposed rules would allow commercial tax preparers to share and even sell confidential taxpayer information to third party marketers and database brokers.<sup>64</sup>

While the National Taxpayer Advocate firmly believes the proposed regulations provide far more protection than existing regulations, she plans to work closely with the IRS and Treasury to consider and potentially incorporate comments from the public into the regulations. However, it is of utmost importance that the revision process continue and receive the highest priority, because the worst possible outcome would be to leave intact the existing regulations which are clearly inadequate in electronic and paper filing environments.<sup>65</sup>

Concerns about the proposed rules have also received congressional attention. Section 512 of S.1321, The Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act, directs the Secretary to amend the regulations under IRC § 7216 to prohibit the disclosure or use of information to or for any person unless such disclosure or use is in connection with preparing or filing, or providing services in connection with the preparation or filing of, a tax return. In addition, the bill directs the Secretary to amend the regulations to prohibit use or disclosure of information to or by any tax return preparer located outside of the United States unless the taxpayer has granted consent to such disclosure or use, a provision that is consistent with the approach taken in the proposed regulations.<sup>66</sup>

In the Senate Report issued in connection with S.1321, the Senate Finance Committee stated it found the use of tax information as a source of clients or data in non-tax preparation lines of business “troubling.” Specifically, the Committee stated “tax return preparers are exploiting their position of trust to market products and services unrelated to the preparation of a tax return.” Taxpayers may not understand how these products work and may provide consent to the products as a part of a stack of forms signed during the return preparation process. To address these concerns, the Committee stated it is appropriate to prohibit the use or disclosure of tax return information for a nontax preparation purpose. The Committee also stated it is important for a taxpayer with or without multinational dealings to provide knowing consent to the transmission of tax

<sup>64</sup> See, e.g., National Consumer Law Center, IRS Proposal Would Let Tax Preparers Sell Citizen Tax Records to Third Parties (March 8, 2006).

<sup>65</sup> The Department of Treasury and the IRS have placed the IRC § 7216 regulations project on the Office of Tax Policy and Internal Revenue Service 2006 – 2007 Priority Guidance Plan, Tax Administration, Item 35 (Aug. 15, 2006).

<sup>66</sup> Several commentators objected to the requirement to obtain written consent for use or disclosure involving overseas activities by tax return preparers, because this requirement would add unnecessary and burdensome steps to the current tax return processes of many multinational practices. See, e.g., American Institute of Certified Public Accountants, Comments on Proposed Regulations, REG-137243-02 Regarding Guidance to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations (Mar. 8, 2006).

return information to tax return preparers overseas, because it is difficult to police IRC § 7216 violations outside the United States.<sup>67</sup> The Committee also recommended that both IRC §§ 6713 and 7216 expand the definition of “tax return preparer” to reflect current technology and business practices. Thus, the term should include preparers of returns other than income tax returns, volunteers, individuals who perform other businesses in addition to tax return preparation, and contractors performing services in connection with tax return preparation.<sup>68</sup>

The National Taxpayer Advocate acknowledges the difficult balancing act between permitting the legitimate use of tax return information and preventing the effect of software and electronic filing on making this information a commodity by persons who have no tax-related products. For example, it is important to preserve the ability of certified public accountants and attorneys, who are bound by legal and ethical responsibilities, to use tax return information or disclose the information to another employee or member of the firm for purposes of rendering legal or accounting services, including estate planning or closely-held business planning.<sup>69</sup>

In conclusion, the National Taxpayer Advocate looks forward to working closely with Treasury and the IRS to develop the final regulations under IRC § 7216. While the proposed regulations provide far more protections than the existing regulations, commentators raised legitimate concerns. Because protecting the privacy of tax return information is fundamental to taxpayer compliance, this issue must receive utmost priority and concerns raised by consumer groups must be thoroughly reviewed and potentially incorporated into the final regulations.

## IRS COMMENTS

### Proposals to Regulate Unenrolled Return Preparers

The National Taxpayer Advocate acknowledges the existence of 582 Program Action Cases as of August 15, 2006. This is up from approximately 100 a year earlier. In addition, the IRS currently has over 1,000 active promoter investigations underway and has worked with the Department of Justice to enjoin well over 200 tax return preparers since inception of the Lead Development Center in April 2004. The IRS recently developed a new IRS-wide strategy to ensure noncompliant preparer leads are effectively coordinated resulting in work being delivered to the appropriate function at the appropriate time. In addition to monthly conference calls, the strategy includes an annual planning meeting to coordinate leads that involve Criminal Investigation, SB/SE, Large and Mid-Size Business (LMSB), Tax-Exempt and Government Entities (TE/GE), Appeals and the Office of Professional Responsibility (OPR).

<sup>67</sup> S. Rep. No. 109-336, 109th Cong., 2d Sess. 86-90 (2006).

<sup>68</sup> *Id.* at 84-86.

<sup>69</sup> See Treas. Reg. § 301.7216-2((e)(2)); Prop. Treas. Reg. § 301.7216-2(h)(1).

**Example: TAS's Recent Experience with One Complaint**

The National Taxpayer Advocate's report describes a situation involving a preparer who misrepresented his or her credentials on Forms 2848. Based on the description, it appears the IRS followed appropriate referral processes for a case of that nature. The Treasury Inspector General for Tax Administration (TIGTA) conducted a criminal investigation involving False Statements under Title 18 USC 1001. If the practitioner "falsely" claimed to be a Circular 230 practitioner, OPR would not have jurisdiction to impose a sanction. The IRS has procedures for the Return Preparer Coordinators or OPR personnel to correct the preparer's designation on the Centralized Authorization File (CAF) when misrepresentation is verified. The preparer would still "appear on the CAF", but with the proper designation.

We cannot confirm whether these procedures were followed in the specific case since the Taxpayer Advocate Service (TAS) would not provide the name of the preparer. However, it should be noted that OPR has recently assigned several TIGTA Reports of Investigation that involve misrepresentation of credentials and some pending assignment. The IRS will correct the CAF designation of these individuals as appropriate.

**TIGTA'S Findings on OPR Oversight**

The NTA accurately describes the TIGTA report on OPR oversight, but does not correctly reflect our response. With respect to "referrals," TIGTA looked at reports OPR collects from state attorney and CPA discipline authorities on actions taken at the state level. The vast majority of these state level actions involve attorneys and CPAs who do not practice before the IRS. When OPR receives a list of state actions, we screen it for people who have represented taxpayers. We individually track those we identify when we open a Circular 230 case. If we have no evidence of tax practice (as would be the case for an attorney in a criminal defense or domestic relations practice for example), we have no jurisdiction and we do not track information on those attorneys and CPAs.

**The Case for a National Preparer Database**

OPR has presented the concept of a centralized system to other functions and Business Units of the IRS to determine whether the project is feasible and has the necessary support. OPR has been focusing on identifying system requirements including potential data sources, users, and business purpose. OPR has also identified a number of related tasks that we must accomplish, such as a new System of Records Notice, before we can develop a system.

We are beginning the required Enterprise Life Cycle (ELC) process and, where appropriate, will address the concerns the National Taxpayer Advocate raises. Part of the ELC process includes an approved Privacy Impact Assessment (PIA) through the IRS' Office of Privacy. The PIA will help us to identify potential privacy risks in the system and limit the information collected, used, and maintained to what is relevant to achieve a



legitimate business purpose. The PIA process will also address what data is to be used, how the data is used, and who will have access to the data.

### Assessment and Collection of Preparer Penalties

With regard to collection of preparer penalties, the IRS uses an enterprise-wide approach to working collection cases. Cases, including those involving preparer penalties, are assigned to an appropriate treatment stream based on case characteristics and expected collection outcome.

The figures cited in the National Taxpayer Advocate's report do not accurately represent collection efforts. Five percent of the tax preparers owe 68 percent of the dollars assessed. Many of these accounts were assigned and worked, and were closed as currently not collectible. Others are in the notice stream or inventory queue, awaiting assignment. Rather than percentage of dollars collected, the percentage of preparer penalties that are paid in full more appropriately reflects the effort to collect preparer penalties.

Excluding abatements, the percentages of cases that are currently paid in full are:

**TABLE 1.12.3, FULL PAID PREPARER PENALTY ACCOUNTS UNDER \$25,000**

Year Assessed	Number of Accounts	Total Fully Paid	Percent Fully Paid
FY 03	146	64	43%
FY 04	151	67	44 %
FY 05	204	49	24 %

Many of the remaining cases will be collected through installment agreements, subsequent payments, and refund offsets over the statutory life of the accounts. There are six to eight years remaining to collect the penalties.

The IRS's Collection Division in SB/SE pursues the delinquent preparer penalty accounts in excess of \$25,000 and often finds that the cases are uncollectible. By the time the penalties are appealed, adjudicated, and assessed, assets are typically encumbered or have been sold. These accounts include cases in which preparers have been prohibited from tax practice, convicted of tax fraud, sent to prison, filed bankruptcy, or have otherwise become unable to pay the large penalties assessed against them.

### Regulation of Offer Mills

The IRS shares the National Taxpayer Advocate's view that it is difficult to track and regulate offer mills and is trying to reduce the negative effects of offer mills on taxpayers. In 2004, we issued a consumer alert about abusive mills that use deceptive advertising. We also have issued instructions to the Offer in Compromise (OIC) staff on how to identify offer mills and make referrals to OPR. The OIC staff has also been trained to work directly with the taxpayer when an unenrolled return preparer has pre-

pared the Form 656, Offer in Compromise, or attempts to represent the taxpayer during the offer process.

The OIC program has methods in place to capture data about practitioners. However, the quality of the data depends on participation. The Form 656 has a section for the paid preparer to complete and a section for the taxpayer to identify who helped prepare the application. This information is not always submitted with the application, however, because completion is not mandatory.

### **Current Oversight of Electronic Return Originators**

The National Taxpayer Advocate does not adequately explain or support her conclusion that the IRS cannot be certain that only qualified individuals are registered. The IRS does not require individuals to register. Firms apply to be Authorized IRS *e-file* Providers and include individuals who are Principals and Responsible Officials of the firm on the application. The National Taxpayer Advocate is correct that the IRS does not check all elements of the suitability on every individual Principal and Responsible Official. We do not have evidence to show that completing all elements of suitability on all individuals would improve tax administration significantly.

### **IRS ERO Sanctions**

Non-compliance outside of the IRS *e-file* rules should not be addressed during an *e-file* monitoring visit, but a referral should be made to the appropriate function.

### **Restrictions on Disclosure of Tax Return Information**

The Treasury Department and the IRS have proposed amendments to Circular 230 and the regulations under § 7216. The guidance is proposed, not final, at this time. We received numerous comments, in addition to the National Taxpayer Advocate's report, and held public hearings on the proposed rules. We are considering all comments in drafting final regulations and will address the comments in the preamble to the final regulations.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

We commend the IRS for its efforts to improve the oversight of unscrupulous preparers. However, the National Taxpayer Advocate believes that more needs to be done. The IRS's current approach concentrates on identifying preparers after they have committed egregious misconduct. While it is important to address problem preparers, a more balanced approach would be to couple enforcement with a system of regulation, which would allow the IRS to better track preparers and ensure preparer competency in the tax laws.

**Proposal to Regulate Unenrolled Return Preparers**

We are pleased that the IRS is increasing its efforts to identify and correct behavior of the most egregious noncompliant preparers. The substantial increase in the number of Program Action Cases is encouraging. We are also confident that the IRS-wide strategy to coordinate noncompliant preparer leads will improve the effectiveness and efficiency of preparer oversight. However, we request that the planning meetings include a representative from the Taxpayer Advocate Service.

**Assessment and Collection of Preparer Penalties**

The IRS provided an explanation for the low percentage of preparer penalties collected. We understand that the low collection percentage is caused by the currently not collectible status of preparers with large penalty accounts. In fact, the SB/SE Collection Division focuses on preparer penalty accounts in excess of \$25,000. Given that experience shows such accounts are uncollectible, the IRS needs to also concentrate on lower dollar balances. We understand that the IRS has limited resources, but the assessment and collection of penalties is a way to correct the behavior of preparers, regardless of the dollar value of their penalty accounts. By sending a message to the preparer community through the assessment and collection of penalties, the IRS may actually reduce downstream compliance costs. Moreover, placing preparer penalties on preparers who are already convicted of fraud is not much of a deterrent. The IRS's limited resources would have a greater deterrent effect by applying preparer penalties for negligent – not just fraudulent - misconduct

**Regulation of Offer Mills**

While issuing consumer alerts on abusive offer mills is important, the National Taxpayer Advocate believes the IRS can do more to track and regulate offer mills. The OIC program's ability to capture practitioner data is limited by the data it actually receives. Requiring and actually enforcing signature requirements is a very powerful tool to improve the amount of data captured by the OIC program. Another way to address the problem of offer mills would be to deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS and covered by Circular 230. Thus, unenrolled preparers who prepare these forms would be performing unauthorized practice in violation of Circular 230.

**ERO Oversight**

The IRS states it does not have evidence to prove that noncompletion of all elements of the ERO suitability checks affects tax administration significantly. However, we are unaware of any analysis performed by the IRS to support its decision to not complete all elements of the checks. It seems reasonable to check an applicant's criminal background, credit history, tax compliance, and prior non-compliance with IRS *e-file* requirements before accepting an individual into an IRS program that significantly impacts taxpayers and their compliance with the tax laws.

Further, the IRS takes the position that non-compliance outside the IRS *e-file* rules should not be addressed on an *e-file* monitoring visit. The National Taxpayer Advocate believes it is cost efficient to include these issues on the ERO Monitoring Checksheet used by SB/SE employees, so they can take a broad-based look at the ERO's operations while they are physically located in the ERO's place of business. Once the SB/SE employee spots a potential issue, a referral can be made to the appropriate function.

**RECOMMENDATIONS**

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

- ◆ Research the preparer community to better design an approach to regulate unenrolled return preparers. The following information would be useful in this analysis:
  1. Types and number of returns prepared by unenrolled preparers;
  2. Assessment and collection of preparer penalties broken down by type of preparer;
  3. Assessment and collection of penalties and interest against taxpayers who use paid preparers, broken down by type of preparer and type of penalty;
  4. Adjustments in tax liabilities on returns prepared by paid preparers, broken down by line item and type of preparer;
  5. Experience of the preparer programs in California and Oregon to determine their effectiveness and costs of administering.
- ◆ Reevaluate the proposed rules under Circular 230 to eliminate the authority of unenrolled return preparers to engage in limited practice before the IRS consider amending Circular 230. The National Taxpayer Advocate recommends that Treasury and the IRS retain the current limited practice provisions.
- ◆ Establish a multi-function task force, including the EITC program office, to design a program to receive and investigate preparer complaints filed by taxpayers or referred by IRS employees. The group should evaluate the feasibility of a national preparer database and address the necessity of safeguards to provide preparers due process and protect preparers from unfair treatment; procedures to limit access, content and use of the information contained therein; and strict guidelines

pertaining to making information public. The group should also design a comprehensive outreach campaign targeted to both taxpayers and IRS employees.

- ◆ Submit the National Preparer Database to the Office of the Taxpayer Advocate for review and issuance of a Taxpayer Rights Impact Statement (TRIS).<sup>70</sup>
- ◆ Prioritize both the assessment and collection of preparer penalties.
- ◆ Deem the preparation of an offer in compromise or request for a collection due process hearing for a fee as practice before the IRS covered by Circular 230.
- ◆ Further, to better track practitioners, the IRS should require a preparer signature on Forms 433-A and 433-B and enforce the signatures on Form 656.
- ◆ Work in conjunction with TAS to determine a methodology for SB/SE to select ERO sites at random for *e-file* monitoring visits. Revise the ERO Visitation Checksheet to review ERO procedures to comply with the use and disclosure requirements under IRC § 7216.
- ◆ Expand access to e-Services to include all practitioners authorized to practice before the IRS under Circular 230, without regard to whether they satisfied an *e-file* threshold.
- ◆ Prioritize the process to revise the regulations under IRC § 7216.

<sup>70</sup> See National Taxpayer Advocate's Fiscal Year 2005 Objectives Report to Congress 2-5.

**PROBLEM****TOPIC #13****CORRESPONDENCE DELAYS****RESPONSIBLE OFFICIALS**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

**DEFINITION OF PROBLEM**

The IRS too often does not respond to taxpayer correspondence in a timely manner. Conflicting IRS quality measures overstate actual correspondence “timeliness,” and allow many delays and problems to remain undiagnosed. Surveys of taxpayers indicate untimely correspondence remains a leading source of dissatisfaction and frustration with the IRS.

**ANALYSIS OF PROBLEM****IRS Correspondence Policy: Action 61 Interim Letter Requirements**

Taxpayers write to the IRS to respond to notices or letters about a variety of issues: for example, a balance due, a failure to file a return, or a potential income-reporting discrepancy. Taxpayers may also contact the IRS to inquire about refunds or the status of their accounts, or to request an abatement of penalties or an installment agreement.

In response to these types of taxpayer correspondence issues, during the 2005 fiscal year the IRS sent nearly 2.9 million “interim” letters advising taxpayers to expect delays of 30 days or more in processing their correspondence, over and above the IRS’s “acceptable” 30-day initial processing period.<sup>1</sup> The IRS issues “interim letters” (to inform taxpayers of IRS processing delays) – in the “interim” – while the taxpayers continue to wait for a substantive IRS reply to their correspondence concerns. Internally, the IRS refers to all interim responses as “stall” letters.<sup>2</sup>

<sup>1</sup> IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes*; IRM 3.0.273.19.4.1 (Jan. 1, 2006).

<sup>2</sup> The term (used in IRS “jargon”) referring to all interim letters as a single group is “stall letters.” In fact, it is so commonly used that it has actually been incorporated within Internal Revenue Manual (IRM) sections such as IRM 4.19.3.25(2), Unpostable AUR Transactions (Sept. 1, 2005). However, there are actually four primary interim letter variations generated through the Integrated Data Retrieval System (IDRS). These four interim letters have been assigned alpha-numeric codes (*i.e.*, 2644C, 2645C, 2644SP, and 2645SP) which appear in the top right corner of each interim letter a taxpayer receives. Letters ending with a “C”-suffix are considered “national” variations. This means that a “C”-letter has been standardized for use by any function within the IRS. The “SP”-suffix letters are the national Spanish-language translations of the “C”-letters. For example, the “2644C” letter is titled, “Second Interim Response.” The Spanish-language variation of the “2644C” letter is the “2644SP” letter. Specialized functions within the IRS will modify a “C” letter to incorporate specialized wording which enables a taxpayer to have a clearer understanding of that letter. For example, the Ogden Campus has modified the initial “stall” letter a taxpayer generally receives, the 2645C letter. The 2645C letter is titled “Interim Letter,” and has been changed to include a few additional paragraphs. Since this modified letter is unique to the Ogden Campus, the modified “2645C” letter designation has also been modified to reflect these alterations as the “2645O” letter. In this instance, the “O” stands for the “Ogden” campus. Other IRS campuses have made similar changes to IRS letters, which can also be identified by an altered alpha-suffix (*e.g.*, “AN” stands for the Andover campus). IRS, *Service-wide Electronic Research Program (SERP) Home Page, Correspondex Letters, Numeric Index*, and IRS, *Office of the Notice Gatekeeper*.

Interim letters generally contain standardized paragraphs with a blank, “fill-in” option in which an IRS employee enters the number of additional days that a taxpayer’s correspondence processing will be delayed. The first interim letter that a taxpayer receives will typically notify him or her that a final IRS response will be delayed between 30 and 45 days. However, if an IRS caseworker will need even longer to respond to a taxpayer, the caseworker also has the option of manually scheduling a second interim letter to the same taxpayer—adding 30-45 more days to that taxpayer’s wait. Therefore, second interim letters actually represent the *third* correspondence delay a taxpayer will experience.<sup>3</sup>

In May 1994, the IRS issued a memorandum entitled, “Action 61 Interim Letter Guidelines.”<sup>4</sup> Those 1994 correspondence guidelines, now simply referred to as “Action 61,” directed the former IRS service centers (later reorganized into “campuses”) to review the interim letter process and set improvement objectives. Action 61 defined the specific types of casework the IRS considers to be taxpayer “correspondence.” In addition, Action 61 established that each response to a taxpayer’s correspondence must be “...initiated within 30 days of the initial IRS received date.”<sup>5</sup>

Action 61, now embedded within the Internal Revenue Manuals (IRMs) of Accounts Management, remains the IRS’s current correspondence policy.<sup>6</sup> Despite the intent of this policy, however, millions of taxpayers continue to be plagued by correspondence delays which the IRS can and should avoid. The 2.9 million IRS interim letters issued in FY 2005 indicate that Action 61 has not resolved the IRS’s problems with responding to taxpayer correspondence in a timely manner.

### Campus Specialization as a Result of the Internal Revenue Service Restructuring and Reform Act of 1998

#### *Accountability and Business Measures*

The IRS Restructuring and Reform Act of 1998 (RRA 1998) generated a major IRS reorganization,<sup>7</sup> which was designed to meet the unique needs of specific taxpayer groups, and created four new IRS operating divisions: Wage and Investment, Small Business/Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. Before the reorganization, each service center was controlled by its own single

<sup>3</sup> The “acceptable” response time for initial correspondence contains a built-in delay of 30 days, per the Action 61 policy. The first interim letter to the taxpayer typically adds a 30 to 45 day delay to the initial response time. The second interim adds at least 30 more days to the taxpayer’s wait. In total, the taxpayer must sometimes experience three different waiting periods or delays.

<sup>4</sup> The IRS established an internal Correspondence Task Force in August of 1990. The IRS did not adopt all of the task force’s recommendations right away. “Action 61” was the sixty-first action recommended by the team. The IRS implemented Action 61 beginning with an IRS memorandum in May of 1994. General Accounting Office, GGD-94-118, *Tax Administration: More Improvement Needed in IRS Correspondence* (Jun. 1, 1994), and GGD-95-66 (Feb. 1995).

<sup>5</sup> IRM 3.0.273.19.5 (Jan. 1, 2006).

<sup>6</sup> IRM 3.0.273.19, Taxpayer Correspondence, (Jan. 1, 2006).

<sup>7</sup> Pub. L. No. 105-206, 112 Stat. 685 (Jul. 22, 1998).

director, with interrelated business measures among the three major functions (*i.e.*, the former Submission Processing, Customer Service I [Accounts] and Customer Service II [Compliance]).

When the new organizational structure officially “stood up” on October 1, 2000, the service centers split into specialized “campus” operations, with the three primary functions typically placed under three separate directorships (*i.e.*, Submission Processing, Compliance Services, and Accounts Management). At the campus level, individual programs, including correspondence variants (*e.g.*, installment agreement requests, account adjustment requests, lost payment concerns etc.), were broken up into the three new directorships, with redefined and differing responsibilities and measures. Therefore, in its effort to specialize services to taxpayers, the IRS has lost its single point of accountability for resolving correspondence delays at the campus level.

#### *Local Procedures and Case Routing*

Some campuses developed local procedures to clarify their new roles, based on varying levels of authority. For example, within a campus, a taxpayer’s letter may be routed from Accounts Management to Compliance Services, based upon instructions in a local desk reference guide<sup>8</sup> or job aid.<sup>9</sup> However, if a second function is not operating at the same location, the IRS may issue a different type of delay notification to the taxpayer, the 0086C letter, “Referring Taxpayer Inquiry/Forms to Another Office.”<sup>10</sup> Combined, referral letters (those transferring taxpayer correspondence to another IRS location for resolution) and interim letters (those extending the delay on an IRS response) accounted for 19 percent of all IRS letters in FY 2005, translating to almost 3.3 million correspondence delays for taxpayers.<sup>11</sup>

<sup>8</sup> For example, if Accounts Management (AM) receives taxpayer correspondence which displays collection activity on IDRS, it is routed to Compliance Services. However, amended returns in a similar status on IDRS will be retained in Accounts Management. Should Accounts Management receive an amended return which also contains taxpayer correspondence attached, then AM will work **both** the amended return, as well as the response to the taxpayer correspondence. But, when Accounts Management receives an amended return containing an attached letter with “collection criteria” (*e.g.*, taxpayer can’t pay, won’t pay, or will pay later), AM will **only** work on the attached amended return portion. The correspondence will be detached and routed to Compliance Services for a response. IRS, *Ogden Accounts Management Campus (OAMC) Desk Reference Guide, Accounts in Status 22, 24, 26* (Jul. 11, 2006).

<sup>9</sup> One example of local correspondence processing variation can be found in a checklist in the Atlanta AM campus, which states, “If TP issues are not worked in AM, route to appropriate area using TPI (Taxpayer Inquiry) routing guide.” But there is no nationally approved “TPI routing guide.” IRS, *Atlanta Accounts Management Center (ATAMC) Correspondence TPI Checklist* (June 2, 2005).

<sup>10</sup> IRS, *0086C letter, “Referring Taxpayer Inquiry/Forms to Another Office”* (May 1, 2006).

<sup>11</sup> Figures are compiled from the IRS, Office of the Notice Gatekeeper’s FY 2005 totals. [(2,888,840 total of FY 2005 IRS 2644/2645 interim letters sent) + (376,502 total FY 2005 IRS 0086 referral letters sent)] / (16,932,474 total volume of FY 2005 IRS “C” and “L” letters of any type sent) = (the percentage of all IRS letters which are delay notifications, or 19.28 percent). NOTE: As described in footnote #2 above, “C” letters are standardized national IRS letters which contain a “C”-suffix. Letters which have been modified for localized use retain the suffix of the site which has modified the letter (*e.g.*, “O” for Ogden; “AN” for Andover). Totals for all local letter suffixes are combined by the IRS Office of the Notice Gatekeeper, and listed under “L” letters. The “L” denotes the letters are “local” variations of IRS letters.



Transshipment (which triggers an 0086C letter) increases correspondence delays. However, the Government Accountability Office (GAO) FY 2005 audit of the IRS found that extremely poor tracking, follow-up, and review procedures – specifically with transshipped taxpayer information – increased the risk of errors, theft, or loss of taxpayer information.<sup>12</sup>

**TABLE 1.13.1,<sup>13</sup> COMBINATION TOTALS FOR INTERIM LETTERS AND REFERRAL LETTERS**

FY05 Correspondence Interim Letter Totals				
	All Letters	Interims	1st (2645)	2nd (2644)
<b>1st Qtr (Oct-Dec, 2004)</b>				
National Versions	3,104,216	407,697	378,053	29,644
Local Versions	162,199	11,925	11,925	0
Spanish Versions	23,150	84	80	4
<b>2nd Qtr (Jan-Mar, 2005)</b>				
National Versions	3,085,782	403,258	378,954	24,304
Local Versions	171,082	16,201	16,201	0
Spanish Versions	19,708	111	111	0
<b>3rd Qtr (Apr-Jun, 2005)</b>				
National Versions	5,837,417	1,112,348	1,073,543	38,805
Local Versions	213,998	26,746	26,746	0
Spanish Versions	33,203	94	94	0
<b>4th Qtr (Jul-Sept, 2005)</b>				
National Versions	4,197,878	873,799	821,548	52,251
Local Versions	159,902	36,866	36,866	0
Spanish Versions	22,346	115	114	1
<b>FY05 Combined Totals</b>				
National Versions	16,225,293	2,797,102	2,652,098	145,004
Local Versions	707,181	91,738	91,738	0
National/Local Combined	16,932,474	2,888,840	2,743,836	145,004
Spanish Versions <sup>14</sup>	98,407	404	399	5

<sup>12</sup> Government Accountability Office, GAO-06-543R, *Management Report: Improvements Needed in IRS's Internal Controls 5* (May 12, 2006).

<sup>13</sup> Figure contains volumes recorded by the IRS, Office of the Notice Gatekeeper, *Correspondence Letter Volumes* (Sept. 22, 2006). The Notice Gatekeeper records all IRS letters generated through the IDRS system. Standard versions are recorded as "National" letters, while "Local" contains site-specific variations.

<sup>14</sup> The IRS Office of the Notice Gatekeeper combines both the English and Spanish variations of its national letters ("C" and "SP" letters) under one heading. The combined total of these letters has been displayed under the heading, "National Versions." However, for comparison purposes, volumes for all Spanish versions have also been separated from "National Versions," and appear again as stand-alone totals. For example, in the chart above, the IRS sent 378,053 national "2645" letters in the 1st Quarter of FY 2005. Of the 378,053 letters sent, 80 were sent in Spanish as the 2645SP letter. The remaining 377,973 were sent using the English version, the 2645C.

### *Training Gaps and Subject Matter Experts*

Taxpayer correspondence that involves a combination of individual and business account issues faces another barrier to timely resolution. The IRS no longer conducts Business Master File (BMF) training classes in sites designated to work individual income tax issues, nor does it conduct Individual Master File (IMF) training classes in its BMF locations. Therefore, the alternate skill base for the employees in both IMF and BMF campuses is diminishing. To address these new limitations, some campuses have developed procedures to deliver service in the post-RRA 98 era by creating specialized Subject Matter Experts (SME) to work combination IMF-BMF issues.<sup>15</sup>

IRC § 6012 establishes the filing requirements for both individual and business tax returns.<sup>16</sup> For example, based on this code section, a taxpayer files a Form 1040, U.S. Individual Income Tax Return, with a Schedule C to report a self-employment tax liability incurred from running his or her own business. In addition, as a self-employed business owner with employees, this taxpayer also files a Form 941, Employer's Quarterly Federal Tax Return, to report an employment tax liability. The taxpayer mails both returns to the IRS and receives balance due notices for each one. The taxpayer contacts an IRS business campus to discuss the accuracy of the balances owed, and if necessary to make payment arrangements to resolve it. However, the IRS assistor receiving this taxpayer's request to discuss the BMF balance cannot respond to questions about the individual balance, and correctly routes the taxpayer's inquiry to the designated SME, creating a delay. If the taxpayer calls an IMF campus to discuss the Form 1040 balance instead, the taxpayer experiences the same problem, but in reverse. Although both of the taxpayer's tax obligations have stemmed from running his or her own business, neither IRS assistor is fully-equipped to answer the taxpayer's questions. The post-RRA 98 combination of IMF-BMF issues is the root cause of both delays.

Unfortunately, in this example, either IRS employee must route the case to a specialist as the IRS reorganization has created gaps in the responding worker's training.<sup>17</sup> The first (BMF) employee cannot resolve any combination IMF-BMF issues because he or she has only been trained in business taxes. The second (IMF) telephone assistor is untrained in any business issues. Meanwhile, interest and penalties will continue to accrue on both the individual and business accounts, while the taxpayer awaits an IRS response. This is just one example of the delays resulting from RRA 98 reorganization, specialization, established local procedures, and case routing. Routing correspondence to specialists – rather than cross-training employees in commonly reoccurring issues – results in further correspondence delays for taxpayers.

<sup>15</sup> IRS, *Ogden Accounts Management Campus (OAMC) Desk Reference Guide* (Aug. 1, 2006) and IRS, *Fresno Campus Technical Issues & Local Support Accounts Management* (undated).

<sup>16</sup> IRC § 6012(a) and IRC § 6012(b).

<sup>17</sup> IRS, *Ogden Accounts Management Campus (OAMC) Managers Handbook*, "SME Listing" (undated).

## Campus Inventory Resources and Measures

### *Seasonal Inventory and Workforce Management*

Traditionally, based on the filing deadlines for the most common tax forms, IRS inventory levels fluctuate on a seasonal basis. In each of these tax “seasons,” inventory levels reach their peak along predictable timelines. The IRS recalls its seasonal workforce during these periods to meet the increasing workload. For example, the peak processing season for individual tax returns (which must be filed by April 15th each year) always occurs during the second quarter of the calendar year. Typically, the second quarter also exhibits the highest volume of correspondence delays.<sup>18</sup>

Although it could be assumed that increased staffing should actually reduce correspondence delays, an inverse relationship actually exists. One reason that both staffing levels and correspondence delays rise simultaneously is that customer service representatives (CSRs) comprise 24 percent of the IRS’s “mission critical” workforce.<sup>19</sup> These same customer service representatives are responsible for answering toll-free telephone calls from taxpayers as well as taxpayer correspondence.<sup>20</sup> Cyclical increases in toll-free contacts generate higher levels of staffing for customer service representatives, but the increased telephone assistors generate corresponding volumes of electronic taxpayer inquiries, or “e-4442s.”<sup>21</sup>

Electronic case referrals generated by the IRS’s toll-free telephone assistors at both call centers and campuses exacerbate the correspondence delay problem. Once these e-4442s are input into the IRS’s electronic referral system – although primarily received via telephone contacts – they actually become part of its “correspondence” inventory and are worked alongside traditional correspondence inventory. Then, to compensate for any delays, the IRS systemically generates interim letters on its e-4442 inventory before the 30 days have elapsed.

Initially, when the IRS automated the interim letter process, it did so to keep taxpayers apprised of the status of their correspondence. However, the automated process has since deviated from its original intent. As a result, in FY 2005, nearly 11 percent of the

<sup>18</sup> April through June 2005 interim letter totals from the letter number 2645, “Interim Letter,” and 2644, “Second Interim Response.” IRS, Office of the Notice Gatekeeper, *Correspondence Letter Volumes*.

<sup>19</sup> The IRS Human Capital Office defines “Mission Critical Occupations” as those series or occupations critical to frontline enforcement and direct support to front-line operations needed to meet the stated IRS goals. IRS, Human Capital Office, *IRS Human Capital Strategic Plan 2005-2009* (undated).

<sup>20</sup> IRS, *Critical Job Elements, Performance Plan for Customer Service Representative, Document 11480*, (Dec. 2004) and IRS, *Standard Position Description, GS-0962-08, Contact Representative, SPD No. 96208*, (Aug. 15, 2002).

<sup>21</sup> Prior to the adoption of the electronic referral system, taxpayer referrals were hand-written or typed onto a paper Form 4442, “Inquiry Referral,” (Revision 11/2004). For example, a taxpayer arrived at a walk-in site. The assistor cannot help him because the taxpayer’s account is assigned to another IRS employee located in a campus. The walk-in assistor writes up a referral on a Form 4442, and tells the taxpayer that someone else will get back to him in X number of days. The hard copy of the Form 4442 was then shipped to the second employee at the campus for final resolution. When the automated process began, the inquiries input into the new system were re-designated “e-4442s.”

e-4442 “correspondence” received an automatically-generated interim letter.<sup>22</sup> Therefore, rather than adjusting its staffing levels to answer these taxpayer inquiries more quickly, the IRS has instead automated the “delay-notification” process.

### *Conflicting Measures*

A priority conflict exists because the IRS employs the same personnel to provide timely responses to taxpayer correspondence, as well as to staff its toll-free telephone lines. By comparing the IRS’s quality measures for both applications, the IRS’s emphasis on the “telephones” begins to materialize. Action 61 (the IRS correspondence policy) standardizes the response time for correspondence “timeliness” at 30 days. However, the Joint Operations Center (JOC),<sup>23</sup> the IRS organization responsible for scheduling and monitoring telephone traffic on the toll-free lines, uses an entirely different timeliness measure.

For example, the JOC may schedule a site for ten CSRs on the toll-free line for installment agreements from 10:30 a.m. to 11:00 a.m. Then, from 11:00 a.m. to 11:30, the site commitment for that same line may jump up to a requirement of 35 CSRs. As one of its quality measures, the JOC tracks the site’s adherence to each 30-minute segment during business day.

The IRS’s FY 2005 Program Letter for Accounts Management states under “Application Staffing Adherence (Site),” “...Sites must meet or exceed 95 percent of each half hourly staffing requirement for 85 percent or more of the total half hours of operation...”<sup>24</sup> Using the example above and the FY 2005 program letter requirements, the site must ensure all 10 CSRs are staffing the toll-free line from 10:30 to 11:00 a.m. to exceed the 95 percent requirement. But during the subsequent half-hour, only 34 CSRs would be necessary to exceed 95 percent, and the site has some leeway in the event of an employee sick day.

Overall, if this site’s hours of operation run from 7:00 a.m. to 7:00 p.m., it must monitor its staffing commitment (for 95 percent adherence) in each of the 24 half-hours scheduled by JOC. Finally, to achieve the 85 percent daily quality measure dictated in the FY 2005 program letter, this site must ensure it does not “miss” more than three half-hours overall.

<sup>22</sup> The IRS supplied data for all FY 2005 interim letters generated by the automated e-4442 system (68,669 automatic interim letters sent / 633,968 e-4442s = 10.8 percent). IRS, Wage and Investment and Small Business/Self-Employed Operating Divisions, (Aug. 23, 2006).

<sup>23</sup> JOC is responsible for coordinating nationwide telephone traffic on the IRS toll-free lines. Its mission statement states: “To provide world-class service, support, and technology for Operating Divisions and Functional Organizations to achieve their desired service levels for all telephone, correspondence, and electronic media inquiries within agreed resource and staffing parameters.” One of its roles is to establish staffing commitments for each half-hour of operation in every campus and call site, and to monitor levels of service. IRS, Joint Operations Center website (<http://joc.enterprise.irs.gov/>), *Mission Statement*.

<sup>24</sup> IRS, Wage and Investment Operating Division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter* (Oct. 25, 2004).

In addition to monitoring each campus and call site for half-hourly adherence, the JOC monitors individual employees using another quality measure, Average Handle Time (AHT). AHT includes the total time that an assistor spends with a taxpayer. This measure includes the following: time spent actually speaking with the taxpayer, time the taxpayer spends waiting on “hold,” and time spent wrapping up the case after the taxpayer has hung up the phone. Unlike the Action 61 correspondence measurement in “days,” AHT results are compiled in “seconds.”<sup>25</sup>

In comparing these three IRS measurements for basic (timeliness) quality against one another – “minutes” and “seconds” for telephones, versus “days” for correspondence – the emphasis is clear: The IRS directs its resources to telephone traffic before the timely resolution of paper correspondence.

### Action 61 as a Timeliness Measure

#### *Inflated Quality Reporting*

Far too often, even the IRS’s “interim” responses are actually delayed. In FY 2005, the IRS issued nearly 16 percent of the required interim letters for individuals,<sup>26</sup> and 31 percent of the business interim letters,<sup>27</sup> late or not at all. Moreover, using its adherence to Action 61 requirements as a quality measure for timeliness, the IRS records its final responses to taxpayers as “timely” as long as those taxpayers have received “timely” interim letters.

As discussed previously, the IRS may issue a taxpayer both a first and a second interim letter to notify him or her of processing delays. But, if the IRS meets its own extended timeframes (cited within the two interim letters), regardless of the multiple delays experienced by a taxpayer, it reports externally that its quality measurements for “timeliness” have been met – misrepresenting its overall service to taxpayers. Therefore, high adherence to Action 61 serves only to mask systemic correspondence delays through inflated IRS quality measures that do not reflect actual correspondence timeliness.

<sup>25</sup> Initially, in both campuses and call sites, JOC monitors the IRS target of keeping a taxpayer’s telephone wait-time (on “hold”) below 300 seconds. Then, using a comprehensive, weighted measurement methodology (primarily based on AHT) it evaluates delivery of the overall services goal. IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter* (Oct. 25, 2004); and, IRS, Joint Operations Center website.

<sup>26</sup> Representative sampling data (936 reviewed; 147 incorrect; 84.3 percent accuracy) from FY 2005 NQRS Enterprise Individual Master File (IMF) correspondence quality rates for “Timeliness” attribute #901, “Interim Contacts (National Quality Review Staff Only),” supplied by the Wage & Investment and Small Business/Self-Employed Operating Divisions (Aug. 23, 2006).

<sup>27</sup> Representative sampling data (157 reviewed; 49 incorrect; 68.8 percent accuracy) from FY 2005 NQRS Enterprise Business Master File (BMF) correspondence quality rates for “Timeliness” attribute #901, “Interim Contacts (National Quality Review Staff Only),” supplied by the Wage & Investment and Small Business/Self-Employed Operating Divisions (Aug. 23, 2006).

*Timeliness Tolerances*

The IRS does not maintain statistical records of the average time it takes to resolve taxpayer correspondence.<sup>28</sup> However, based on the standards contained in its program letter, this period can be quite protracted.<sup>29</sup> Per the FY 2005 IRS Program Letter for Accounts Management, “Each individual W&I AM campus, and W&I overall, should meet the following targeted overage percentages in *at least 75 percent* of the weeks in FY 2005.”<sup>30</sup> Performance data (for the FY 2005 target overage percentages for tax returns) was extracted during the pre-identified periods shown below, with each allowable overage percentage shown at the right.

**TABLE 1.13.2,<sup>31</sup> W&I FY 2005 ACCOUNTS MANAGEMENT ADJUSTMENTS OVERAGE PERCENTAGE TIME PERIODS**

Time Periods	Objective
10/09/04	<13 %
10/16/04 to 10/30/04	<10 %
11/06/04 to 11/27/04	<10 %
12/04/04 to 01/01/05	<15 %
01/08/05 to 01/29/05	<15 %
02/05/05	<13 %
02/12/05 to 02/26/05	<10 %
03/05/05 to 04/02/05	<7 %
04/09/05 to 04/30/05	<7 %
05/07/05 to 05/28/05	<7 %
06/04/05 to 07/02/05	<10 %
07/09/05 to 07/30/05	<15 %
08/06/05 to 09/03/05	<15 %
09/10/05 to 09/30/05	<15 %

For the majority of FY 2005 (nine months), the IRS overage quality standards allowed a minimum of 10-15 percent of its taxpayers to wait for more than 30 days for a correspondence reply. Moreover, as the program letter requires only 75 percent adherence (to

<sup>28</sup> The General Accounting Office (now the Government Accountability Office) stated in 1994, “(The) IRS’ measure of timeliness focuses on providing an interim or a final response... (and) does not include the time that elapses after an IRS employee puts a letter or notice into the computer system until it is mailed...not measuring timeliness from a taxpayer’s perspective...” General Accounting Office, GGD-94-118, *Tax Administration: More Improvement Needed in IRS Correspondence 2* (Jun. 1, 1994).

<sup>29</sup> IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter, Attachment V* (Oct. 25, 2004).

<sup>30</sup> The IRS defines “overage” timeframes based on the specific work types. “Correspondence” becomes overage on the 45th calendar day following the IRS received date. For example, if the IRS receives a taxpayer’s letter on January 1st, it becomes “overage” 45 days later on February 15th. IRM 3.30.123.2.10(13), Taxpayer Correspondence (Jan. 1, 2006).

<sup>31</sup> “Adjustments” refers to AM’s paperwork inventory, which includes taxpayer correspondence. IRS, Wage and Investment operating division, *2005 Program Letter, Measures and Operating Guidelines, Final FY05 Program Letter, Attachment V* (Oct. 25, 2004).

meet “timeliness” standards), for up to 25 percent of the entire FY 2005 period, the IRS placed no limit on the number of taxpayers who could be impacted by delays. These were the “quality” measures the IRS used to externally report its correspondence “timeliness.”

### *Refund Delays*

In response to taxpayer complaints, TAS recently collaborated with the Gallup Organization to conduct a survey (the “TAS Cognitive Survey”) of taxpayers who had filed amended tax returns.<sup>32</sup> Although amended returns are not typically considered “correspondence” unless a letter is also attached, as previously discussed, the IRS uses the same personnel to work both taxpayer correspondence and amended returns. Both inventory types commonly require similar account actions.<sup>33</sup> Eighty-eight percent of all taxpayers surveyed were expecting a refund.<sup>34</sup>

The IRS provided about two-thirds of the respondents with a processing timeframe.<sup>35</sup> Of those taxpayers given any timeframe at all, the IRS told almost 90 percent that it

<sup>32</sup> The Taxpayer Advocate Service (TAS) conducted a 12-month study under contract with the Gallup organization, involving the selection and polling of a sample of TAS customers who had recently opened cases under Core Issue Code 330, Processing Amended Returns. This core issue code is the largest category of work that TAS receives from SB/SE accounts. At the beginning of the survey period, TAS case advocates were given instructions to ensure they documented each Core Issue Code 330 case completely. Before initiating any taxpayer contacts, Gallup screened the TAS supporting documentation on all Core Issue 330 cases for the prerequisite TAS case advocate documentation. It deemed 1,197 Core Issue 330 cases to have had the proper documentation, and used those TAS cases as the basis for the survey. It called 1,197 taxpayers or Powers of Attorney (POA) and asked them to answer a series of questions. Using the survey questions, Gallup attempted to determine what had occurred (in the eyes of the respondent) that caused the taxpayer to qualify for the services of TAS. The study gathered information regarding the taxpayer’s circumstances, his experiences prior to presenting a request to TAS for assistance and his perspective about where IRS may have failed to provide him with the level of service he expected. After all the contacts had been made, Gallup returned the results (from the 1,197 contacts) to TAS for analysis. Taxpayer Advocate Service/The Gallup Organization, “*Cognitive Study of Small Business/Self Employed (SB/SE) Customers*” (May 2006).

<sup>33</sup> Generally, amended returns are “structured” submissions by taxpayers that contain change requests, or are provided simply for information-only. Their structure comes from the numbered lines which correspond to specific entries on various tax items. However, taxpayer correspondence—while more “unstructured” in its format—contains similar (if not identical) taxpayer account issues to those found in amended returns. Campus personnel in Accounts Management are trained to work either type of work, as well as (for customer service representatives) telephone account adjustments.

<sup>34</sup> Question #4 on the TAS-Gallup Cognitive Survey was, “Did you owe money to the IRS, or did you expect a refund from the IRS as a result of your amended return?” Of the 1,197 taxpayers surveyed, 1,056—or 88.2 percent—responded, “Expected a refund.” Taxpayer Advocate Service/The Gallup Organization, “*Cognitive Study of Small Business/Self Employed (SB/SE) Customers*” (May 2006).

<sup>35</sup> (574 taxpayers responding affirmatively to the TAS-Gallup Cognitive Survey question #7f, “Did the person you spoke to indicate how long it might take to process your return?”) / (875 taxpayers responded to this question [from the 1,197 total in the survey]) = (Taxpayers in the survey who received an IRS timeframe, or 65.6 percent). Taxpayer Advocate Service/The Gallup Organization, “*Cognitive Study of Small Business/Self Employed (SB/SE) Customers*” (May 2006).

would take at least a month for them to receive their refunds.<sup>36</sup> More than half were told it would take three months or more before the IRS could process their refund claims.<sup>37</sup> If we apply the taxpayer rates for refund claims (from the TAS-Gallup Cognitive Survey) to taxpayer letters, then delayed correspondence processing primarily impacts taxpayer refund requests.

**TABLE 1.13.3,<sup>38</sup> TAS SURVEY**

Taxpayer Advocate Service Survey Results: How long did the IRS say it would take?	
Period*	Survey Responses
Less than 1 month	8 %
1 month or more	89 %
6 weeks or more	76 %
2 months or more	66 %
3 months or more	52 %

\*Note: "Period" figures are cumulative, and exceed 100 percent.

#### *Taxpayer and Downstream Impact*

Delayed correspondence resolution negatively impacts a variety of corrective actions to a taxpayer's account. Data from the TAS Cognitive Survey indicate the primary reasons for account changes involve taxpayer claims for refunds. Refund delays can increase the potential for economic harm to the taxpayer (e.g., eviction, inability to buy medication, or bankruptcy.)

Correspondence delays generate additional follow-up contacts from concerned taxpayers, including duplicate tax return filings, duplicate correspondence, calls to the toll-free lines, and referrals to TAS, all of which mean re-work for IRS employees. Taken cumulatively, the total cost (e.g., labor, postage, paper, and printing costs) for the nearly three million interim letters sent in FY 2005 was not inexpensive. These funds could have been better spent on hiring additional customer service representatives and tax examiners to provide quality taxpayer correspondence resolution.

<sup>36</sup> Question #7g on the TAS-Gallup Cognitive Survey asked taxpayers, "How long did they (the IRS) say it would take (to process your amended return)?" From the original 1,197 participants, 561 respondents answered this question, indicating the IRS had provided a timeframe for processing. The responses ran anywhere from "1 week or less" to "97+" weeks. The responses in the chart have been placed in categories. For example, if a taxpayer was told "eight-weeks," that response is included in three of the periods listed. Eight-weeks is "1 month or more," "6 weeks or more," and also, "2 months or more." Therefore, from the data, it can be stated that, "89 percent were told it would take at least a month. Of those taxpayers, 76 percent were actually told that it would take "6 weeks or more." NOTE: 3.4 percent of taxpayers responded either "Don't Know," or "refused" to answer this question. Taxpayer Advocate Service/The Gallup Organization, "Cognitive Study of Small Business/Self Employed (SB/SE) Customers" (May 2006).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*



### Spanish Correspondence

Another related problem is evident in the figures previously displayed in Table 1.13.1. The IRS Office of the Notice Gatekeeper tracks all letters generated through Integrated Data Retrieval System (IDRS),<sup>39</sup> including the Spanish variations of interim letters (called the 2645 and 2644 letters).

According to the U.S. Census Bureau's 2005 American Community Survey, 12 percent of the U.S. population over age five, or 32 million people, speak Spanish at home.<sup>40</sup> Over 15 million of these Spanish-speaking persons, or nearly six percent of the U.S. population, speak English less than "very well."<sup>41</sup> However, of the 2.7 million first interim letters sent by the IRS in FY 2005, only 399, or 0.01 percent, were written in Spanish.<sup>42</sup> Ratios for the second interim letter were even lower, as the IRS sent only *five* of these letters in Spanish all year,<sup>43</sup> or 0.003 percent of the total issued.<sup>44</sup> Clearly, the IRS is not meeting its obligation to provide service to Spanish-speaking taxpayers.<sup>45</sup>

Comparative data from the IRS's own FY 2005 toll-free lines can be used to estimate appropriate FY 2005 levels for Spanish interim responses. Of the approximately 22 million calls scheduled for the top five (by volume) IRS toll-free lines for which a Spanish

<sup>39</sup> The Integrated Data Retrieval System (IDRS) is a mission critical steady state system that consists of databases and operating programs that support Internal Revenue Service employees working active tax cases within each business function across the entire Internal Revenue Service. This system manages data that has been retrieved from the tax Master File allowing Internal Revenue Service employees to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master File. It provides for systemic review of case status and notice issuance based on case criteria, thereby alleviating staffing needs and providing consistency in case control. IRS, www.IRS.gov website, at <http://www.irs.gov/privacy/article/0,,id=131489,00.html> (last accessed Sept. 28, 2006).

<sup>40</sup> U.S. Census Bureau, *2005 American Community Survey, Table R1602*, Percent of People 5 Years and Over Who Speak Spanish at Home; and, *Table B16001*, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>41</sup>  $(15,396,674 \text{ Spanish-speakers over age five speak English less than "very well"} / 268,110,961 \text{ total U.S. population over age five}) = 5.7 \text{ percent of the Spanish-speaking U.S. population which speaks English less than "very well."}$  U.S. Census Bureau, 2005 American Community Survey, *Table B16001*, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>42</sup>  $(399 \text{ total FY 2005 2645SP letters sent by IRS}) / (2,743,836 \text{ total FY 2005 first interim letters [2645] sent by IRS}) = (\text{The percentage of Spanish-language first interim letters sent to taxpayers, or .0145 percent}).$  The letter data was extracted from the website operated by the IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes*. (Sept. 22, 2006).

<sup>43</sup> Five Spanish-language second interim letters (2644SP) were sent by IRS to taxpayers in FY 2005. IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes* (Sept. 22, 2006).

<sup>44</sup>  $(5 \text{ total FY 2005 2644SP letters sent by IRS}) / (145,004 \text{ total FY 2005 second interim letters [2644] sent by IRS}) = (\text{The percentage of Spanish-language second interim letters sent to taxpayers, or .0034 percent}).$  The letter data was extracted from the IRS, Office of the Notice Gatekeeper, *Correspondex Letter Volumes* (Sept. 22, 2006).

<sup>45</sup> Per IRM 21, "...if Spanish-language correspondence is received, you must reply using the Spanish version of the appropriate C letter, if one is available." The caveat only stipulates an exception "...if one is (not) available." However, the Spanish-English disparity is not solely limited to interim letters. During FY 2005, the IRS sent the English-language 105C letter (used to disallow a taxpayer's claim, and to provide him or her with "Appeal Rights") to 425,443 taxpayers. The Spanish-language equivalent, the 105SP, was only issued 148 times, or .03 percent of all 105-series disallowance letters. IRM 21.3.3.4(2)a, *Correspondence Procedures* (Jan. 24, 2006), and IRS, Office of the Notice Gatekeeper, *Correspondex Letters Statistical Reports On-line*.

option exists, the IRS planned for nine percent of those taxpayer contacts to occur on the Spanish-language lines.<sup>46</sup>

If scheduled rates for Spanish telephone contacts are applied to interim letters using the same nine percent standard, the IRS would have expected to send approximately 260,000 Spanish interim letters to Spanish-speaking taxpayers in FY 2005, or 644 times the number actually issued.<sup>47</sup> Given the disparity between the volumes of English- and Spanish-language interim letters, there is evidence of a serious lapse in the IRS's service to the Spanish-speaking population.<sup>48</sup>

### Taxpayer Feedback

Taxpayer satisfaction surveys routinely report the “Length of Time to Resolve Your Issue” is a major source of taxpayer dissatisfaction.<sup>49</sup> For example, when the IRS separated statistical groups of taxpayers who had responded on both extreme ends of its “satisfaction spectrum,” the spotlight was further focused on overall timeliness. These divergent groups of taxpayers, labeled as either “satisfied” (those scoring a four or a five on a five-point scale), or “dissatisfied” (those scoring a one or a two on the same scale), cited “timeliness” as a top priority for change.<sup>50</sup> It was the only issue consistently cited by both divergent groups in separate “Top Three” listings. Taxpayers’ historical “Top Three” responses are displayed in Table 1.13.4.

<sup>46</sup> The IRS Joint Operations Center (JOC) uses historical IRS telephone traffic to schedule staffing levels for subsequent periods. Therefore, the JOC's FY 2005 “Calls by Site by Pay Period” reflects predictive planning by the IRS that nine percent of its telephone contacts will be on the Spanish lines. For the purposes of this report, FY 2005 figures were extracted from the “Calls by Site by Pay Period” table created by (JOC). The IRS's English-language toll-free lines were matched for services provided to determine the equivalent Spanish-language toll-free lines. Totals from the five highest (scheduled call volume) matching Spanish-language lines were compared against the English-language equivalents. In actuality, the English-language (business) toll-free lines are further specialized than the Spanish equivalent. English toll-free line (business) numbers 25, 28, and 30 are consolidated for Spanish business calls into a single toll-free line (line #31). Therefore, the top five Spanish-language toll-free lines take seven English-language lines to match the services they provide. Adding the FY 2005 scheduled call volumes for the seven top English lines to the equivalent top five Spanish lines, the total approached 22 million calls. The calculations were as follows: English Total 19,921,969 (Line #5 = 1,824,297; #10W = 958,455; #13 = 207,284; #20WI = 13,137,446; #25 = 2,395,756; #28 = 119,127; #30 = 1,279,604) + Spanish Total 1,968,428 (Line #6 = 125,420; #11 = 99,328; #14 = 7,833; #21 = 1,578,238; #31 = 157,609) = 21,890,400 scheduled calls. Therefore, (1,968,428 Spanish calls) / (21,890,400 total calls) = (9 percent of the calls scheduled for the Spanish lines). IRS, Joint Operations Center, *Site Level Measures Bucket File Extracts, Calls by Site by Pay Period* (Sept. 4, 2004).

<sup>47</sup> 2,888,840 (total interims sent in FY05, per the Notice Gatekeeper) x .09 (the percentage of taxpayers scheduled by IRS for the Spanish toll-free lines) = 259,996 (letters which should have been issued in Spanish) 259,996 (letters which should have been issued in Spanish) / 404 (FY05 Spanish interims per the Notice Gatekeeper) = 643.55 (the number of times the Spanish volume should have been increased).

<sup>48</sup> See Most Serious Problem, *Limited English Proficient (LEP) Taxpayers; Multilingual and Cultural Barriers, infra*.

<sup>49</sup> The IRS hired an independent research company, the Pacific Consulting Group (PCG), to design and administer customer satisfaction surveys. PCG surveyed eleven areas of the IRS, including Toll-free telephone and Walk-in services, Examination, Collection, Automated Collection System (ACS), Employee Plans and Exempt Organizations (EP/EO), Service Center Examination, and Appeals. IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct – Dec 05).

<sup>50</sup> IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct – Dec 05).

**TABLE 1.13.4, IRS CUSTOMER SATISFACTION SURVEY SUMMARY: IMPROVEMENT PRIORITIES (OCT—DEC 2004 VS. OCT—DEC 2005)<sup>51</sup>**

Improvement Priorities for All Customers			
Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Keeping you informed of the status of your case	Length of time to resolve your issue	Ease of getting more information about your issue
Oct—Dec 2004	Ease of getting more information about your issue	Length of time to resolve your issue	Keeping you informed of the status of your case

Improvement Priorities for All Satisfied Customers			
Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Length of time to resolve your issue	Keeping you informed of the status of your case	Ease of understanding information provided by IRS
Oct—Dec 2004	Ease of understanding information provided by IRS	Ease of getting more information about your issue	Length of time to resolve your issue

Improvement Priorities for All Dissatisfied Customers			
Period of Survey Administration	Highest Priority	Second Priority	Third Priority
Oct—Dec 2005	Explanation regarding the resolution of your issue	Ease of getting more information about your issue	Length of time to resolve your issue
Oct—Dec 2004	Length of time to resolve your issue	Fairness of treatment by IRS	Explanation regarding the resolution of your issue

**TECHNOLOGICAL IMPACT****Correspondence Imaging System (CIS)**

The IRS has implemented the Correspondence Imaging System (CIS), which scans electronic images of taxpayer correspondence, at seven campuses.<sup>52</sup> However, CIS is limited to individual taxpayer correspondence, and its expansion to business return processing sites is only in the planning stages. Further, CIS guidelines within campuses may conflict with a CSR's ability to provide taxpayers with quality service.

For example, one campus posted its CSR's "Frequently Asked Questions" (FAQ) on its website. One FAQ in particular highlights the ongoing difficulties taxpayers face:

**CSR Question:** If (an) open CIS case is (available online) and I am on the phone (with the taxpayer), can I take over the case?

<sup>51</sup> IRS Office of the Chief Financial Officer, *Customer Satisfaction Quarterly Reports, Thirty-Second Quarterly Reports* (Feb. 2006), Adjustments Summary (Oct - Dec 05).

<sup>52</sup> IRS, *Memphis Accounts Management, Talking Paper for Managers, "Correspondence Imaging (CIS): What's it all about?"* (Jun. 14, 2006).

**Answer:** No, the (contact representative) cannot take over a CIS case. This would be giving preferential treatment to the taxpayer. The (contact representative) is to advise the (taxpayer) of the processing timeframes for the case. If the timeframe has expired, follow the instructions in the IRM. If necessary, follow Taxpayer Advocate Service (TAS) procedures...”<sup>53</sup>

CIS has also automated the correspondence delay notification process (similar to the automated e-4442 process discussed previously).<sup>54</sup> Based on the automated interim process, and the FAQ procedures outlined above, here is a potential scenario of how this policy could play out for taxpayers calling the toll-free lines:

**Taxpayer:** Hi, you sent me two notices now that said I owed you money. So, I wrote you a letter last month which explained the problem with my 1040, and why I really don't owe you anything. In fact, I'm still actually expecting a refund.

**CSR:** Yes, I'm reading your correspondence right now. It seems like you've explained the situation quite well. And, it looks like we've just sent you a letter. You'll probably get it sometime next week, but basically that letter's just going to say we need more time to process your case. I can't verify exactly what our letter to you says specifically, but – normally – these letters ask you to wait approximately 30 more days for our response. But, if you don't hear anything from us by then, you should probably call back, and we can check on the status again...

In the example listed above, the IRS guidelines for processing correspondence cases in the order they are received (basically, a “first come, first serve” policy) has failed to evolve with the “new” CIS technology. Though the CSR can access a scanned image of the taxpayer's correspondence – per the policy – he or she must inform the taxpayer to endure further delays, unless TAS intervention is required.

### Electronic IDRS Enhancement Tools

Campus-based groups of employees have begun developing programming tools designed to improve productivity for IDRS users, including the creation of a more user-friendly IDRS interface. These tools (*e.g.*, IDRS Decision Assisting Program [IDAP], Standard Workflow Tools [SWFT], and others) are designed to increase productivity by streamlining common or repetitive actions. The IRS Integration Development for Enterprise

<sup>53</sup> IRS, *Fresno Accounts Management Campus*, “Correspondence Imaging System Frequently Asked Questions” (undated document).

<sup>54</sup> Interim letters will be automatically generated, when required, on the 23rd day to ensure receipt by the taxpayer within 30 days. If required, a second interim letter will be generated after an additional 45 days. IRS, Brookhaven Campus Accounts Management, *Correspondence Imaging System* website.

Automation (IDEA) Lab has tested and approved 131 of these tools.<sup>55</sup> However, none appears to be primarily targeted toward resolving correspondence delays.

### IRS Electronic Services

RRA 98 establishes a goal for the IRS to receive 80 percent of all returns electronically by 2007, and authorizes the IRS to promote and encourage electronic filing (e-file).<sup>56</sup> As a result, the IRS has taken steps to modernize its technical infrastructure to support its Electronic Tax Administration (ETA) program, including the development of the e-services suite to enable tax professionals and payers to conduct business with the IRS electronically.<sup>57</sup>

One of the e-services products is Electronic Account Resolution, which allows tax professionals to make inquiries and to expedite closure on clients' account problems by electronically sending or receiving account related inquiries. Using the Electronic Account Resolution tool, tax professionals may inquire about individual or business account problems, refunds, installment agreements, missing payments or notices. The IRS delivers its response to a secure electronic mailbox within three business days. As an alternate means for taxpayers to contact the IRS with concerns regarding account issues, the e-services' Electronic Account Resolution tool has the potential to eliminate many of the current (paper) correspondence delays which negatively impact taxpayers.

### Online Privacy<sup>58</sup>

The e-services website uses temporary session "cookies" to give users a single, uninterrupted session when they are online. Each "cookie" contains a system-generated session ID only, and is immediately deleted upon leaving the site. The IRS also monitors network traffic to identify unauthorized attempts to upload or change information or otherwise cause damage to the web service. It does not attempt to identify individual users unless it suspects illegal behavior.

<sup>55</sup> The IRS Integration Development for Enterprise Automation (IDEA) Lab is testing the effectiveness of new programming. For example, the IDEA Lab's programming can track the individual keystrokes of both old and new processes, and calculate a percentage increase in productivity. Or, the lab can run simulations for the "load testing," to determine if programming will bog down other systems shared on a terminal. The lab's approval means these programs have been proven effective and safe. The 131 tools are the groups' combined total. IRS, *IDRS Decision Assisting Program (IDAP)*, "IDAP Briefing," (May 25, 2006).

<sup>56</sup> The IRS's electronic filing (e-file) program allows taxpayers to electronically file (e.g., a taxpayer complete and submit a Form 1040 from a home computer) an accurate tax return or get an extension of time to file without sending any paper to the Internal Revenue Service. RRA 1998 set a requirement for the IRS to receive an 80 percent electronic filing rate by the 2007 tax year. Public Law No. 105-206, 112 Stat. 723, Section 2001 (July 22, 1998) and IRS, Publication 3187, *The IRS e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives* (Jan. 2005).

<sup>57</sup> The IRS website, [www.irs.gov](http://www.irs.gov), provides 24 hour services for those tax professionals registered to use its e-services tools. IRS, [www.irs.gov, e-services—Online Tools for Tax Professionals](http://www.irs.gov/taxpros/article/0,,id=109646,00.html), at <http://www.irs.gov/taxpros/article/0,,id=109646,00.html>.

<sup>58</sup> All information cited under this subheading has been extracted from the IRS e-services website. IRS, *e-services Online Policy Statement* at <http://www.irs.gov/taxpros/article/0,,id=138814,00.html>.

The IRS has modified its Online Privacy Policy for e-services to address the use of data for conducting anonymous, voluntary surveys. Providing the required registration information implies a tax professional's consent. Any information the IRS collects and maintains in the course of responding to tax preparers is handled in accordance with the access and privacy protection requirements of the Privacy Act, the Freedom of Information Act, and the Internal Revenue Code. The IRS will not share information provided with anyone unless required by law.

#### *Taxpayer Limitations and Enhancement Timeframes*

Unfortunately, e-services is not available to individual taxpayers. Only approved IRS business partners, such as e-filing tax professionals and payers, are eligible to participate. The IRS has placed its focus on enabling the "value-added" e-services requested by the preparer community as "incentives" to promote and encourage the IRS e-file program. The IRS's decision to cater solely to tax preparers (in an attempt to meet its RRA 1998-imposed, 80 percent e-file requirement by 2007) has relegated taxpayer access to a secondary status. In the IRS's January, 2005 release of its e-services implementation phases, "Taxpayer Account Access" is listed as "3-5 years" away from implementation.<sup>59</sup>

#### **SUMMARY**

The IRS does not respond to taxpayer correspondence in a timely manner. Action 61 has not resolved the IRS's correspondence delay problems, as evidenced by the 2.9 million "stall" letters sent to taxpayers in FY 2005. In addition, conflicting IRS quality measures overstate actual correspondence "timeliness."

An unfortunate outcome of IRS reorganization (RRA 1998) has been the loss of single accountability for monitoring correspondence measures within campuses. In addition, IRS employees' training gaps present a barrier to timely one-stop resolution. Local procedures include routing correspondence to cross-trained specialists, and result in further delays to correspondence resolution.

Rather than adjusting campus resources to answer taxpayer correspondence more quickly, the IRS has automated the "delay-notification" process. The IRS directs its resources to telephone traffic before the timely resolution of paper correspondence. The current correspondence policy (Action 61) masks systemic delays with artificially inflated IRS quality measures, which do not reflect actual correspondence timeliness. IRS

<sup>59</sup> The IRS timeframes for additional e-services appear in IRS Pub 3187, *The IRS e-Strategy for Growth: Expanding e-Government for Taxpayers and Their Representatives* (Jan. 2005). However, the IRS's decision to place individual taxpayer services below those provided to tax preparers and other business professionals was again demonstrated in a recent press release. The IRS announced that it would cut the time it takes to respond to mortgage firms with a new Income Verification Express Service (IVES). Using IVES, mortgage lenders will receive an electronic transcript on either personal or business tax returns in two business days. As this service is only available to lenders, taxpayers still must contact IRS customer service representatives by phone. The IRS timeframe provided for mailed transcripts is 7-10 business days. IRS, Internal Revenue Bulletin: 2006-42, Announcement 2006-74, Income Verification Express Service (IVES) Program (Oct. 16, 2006), and IRS, *Ogden Accounts Management, Lessons Online*, TDS CENTRA Conference Call Transcript (undated).

correspondence “overage” measures allow taxpayers to wait for more than 30 days for a correspondence reply, and require only 75 percent adherence to standards.

Not only are costs for nearly three million FY 2005 interim letters to taxpayers significant, but the disparity between the volumes of English- and Spanish-language interim letters demonstrates a serious lapse in the IRS’ service to the Spanish-speaking population. Overall, taxpayer satisfaction surveys continue to reflect that “timeliness” is a major source of taxpayer dissatisfaction.

The IRS’s technological advances, while demonstrating potential, are not available to all taxpayers. The CIS program is currently limited to individual taxpayer correspondence, and contains guidelines which limit the IRS’s ability to provide taxpayers with quality service. IDRS enhancement tools have not been designed specifically to reduce correspondence delays, and the multiple campus based programs lack national oversight. The e-services suite of tools enabling tax professionals and payers to conduct business with the IRS electronically shows promise, but remains three to five years away from its availability to individual taxpayers.

### IRS COMMENTS

The IRS recognizes and endorses the National Taxpayer Advocate’s desire that all taxpayer correspondence be responded to in a timely manner. We share that goal and are committed daily to delivering timely and quality service to each of our customers regardless of the channels they choose to contact us. We offer the following points in response to issues raised in the National Taxpayer Advocate’s description of this problem.

#### Inventory and Workload Management

Each year the IRS strategically employs its limited resources to address shifts in customer service demands as both the volumes and channels of demand change. The planning and scheduling staff of our JOC work in conjunction with Accounts Management to develop staffing schedules. These schedules establish the staffing needed to handle the anticipated call volumes in the different telephone applications. However, in real time application, these schedules become dynamic and can change as call demand fluctuates. The Accounts Management staff works closely on a daily basis with the JOC to minimize temporary variances in staffing requirements for both telephones and correspondence.

During FY 2005, approximately 15,000 Accounts Management employees answered over 33 million telephone calls. These employees also responded to approximately 10 million pieces of correspondence and other Adjustment receipts. Correspondence represented 44 percent (4.4 million) of the paper workload and amended returns and other account related issues comprised the remainder.

Forty-four percent of the 33 million calls answered in FY 2005 were received during the period of January 1 through April 16. The call volumes received throughout this period

were not received in a consistent equal pattern, but rather in compressed, intermittent time bursts. For example, 6.6 million telephone calls were answered within a six week period. In contrast, as the volume of calls begin to subside, the correspondence and adjustment receipts climb at a rapid, consistent rate. Forty-five percent of all new receipts for correspondence and adjustments in fiscal year 2005 were received during a 90 day period from April 1 through June 25. It is during this same time period that 40 percent of all the interim letters were issued in FY 2005.

Telephone call demand in FY 2005 far exceeded all other channels of assistor services. For example, in FY 2005 the Taxpayer Assistance Centers serviced approximately seven million taxpayers and there were approximately ten million Correspondence/Adjustment receipts in Accounts Management (correspondence, amended returns, and other written account related inquiries). When compared to 33 million telephone calls answered, it becomes apparent that the telephone is the predominant method used by taxpayers to contact the IRS.

In response to customer demand for telephone service, the IRS is committed to providing toll-free callers an 82 percent Level of Service (LOS). In addition to staffing our phone operations to meet this goal, both the IRS and taxpayers benefit from the fact that callers often receive more thorough and expeditious service. In this interactive setting, assistors are able to probe for needed information and in most cases either deliver one-stop service or provide guidance necessary for the taxpayer to resolve their inquiry.

In addition to having a significantly different receipt pattern from telephone contacts, taxpayer correspondence, amended returns, and other account-related written inquiries vary significantly in complexity. As a result, the amount of time needed to resolve a particular case also varies significantly. Interim letters are issued when taxpayer correspondence can not be resolved within 30 days. The interim letters are used both in times of processing delays due to peak volumes, as well as those cases where the complexity or the nature of the case requires additional time to resolve the taxpayer's issue. Of the 2.9 million interim letters issued in FY 2005, it is not possible to distinguish the percentage applicable to peak volume or complexity delays.

### Conflict of Measures

There are different measures for correspondence timeliness and telephone timeliness because the nature and customer expectations of these communication channels differ. The different measures do not reflect, as asserted by the National Taxpayer Advocate, any conflict in IRS priorities. Resolving taxpayer correspondence issues often requires a number of steps. For example, resolution of the issue may require multiple coordinated actions, it may be necessary to request additional information, or it may be necessary to secure a copy of a tax return. As a result, the desired response time for taxpayer correspondence is measured in days and the IRS established a goal to resolve all correspondence issues within 30 days. In those cases where the issue can not be resolved within 30 days, Action 61 established guidelines and requirements for the issuance of



interim letters to inform taxpayers of the delay and to provide an expected timeframe for issue resolution.

The automated process of issuing interim letters through the Correspondence Imaging System (CIS) serves to ensure the timeliness measure has been met when an interim letter is necessary. Automated interim letters are also generated through other IRS systems, such as the Automated Underreporter (AUR) System and the Audit Information Management System (AIMS). In numerous Customer Satisfaction Surveys, taxpayer's have repeatedly stated they want to be kept informed on the status of their case. In part, this measure also ensures that timely case actions have been taken while a case is being worked. Each functional area is aware of the importance of this standard and both management and employees maintain listings to control and manage overage case inventories.

Telephone contacts are also measured for timeliness but these measures are based on various elements of the call duration. For example, the Average Speed of Answer (ASA) is a common call center industry metric. ASA is the number of seconds the taxpayer must wait to speak to an assistor. Telephone measures are established to measure and improve performance as well as to set standards and identify anomalies. Accounts Management is committed to delivering a balanced overall program with quality service to both our correspondence and telephone customers. However, it is not reasonable to suggest correspondence and telephone inquiries should be measured by the same time increments. Customer expectations, as well as IRS capabilities, dictate these differences. For example, callers expect the IRS to answer their calls in a matter of minutes but they have no such expectation when it comes to written inquiries.

### **Campus Reorganization, Specialization and Employee Training Gaps**

The National Taxpayer Advocate contends that both the IRS reorganization and the IRS's effort to specialize services to taxpayers have resulted in a reduction in the level of accountability for resolving correspondence delays. In fact, the functional lines of Submission Processing, Compliance, and Accounts Management (previously Customer Service) existed before the reorganization. Under the prior campus organizational alignment, correspondence was routed according to the functional lines that were essentially the same as they are today. As a result, campus organizational changes have not affected the work flow.

The National Taxpayer Advocate states that the alternate skill base for IRS employees in both the Individual Master File and Business Master File campuses is diminishing because IMF training is not provided at BMF campuses and BMF training is not provided at IMF campuses. However, accuracy trends indicate that specialization has improved quality for both telephone and Adjustment account related contacts. It also should be noted that campus employees assigned to work Accounts Management correspondence have historically been trained to work both IMF and BMF accounts.

The National Taxpayer Advocate suggests that the lack of cross training is the cause of delays in working combined IMF/BMF issues. However, a National Quality Review sample of 1,300 calls (1,000 were IMF and 300 were BMF) was reviewed to determine the percentage of callers with both IMF and BMF issues. None were identified. Regardless of the actual volume, callers with both IMF and BMF issues may call either of the IMF or BMF toll-free numbers. The Customer Service Representative (CSR) that answers their call would be able to provide assistance in their trained area and then transfer the caller to the appropriate location where employees with the necessary training and experience are available to address the remaining issue. It is also important to note that as a result of such specialization, business callers have experienced improved service compared to prior years when the work was combined.

#### **Disparity in Service to Spanish-speaking Taxpayers**

The IRS provides Spanish toll-free assistance. In addition, each functional area has staffing that is trained and skilled to process Spanish written correspondence so that correspondence received in Spanish is responded to in Spanish. The National Taxpayer Advocate's assessment of this issue is based on an assumption that the volume of Spanish language correspondence is comparable to the number of Spanish language calls. In practice, the IRS actually receives very few pieces of correspondence written in Spanish (less than one percent of all written inquiries).

#### **Technological Impact**

The Correspondence Imaging System (CIS), which provides electronic images of taxpayer correspondence, has been tested for our BMF sites and will begin to roll out in January 2007. In addition, while CIS does not allow an individual CSR to take control of a CIS case that is already controlled to another employee, this does not mean that the CSR can not work the taxpayer's issue. The CSR's authority to work the issue is the same regardless of whether or not there is a CIS case/control. An Internal Revenue Manual (IRM) change will be made to clarify this issue.

Accounts Management has developed Integrated Data Retrieval System (IDRS) Accessory Management programming tools; the JEEDA tool for IMF and the Standard Work Flow Tools (SWFT) for BMF. This innovative software retrieves data from up to fifteen different data sources and compiles the data on a single viewing screen. These tools streamline research, provide consistent treatment to taxpayers and increases timeliness. These tools are used by Accounts Management employees in answering both telephone and correspondence inquiries.

Currently only tax preparers have access to e-Services. The e-Services will become available to reporting agents in fiscal year 2007 and current plans call for the IRS to deliver online account and transcript access to taxpayers in 2009. However, several electronic services are currently available to assist individual taxpayers. For instance, the IRS provides electronic services that allow taxpayers to establish an online installment agree-

ment. The Internet application “Where’s My Refund” allows customers to check the status of their refund online. Additionally, IRS.gov affords customers the ability to access forms, publications, and a wide variety of information online.

In summary, we agree the IRS should respond to taxpayer’s written inquiries in a timely manner. However, just as toll-free customers experience times when peak call volumes limit their ability to reach us by telephone, there are times when responses to correspondence are delayed because of their complexity or overall receipt volumes. We make every effort to plan and schedule our finite Accounts Management staffing to minimize these delays and to provide the best possible services for taxpayers that write or call us for assistance.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate appreciates the services provided by the IRS to respond to a combined 43 million phone calls, letters, and other adjustments receipts. The National Taxpayer Advocate also commends the IRS’s attempt to target its finite resources to meet the needs of taxpayers. However, the intention of this Most Serious Problem is to point out the need for increased balance in the services the IRS provides, and for the IRS to resolve taxpayer correspondence delays.

#### Inventory and Workload Management

The IRS maintains historical records detailing the time periods during which it receives both telephone contacts and paper receipts. Not surprisingly, the IRS response states that in FY 2005, 44 percent of the telephone contacts occurred before the April 16 filing deadline for IMF taxpayers. Equally predictable, as calls decreased after the deadline, taxpayer correspondence – following a historical trend – began to climb. These letters would include taxpayers’ responses to IRS math error notices, information omitted from original tax returns, requests for payment arrangements, and similar correspondence. The IRS response states that fully 45 percent of these correspondence and adjustments receipts occurred within a 90-day window from April to June, which was the reason it issued 40 percent of its interim letters during the same period. However, since historical patterns are already known to the IRS, the National Taxpayer Advocate believes that the IRS should redirect its resources to meet the “wave” of taxpayer correspondence that naturally occurs in April of each year.

The National Taxpayer Advocate appreciates the IRS’s commitment to offering high levels of telephone service. There is no question that taxpayers and the IRS mutually benefit from the direct one-on-one communication shared through telephone contacts. But what was the IRS’ commitment to the approximately ten million “other” taxpayers who sent Correspondence/Adjustments receipts (instead of calling) in FY 2005? The IRS states that written responses can vary significantly in their complexity. However, it is unable to distinguish how many of its 2.9 million correspondence delays resulted from “complex issues,” versus how many were caused through “ordinary” delays.

### Conflict of Measures

The National Taxpayer Advocate appreciates that the IRS must develop different measures for its correspondence and telephone timeliness based on taxpayer expectations. The measures cited in the Most Serious Problem were used to demonstrate the present imbalance in the IRS toward answering taxpayers' telephone calls at the expense of timely resolving correspondence. However, the National Taxpayer Advocate does not believe automating the "delay notification process" meets the spirit of the customer satisfaction survey responses to "(keep) taxpayers informed on the status of their case." Merely standard form letters, interim responses do not "inform" taxpayers on anything – except how much longer they must continue to wait. While a taxpayer may not expect an IRS answer to his or her correspondence in a matter of minutes, he or she still has expectations that the IRS will respond in a timely manner. Customer satisfaction survey responses confirm this sentiment (*i.e.*, "Length of Time to Resolve Your Issue.") Therefore, while each functional area may be aware of its correspondence inventory responsibilities, if the correspondence measurements used are not weighted as heavily against campuses (as telephone measurements), or are much more easily achieved (than telephone measurements), taxpayer correspondence will remain under-serviced.

### Campus Reorganization, Specialization and Employee Training Gaps

The National Taxpayer Advocate acknowledges that correspondence routing, according to functional lines, is essentially the same as it was prior to reorganization. However, there were two important changes. First, within campuses, a single point of accountability (Service Center Director) no longer exists to address overall correspondence delays cross-functionally. Using the examples of systems generating automated interim letters provided in the IRS response (*i.e.*, CIS, AUR, and AIMS), the responsibility would fall under two separate campus field directors, working in two separate business operating divisions (*i.e.*, W&I and SB/SE).

Second, despite the accuracy trends for increased quality cited in the IRS response, the IRS does not adequately provide employees with the technical knowledge needed to resolve complex IMF-BMF issues, thus creating a source of correspondence delays. The IRS response cites a sample of 1,300 calls reviewed for IMF-BMF issues, and states that "None were identified."<sup>60</sup> Yet, the IRS tracks the volume of phone calls its CSRs transfer from an IMF line to a BMF line and vice-versa, so repetition and delays do occur. The IRS response states that campus employees in Accounts Management have historically been cross-trained to work both IMF and BMF accounts. But since Accounts Management's CSRs work the bulk of its correspondence inventory, and are transferring callers to specialized employees, cross-training is no longer the current practice. As the IRS experiences attrition in this area, there will be no employees with past cross-training to even properly recognize issues.

<sup>60</sup> The IRS response did not provide information to verify the appropriateness of the sample methodology.

### Disparity in Service to Spanish Speaking Taxpayers

The IRS response implies that no disparity exists in the services provided to its Spanish speaking taxpayers (versus English speakers), as less than one percent of its correspondence is received in Spanish. However, it would not be unreasonable to assume that the IRS's vast majority of outgoing, English correspondence primarily generates English responses. The IRS sample is not necessarily reflective of those who wished to correspond with the IRS in Spanish, but could not. The IRS does not allow an option for Spanish speakers to select "Spanish," as a communication preference (*e.g.*, a checkbox on tax returns). Moreover, the IRS's Spanish-language interim response ratio (.01 percent for FY 2005) denotes a response-rate that is still up to 99 times lower than expected.<sup>61</sup> The National Taxpayer Advocate's position is based not only on IRS data, but also on current data from the U.S. Census Bureau which shows 32 million people speak Spanish at home.<sup>62</sup> Therefore, the IRS's own correspondence data, as well as the Census Bureau's figures confirm the disparity exists.

### Technological Impact

The National Taxpayer Advocate is pleased that the IRS will clarify its Internal Revenue Manual regarding CIS casework, and CIS will now be available for BMF sites in 2007. However, the National Taxpayer Advocate is still concerned that this new technology is not being used to its fullest extent. For example, assume a CIS case is assigned to a CSR at the Fresno Campus. High call volumes on the toll-free line prevent the Fresno CSR from working his or her CIS inventory in a timely manner. The taxpayer subsequently grows concerned over the correspondence delay, calls the toll-free line, and reaches a CSR in Atlanta. This CSR cannot fully resolve the taxpayer's issue, even though he has full access to the taxpayer's original correspondence through CIS, because the CIS case has already been controlled (assigned). At best, the Atlanta CSR may only resolve the minor issues covered under "oral statement authority" guidelines.<sup>63</sup> The CSR then refers the case to TAS for resolution.

Current IRM rules regarding control bases were originally written prior to the adoption of CIS. Previously, CSRs would have no knowledge of the specific content of a taxpayer's correspondence, unless the "paper" document was physically in his or her

<sup>61</sup> To validate that Spanish-speakers received services equal to English-speakers, the Spanish interim response rate should mirror the volume of Spanish correspondence received. For example, if 50 percent of the IRS's correspondence were received in Spanish, then it would be expected that approximately 50 percent of the IRS's interim letters should also be generated in Spanish (50 percent Spanish correspondence / 50 percent Spanish interims = 1, or a 1:1 ratio of service). The IRS response states that Spanish-language correspondence accounts for "less than one percent." However, the percentage of Spanish-language interims issued in FY 2005 was only .01 percent. Therefore, if the IRS's actual Spanish-language correspondence is .99 percent, then the interim response-rate is 99-times lower than expected (.99 percent Spanish correspondence / .01 percent Spanish interims = 99, or a 99:1 ratio of underservice).

<sup>62</sup> U.S. Census Bureau, 2005 American Community Survey, Table R1602, Percent of People 5 Years and Over Who Speak Spanish at Home; and, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>63</sup> IRM 21.1.3.20, Oral Statement Authority, (Oct. 1, 2006).

## PROBLEMS

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possession. Therefore, if another CSR wished to make an account adjustment, he or she would first be required to contact the original CSR maintaining physical possession of the original correspondence. The second CSR would then ask for verification of the correspondence content and permission to take over the first CSR's control, prior to performing an account adjustment. However, with the inception of CIS, CSRs now have nationwide access to any taxpayer correspondence scanned into CIS. In addition, Desktop Integration (DI), the tool used by CSRs to input detailed case histories and account actions, is also available nationwide. The IRM should be revised to take full advantage of these expanded technologies to benefit taxpayers.

The IRS's e-services suite displays the most potential for providing taxpayers with direct access to current IRS information and eliminating many correspondence delays. However, due to budgetary constraints, taxpayers will wait at least two more years for even the most basic online transcript access of the sort that most financial institutions have possessed for years. The National Taxpayer Advocate believes Congress should earmark additional funding for this program, to enable the IRS to provide e-services access to all taxpayers as soon as possible.

In conclusion, the National Taxpayer Advocate recognizes that the IRS may well need additional staffing for which they are not currently funded. Additional IRS staffing assigned to resolve taxpayer correspondence (and answer telephone calls) may have a significant impact on resolving correspondence delays – particularly during the filing season. The IRS should develop a hiring initiative that addresses its correspondence delay problem, and Congress should increase taxpayer service budgets accordingly.

**RECOMMENDATIONS**

The National Taxpayer Advocate recommends that the IRS implement the following changes to alleviate the numerous correspondence delays experienced by taxpayers. First, the IRS should incorporate the following corrections to its system of measuring "timeliness":

- ◆ Solicit input from taxpayers regarding "acceptable" correspondence processing timeframes, and balance those desires along with reasonable staffing; and
- ◆ Develop a system to recognize and accelerate the treatment of correspondence that has received prior interim contacts.

Then, the IRS should re-think its previous specialization effort, and consider the following actions:

- ◆ Increase the balance within the specialization processes. Re-organizational fallout has created measures without clear accountability for "timeliness" in its responses to the taxpayers. Campuses must align goals and measures, and establish processes – including a single point of accountability – to address barriers created

by specialization (*e.g.*, transshipment, subject-matter-experts, unrelated business measures).

Next, the IRS should balance the utilization of resources allocated to its toll-free lines and correspondence inventory:

- ◆ Avoid utilizing the same personnel to answer the bulk of both taxpayer correspondence and toll-free telephone calls, especially during the peak of tax filing season;
- ◆ Eliminate policies designed to automatically generate form letters (interims) to taxpayers. For planning purposes, the IRS should get behind the problem by coding and tracking the reasons for interim letters. Then, initiate solutions that benefit both the IRS and the taxpayer. Where interim responses are necessary due to complexity, IRS responses should be substantive;
- ◆ Redirect the dollars currently spent on postage and work toward hiring additional employees to perform its correspondence and telephone casework; and
- ◆ Develop a new hiring initiative that specifically addresses the need to provide taxpayers with timely correspondence resolution, which becomes particularly acute during filing season, for congressional funding consideration.

The IRS should rewrite its current correspondence policy statement:

- ◆ Develop proper measures for timeliness, based on taxpayer expectations. Create ongoing advisory teams consisting of front-line workers and management, who are the most familiar with current, procedural issues and taxpayers' common correspondence complaints, to identify emerging issues and technology, and problem resolution.

The IRS should make the following corrections in its handling of its Spanish language correspondence:

- ◆ Acknowledge the evolving demographics of the nation's taxpayer population, and enhance efforts to communicate with Spanish speaking taxpayers in their primary language;
- ◆ Record taxpayer requests for all future communications to be issued in Spanish by providing a checkbox option on each of its notices, letters, and forms to use as indicators; and
- ◆ Determine proper staffing levels for Spanish speaking assistants and hire to the appropriate level.

Regarding the coordination of its own internal systems, the IRS should:

- ◆ Maintain a proactive focus on increasing taxpayer-satisfaction. Adopt a nationally-coordinated IDRS tool development process (for SWFT, JEEDA, and IDAP) to support further developments, while still encouraging "homegrown" solutions.

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The development of an IDRS tool designed specifically to reduce correspondence delays should be made a priority.

- ◆ Ensure that the e-services suite of products will be made available to taxpayers as soon as possible. As these products allow a taxpayer to access his or her own account instantly, in many instances, the taxpayer's need to correspond with the IRS at all will be eliminated.

Finally,

- ◆ Congress should provide sufficient funding to the IRS to enable it to provide world-class taxpayer services to its taxpayers.



**PROBLEM****TOPIC #14 DISASTER RESPONSE AND RECOVERY****RESPONSIBLE OFFICIALS**

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Richard J. Morgante, Commissioner, Wage and Investment Division

Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division

Deborah M. Nolan, Commissioner, Large and Mid-Sized Business Division

Carl Froehlich, Chief, Agency Wide Shared Services

**DEFINITION OF PROBLEM**

Each year, many thousands of people have their lives unexpectedly altered by disasters. Disasters do not discriminate; they hurt the rich and the poor, the old and the young, men and women. Disasters affect all geographic regions of the country. A disaster may strike as a hurricane, tornado, fire, flood or winter storm. It may be a terrorist attack or pandemic. The only thing we know with certainty about disasters is that they will occur in some form or fashion.

Over the years, the IRS has successfully responded to many disasters. For example, the IRS provided and staffed toll-free FEMA phone assistance lines for Hurricane Katrina victims and answered approximately 950,000 calls.<sup>1</sup> The IRS also implemented numerous tax law changes to help the victims in disaster areas and to encourage individuals donating to charities to support the victims.

Notwithstanding its successes, the IRS has room for improvement in planning for disaster relief. The IRS has yet to establish comprehensive short-term and long-term strategies to assist victims of Presidentially declared disasters. This failure to incorporate the lessons of the past into a fluid planning and response process may harm the victims of the next disaster. The IRS must take steps to correct these problems before future disasters strike.

<sup>1</sup> See *Hearing On 2006 Tax Return Filing Season and the IRS Budget For Fiscal Year 2007, Subcomm. on Oversight, House Comm. On Ways and Means, 109th Cong. 2nd Sess (Apr. 6, 2006)* (Statement of Mark Everson, Commissioner, Internal Revenue. See also IRS Oversight Board, *IRS Oversight Board Commends IRS's Katrina Response and Progress on Modernization: Points to Importance of Critical Infrastructure* (Oct. 6, 2005), available at <http://www.ustreas.gov/irsob/releases/2005/0905.pdf>. IRS Oversight Board Chairman Raymond Wagner, Jr., said, "The IRS is to be applauded for getting out of the blocks quickly and getting ahead of the problem."

## ANALYSIS OF PROBLEM

## Background

From 2001 through 2005, the United States has averaged 53 Presidentially declared disasters each year.<sup>2</sup> Seven of the ten most costly disasters in U.S. history occurred during that same five-year period.<sup>3</sup>

The Insurance Information Institute classified half (24) of the 48 Presidentially declared disasters in 2005 as catastrophes.<sup>4</sup> The Federal Emergency Management Agency (FEMA) offered assistance to individuals in 14 of these disasters.<sup>5</sup> In contrast, the IRS provided automatic relief in only three of them.<sup>6</sup>

TABLE 1.14.1, THE TEN MOST COSTLY CATASTROPHES IN THE UNITED STATES<sup>7</sup>

Rank	Date	Event	Insured loss (\$ millions)	
			Dollar when Occurred	In 2005 dollars (2)
1	Aug. 2005	Hurricane Katrina	40,600	40,600
2	Aug. 1992	Hurricane Andrew	15,500	21,576
3	Sep. 2001	World Trade Center, Pentagon terrorist attacks	18,800	20,732
4	Jan. 1994	Northridge, CA earthquake	12,500	16,473
5	Oct. 2005	Hurricane Wilma	8,400	8,400
6	Aug. 2004	Hurricane Charley	7,475	7,728
7	Sep. 2004	Hurricane Ivan	7,110	7,351
8	Sep. 1989	Hurricane Hugo	4,195	6,607
9	Sep. 2005	Hurricane Rita	5,000	5,000
10	Sep. 2004	Hurricane Frances	4,595	4,751

(1) Property coverage only.

(2) Adjusted to 2005 dollars by the Insurance Information Institute.

After surviving a disaster, victims start to try to put their lives back together. This process calls for the victims to determine the financial impact of the disaster, including its tax implications.

<sup>2</sup> Federal Emergency Management Agency (FEMA), *Declared Disasters by Year or State*. According to FEMA, there were 48 declared disasters in 2005, 68 in 2004, 56 in 2003, 49 in 2002, and 45 in 2001; See [http://www.fema.gov/news/disaster\\_totals\\_annual.fema](http://www.fema.gov/news/disaster_totals_annual.fema) (Sept 2006).

<sup>3</sup> Insurance Information Institute, *The Ten Most Costly World Insurance Losses, 1970 – 2005*, available at <http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/>.

<sup>4</sup> The Insurance Information Institute classifies as a catastrophe any disaster or terrorist event with insured losses greater than \$25 million. See <http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/> (Sept. 2006).

<sup>5</sup> If FEMA designates a disaster as eligible for Individual Assistance, victims may receive financial assistance for housing expenses under its Individuals and Households Program. See <http://www.fema.gov/media/factsheets/individual-assistance.shtm> (Sept. 2006).

<sup>6</sup> In 2005, the IRS designated victims of Hurricanes Dennis, Katrina and Rita, for automatic relief.

<sup>7</sup> Insurance Information Institute, *The Ten Most Costly World Insurance Losses, 1970 – 2005*, available at <http://www.iii.org/media/facts/statsbyissue/catastrophes/content.print/>.

The tax law governing disaster relief is complex and burdensome. When dealing with the aftermath of a disaster, taxpayers must navigate a maze of statutes, regulations, and recordkeeping tasks to learn about and satisfy tax filing requirements. These include:

- ◆ How to determine and claim a casualty loss;
- ◆ Whether payments received related to the disaster are taxable; and
- ◆ What relief, if any, is available from the IRS.

In 2005, Congress simplified the disaster relief process by expanding Internal Revenue Code (IRC) § 139 to exclude from income mitigation payments received from government entities by disaster victims.<sup>8</sup> Still, disaster victims must make critical tax decisions while dealing with trauma and other emotional distress and trying to meet basic needs, at a time when they lack access to records and expert assistance.

### Overview of the Federal Disaster Response Process

In 1988, Congress enacted the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the “Stafford Act”) to support state and local governments and their citizens when disasters overwhelm them.<sup>9</sup> This law, as amended, establishes a process for requesting and obtaining a Presidential disaster declaration, defines the type and scope of assistance available from the federal government, and sets the conditions for obtaining that assistance.<sup>10</sup> FEMA, now part of the Emergency Preparedness and Response Directorate (EPR) of the Department of Homeland Security, is tasked with coordinating the response. Section 401 of the Stafford Act requires that “all requests for a declaration by the President that a major disaster exists shall be made by the Governor of the affected State.”<sup>11</sup>

The government does not, however, activate all of its programs for every disaster. The determination of which programs to activate is based on damage assessments and any

<sup>8</sup> H.R. 1134, 109th Cong. (2005), amended IRC § 139 by adding subsection (g) Qualified Disaster Mitigation Payments:

(1) IN GENERAL. Gross income shall not include any amount received as a qualified disaster mitigation payment.

(2) QUALIFIED DISASTER MITIGATION PAYMENT DEFINED. For purposes of this section, the term ‘qualified disaster mitigation payment’ means any amount which is paid pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act (as in effect on the date of the enactment of this subsection) or the National Flood Insurance Act (as in effect on such date) to or for the benefit of the owner of any property for hazard mitigation with respect to such property. Such term shall not include any amount received for the sale or disposition of any property.

(3) NO INCREASE IN BASIS. Notwithstanding any other provision of this subtitle, no increase in the basis or adjusted basis of any property shall result from any amount excluded under this subsection with respect to such property.

<sup>9</sup> 42 U.S.C. §§ 5121-5206.

<sup>10</sup> 42 U.S.C. § 5170.

<sup>11</sup> FEMA, *Guide to the Disaster Declaration Process*. A “state” also includes the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. The Marshall Islands and the Federated States of Micronesia are also eligible to request a declaration and receive assistance. Available at: [http://www.fema.gov/pdf/rebuild/recover/dec\\_proc.pdf](http://www.fema.gov/pdf/rebuild/recover/dec_proc.pdf).

information subsequently discovered. FEMA/EPR disaster assistance falls into three general categories:

- ◆ Individual Assistance – aid to individuals and households;
- ◆ Public Assistance – aid to governments (and certain private non-profit) entities for certain emergency services and the repair or replacement of disaster damaged public facilities; and
- ◆ Hazard Mitigation Assistance – funding for measures designed to reduce future losses to public and private property.

Some declarations provide only public assistance or only individual assistance while others provide both. Hazard mitigation opportunities are assessed in most situations.<sup>12</sup>

### Internal Revenue Code and Other IRS-Provided Relief

Just as relief under the Stafford Act varies by disaster, so does the relief the IRS provides. The IRS has the authority to activate relief provisions that grant extensions for filing and paying taxes, remove penalties, and abate interest for affected disaster victims.<sup>13</sup> The IRS may grant this relief without a Presidential declaration or FEMA determination.

The Code permits the IRS to grant additional relief if the President declares an area a disaster. The additional disaster relief authorized by statute includes the authority by the Secretary to:

- ◆ Postpone deadlines by reason of Presidentially declared disaster or terrorist or military actions;<sup>14</sup>
- ◆ Grant a reasonable extension of time for filing returns;<sup>15</sup>
- ◆ Extend the time for payment of tax;<sup>16</sup>
- ◆ Provide relief from penalties due to “reasonable cause”;<sup>17</sup> and
- ◆ Provide special rules for property damaged by presidentially declared disasters and provide key definitions of terms.<sup>18</sup>

<sup>12</sup> FEMA, *The Disaster Process and Disaster Aid Program*, available at <http://www.fema.gov/hazard/dproc.shtm> (Sept. 2006).

<sup>13</sup> IRM 1.2.52.5 (11-18-2002) *Granting Relief to Taxpayers Affected by Disasters or Terrorist or Military Actions*, Delegation Order 25-11 (formerly DO-268).

<sup>14</sup> IRC § 7508A.

<sup>15</sup> IRC § 6081.

<sup>16</sup> IRC § 6161.

<sup>17</sup> IRC § 6656.

<sup>18</sup> IRC §1033(h).

### The IRS's Initial Decision Making and Response Options

After a disaster, the IRS State Disaster Assistance Coordinator is required to complete a State Disaster Assistance Coordinator Assessment and Recommendations Checklist and send it to the National Disaster Assistance Coordinator within 72 hours of the disaster. The checklist asks for the state coordinator's recommendations on specific relief, duration of tax relief, whether to suspend enforcement contacts and for how long.<sup>19</sup> However, the IRS provides no guidelines or criteria for the state coordinator to use when making these recommendations. Further, the coordinator may not be in the disaster area and is not required to make an on-site assessment. Without such an assessment, the state coordinator's recommendations on relief lack a crucial perspective.

After the President declares a disaster area and FEMA offers individual assistance, the IRS issues a "Disaster Relief Memorandum" and an accompanying press release. However, the IRS may invoke relief provisions without a determination by FEMA or even a declaration by the President. The IRS has not established criteria for deciding which available relief provisions should apply for a particular disaster. We found the IRS extended relief beyond the Presidentially declared individual assistance areas (*e.g.*, zip codes) only once in the past three years – for Hurricane Katrina.<sup>20</sup>

When the President declares a disaster area and FEMA decides to offer individual assistance, the IRS may offer services in addition to statutory relief. Some of these services are:

- ◆ *Press Releases.* The IRS may issue press releases identifying the disaster area and offering guidance about how to get relief. The IRS also provides information on its website (<http://www.irs.gov>).
- ◆ *Outreach and Education.* The IRS sends staff to FEMA recovery sites as part of the federal government's interagency task force assistance plan. The IRS Stakeholder Liaison Area Manager is responsible for the IRS operation.

Besides outreach and education, the IRS offers services to disaster victims at FEMA sites, IRS Taxpayer Assistance Centers (TACs), and by telephone. These services include:

- ◆ *Copies of Transcripts.* The IRS works with the Small Business Administration (SBA) at FEMA sites to provide account transcripts to taxpayers seeking SBA loans.
- ◆ *Tax Return Copy Requests.* The IRS may waive fees for disaster victims requesting copies of their prior tax returns.
- ◆ *Disaster Kits.* These kits contain information and forms to help taxpayers determine and file casualty loss claims.

<sup>19</sup> IRM 25.16.3 Exhibit 2 (Jun. 1, 2003).

<sup>20</sup> IRS Disaster Relief Declarations and IRS Disaster Assistance Program. See <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.

- ◆ *Return Preparation.* The 2006 Field Assistance Program Letter removed many earlier income-based restrictions on return preparation and other help by TACs, and extended these services to the hurricane victims of the Gulf Coast for 2006. The IRS later made these changes permanent and applicable to future disaster victims.
- ◆ *Delinquent Return Preparation.* To qualify for some federal benefits, taxpayers must provide their last two or three years of income tax filings. Taxpayers who have not filed these returns may need help preparing past year returns to qualify for SBA loans and other benefits.<sup>21</sup> The IRS generally offers limited delinquent return preparation at TAC offices. Since Katrina, the IRS has permanently changed its procedure and now exempts taxpayers impacted by a declared disaster from income limitation restrictions for preparing delinquent returns.<sup>22</sup>
- ◆ *Stakeholder Partnerships.* The IRS may set up stakeholder partnerships with professional organizations, such as practitioner and industry groups, to provide help that is beyond IRS capacities. An example is the partnership with the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, several Low Income Taxpayer Clinics, and other organizations to assist victims of Hurricanes Rita, Katrina, and Wilma.

## ANALYSIS

### The IRS's Initial Disaster Response

The IRS has not set criteria for classifying disasters or established a response plan based on the disaster's size or characteristics. In our analysis of how the IRS reacted to disasters, we classified the IRS response into four categories: Traumatic National Event, Major Catastrophic Disaster, Major Disaster, and Presidentially Declared Disaster Without Individual Relief Offered by FEMA. The following is a brief discussion of each:

- 1) *Traumatic National Event.* The IRS convenes its Disaster Relief Council (DRC)<sup>23</sup> in case of a traumatic national event.<sup>24</sup> The DRC has convened only twice, once after the September 11 attacks and again after Hurricane Katrina. The group reacts to disasters by deciding issues as events occur. The IRS has no established criteria to trigger action by this high-level group, nor does it commit the lessons learned and experience gained to its institutional memory to plan for future events.

<sup>21</sup> Small Business Administration, *Home and Personal Property Disaster Loans*, available at [http://www.sba.gov/disaster\\_recov/loaninfo/property.html](http://www.sba.gov/disaster_recov/loaninfo/property.html).

<sup>22</sup> IRM 21.3.4.10.10.1

<sup>23</sup> Also referred to as Disaster Tax Administration Policy Group (DTAPG).

<sup>24</sup> IRM 25.16.3.1, Disaster Assistance and Emergency Relief - National Disaster Assistance Coordinator (NDAC) (Jun. 1, 2003).

- 2) *Major Catastrophic Disaster.* A Major Catastrophic Disaster is one in which FEMA has offered individual assistance and the IRS has automatically suspended enforcement and other activities (known internally as O Freeze or Disaster Freeze). These disasters have no DRC involvement. The National Disaster Coordinator is in charge of the agency's response. For 2003, the IRS used the automatic relief mechanism for two events that affected three states.<sup>25</sup> In 2004 and 2005, the IRS used the automatic relief mechanism in three disasters involving six states.<sup>26</sup>
- 3) *Major Disaster.* A Major Disaster is one in which FEMA has offered individual assistance but the IRS does not automatically suspend tax filing, payment, and enforcement activities for the affected area. In this type of disaster, the affected taxpayers must "self-identify" to the IRS. Thirty-nine disasters fit this class in 2003, 41 in 2004, and 14 in 2005.<sup>27</sup>
- 4) *Presidentially Declared Disaster Without Individual Relief Offered by FEMA.* The IRS offers no special relief for victims of this group of disasters. The IRS could invoke relief for affected taxpayers, but in practice, the IRS has rarely offered any relief provisions.<sup>28</sup>

TABLE 1.14.2, DISASTER DECLARATIONS, CALENDAR YEAR 2005<sup>29</sup>

Event Type	FEMA Determined Qualified For Individual Assistance		
	Yes	No	Grand Total
Hurricanes	8	3	11
Severe Storm		1	1
Storm/Flood/Mud -Landslide	5	19	24
Tornado	3		3
Tropical Cyclone	1		1
Tropical Storm		1	1
Winter Storm/Flood	2	5	7
<b>Grand Total</b>	<b>19</b>	<b>29</b>	<b>48</b>

Note: Systemic -O Freeze authorized seven times from three events Hurricanes Katrina, Wilma and Rita.

<sup>25</sup> IRS News Releases IR-2003-112 (Sept. 24, 2003) and IR-2003-126 (Oct. 28, 2003). In 2003, the IRS provided automatic relief to victims of Hurricane Isabel (NC and VA) and the California Wildfires. See <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.

<sup>26</sup> IRS News Releases IR-2004-108 (Aug. 16, 2004), IR-204-115 (Sept. 10, 2004), IR-2004-118 (Sept. 22, 2004), IR-2005-016 (Jul. 15, 2005), IR-2005-084 (Aug. 30, 2005), and IR-2005-110 (Sept. 26, 2005). In 2004, the IRS provided automatic relief to victims of Hurricane Ivan (AL, FL, LA, and MS), Hurricane Francis (FL), and Hurricane Charley (FL). In 2005, the IRS provided automatic relief to victims of Hurricane Katrina (AL, LA, and MS), Hurricane Rita (LA and TX), and Hurricane Dennis (FL). See <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.

<sup>27</sup> IRS Disaster Relief Declarations. See <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.

<sup>28</sup> See IRC §§ 6081 and 6161. The IRS may provide relief to taxpayers affected by natural disasters by extending the deadline to file certain tax returns and pay certain taxes.

<sup>29</sup> FEMA, 2005 Federal Disaster Declarations, available at <http://www.fema.gov/news/disasters.fema?year=2005>.

The IRS's method of reacting to disasters as they happen is not the most effective strategy. To improve its response to these events, the IRS needs a dedicated cross-organizational group that reviews lessons learned, modifies guidance, and develops and conducts training internally and with stakeholders. Such a group should include representatives from all IRS business units, including TAS and should function as a standing, ongoing task force. This group's primary responsibility would be to work with FEMA and the Department of Homeland Security to identify the types of potential disasters, and develop models and plans to respond quickly and effectively in the event of a major disaster or terrorist attack.

### **IRS State Disaster Coordinators**

In all but the most serious disasters, the IRS's State Disaster Coordinators provide recommendations to the National Disaster Coordinator about what relief the IRS will offer, if any. We are concerned about the lack of guidance given to the state coordinators before they conduct the assessments. There are no specific disaster assessment criteria, nor even a requirement that the coordinator visit the disaster area. The ability to assess a disaster and the resources available to the state coordinators to respond vary from location to location.

The IRS has not established specific expectations for its operating divisions and functions to provide staff and other support to the State Disaster Coordinator. Again, this lack of clear direction may lead to inconsistent responses. The Stakeholder Liaison Area Manager coordinates IRS staffing at FEMA sites from a cadre of trained volunteers and others, but available cadres differ from site to site, and volunteers may themselves be disaster victims, leaving the manager short-staffed. The IRS has no templates for staffing at FEMA sites or setting up and training cadre volunteers. We believe the IRS should form a Standing Committee on Disasters (SCOD) to plan, coordinate, and implement all facets of disaster planning and relief.

### **The Automatic Disaster Relief Decision (O Freeze)**

The disaster relief freeze condition (the "O Freeze") suspends all action on a taxpayer's account for the relief period. The freeze may be set automatically by IRS computers by using affected zip codes or input manually by employees on a case-by-case basis (when taxpayers identify themselves as disaster victims). However, because the IRS does not provide criteria for applying the automatic disaster relief freeze, similarly situated taxpayers may be treated inconsistently. In 2005, only areas affected by Hurricanes Katrina, Rita, and Dennis received automatic relief treatment, and even then it did not cover all the counties in the Presidentially declared areas.<sup>30</sup>

<sup>30</sup> IRS, *Disaster Declaration #1606*, available at *Around the Nation* <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.



In zip codes for victims of Hurricanes Katrina and Rita, the IRS decided to systemically place disaster freezes on the accounts of affected taxpayers.<sup>31</sup> Taxpayers not in an automatically frozen area may identify themselves as victims in several ways (e.g., by calling the IRS, or writing the disaster identification on their tax returns). According to the Treasury Inspector General for Tax Administration (TIGTA), the systemically generated indicators were 99.9 percent accurate and effective.<sup>32</sup> On the other hand, TIGTA found that when disaster relief indicators were input manually for taxpayers who self-identified, the IRS had a 68 percent error rate.<sup>33</sup> These errors can cause taxpayers to receive incorrect bills for interest and penalties even when the taxpayers were covered by a granted relief provision. Even when on accounts with properly placed disaster relief indicators, problems can occur when there is no pre-planning or execution. For example, disaster freezes started expiring for many Hurricane Katrina affected taxpayers on approximately October 9, 2006. The IRS failed to anticipate that the freeze release would trigger the automatic issuance of nearly 25,000 Federal Payment Levy Program (FPLP) levies. Had the IRS run through a scenario, set up a comprehensive plan, or learned from previous disasters, it could have expected these levies and dealt with them.<sup>34</sup>

In examining the IRS's procedures, we found disparate treatment of taxpayers who self-identified by making a notation on their tax return. The IRS processing centers only restricted penalty assessments for these taxpayers.<sup>35</sup> Taxpayers in identical circumstances who self-identified by telephone or whose accounts were identified systemically by the IRS received better treatment than those who self-identified by notating their tax return. For these taxpayers, the IRS restricted penalty assessments, restricted interest assessments, and suspended collection and examination activity during the relief period.<sup>36</sup>

The IRS's problems with properly identifying and providing relief for disaster victims who self-identify are not new. In April 2000, the Local Taxpayer Advocate (LTA) in Dallas, Texas, identified the same issues after a tornado in Fort Worth.<sup>37</sup> In the six intervening years, the IRS has not been able to resolve these problems.

<sup>31</sup> IRS, *Disaster Declaration #1610 - Zip Codes*, available at <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>. Not all of Hurricane Rita's Presidentially declared disaster counties were included in the IRS's systemic disaster relief. The most notable exception was Harris County, TX (which includes Houston).

<sup>32</sup> Treasury Inspector General For Tax Administration, Ref. No. 2006-40-109, *Taxpayers Residing in the Hurricanes Katrina and Rita Disaster Areas Were Accurately Identified for Tax Relief* (Jul. 31, 2006).

<sup>33</sup> *Id.*

<sup>34</sup> Email from Director Stakeholder Liaison, Small Business/Self Employed, October 20, 2006. The IRS says only 30 of the 25,000 attached, but the fact so few attached is simply lucky.

<sup>35</sup> IRM 3.11.3.7.1.7 *Natural Disaster Emergency Relief Program* (Jan. 1, 2006).

<sup>36</sup> IRC § 7508A and *Disaster Assistance for the State of Louisiana (FEMA 1603-DR)* August 30, 2005, See <http://www.irs.gov/newsroom/article/0,,id=98936,00.html>.

<sup>37</sup> TAS, Systemic Advocacy Management System - Project P0000437, *Disaster Relief Processing Errors*.

A newspaper article recently reported that the IRS was not properly processing requests for relief by self-identified disaster victims in Missouri and again in Montana.<sup>38</sup> TIGTA has reported that even when taxpayers properly self-identified themselves to the IRS, the IRS did not accurately identify these taxpayers affected by Hurricanes Katrina and Rita to grant them the extended relief period.<sup>39</sup>

### Tax Law Complexity (Post Disaster Filing)

Although many types of relief provided by governments, charities, and individuals are not taxable, disaster victims may still have many complex tax issues. Much of this complexity involves the receipt of insurance proceeds that are greater than the taxpayer's "adjusted basis" in the destroyed or damaged property.<sup>40</sup> In the days and weeks following a disaster, victims must assemble, locate, or newly obtain documents such as birth certificates, drivers' licenses, Social Security cards, property records, and insurance policies in order to file insurance claims and apply for aid.

An analysis of all possible tax consequences of a disaster is beyond the scope of this discussion.<sup>41</sup> Disaster victims may receive various types of payments from governments, charities, individuals, insurance companies and so on. The victim will have to determine whether the payments received are taxable. Taxpayers who suffer damage to their homes or personal property are required to complete a complex analysis of their records, including reconstruction of lost or damaged records. They must determine their basis in the property and compare that to the property's fair market value and replacement cost to determine whether they have a loss or a gain. Once taxpayers calculate gains and losses, they face many complicated tax decisions, which are contingent on other choices the taxpayers make about replacing or repairing their property. Taxpayers reimbursed by insurance for more than the cost of their property may find they have a potentially taxable capital gain. Their gains may be taxable now, they may be deferred, or they may be fully free from tax. The disaster victim is faced with daunting choices that may be costly if made incorrectly. Other disaster victims will incur casualty losses. Taxpayers in a Presidentially declared disaster area have the option of claiming their loss on the preceding tax year or the current year. Normally, these losses are reduced by ten percent of

<sup>38</sup> Kevin Coleman, *IRS Relief a Disaster for Some*, Columbia Daily Tribune June 1, 2006. See also TAS, Systemic Advocacy Management System - Project P0025302, *Penalty and Interest Assessed on Returns with Disaster Designations*.

<sup>39</sup> Treasury Inspector General For Tax Administration, Ref. No. 2006-40-109, *Taxpayers Residing in the Hurricanes Katrina and Rita Disaster Areas Were Accurately Identified for Tax Relief* 4 (Jul. 31, 2006).

<sup>40</sup> See IRC § 1033. Basis is generally the amount of a taxpayer's investment in a property. For tax purposes, the taxpayer uses his or her basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale or exchange of the property. The basis of property is usually its cost.

<sup>41</sup> See Francine J. Lipman, *Anatomy of a Disaster Under the Internal Revenue Code*, Florida Tax Review 2005, Volume 6, Number 10. This article provides a comprehensive analysis of the application of the Internal revenue Code to a hypothetical taxpayer who was a victim of a disaster.

the taxpayer's adjusted gross income plus \$100.00.<sup>42</sup> Again, disaster victims must make decisions that may be costly if they are poorly informed.

### Post Disaster Execution of Relief Provisions and Processing of Disaster Claims

Immediately after a disaster, the IRS's response focuses on information distribution at FEMA Recovery Centers and similar sites. At this beginning stage of recovery, most taxpayers are not yet able to focus on their tax matters. Later in the recovery cycle, after obtaining necessities, determining losses, receiving reimbursements, and securing loans, taxpayers start dealing with their taxes and the IRS. Unfortunately, at this point, the IRS's once abundant assistance and presence may have disappeared from the disaster area. Taxpayers needing help must now contact the IRS by telephone or go to a Taxpayer Assistance Center. The loss of IRS support, which was so visible and available at FEMA sites immediately following a disaster, often triggers taxpayer confusion and unnecessary delays.

Taxpayers trying to comply with their obligations but who need help often contact TAS for assistance. The Taxpayer Advocate Management Information System (TAMIS) database shows that TAS has received taxpayer cases involving many disaster related issues. These cases include the following:

- ◆ Replacing lost records;
- ◆ Help in preparing and filing disaster loss tax claims;
- ◆ Resolving delays in processing claims including related examinations;
- ◆ Correcting problems with payments returned from electronic transfer programs; and
- ◆ The proper processing of Form 8914, *Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina*.

Three of the high volume issues involved lost records, examining claims and installment agreements.

#### *Lost Records*

After Hurricane Katrina, the IRS released guidance on lost or destroyed documents that might not be immediately replaced. This release included guidelines for an oral disclosure authentication process for taxpayers who were left without government identification, so they could obtain their tax records.<sup>43</sup> Additional guidance covered taxpayers who were unable to get Social Security numbers for their children before the 2005 filing deadlines. Although the IRS promptly addressed these situations, it could have anticipated them and had procedures in place. The initial lack of guidance caused

<sup>42</sup> IRC §§ 165(h)(1) & (2).

<sup>43</sup> IRS, Disaster Assistance Self-Study - Record Reconstruction, available at <http://www.irs.gov/businesses/small/article/0,,id=147164,00.html> (Sept. 2006).

taxpayer and preparer delays and confusion about how to file their tax returns. Standing procedures, incorporated into the Internal Revenue Manual (IRM), will result in better informed IRS employees and stakeholders, and will allow for training of IRS employees and stakeholders outside the “crunch” time of the actual disaster.

#### *Examination Criteria*

When taxpayers file returns claiming disaster losses, the IRS may select the claims for examination before processing the returns and paying refunds. TAS becomes involved because of delays in examining disaster claims. The IRS has been slow to adjust its criteria for returns it wants to audit to reflect the total uninsured losses on the Gulf Coast.

In examinations where the claimed disaster loss exceeds a certain threshold, the IRM requires “expert analysis.”<sup>44</sup> This requirement involves obtaining an IRS engineering report to verify the value of the damaged or destroyed property. The process is time-consuming and of questionable benefit in an area damaged as severely as the region struck by Hurricane Katrina. TAS has worked with the Examination function to ease this requirement and raise the threshold.

#### *Direct Deposit Installment Agreements (DDIA)*

A taxpayer in a disaster area who is paying a tax liability through an installment agreement with the IRS may stop making payments during the relief period. However, if the taxpayer has set up a Direct Debit Installment Agreement (which automatically takes the payment from his bank account) he or she must call and ask the IRS to stop the DDIA. TAS has worked cases that involve delays in obtaining these releases, which may result in the IRS taking additional payments from the taxpayer’s bank account and applying them to the IRS balance.

### CONCLUSION

Disasters are an unfortunate but inescapable part of life, striking almost every state and yielding an average of more than 50 Presidential declarations annually in recent years.<sup>45</sup> FEMA data shows over 2.5 million people in every state and Puerto Rico registered with FEMA for Individual Assistance relief from Hurricanes Katrina and Rita.<sup>46</sup>

The IRS responded to Katrina, Rita and Wilma by giving out over 400,000 *Disaster Kits*, providing over 150,000 account transcripts and preparing 934 tax returns in TAC offices.<sup>47</sup> After Katrina, the IRS convened a Disaster Relief Council of high-level executives, charged with making policy and resource decisions. The IRS deserves the praise it

<sup>44</sup> IRM 4.8.8.10.1, Technical Support (Exam) - Miscellaneous Responsibilities (Oct. 2003).

<sup>45</sup> FEMA, *Declared Disasters by State*, available at [http://www.fema.gov/news/disaster\\_totals\\_annual.fema](http://www.fema.gov/news/disaster_totals_annual.fema).

<sup>46</sup> FEMA, *Hurricane Katrina and Hurricane Rita*, available at <http://www.fema.gov/hazard/hurricane/2005katrina/index.shtm>, and <http://www.fema.gov/news/newsrelease.fema?id=29987>, and <http://www.fema.gov/news/newsrelease.fema?id=30941>.

<sup>47</sup> SB/SE Response to TAS Information Request (Jun. 21, 2006).

has received for its Katrina response effort. However, its success is more attributable to the outstanding efforts of its employee “first responders” than its planning and strategy execution.

The IRS must institutionalize the many lessons learned from responding to September 11 and the Gulf Coast hurricanes of 2005, as well as many smaller disasters. The IRS must use these lessons to develop comprehensive plans for different types and sizes of disasters. It needs practice scenarios, better training, and expanded and better support for taxpayers trying to file disaster related returns. All these objectives and more call out for a permanent high-level servicewide group to change IRS strategies from reactive to proactive.

### IRS COMMENTS

The IRS strongly disagrees with the National Taxpayer Advocate’s observations that the IRS’s disaster response and recovery efforts deserve to be called one of the Most Serious Problems facing taxpayers. Dealing with disasters is not an exact science. Each one is different in scope, nature, and geographic location. A degree of flexibility in the decision making process, with respect to the granting of administrative tax relief, is crucial to assisting victims of a disaster. However, the IRS does have sound criteria and established policies and procedures in place for responding to disasters.

The Gulf Coast hurricanes of 2005 resulted in an unparalleled need for coordination between IRS operating divisions and external partners to provide disaster assistance to taxpayers in the impacted areas. In the GAO Report on Catastrophic Disasters, GAO-06-618, the Comptroller General recognized the IRS among a few agencies for its “flexibility and adaptability” in responding to Katrina’s challenges. Specifically, GAO recognized the IRS for the assignment of 5,000 employees to augment the FEMA hurricane registration efforts, the establishment of a dedicated toll-free disaster hotline, the distribution of over 291,000 disaster kits (through February 2006), and the creation of a special section on the IRS internet site.

TIGTA and GAO have conducted a total of 10 audits involving our response to the disasters with very few findings. In addition, the Director, Communications, Liaison and Disclosure, who has overall stewardship for the Disaster Assistance and Emergency Relief Program, commissioned an internal review of the current disaster policies and procedures to identify lessons learned and recommend formalized procedures and policies for future use.

Pursuant to that direction, the Disaster Assistance Review Team (DART) completed a comprehensive program review and issued a report in May 2006. The DART report already raised many of the issues noted in the NTA’s report and outlined many recommendations and program enhancements that are currently in process, including a complete revision of the IRS Disaster IRM Section 25.16.

## PROBLEMS

The IRS Disaster Tax Administration Policy Group (DTAPG), a cross-functional team of senior officials responsible for directing IRS policy in disaster response efforts, reviewed and approved the DART report. The Taxpayer Advocate Service (TAS) representative to the DTAPG did not raise concerns during this program review or the many DTAPG policy meetings conducted since the hurricanes. On several occasions, the TAS representative expressly stated there had not been any increase in inventory or contacts as a result of our response to the unprecedented level of disasters.

The IRS has used its administrative authority to reduce taxpayer burden by granting broad relief for impacted taxpayers. In almost all cases, the IRS suspended taxpayer correspondence and prevented compliance activities from occurring. The IRS made every possible effort to help taxpayers in their financial recovery from the devastating storms. The National Taxpayer Advocate's report states that the IRS generated nearly 25,000 Federal Payment Levies erroneously. However, less than 30 of these levies actually attached to an account and, in each instance, the IRS reversed actions to ensure that taxpayers were not adversely affected.

In an agency first, the IRS secured agreements with seven tax professional organizations to jointly provide assistance to taxpayers at local disaster recovery centers. These agreements outlined careful guidance for disaster coordinators and several of these organizations went beyond expectations, accepting referrals for free tax return preparation for low income taxpayers needing to report unreimbursed casualty losses as a result of the Hurricane disaster. In addition, the Wage and Investment Division permanently removed income-based restrictions on preparing delinquent returns at the Tax Assistance Centers for taxpayers directly impacted by disasters.

In another program improvement initiative, the IRS is creating a new Master File freeze code to ensure that all taxpayers located in a Presidentially declared disaster area receive filing and payment relief without having to self-identify.

In 2005, the IRS granted tax relief in 20 Presidentially declared disaster areas. For Katrina victims, filing and payment deadlines were postponed until October 16, 2006 for the most severely affected areas in Louisiana, Mississippi, and Alabama. In addition, the IRS assisted over 175,000 taxpayers at the FEMA Disaster Recovery Centers, responded to over 100,000 telephone calls made to the toll-free Disaster Hotline, and expedited over 1.3 million tax return transcripts to the U.S. Small Business Administration Office of Disaster Assistance for taxpayers who applied for federal disaster loans.

Finally, the IRS initiated many administrative tax relief measures including increasing the standard mileage rate for the final months of 2005, implementing an expedited review and approval process for new organizations seeking tax exempt status in order to provide relief to victims of Hurricane Katrina, allowing retirement plan participants affected by the disaster to use streamlined loan procedures, liberalizing hardship distribution rules for certain retirement plans, and many other similar types of administrative tax relief.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

It is surprising that the IRS does not recognize its lack of a disaster response strategy as a Most Serious Problem. In this report, we have complimented the IRS on its reaction to Hurricane Katrina and the other Gulf Coast hurricanes of 2005. Frontline managers and employees responded extraordinarily. To anyone watching a television set, it was obvious the number of victims needing help in New Orleans and Mississippi far exceeded the number affected by prior disasters. The IRS's primary response was convening the Disaster Tax Administration Policy Group. The Taxpayer Advocate Service (TAS) was part of this group and is proud of its participation. TAS did in fact raise many of the issues discussed in this report with the group, while contributing to timely solutions as events unfolded. Again, this group reacted well to events as they surfaced; but that does not mean the IRS could not have done better. The U.S House of Representatives and the Senate apparently believed taxpayers deserved better, having passed legislation to establish a permanent IRS Disaster Response Group.<sup>48</sup> This high-level cross-organizational group would develop strategies, plans, and models, and work with other governmental agencies developing disaster responses.

The IRS and the National Taxpayer Advocate share common ground on issues raised in this report and by the IRS's Disaster Assistance Review Team. We differ on how to fix these deficiencies. For example, the IRS's new IRM draft still fails to set standards for evaluating and classifying disasters, or templates for responding to different types of disasters; nor does it create procedures for deciding what relief to offer disaster victims. The IRS response discusses a new Master File freeze code, stating, "...all taxpayers located in a Presidentially declared disaster area receive filing and payment relief without having to self-identify."

The National Taxpayer Advocate welcomes the decision to grant filing and payment relief (penalty and interest) to all taxpayers in a Presidentially declared disaster area. We expect the IRS to incorporate this commitment into its new manual.

This commitment to grant filing and payment relief to all taxpayers in a Presidentially declared disaster area takes a first step towards addressing a key concern. We believe disaster victims in similar circumstances deserve similar relief, which, under current IRS policy and procedures, is not always the case. A resident who lost his home in a hurricane and another who lost his home to a tornado should expect the same treatment. From January 1 through November 30, 2006, the President declared 48 major disasters. FEMA offered Individual Assistance in 24 of these disasters.<sup>49</sup> The IRS did not implement automatic relief for any disaster in 2006.<sup>50</sup> The IRS disbanded the DTAPG after 9/11. Had the group continued the work it began in 2001, the IRS would be better

<sup>48</sup> Tax Administration Good Government Act, H.R. 1528, 108th Cong. (2004). The Senate version of the Tax Administration Good Government Act, S. 882, was incorporated into H.R. 1528 with an amendment. H.R. 1528 was passed by Senate on May 19, 2004, by unanimous consent.

<sup>49</sup> FEMA, 2006 Federal Disaster Declarations, available at <http://www.fema.gov/news/disasters.fema?year=2006>.

<sup>50</sup> IRS Disaster Relief Declarations. See <http://www.irs.gov/newsroom/article/o,,id=98936,00.html>.

## PROBLEMS

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ONE

prepared for devastating hurricane disasters in 2005. Once engaged, the IRS reacted by taking actions, making plans and issuing guidance. Many of these decisions and actions should be part of a strategic plan. Had the IRS developed such a plan *before* the 2005 hurricanes struck, the thrust of our analysis today would be considering whether the IRS's tactics met its strategic goals, instead of discussing the effectiveness of the IRS's crisis management.

**RECOMMENDATIONS**

- 1) Establish a permanent disaster response team in the national office of the Internal Revenue Service. The team should be composed of employees who, besides their regular responsibilities, shall assist taxpayers in clarifying and resolving federal tax matters associated with or resulting from any Presidentially declared disaster. The disaster response team would include personnel from the Office of the Taxpayer Advocate, and others from the IRS's national office with expertise in individual, corporate, small business tax matters, including Counsel, Chief Information Officer, Agency Wide Shared Services, Communications and Liaison and so on. The team shall operate in coordination with the Secretary of the Treasury, the Directors of the Federal Emergency Management Agency and the Department of Homeland Security.

We believe that once it is formed, the permanent disaster response team should address these issues:

- ◆ Develop methodology to evaluate and classify disasters based on characteristics relevant to an effective response effort. This methodology would include criteria for any "on the ground" evaluation by the State Disaster Coordinator or other personnel charged with making an on-site assessment. Develop a plan for coordinating the disaster classification with templates of planned response strategies including staffing and services offered at FEMA and other recovery sites.
- ◆ Set up Service Level Agreements with IRS business units and functional divisions specifying their disaster support commitments.
- ◆ Establish specific criteria for using automatic disaster relief (O Freeze).
- ◆ Change the processing procedures of IRM 3.11.3.7.1.7 to ensure that taxpayers who self-identify by notating their tax returns get the same treatment as those identified by the IRS or who self-identify by telephone.
- ◆ Adopt the safe harbor valuation rules detailed in Revenue Procedure 2006-032 for personal use residential real property.
- ◆ At technical employee Continuing Professional Education, provide technical disaster tax law training to all employees to provide the IRS with a core of "first responder" tax specialists to deploy in case of a disaster.



- ◆ Coordinate with other agencies to identify most likely disasters and likely areas to experience disasters, and to develop specific models and strategies for response to the future disasters.

**PROBLEM****TOPIC #15****CONCERNS WITH THE IRS OFFICE OF APPEALS****RESPONSIBLE OFFICIAL**

Sarah Hall Ingram, Chief Appeals

**DEFINITION OF PROBLEM**

In the 2003, 2004, and 2005 Annual Reports to Congress, the National Taxpayer Advocate identified issues related to the IRS Office of Appeals (Appeals) as one of the most serious problems facing taxpayers for each of these years. Appeals has not adequately responded to concerns raised and discussed in these prior annual reports, and these same issues remain problematic:

- ◆ Despite Appeals' implementation of its campus strategy and other measures to eliminate inventory delays, taxpayers and their representatives continue to complain that it takes an unreasonable time to complete the Appeals process;
- ◆ Taxpayers and practitioners are still dissatisfied with Appeals' independence; and
- ◆ Under the present structure, taxpayers must often choose between waiting a long time to obtain a hearing with an Appeals officer locally or accepting an alternative, remote hearing with an Appeals officer who does not understand local issues.

Appeals inventory and processing delays can harm unrepresented (pro se) as well as represented taxpayers, leading to an increase in defaulted cases or incorrect results.

**ANALYSIS OF PROBLEM****Background**

Ever since Congress established the Treasury Department in 1789, the federal government has provided an administrative appeal process to taxpayers who do not agree with proposed tax assessments.<sup>1</sup> The mission of the present-day IRS Office of Appeals is to resolve tax controversies without litigation, on a basis that is fair and impartial to both the government and the taxpayer, in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the IRS.<sup>2</sup> To achieve this mission, Appeals must maintain independence from the IRS compliance functions in fact and appearance, and afford all taxpayers reasonable and equal access to the Appeals process. If taxpayers perceive that Appeals does not provide a fair, timely, and independent forum for resolving tax controversies, they will bypass Appeals and proceed directly to litigation or simply give up and accept the determinations of the IRS. Low income or unrepresented taxpayers may take the latter course of action by default.<sup>3</sup>

<sup>1</sup> Act of Congress Establishing the Department of the Treasury, September 2, 1789, Chapter XII, Section 5.

<sup>2</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009 2*.

<sup>3</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 264.

In the IRS Restructuring and Reform Act of 1998 (RRA 1998), Congress required the IRS to “ensure an independent appeals function within the [IRS], including the prohibition . . . of *ex parte* communications between appeals officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the appeals officers.”<sup>4</sup>

The Appeals process is essential for both taxpayers and the IRS. For Appeals to fulfill its congressional mandate, taxpayers must have confidence that their cases will be handled fairly and timely. Taxpayers must also have access to a competent and trained Appeals officer who understands fully the taxpayer’s case, including any applicable issues related to the taxpayer’s business or locality, while his or her case is being considered.

### The “Modernized” Office of Appeals

In fiscal year 2004, Appeals implemented the Campus Specialization Initiative (CSI) and moved certain cases from the local field offices to IRS campuses. Appeals goal for this initiative is to “re-engineer our processes to reduce the length of the appeals process.”<sup>5</sup> To reduce cycle time, Appeals plans to:

- ◆ Automate more of its campus function to work correspondence cases in any of its campus locations;
- ◆ Use the breakthrough approach to further streamline the traditional process;<sup>6</sup>
- ◆ Actively promote the use of early intervention and alternative dispute resolution to resolve tax matters before they come to Appeals;
- ◆ Pursue the development of additional innovative approaches to reducing case cycle time;
- ◆ Tailor the way Appeals interacts with taxpayers to the most efficient means for resolving the matter; and
- ◆ Actively promote the advantages of resolving appeals cases via teleconference or correspondence so they remain the preferred choice of taxpayers, while continuing to advise taxpayers of the availability of face-to-face conferences.”<sup>7</sup>

Appeals plans to measure its success in accomplishing these goals through:

- ◆ Appeals Quality Measurement System (AQMS);
- ◆ Customer Satisfaction Survey results; and

<sup>4</sup> Pub. L. No. 105-206 Sec. 1001(a)(4). *Ex parte* communication is any communication about disputed issues between Appeals and another IRS function without the participation of the taxpayer or the taxpayer’s representative. Rev. Proc. 2000-43, 2000-2 C.B. 404.

<sup>5</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 4.

<sup>6</sup> The breakthrough approach is Appeals method of developing new programs and processes.

<sup>7</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 4.

- ◆ Average Cycle Time.<sup>8</sup>

### Appeals Inventory and Cycle Time

Appeals tracks inventory and cycle time to determine the effect of workstreams (type of case) and days required to work cases. In fiscal year 2004, Appeals started to reduce its inventory by closing more cases than it received. Appeals' critical measure is the ratio of resolutions to receipts. As of August 2006, Appeals reported closing 106 cases for every 100 receipts.<sup>9</sup> Field closures (a ratio of 114 to 100) in fiscal year 2006 were much higher than campus closures (93 to 100).<sup>10</sup> An analysis of closed cases indicates that Appeals has improved cycle time in some workstreams, but times in others have risen or remained essentially constant.

In measuring cycle time for its Business Performance Review (BPR),<sup>11</sup> Appeals includes the days beginning when Appeals receives the case and ending when Appeals closes the case through its processing section. Cycle time measurements include days spent in the Appeals processing section, which provides technical support for controlling and processing all Appeals and IRS Office of Chief Counsel tax cases. This unit is the final processing point in the Appeals office and performs the full range of interim and closure processing actions, including adjustments, assessments, manual refunds, and abatements for all types of tax cases.<sup>12</sup>

An analysis of the Appeals life cycle<sup>13</sup> as compared to cycle time reported in the BPR shows significant delays by IRS operating divisions in sending cases to Appeals. For some types of cases, transfer and processing time can add nearly a year – or more – to reported Appeals cycle time. The time can certainly matter to the taxpayer if he or she is waiting for a refund. Further, if the reversal of an Earned Income Tax Credit (EITC) assessment is not restored in a timely manner, the IRS may automatically freeze the taxpayer's EITC for a later tax year.<sup>14</sup>

Appeals' ability to manage its inventory is critical to fostering compliance and projecting a fair and impartial presence in the IRS. Inventory delays create a myriad of related issues such as amended return filings, multiple calls, taxpayer uncertainty, additional interest charges, impact on future years, Taxpayer Advocate Service (TAS) referrals, and

<sup>8</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 5.

<sup>9</sup> Appeals response to TAS research request, Sept. 15, 2006.

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

<sup>11</sup> The BPR is part of the balanced measures system mandated by the IRS Reform and Restructuring Act of 1998, Pub. L. No. 105-206. This system measures performance in customer satisfaction, employee satisfaction, and business results.

<sup>12</sup> IRM 8.20.1.3 (Sept. 25, 2006).

<sup>13</sup> The Appeals life cycle covers the time from a taxpayer's initial request for an appeal to the date of final closure through any operating division's processing section.

<sup>14</sup> The law now requires the IRS, if it denies EITC as a result of deficiency procedures, to also deny the credit for subsequent years unless the taxpayer provides evidence of eligibility. IRM 21.5.10 (Oct. 1, 2006).

most importantly, the loss of confidence in the Appeals function. Although Appeals has implemented strategies to address workload issues, TAS has noted only minimal improvement. For the past several years, Appeals has sought to reduce cycle time by “getting the right work to the right employee at the right time to get to the right decision.”<sup>15</sup> However, the cycle time numbers show that this strategy did not improve cycle time in any significant way.

**TABLE 1.15.1, APPEALS LIFE CYCLE (REQUEST APPEAL TO DATE CLOSED ON AIMS<sup>16</sup>) COMPARED TO APPEALS CYCLE TIME (APPEALS RECEIVED TO DATE CLOSED TO APPEALS PROCESSING SECTION).**

Work Stream	FY 2006 Average Cycle Time <sup>17</sup>	Appeals Average Life Cycle <sup>18</sup>	Average Days Difference
Collection Due Process	247	262	15
Offers in Compromise	234	429	195
Innocent Spouse	356	859	503
Penalty Appeals	121	405	284
Coordinated Industry Cases	786	993	207
Industry Cases	541	682	141
Examination	352	508	156

*Appeals Quality Measurement System (AQMS)*

Appeals developed AQMS to provide statistically valid data on case quality,<sup>19</sup> which the system defines by specific quality standards, attributes and reason codes. To obtain the

<sup>15</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009 2*.

<sup>16</sup> Audit Information Management System provides inventory and activity controls of active Examination cases.

<sup>17</sup> IRS Office of Appeals, *Commissioner’s Monthly Report* (Apr. 2006).

<sup>18</sup> IRS Office of Appeals, *Diagnostics and Balanced Appeals Measures Report System for ACDS Process Measures Cycle Time for (National) Cases by Categories*, FY 2006 Cumulative through Apr. 30, 2006.

<sup>19</sup> Appeals Quality Measurement System, *Reviewer’s Guide for Cases Selected for Review after 10/1/2005 15-16* (Dec. 20, 2005).

AQMS measures, Appeals' quality staff performs statistical closed case reviews and measures eight standards:<sup>20</sup>

- ◆ Standard 1: Taxpayer Service and Rights
- ◆ Standard 2: Quality of Decision
- ◆ Standard 3: Accuracy of Computations
- ◆ Standard 4: Appeals Case Memo
- ◆ Standard 5: Time Span & Time Applied
- ◆ Standard 6: Procedural Compliance
- ◆ Standard 7: TCS Computations
- ◆ Standard 8: Appeals Interest and Assessment

Appeals' quality measurement staff reviews a representative number of cases from each Appeals area, scoring them based on compliance with the standards and related attributes so that the maximum score per case is 100. If all eight standards apply to a given case, each standard contributes 12.5 percent to the overall score. According to AQMS reports for fiscal years 2003-2005, Appeals consistently scored low on timeliness (Standard 5).<sup>21</sup>

In fiscal year 2006, Appeals revised its scoring methodology to create "a more equitable approach" to computing the score.<sup>22</sup> This new approach involved adding Standards 7 and 8 to measure the processing function of Appeals once a case was resolved. A

<sup>20</sup> Appeals Quality Measurement System, *Reviewer's Guide for Cases Selected for Review after 10/1/2005 15-16* (Dec. 20, 2005).

Quality standards defined:

- ◆ Taxpayer Service and Rights – measures whether Appeals communicated with the Taxpayers in an appropriate, professional manner, addressed their needs and respected their rights.
- ◆ Quality of Decision – measures whether the Appeals settlement is supported by a well-reasoned analysis of facts and law.
- ◆ Accuracy of Computations – measures the accuracy of the tax and penalty computations prepared by the AOs, ATCLs, etc. who do their own computations and whether correct closing information was provided for the computation of interest.
- ◆ Appeals Case memo – measures whether the Appeals Case Memorandum adequately explains and documents the rationale and merits of each settlement or unagreed disposition.
- ◆ Time Span and Time Applied – measures the timeliness of actions taken by the AO/SO/ATCL during the time span required to complete the case, and the use of time relative to the complexity of the issues.
- ◆ Procedural Compliance – measures whether important procedural aspects of the case were performed.
- ◆ Tax Computation Specialist Computations – measures the accuracy of the tax and penalty computations prepared by the TCS, whether correct closing information was provided for the computation of interest and whether the TCS time span and time applied were appropriate.
- ◆ Appeals Interest and Assessment – measures the accuracy of the interest computations, whether computational and assessment/abatement procedures were followed, the accuracy and timeliness of assessments/abatements and whether the Tax Examiner and Tax Specialist time spans and time applied were appropriate.

<sup>21</sup> Appeals Quality Measurement System Results Report for cases reviewed in FY 2005, Executive Summary 2 (Aug. 4, 2006).

<sup>22</sup> Appeals Quality Measurement System, *Reviewer's Guide for Cases Selected for Review after 10/1/2005 1* (Dec. 20, 2005).

comparison of the “old” and “new” systems reveals that the overall average rating changed very little.<sup>23</sup>

AQMS management recommended Appeals increase its “Organizational Commitment to Improving Timeliness:”

AQMS believes that Appeals needs to make a much stronger organizational commitment to improving the timeliness and effectiveness of case actions. For example, reviewers have noted a wide disparity of accomplishment of timely actions among individual employees, groups and areas. There are, apparently a number of employees who, in spite of workload and inventory concerns, etc., continue to perform their case activity in a timely and effective manner. It would benefit the Appeals organization to identify these high performers and seek from them the keys to taking timely actions on cases when faced with high inventories or excessive workloads.<sup>24</sup>

To improve timeliness, reduce taxpayer burden, and reach performance goals, AQMS strongly recommended that Appeals establish a mentor program for Appeals officers to obtain advice in resolving timeliness issues. Appeals must focus on timeliness of actions rather than cycle time to improve quality and customer satisfaction.<sup>25</sup> Instead of implementing this recommendation, Appeals continues to pursue its campus centralization and “right work/right employee/right time” strategies to reduce inventories.

#### *Customer Satisfaction Survey Results*

Appeals works with an independent consulting group to conduct annual customer satisfaction research as part of the IRS-wide initiative to improve taxpayer satisfaction. Ratings are based on a scale of 1 to 5, with 1 Very Dissatisfied and 5 Very Satisfied. For Appeals, the survey categories with the lowest customer satisfaction ratings are “Length of Appeals Process” and “Time to Hear from Appeals.”<sup>26</sup>

In the survey covering April through September 2005, 56 percent of Appeals customers were satisfied with the service they received (*i.e.*, the overall satisfaction rating was a 4 or 5 on a 5-point scale), while 26 percent were dissatisfied (the overall satisfaction rating was a 1 or 2).<sup>27</sup> Eighteen percent of Appeals customers were neither satisfied nor dissatisfied (a rating of 3). Some sample customer comments from the survey include:<sup>28</sup>

<sup>23</sup> Appeals Quality Measurement System Third Quarter 2006 Update (Mar. 31, 2006).

<sup>24</sup> AQMS, *Appeals (All Areas) Results, For Cases Reviewed in FY 2004 A-17* (Aug. 2, 2005).

<sup>25</sup> The Taxpayer Advocate Service emphasizes timeliness of actions to improve cycle time on cases. This policy has reduced TAS’s overall cycle time without measuring cycle time directly.

<sup>26</sup> IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results*, Satisfaction Ratings 21 (Feb. 2006).

<sup>27</sup> *Id.* at 5.

<sup>28</sup> *Id.* at 8.

## PROBLEMS

- ◆ “It took Appeals two years to resolve my case.”
- ◆ “I never received a call back from the Appeals agent. My case has been in their office for two years, and it appears that nobody is working on it.”
- ◆ “The amount of time that it took to complete my case was very long and made me very anxious.”
- ◆ “The Appeals Officer had a very heavy workload which prevented him from settling our case quickly.”
- ◆ “The length of time it took to get an answer was too long. We were never sure what the next step was because we never received a clear explanation of what to do.”
- ◆ “The time it took to resolve our case was excessive. We were kept in limbo too long.”

This last issue – that taxpayers are left in limbo – is a very important point. The process keeps taxpayers on hold, potentially with respect to large dollar amounts or recurring transactions with impact on future years.

Appeals attributes the low overall customer satisfaction rating to the increased number of *pro se* (unrepresented) taxpayers.<sup>29</sup> Taxpayers generally expect the Appeals process to take much less time than it actually requires. Appeals maintains that this is especially true for *pro se* taxpayers who may not be familiar with the process.<sup>30</sup> If this is true, because more taxpayers are representing themselves, Appeals should ensure that *pro se* taxpayers understand their rights and the expected length of the Appeals process rather than using these taxpayers as an excuse for low customer satisfaction ratings.

Based on the survey results, the Pacific Consulting Group recommended Appeals shorten the time it takes customers to complete the process. The length of the Appeals process is the top improvement priority for all Appeals customers.<sup>31</sup>

### Campus Centralization

In an attempt to reduce cycle time and save resources by more efficiently working its “less complex” cases, Appeals centralized certain workstreams at IRS campuses in 2003 and 2004. The National Taxpayer Advocate raised questions about this initiative in her 2005 Annual Report to Congress and still holds many of the same concerns.<sup>32</sup>

<sup>29</sup> IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results*, Report Summary 6 (Feb. 2006).

<sup>30</sup> *Id.* Appeals has not provided empirical evidence to support this statement.

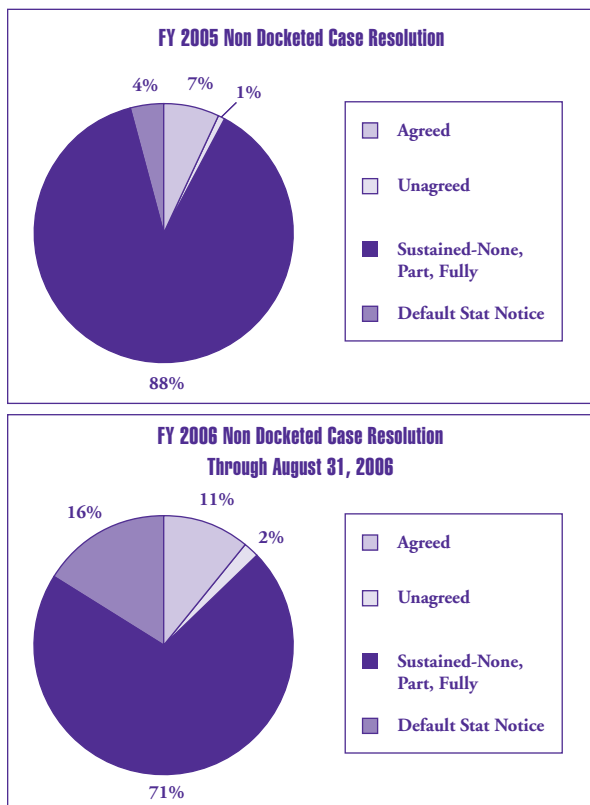
<sup>31</sup> IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results*, Report Summary 6 (Feb. 2006).

<sup>32</sup> National Taxpayer Advocate 2005 Annual Report to Congress 136-161.



An analysis of campus inventory dispositions reveals that the percentage of total dispositions attributable to defaults rose sharply, from four percent to 12 percent, from FY 2005 to FY 2006 (through August 31, 2006).<sup>33</sup>

**CHART 1.15.2, CAMPUS INVENTORY RESOLUTION**<sup>34</sup>



**Reduced Face-to-face and Local Appeals Office Interaction**

Some taxpayers prefer to meet with Appeals officers face-to-face or deal with an officer who is familiar with local circumstances. The initial Appeals letter mentions face-to-face conferences but campus Appeals emphasizes telephone or correspondence contacts to expedite the process.<sup>35</sup>

Appeals has indicated that it will not grant every request for a transfer to a local office. The Appeals response in the 2005 Annual Report to Congress stated that “Management evaluation of the request is required to ensure the taxpayer is not raising issues such as

<sup>33</sup> IRM 8.20.725 (Jan. 31, 2002). Default cases arise when a taxpayer fails to petition the U.S. Tax Court within the allotted 90 days after the IRS issues a statutory notice of deficiency. The proposed deficiency is then assessed.

<sup>34</sup> Appeals Centralized Database System.

<sup>35</sup> IRS Letter 4141(C)(G) (Aug. 2006).

the constitutionality of the tax system or using the request as part of a scheme to avoid or delay the resolution of the case.”<sup>36</sup>

In fact, IRS campus procedures do not address denied transfer requests due to constitutionality claims. Rather, the procedures direct campus employees to telephone taxpayers who request an area office interview and “provide assurance that the issue can be resolved at the Campus.” If unable to contact the taxpayer by telephone, IRS employees are directed to issue a letter to the taxpayer and refile the case for the remaining suspense period. Only if the taxpayer insists on an interview at an area office will the request be granted.<sup>37</sup>

From October 1, 2005 through May 31, 2006, Appeals transferred 8,445 cases from campuses to field offices.<sup>38</sup> These cases involved essentially equal numbers of represented and *pro se* taxpayers. Appeals does not track instances where requests are made and denied.

### Protecting Taxpayer Rights

In its most recent strategic plan, Appeals lists taxpayer awareness of the appeal process and taxpayer rights, especially for *pro se* taxpayers, as key to improving taxpayer service and facilitating participation in the tax system by all sectors of the public. Appeals commits to “vigorously champion a taxpayer’s right to a fair and impartial appeal, independent of outside influences,” and to “expand our efforts to increase awareness of the appeals process through a wide range of products and communication methods, with an emphasis on reaching *pro se* taxpayers.”<sup>39</sup> While we commend this goal, it is not clear exactly how Appeals intends to implement this strategy.

In one recent TAS case, the taxpayer requested a face-to-face conference with Appeals regarding a denied offer in compromise (OIC). Due to extraordinary local news coverage of a company that impacted the OIC issues, and at the recommendation of the IRS unit rejecting the compromise, the taxpayer sought a local conference. Appeals denied the request because there were apparently no Appeals officers in the local IRS office serving that state. TAS intervened and arranged a face-to-face meeting between the taxpayer and an Appeals officer from a neighboring state. It is unclear how many other taxpayers may have faced similar situations and simply accepted telephonic hearings.

Appeals’ concerns with staffing and inventory balancing should not trump the taxpayer’s need to raise issues in the setting most conducive to securing the correct resolution. Appeals must make clear in all taxpayer correspondence that taxpayers can resolve audit issues face-to-face as well as by telephone from a local area office.

<sup>36</sup> National Taxpayer Advocate 2005 Annual Report to Congress 158.

<sup>37</sup> IRM 4.19.1.4.14 (Jan. 1, 2006).

<sup>38</sup> Appeals response to research request (June 6, 2006). The data includes only regular transfers-not transfers due to workload balancing.

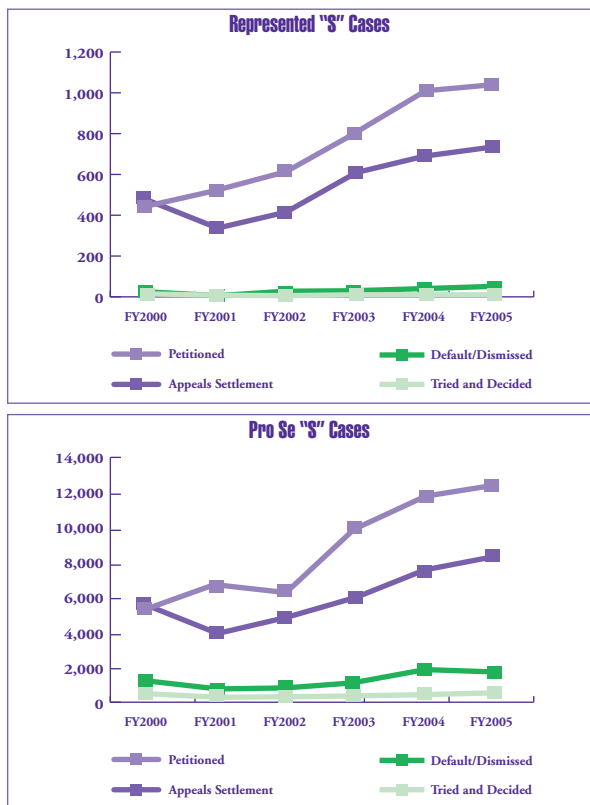
<sup>39</sup> IRS Office of Appeals, *Strategic Plan FY 2006 – 2009* 3.

**Docketed “S” Cases**

A small or “S” case is a Tax Court case with a deficiency of \$50,000 or less.<sup>40</sup> Taxpayers may elect to have their cases considered under the United States Tax Court’s simplified small “S” tax case procedure. Trials in “S” cases generally are less formal and result in a speedier disposition.<sup>41</sup>

Petitioned “S” cases for *pro se* and represented taxpayers increased by an annual average of 20 percent and 19 percent, respectively, from fiscal year 2000 through fiscal year 2005.<sup>42</sup> Based on historical data on “S” cases from fiscal years 2000 to 2005, the default/dismissal rate is almost three times higher for *pro se* cases than cases where taxpayers had a representative.<sup>43</sup> This may indicate that *pro se* taxpayers are not as familiar with the process as those with representation, and fail to properly submit technical documents and narratives.

**CHARTS 1.15.3 AND 1.15.4, COMPARISON OF DOCKETED “S” CASES OVER TIME<sup>44</sup>**



<sup>40</sup> IRC § 7463(a).

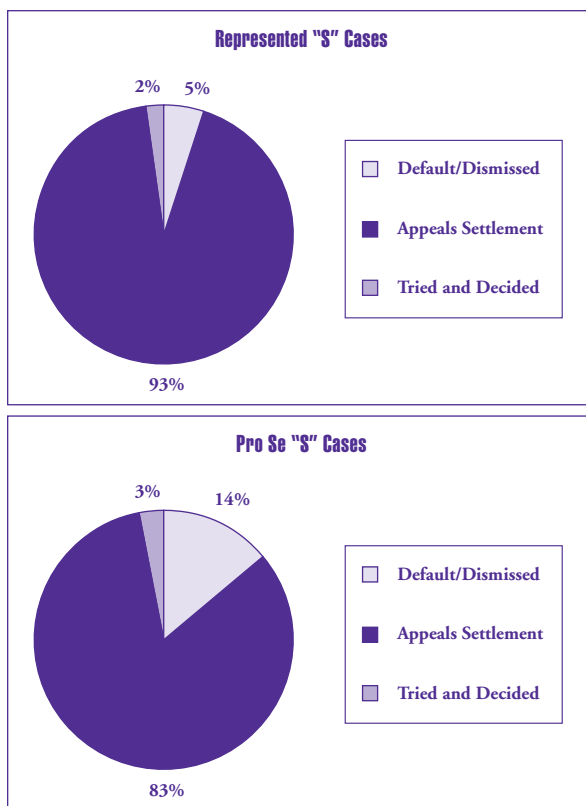
<sup>41</sup> See [www.ustaxcourt.gov/forms/Petition\\_Kit.pdf](http://www.ustaxcourt.gov/forms/Petition_Kit.pdf)

<sup>42</sup> Data derived from Counsel Automated Tracking System TL-708A.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

**CHARTS 1.15.5 AND 1.15.6, RESOLUTION OF DOCKETED "S" CASES FROM FISCAL YEAR 2000 TO FISCAL YEAR 2005<sup>45</sup>**



The United States Tax Court recently proposed an amendment to its Rules of Practice and Procedure to require the IRS to file answers in all "S" cases, effective for petitions filed after November 27, 2006. The discussion of the proposal cited a lack of pretrial communication between the parties as a reason for the amendment. Further, the court believes an earlier exchange of information may reveal issues with precedential value that lead to discontinuance of small tax case proceedings.<sup>46</sup> This change highlights the need for taxpayers and counsel to engage in dialogue to understand and potentially resolve issues prior to the court date. This is especially important to the campus appeals process, as most "S" cases originate from campus correspondence examinations.<sup>47</sup>

*Appeals Staffing*

While Appeals receipts continue to grow, field staffing statistics show significant declines in the number of Appeals officers and settlement officers.

<sup>45</sup> Data derived from Counsel Automated Tracking System TL-708D, E and F.

<sup>46</sup> U.S. Tax Court Notice of Proposed Amendment to Rule 173 (Sep.12, 2006).

<sup>47</sup> IRS Office of Appeals, *Breakthrough Performance Plan, Small Docketed Cases ("S" Cases)* (Jun. 18, 2004).

**TABLE 1.15.7, APPEALS FIELD STAFFING<sup>48</sup>**

Job Title	Employees Oct. 1, 2005	Employees Sept. 30, 2006	Gain (Loss)
Tax Computation Specialists	94	91	(3)
Appeals Officers	742	714	(28)
Settlement Officers	216	236	20
Tax Specialists	4	4	0
Account Resolution Specialists	28	25	(3)
Case Processors	22	22	0
Tax Examiners	239	208	(31)
Other	185	218	33
<b>TOTAL</b>	<b>1,530</b>	<b>1,518</b>	<b>(12)</b>

**TABLE 1.15.8, APPEALS CAMPUS STAFFING<sup>49</sup>**

Job Title <sup>50</sup>	Employees Oct. 1, 2005	Employees Sept. 30, 2006	Gain (Loss)
Appeals Officers	80	98	18
Settlement Officers	63	74	11
Tax Specialists	31	23	(8)
Account Resolution Specialists	24	25	1
Case Processors	12	7	(5)
Tax Examiners	75	73	(2)
Other	35	20	(15)
<b>TOTAL</b>	<b>320</b>	<b>320</b>	<b>0</b>

Although Appeals' overall staffing decreased by less than one percent in FY 2006, campus appeals officer staffing increased by 22.5 percent while the number of field appeals officers declined by 3.8 percent. Appeals projects a 10.7 percent attrition rate for fiscal year 2007 and plans to hire 80 field Appeals officers to replace the projected 86 losses in field offices.<sup>51</sup> In addition, the fiscal year 2007 attrition rate for tax computation specialists is expected to reach nearly 20 percent with no hiring anticipated.<sup>52</sup> The loss of employees in this position will negatively impact processing time in the Appeals life cycle.

<sup>48</sup> Appeals research request (Sept. 15, 2006) and Employee Service Record Report (ESRR) for pay period ending October 1, 2005.

<sup>49</sup> Appeals research request (Sept. 15, 2006).

<sup>50</sup> *Appeals Officers* are responsible for handling issues and cases generated by various compliance functions in campuses and the field and for arriving at the final dispositions and to approve the final settlements of the cases. *Settlement Officers* are responsible for resolving collection cases generated and referred to Appeals by various compliance components in campuses and the field. *Tax Specialists* are responsible for resolving tax issues that are generated and referred to Appeals by various campus compliance and accounts management components. *Case Screeners* review new receipts, determine initial case processing, and prepare the administrative file for transfer or reassignment. *Case Processors* provide administrative and clerical support in processing and closing cases. *Tax Examiners* are responsible for reviewing cases, processing adjustments, computing internal interest and simple restricted interest cases, and closing pipeline and special processing cases.

<sup>51</sup> Appeals response to research request (Jun. 14, 2006).

<sup>52</sup> *Id.*

The knowledge and experience of seasoned Appeals officers and support staff cannot be replaced overnight. Appeals' challenge is to recruit, train, and mentor employees in an environment of continuous change. This situation also presents opportunities for Appeals management to implement new practices and procedures.

### Alternative Dispute Resolution (ADR)

Alternative Dispute Resolution describes a broad range of nontraditional methods for resolving disputes. Mediation is one form of ADR used extensively in the federal and private sectors to resolve disputes such as Equal Employment Opportunity complaints and collective bargaining disputes. Mediation is a voluntary process that employs a trained mediator to help opposing parties reach a mutually agreeable solution. Mediation is widely considered an effective alternative to litigation and is less costly to impacted parties.<sup>53</sup>

The Administrative Dispute Resolution Act of 1996 directed each federal agency to adopt a policy that addresses ADR.<sup>54</sup> A 1998 presidential memorandum directed heads of executive departments to "promote greater use of mediation, arbitration, early neutral evaluation, agency ombudsmen, and other alternative dispute resolution techniques."<sup>55</sup>

The Federal Mediation and Conciliation Service (FMCS) is the U.S. government agency responsible for mediating collective bargaining agreements.<sup>56</sup> Federal disputes are increasingly resolved through ADR to reduce cost to both the claimant and the government.<sup>57</sup> Appeals Policy Statement P-8-1 (approved 11-4-98) reaffirms the dispute resolution process as a necessary alternative to litigation. The IRS Appeals office administers both Fast Track mediation<sup>58</sup> and Fast Track settlement<sup>59</sup> to expedite case resolution. Both programs offer an opportunity for the taxpayer (or representative) to engage in dialogue about the protested issue with the examination team and Appeals.

The IRS implemented a Fast Track Dispute Resolution Pilot Program in the Large and Midsize Business (LMSB) operating division.<sup>60</sup> This program demonstrated that IRS can successfully use ADR techniques to promote issue resolution and decrease the time from

<sup>53</sup> Federal Alternative Dispute Resolution Council, Inc., at <http://www.fadrc.com/History.htm> (2004).

<sup>54</sup> Pub. L. No. 104-320 (amending Pub. L. No. 101-552 and Pub. L. No. 102-354) Sec. 1.

<sup>55</sup> Presidential Memorandum, *Interagency Committees on Use of Alternate Means of Dispute Resolution and Negotiated Rulemaking* (May 1, 1998).

<sup>56</sup> A collective bargaining agreement literally means bargaining between and/or among representatives of collectivities (thus involving internal as well as external bargaining); but by custom the expression refers to bargaining between labor organizations and employers.

<sup>57</sup> Federal Mediation and Conciliation Service at <http://www.fmcs.gov/internet/itemDetail.asp?categoryID=39&itemID=19768> (Nov. 16, 2005).

<sup>58</sup> Fast Track mediation employs a trained Appeals Officer mediator. Although all parties discuss issues involved in the disagreement, the Appeals Officer does not have settlement authority.

<sup>59</sup> Fast Track settlement employs a trained Appeals Officer with settlement authority.

<sup>60</sup> Notice 2001-67, 2001-2 C.B. 544.

tax return filing to ultimate resolution. Revenue Procedure 2003-40 made Fast Track Dispute Resolution a permanent program for LMSB taxpayers.

In July 2006, Appeals announced an agreement with the Small Business/Self-Employed division (SB/SE) to implement a Fast Track Settlement process. Previously, only Appeals mediation was available to individual taxpayers and small businesses. In IRS Announcement 2006-61, Section 2, cases with specified criteria are excluded from Appeals Fast Track Settlement consideration. Collection Due Process, offer in compromise, and Trust Fund Recovery cases are presently excluded but may be added later. Campus cases are not eligible for Fast Track Settlement due to the lack of a manager's closing conference.<sup>61</sup> This rule effectively eliminates the right to alternative dispute resolution procedures for many low income and middle income taxpayers.

Appeals' use of settlement and mediation alternatives is increasing at a much lower rate than in the federal sector as a whole. For example, in fiscal year 2005, Appeals receipts for unagreed examination cases totaled 99,245.<sup>62</sup> Only 167 of these cases were referred for fast track mediation or settlement.<sup>63</sup> This is an area of opportunity for Appeals to utilize resources more efficiently and reduce cycle time.<sup>64</sup>

Appeals added new questions regarding the ADR program to its FY 2005 customer satisfaction survey. Only three large and midsize business taxpayers that the IRS surveyed used ADR so the results are not statistically representative. Customers who did not use the ADR program were asked a series of questions concerning the value of the ADR program. Forty-eight percent of these customers reported that ADR options were not explained to them during the audit.<sup>65</sup> Taxpayers who did have the ADR options explained to them offered a number of reasons why they did not use the program:

- ◆ "We only had one issue, so there was no need to use it."
- ◆ "Our case was very simple, so there was no reason to use it."
- ◆ "We were able to come to a mutual agreement without having to use ADR."<sup>66</sup>

The survey responses indicate that taxpayers do not fully understand the alternative dispute resolution options available in Appeals, or the advantages of participating in the mediation or settlement process.

<sup>61</sup> General Appeals Fast Track Mediation Technical and Procedural Guidelines, (Feb. 23, 2005).

<sup>62</sup> Appeals response to research request (Sept. 13, 2006).

<sup>63</sup> *Id.*

<sup>64</sup> During an October 23, 2006 tax controversy conference sponsored by the UCLA Extension in Los Angeles, IRS Appeals Chief Sarah Hall Ingram praised the fast-track program and addressed the significant decrease in program cases from fiscal year 2004 to fiscal year 2005. Ms. Ingram cited benefits of reduced processing times and high resolution rates when using the Fast Track settlement program.

<sup>65</sup> The sample margin was plus or minus 12.7 percent at the 95 percent confidence level.

<sup>66</sup> IRS Customer Satisfaction Survey, *Appeals National Report Covering April through September 2005, with Fiscal Year 2005 Results* 37 (Feb. 2006).

### Appeals Independence

In the 2004 Annual Report to Congress, the National Taxpayer Advocate noted that public perception of Appeals as an arm of the compliance function persists. The IRS Restructuring and Reform Act of 1998 (RRA 98) mandated that

“The Commissioner of Internal Revenue shall develop and implement a plan to reorganize the Internal Revenue Service. The plan shall ensure an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of *ex parte* communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the Appeals officers.”<sup>67</sup>

Recent correspondence from the public and court opinions support the notion that Appeals independence is still questionable. For example, Tax Executives Institute (TEI) is a professional organization whose members are primarily tax professionals of large corporations. A January 17, 2006 letter from TEI President Michael P. Boyle to IRS Commissioner Mark W. Everson questioned Appeals’ independence. Mr. Boyle challenged the implications of Announcement 2005-80, which was designed to promote settlement of a tax shelter issue. The announcement asserts that “eligible persons who forgo resolving eligible transactions under this settlement initiative...should not expect to receive a better offer than that offered under this settlement initiative.”<sup>68</sup> Mr. Boyle wrote “Regrettably, Announcement 2005-80 threatens to fundamentally change the balance between Examination, Appeals, and taxpayers and to deprive taxpayers of a right conferred by Congress.”<sup>69</sup>

In *Moore v. Commissioner*,<sup>70</sup> the U.S. Tax Court remanded an individual’s case to an IRS Appeals office because before issuing an adverse collection due process determination, the appeals officer received prohibited *ex parte* communication from IRS compliance employees who had been involved in the taxpayer’s collection process. The court held that the IRS conducted *ex parte* communications that were covered by the prohibition and ordered the case remanded to Appeals for a remedy to avoid prejudice to the taxpayer.

In *Drake v. Commissioner*,<sup>71</sup> the Tax Court held that *ex parte* communications between the IRS insolvency unit advisor and an Appeals settlement officer may have damaged the taxpayer’s credibility in future administrative proceedings. The case was remanded to Appeals for a new hearing with an independent Appeals officer.

<sup>67</sup> Pub. L. No. 105-206 § 1001(a)(4).

<sup>68</sup> Announcement 2005-80. 2005-46 I.R.B. 1.

<sup>69</sup> Tax Executives Institute, *TEI Encourages IRS to reaffirm Independence of Appeals* (Jan. 17, 2006).

<sup>70</sup> *Moore v. Comm’r*, T.C. Memo. 2006-171.

<sup>71</sup> *Drake v. Comm’r*, 125 T.C. 201.



The American Bar Association (ABA) Tax Section recently surveyed its members about the IRS Appeals process in an effort to give the IRS honest, constructive feedback. The survey was designed to measure

1. The satisfaction of ABA Tax Section members with the overall IRS Appeals process, and
2. The current perception regarding whether the Appeals Division conducts its activities independently of the examination, collection, and enforcement functions of the IRS.<sup>72</sup>

Although the survey results are not final at the time of this writing, the responses to questions about campus centralization, use of alternative dispute resolution strategies, and Appeals independence will produce a picture of the Appeals function from the perspective of an important external stakeholder.

### CONCLUSION

Taxpayers who find themselves in a tax controversy with IRS should view Appeals as an objective, informed third party. If taxpayers sense that Appeals is merely another arm of IRS enforcement, they may well bypass the Appeals process in favor of litigation or possibly noncompliance. The National Taxpayer Advocate remains concerned that if Appeals is perceived as a mere extension of IRS enforcement, it will begin to fail its historical mission.

### IRS COMMENTS

At the heart of the National Taxpayer Advocate's Report to Congress is her continuing strong support for the Appeals organization. The IRS agrees that the Appeals function is vital to good tax administration. However, we are not convinced that the issues described by the National Taxpayer Advocate rise to the level of a "most serious problem."

The issues raised in this year's report are nearly identical to those raised in prior reports and without any level of detail or documentation to support the findings. One particular case, selected examples from the customer satisfaction survey and two court cases, are not persuasive when a greater weight of evidence indicates to the contrary.

The National Taxpayer Advocate's report finds that the IRS has not adequately responded to the prior concerns raised in her reports. We disagree and believe that the IRS's strategic plan shows that it promotes and supports an independent Appeals function knowledgeable of its mission and ready and able to deliver fair and impartial case resolution services.

<sup>72</sup> American Bar Association Section of Taxation, *A Survey of Satisfaction and Experience with the IRS Appeals Office* (Aug. 2006).

**Cycle Time**

The IRS agrees that cycle time is an important issue. Appeals has indeed found this one aspect of its performance measures the most resistant to improvement. In part, this is because Appeals has devoted significant attention to repositioning itself through its specialization and early intervention strategies and by improving efficiencies, and has not solely focused on cycle time. However, Appeals has identified cycle time as its major emphasis to improve customer service for FY 07.

Appeals has worked with each Operating Division in an effort to reduce the amount of time it takes to move a case into Appeals. We agree that this is an important part of case consideration from the taxpayers’ perspective and it cannot be overlooked.

In FY 2005, it took an average of 69 days to get a case into Appeals. In FY 2006, this was reduced to 67 days. We continue to work with each Operating Divisions to analyze the cause for delay in each workstream and provide feedback for improvement.

**TABLE 1.15.9, P1 TIME – FROM TP REQUEST FOR APPEAL TO TIME THE CASE IS RECEIVED IN APPEALS**

	CDP	CIC	Exam	IC	INNSP	OIC	PENAP	Other	Overall
FY 05	60	88	86	93	58	38	87	106	69
FY 06	57	96	80	90	48	47	70	117	67

**AQMS and Customer Satisfaction Data**

The IRS agrees that the Appeals Quality Measurement System (AQMS) and customer satisfaction survey results are important measures. Both are measures Appeals wants to strengthen.

Regarding the customer satisfaction survey data, we agree that *pro se* taxpayers’ rights need to be protected. We believe the Appeals initiatives in this area actively support such protections.

**Campus Centralization Efforts**

The National Taxpayer Advocate continues to assert that field consideration and the right to a “face to face” conference is a panacea for curing all problems. The IRS disagrees with the National Taxpayer Advocate’s assumptions. However, we do agree that tracking such requests may help to add meaningful data to the discussion. We have initiated programming enhancements so that we will have the capability to capture this data.

We do not understand the National Taxpayer Advocate’s discussion of Campus Examination employee’s procedures as part of an MSP regarding Appeals. She does, however, clarify in a footnote that this was a Campus Exam procedure and that it will be deleted in January 2007 in the new updated IRM Part 4.

### S Docketed Case Consideration

The IRS does not agree with inclusion of this specific issue in an MSP discussion about Appeals. Petitioned/Default rates are a discussion that relate to the Compliance programs that generate the case, not Appeals. However, the IRS agrees that this is an area it needs to explore cross-functionally. Appeals has a “feedback loop” process in place to assist Compliance in improving in this area.

We are uncertain as to the meaning of the discussion on data regarding *pro se* versus represented cases but agree that the IRS should make every effort to explain the process and invite taxpayers to be active participants.

### Campus/ Field Staffing

As the IRS has stated previously, campus versus field hiring is a planned strategy. We believe Appeals campus operations provide the same quality case resolution services as the field operations. This is supported by AQMS and customer satisfaction survey data. However, our conclusion is the opposite of the National Taxpayer Advocate’s –campus centralization is a healthy initiative supporting organization efficiency and provides, when coupled with a strong Appeals field presence, a fair and impartial case resolution forum.

It is an organizational concern for Appeals and for TAS that its employees be knowledgeable and experienced. We agree with the National Taxpayer Advocate’s identification of “...Appeals’ challenge is to recruit, train, and mentor employees in an environment of continuous change.” As evidenced by the Appeals strategic plan, these are identified goals.

### ADR

Alternative Dispute Resolution techniques are still in their infancy. We are pleased that the National Taxpayer Advocate discussed them. They need as much communication and support, particularly with the practitioner community, as we can obtain.

### Appeals Independence

As stated at the beginning, the IRS is confident that Appeals is providing fair and impartial case resolution services. We see nothing in this report which provides any convincing evidence to the contrary. In fact, we think a careful examination of court proceedings would show quite the contrary - taxpayers’ positions are exceptionally well attended to by Appeals. In addition, TIGTA conducted an audit and issued a report in September 2005 concluding that Appeals is an independent dispute resolution organization.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate is disappointed in Appeals' dismissive response to her concerns about the operation of the Office of Appeals. While we do not expect the IRS to agree with all of our observations and comments, rarely does the IRS dismiss our well-supported discussion, and rarer still does the IRS do so without any supporting data or references itself. To merely say that there are no problems does not make it so.

**Appeals Cycle Time**

The National Taxpayer Advocate commends Appeals for its identification of cycle time as a major emphasis for improving customer service in fiscal year 2007. Continued emphasis on timeliness of actions in Appeals and working with the operating divisions to reduce the overall life cycle of a case promotes taxpayer confidence in the Appeals function.

Customer satisfaction survey data serves as a barometer for taxpayer confidence in Appeals. It is a snapshot of taxpayer attitudes about the Appeals process and serves as a reminder that taxpayers demand and deserve our attention when tax disputes arise. Customers that report lengthy delays and lack of communication deserve better treatment. The dissatisfaction rate and individual taxpayer comments indicate frustration with the Appeals process. To ensure that taxpayers have confidence in the Appeals function, Appeals must take customer satisfaction survey comments to heart and improve timeliness of responses and actions.

**Campus Centralization**

Appeals mischaracterizes the National Taxpayer Advocate's position with respect to Appeals' Campus Centralization initiative. The National Taxpayer Advocate does not maintain that a face-to-face conference "is a panacea for curing all problems." In fact, our discussion about the campus initiative highlighted the need, in specific cases, for a *local* conference, with a *local* Appeals officer, not necessarily a face-to-face conference. In some cases – and certainly not all – taxpayers believe their cases will be better understood by an Appeals Officer in the community, particularly when the underlying examination was conducted by a remote correspondence unit. Face-to-face conferences are particularly important to taxpayers with functional or language literacy challenges.

In short, we are not denying that "campus versus field" is a "planned strategy" on the part of Appeals and the IRS. We are saying that it is a controversial strategy, and one that involves great risk at the taxpayer's expense. It requires extensive training and oversight. It also requires a willingness on the part of Appeals to recognize that some taxpayers will be harmed by being channeled to remote Appeals conferences and that alternate approaches must be available to help these taxpayers. The data cited in our report – that defaults in campus appeals inventory increased by 12 percent between FY 2005 and FY 2006 – indicate that something is wrong with Appeals' current

approach. Rather than denying the existence of the problem, Appeals should be analyzing the causes of the increased default rate.

The National Taxpayer Advocate commends Appeals, however, for initiating programming enhancements that will capture data on taxpayer requests for transfers to local offices. Tracking transfers and analyzing reasons for requests as well as reasons for denial will reveal patterns among issues or taxpayer groups. Appeals must get behind the numbers and develop a strategy that minimizes taxpayer burden while preserving taxpayer rights.

### Small Tax Court Case Resolution

The National Taxpayer Advocate is puzzled by Appeals' failure to acknowledge the role it plays in the resolution of Tax Court cases, and S cases in particular. Most *pro se* taxpayers have not availed themselves of an Appeals conference before filing a petition in Tax Court. Under Chief Counsel's own guidance,<sup>73</sup> petitioners who did not have an Appeals conference prior to the issuance of the Notice of Deficiency are referred to Appeals to attempt settlement. At a recent conference of Low Income Taxpayer Clinic (LITC) representatives, many of whom have entered into agreements with the Tax Court to notify *pro se* petitioners about the availability of representation by LITCs, there was unanimous concern that the handling of these appeals in remote campuses harmed low income taxpayers.<sup>74</sup> Many expressed the view that taxpayers equate Campus Appeals with Campus Exam, whose results the taxpayer is disputing. We believe the data cited in our report about default rates demonstrates the importance to *pro se* petitioners of an independent Appeals function, and that any compromise of that independence – in appearance or in fact – harms those taxpayers specifically and tax administration generally.

Moreover, a discussion of petitioned "S" cases primarily emanating from campus correspondence examinations is relevant to the National Taxpayer Advocate's concerns about *pro se* taxpayers and their understanding of the appeals process. A study of docketed "S" case dispositions by issue and type of petitioner is necessary to determine why taxpayers do not resolve issues in Appeals or whether taxpayers simply fail to follow IRS procedures that enable them to reach Appeals. Appeals should seek the answers to questions such as:

- ◆ Why are "S" case petitions increasing by an annual average of 19-20 percent? Are these taxpayers bypassing Appeals or are they not reaching agreement at the Appeals level?

<sup>73</sup> IRS Delegation Order No 60 (Rev. 7) (May 5, 1994).

<sup>74</sup> Taxpayer Advocate Service FY 2007 Annual Low Income Taxpayer Clinic Conference, held December 4 through 7, 2006, in New Orleans, Louisiana. At least one representative of each of the 150 clinics awarded funding under IRC § 7526 for the 2007 grant cycle attended the conference.

- ◆ Why is the default/dismissal rate almost three times higher for *pro se* cases than cases where taxpayers are represented? Are these taxpayers in the Appeals process but give up on the system?

The answers to these questions will produce a clearer picture of IRS roadblocks that prevent taxpayers from timely and accurately resolving their tax disputes. We urge Appeals to take responsibility for researching the underlying reasons why so many “S” case taxpayers default or have their cases dismissed by the United States Tax Court, and we offer our assistance in conducting that research. TAS also welcomes the opportunity to participate in a cross-functional effort to improve this process upon completion of the research.

### Appeals Independence

Appeals independence is called into question based on public perception as well as documented cases of prohibited *ex parte* communication. The National Taxpayer Advocate is closely monitoring the results of the American Bar Association’s survey of its members about the IRS Appeals process. Survey feedback will summarize perceptions of Appeals independence by stakeholders with significant interaction with Appeals.

In addition to documented *ex parte* communication, one need look no further for evidence of the erosion of Appeals’ independence than recently-announced new procedures that link Appeals with the examination function.<sup>75</sup> These procedures, which operate after Appeals and the taxpayer are unable to reach agreement casts doubt on Appeals ability to remain objective. They also diminish the role of Appeals as an independent function, and place it as a mere stepping stone for additional IRS enforcement review.

Specifically, the new procedures provide that, where Appeals and the taxpayer cannot agree on a resolution in cases involving a listed transaction that are not docketed in the Tax Court, “the Office of Appeals will close out its consideration, notify the taxpayer, and send the case to the appropriate Operating Division for further handling.” According to the notice, it is the operating division that will decide whether the case needs “further development.” If the operating division so determines, the IRS will proceed with further case development. If the division determines further development is not necessary, it is the division that issues the Notice of Deficiency.

The IRS’s rationale for implementing these extraordinary procedures is that it “wants to ensure that it has fully developed the limited number of unagreed cases that involve listed transactions . . . before it sends a statutory notice of deficiency . . . to the taxpayer.” Leaving aside the IRS’s astonishing admission that it deliberately sends forth to Appeals inadequately developed cases, the National Taxpayer Advocate believes that

<sup>75</sup> IRS, *Appeals Closing Cases Involving Unsettled Listed Transactions*, Announcement 2006-100 (Dec. 5, 2006).

these procedures impairs both the effectiveness of the Appeals process as well as the perception of Appeals' independence.

Whereas taxpayers heretofore knew that Appeals was the final step in the administrative process after the IRS examination function completed its development of a case, Appeals will now become an *interim* step in the IRS examination process. If issues remain unagreed, the examination function will get another bite at the apple. In both reality and perception, this change will erode the attractiveness of Appeals and make it more likely that taxpayers will choose to avoid the Appeals process and litigate. And that, in turn, will undermine Appeals' role and cause a needless waste of resources for both taxpayers and the government. The IRS's demurral that "Nothing else has changed in Appeals,"<sup>76</sup> does not mask the fact that in order to go after listed transactions the IRS has undermined longstanding tax administration principles. It is the IRS enforcement function that will make the decision in these cases, not the independent Office of Appeals. As a former IRS Chief Counsel put it, "it is the first time in the history of the tax code that the tools of tax administration 'have themselves been turned into a kind of threat.'"<sup>77</sup> Bad facts not only make bad law, they make bad tax administration.

### RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to protect the independence of Appeals and enable it to better fulfill its mission:

- ◆ Research what *pro se* taxpayers expect of the Appeals process, then determine whether their expectations are unrealistic or Appeals is failing its mission.
- ◆ Insert information on locations of Low-Income Taxpayer Clinics in all Appeals campus initial contact letters.
- ◆ Establish a mentor program to reduce cycle time.
- ◆ Look at "timeliness" quality standards as opposed to time span or cycle time measures.
- ◆ Train Appeals and Examination employees to use ADR processes and promote their use throughout IRS compliance functions.
- ◆ Expand Fast Track Mediation to the campus Appeals function. Offer campus examination taxpayers Fast Track Mediation and transfer the case to a local office if the taxpayer agrees to mediation.
- ◆ Analyze campus case results and results on cases transferred to Appeals field offices. Are there more defaults on campus cases? Is there a better resolution for taxpayers at field offices? Is there more time on field cases? What is the cycle time

<sup>76</sup> IRS Officials Defend New Approach to Appeals and Penalties, Tax Notes (Dec. 15, 2006) (quoting Diane Ryan, director of technical services for Appeals).

<sup>77</sup> *Id.*

## PROBLEMS

SECTION  
ONE

on campus versus field cases? Why do more *pro se* taxpayers default on “S” cases? Is the default rate higher in campus than in field cases, and if so, why? What are the characteristics of cases in which taxpayers request to be transferred from campus to field offices? Appeals is missing an opportunity to research the impact of its processes and develop proactive solutions.

- ◆ Conduct a survey of *pro se* taxpayers in Tax Court “S” cases to determine what their needs, expectations, concerns, misconceptions, and reservations are with respect to Appeals’ role in Tax Court case resolution.
- ◆ Explore moving the Office of Appeals from the Commissioner of Internal Revenue to the Secretary of the Treasury, to better protect its independence from further compromise by the IRS’s enforcement focus.<sup>78</sup>

<sup>78</sup> A 1987 IRS document summarized Appeals’ history:

A 1952 reorganization established the structure of the Appeals organization along the lines we see today [*i.e.*, 1987]. Prior to the 1952 reorganization, the Appeals function (Technical Staff) reported directly to the Commissioner through the Head of the Technical Staff. The reorganization brought about the establishment of a system of regional administration of districts under Regional Commissioners of Internal Revenue. However, to maintain the independent status of Appeals and preserve the principle of separating the Audit and Appeals operations, the Appeals function was carved out and placed under the office of the Assistant Regional Commissioner (Appellate), who had final settlement authority. In 1982, the Chief Counsel was delegated line supervisory authority over Appeals by the Commissioner. The transfer of Appeals to Chief Counsel facilitates the flow of information and assistance between appeals officers and counsel attorneys. *See* IRS Document 7225, “History of Appeals” (Nov. 1987).

In 1995, the IRS moved the reporting structure of the Office of Appeals from Chief Counsel back to the Commissioner and Regional Commissioners. *See* IRS Appeals to be Under Commissioner in Chief Counsel Reorganization, 95 TNT 117-4, June 16, 1995; Linda B. Burke, TEI Says IRS Appeals Function Should Report to Deputy Commissioner, Not Chief Counsel, 95-TNT 108-89, June 5, 1995 (“The current structure of Appeals, reflecting the 1982 decision to shift Appeals to the Chief Counsel’s “side of the house,” has contributed to a perceived diminution in Appeals’ independence. Given Counsel’s role as the adviser to Examination personnel, it is hardly surprising that taxpayers are less than sanguine about Appeals’ reporting to Counsel. Indeed, anecdotal evidence suggests that Counsel has generally become more involved in the management and oversight of Appeals’ workload and that this involvement has affected Appeals’ attitude toward settlement”).

In 1998, Congress enacted legislation to “ensure an independent appeals function within the [IRS]”. Pub. L. No. 105-206 § 1001(a)(4). For examples of congressional concerns with Appeals independence, see 144 Cong. Rec. S4182 (1998) (“One of the main concerns we’ve listened to throughout our oversight initiative – a theme that repeated itself over and over again – was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals – one that may not be influenced by tax collection employees and auditors”) and 144 Cong. Rec. S7639 (1998) (“the bill mandates that the Commissioner’s restructuring of the IRS include an independent appeals function. This appeals unit is intended to provide a place for taxpayers to turn when they disagree with the determination of front-line employees. A truly independent appeals unit will assure that someone takes a fresh look at taxpayers’ cases, rather than merely rubber-stamping the earlier determination”).



**PROBLEM****TOPIC #16****CORRESPONDENCE EXAMINATION****RESPONSIBLE OFFICIALS**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**DEFINITION OF THE PROBLEM**

The IRS examination functions support the IRS mission by maintaining an enforcement presence and promoting correct reporting by taxpayers. While many complex tax issues necessitate face-to-face interviews or field examinations, the IRS can often conduct the less complicated examinations by correspondence. This process is most effective for tax returns with questionable items that the IRS can directly verify with records the taxpayer can easily submit by mail.<sup>1</sup>

There are several problems associated with the IRS correspondence examination program. These include:

- ◆ Identifying appropriate inventory for correspondence examination;
- ◆ Inadequate communication with taxpayers;
- ◆ Inappropriate use of a combination letter that both shortens the amount of time the taxpayer has to respond to the exam function and prematurely triggers the right to an administrative appeal;
- ◆ Inconsistency among examiners in the verification required to substantiate a deduction; and
- ◆ Cycle time measures that exacerbate problems and create rework.

The correspondence examination process was designed to expedite resolution of issues in a fair and impartial manner. Significant procedural impediments have led to disparate treatment of taxpayers, ineffective communication with taxpayers, premature audit closures, and increased taxpayer burden.

**ANALYSIS OF THE PROBLEM****Background**

The primary purpose of correspondence examinations is to effectively utilize examination resources to promote voluntary compliance.<sup>2</sup> The Wage and Investment (W&I) division's Examination Operations and Small Business Self-Employed (SB/SE) division's Campus Examination units share ownership of the correspondence examination process in IRS campuses.<sup>3</sup>

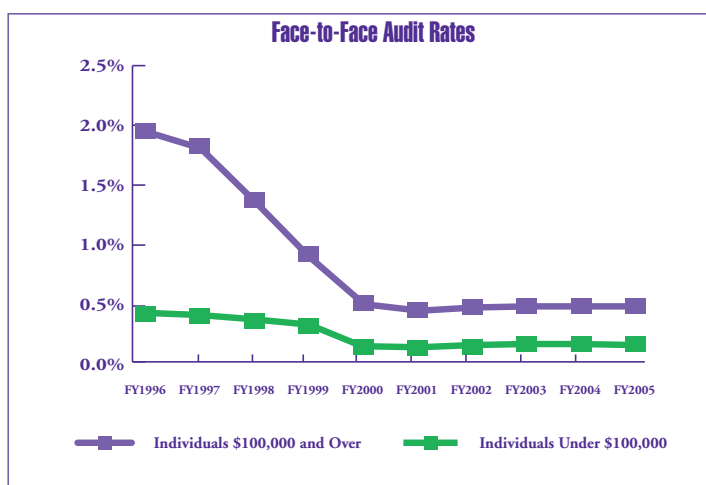
<sup>1</sup> IRM 4.19.1.2.3(6) (Jan. 1, 2006).

<sup>2</sup> IRM 4.19.1.1 (Jan. 1, 2006).

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

During fiscal year (FY) 2005, the IRS examined 1,215,308 individual income tax returns, with 84 percent of those examinations conducted by correspondence.<sup>4</sup> Correspondence examinations accounted for 88 percent of the FY 2005 examinations of individuals with incomes under \$100,000 and 67 percent of those with incomes of \$100,000 or more.<sup>5</sup> While face-to-face examinations rose by 25 percent from FY 2002 through FY 2005, correspondence examinations increased by 170 percent over the same period.<sup>6</sup>

**TABLE 1.16.1, FACE-TO-FACE AUDIT RATES<sup>7</sup>**

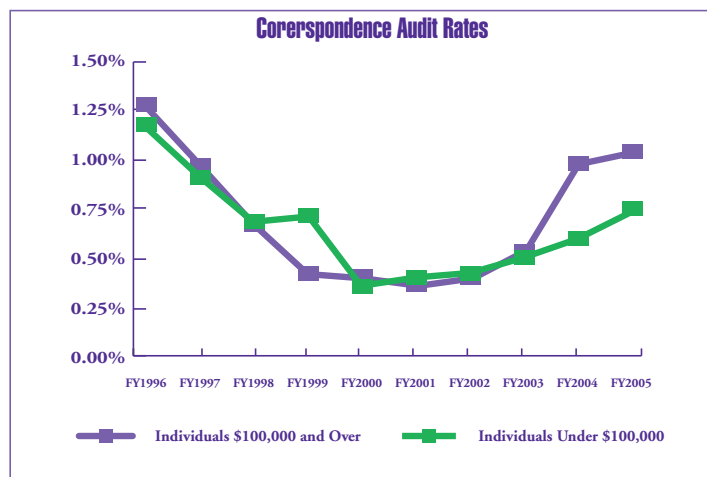


<sup>4</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 8 (Mar. 27, 2006).

<sup>5</sup> *Id.*

<sup>6</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* 2 (Jul. 25, 2006).

<sup>7</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* 8 (Mar. 27, 2006); see also IRS Data Book Spreadsheet (Mar. 2006).

TABLE 1.16.2, CORRESPONDENCE AUDIT RATES<sup>8</sup>

In correspondence examinations, the IRS sends an initial contact letter informing the taxpayer that his or her return is under examination, then a 30-day letter accompanied by a report detailing any tax adjustment attributable to examined issues, and finally a Statutory Notice of Deficiency if the taxpayer does not agree to, or otherwise resolve, the proposed adjustment.<sup>9</sup> Each phase of the process has timeframes established by internal policy. If the taxpayer does not respond within a prescribed time for action, the case moves to the next phase through an automated batch process.<sup>10</sup>

### Identifying Appropriate Inventory for Correspondence Examinations

The IRS utilizes internal database information to identify audit issues such as the Earned Income Tax Credit (EITC). The exam functions may select a return for correspondence audit if all the questioned items are susceptible to direct verification from records that the taxpayer could easily provide by mail, and a review of the return clearly indicates the taxpayer can effectively communicate with the IRS in writing.<sup>11</sup>

<sup>8</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities Through Fiscal Year 2005* (Mar. 2006); see also IRS Data Book Spreadsheet. The significant drop in correspondence audits between 1996 and 1997 may be due to Congress authorizing the IRS to use Math Error Authority for specific dependency, EITC, and child tax credit issues. Once the IRS had authority, it didn't have to use deficiency procedures to assess tax so the results are excluded from correspondence audit rates. For a more detailed discussion of the IRS's math and clerical error authority see National Taxpayer Advocate 2002 Annual Report to Congress 25-31 and 185-197.

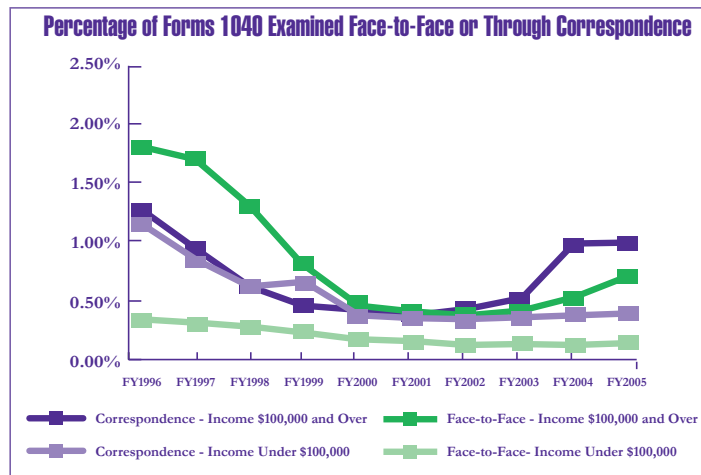
<sup>9</sup> IRC § 6212. If the IRS proposes changes to a tax liability and the taxpayer does not respond or cannot reach an agreement with the IRS, the IRS issues a statutory notice of deficiency. The notice of deficiency allows the taxpayer 90 days to petition the U.S. Tax Court and outlines the procedures to follow. If the taxpayer does not petition the Tax Court, the IRS assesses the tax and gives notice and demand to the taxpayer for the amount due.

<sup>10</sup> IRS Wage and Investment Division, *Correspondence Examination Automation Support, Concept of Operations 6* (Jul. 16, 2004).

<sup>11</sup> IRM 4.1.5.9.1(4) (Oct. 1, 2001).

Correspondence examinations rely heavily on information reporting. While correspondence examiners may request certain documents to identify unreported income, the revenue agents and tax compliance officers who conduct field and office examinations, respectively, use more sophisticated indirect methods. Unlike correspondence examiners, revenue agents are trained to use a “dynamic” examination strategy and change the focus of the examination in response to new information. This approach allows agents to find unreported income that the IRS could not locate in a correspondence examination of limited scope.<sup>12</sup> There are indications that the IRS is using correspondence examinations to accomplish work that is better reserved for interviews or field audits. As depicted in the following chart, since fiscal year 2000, high income taxpayers filing individual income tax returns are increasingly examined by correspondence.

**CHART 1.16.3, PERCENTAGE OF FORMS 1040 EXAMINED FACE-TO-FACE OR THROUGH CORRESPONDENCE<sup>13</sup>**



Correspondence examinations have expanded to include strategies for dealing with nonfilers, projects involving return preparers, and high income taxpayers. However, the complexity of a case should dictate the audit method. Conducting a correspondence examination that fails to identify adjustments attributable to a complex issue only serves to reinforce the noncompliance, not deter it.

A 2006 report by the Treasury Inspector General for Tax Administration (TIGTA) found the IRS either abated or did not collect 86 percent of the audit assessments on high

<sup>12</sup> *The Tax Gap: Hearing Before the Subcomm. on Federal Financial Management, Government Information, and International Security, Senate Comm. On Homeland Security and Governmental Affairs, 109th Cong., 2nd Sess (Oct. 26, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).*

<sup>13</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-055, *Trends in Compliance Activities 33* (Mar. 2006).

income taxpayers, almost two years after the assessments.<sup>14</sup> In addition, of the \$2.1 billion assessed on high-income taxpayers through correspondence examination in FY 2004, \$1.4 billion (66 percent) was attributable to taxpayers who did not respond to the examiner.<sup>15</sup>

The increase in correspondence examinations of taxpayers with Schedule C businesses rose to about 30 percent of all high-income taxpayer Schedule C examinations from FY 2002 through FY 2004, and 54 percent of all high-income taxpayer Schedule C examinations in fiscal year 2005.<sup>16</sup> Given the potential for unreported income in Schedule C business activities and the lack of third-party information reporting, it would appear that the IRS should conduct most of these examinations face-to-face. Recent reports on the makeup of the tax gap support this notion, indicating that well over half (\$109 billion) of the individual underreporting gap came from understated net business income – underreported receipts and overstated expenses.<sup>17</sup>

### Communication with Taxpayers

In 2004, the Taxpayer Advocate Service conducted a study of audit reconsideration cases where taxpayers had claimed the EITC. The findings suggested that the manner in which the IRS communicates with taxpayers may significantly affect the outcome of the audit process.<sup>18</sup> Considering that more than 40 million adults, or approximately 21 percent of the adult population of the United States, have less than a high school education, the lack of telephone or face-to-face individual contact can negatively impact these taxpayers.<sup>19</sup>

<sup>14</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited 2* (Jul. 25, 2006).

<sup>15</sup> For a related discussion of non-responders, see Most Serious Problem, *Taxpayer No Response Rates*, *infra*.

<sup>16</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-30-105, *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited 2* (Jul. 25, 2006).

<sup>17</sup> IRS, *Business Income and the Tax Gap*, at <http://www.irs.gov/newsroom/article/0,,id=158618,00.html> (Jun. 2006).

<sup>18</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 at i. The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study included a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003. Ultimately, 679 cases (340 IRS Examination and 339 TAS) were analyzed in detail. The study found 70 percent of the EITC audit reconsideration cases came to TAS for assistance because the taxpayer had not heard from IRS concerning his or her original audit or audit reconsideration request. For the 339 TAS cases, employees made 293 follow-up contact phone calls with the taxpayers and sent 436 follow-up letters. In contrast, of the 340 IRS Examination cases, tax examiners made only six follow-up contact phone calls to taxpayers and sent only 173 follow-up letters during the initial audit process. The likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employees. Overall, of taxpayers who went through the audit reconsideration process and received no phone calls, only 38 percent were awarded EITC. This percentage increased to 67 percent for taxpayers who received three or more calls.

<sup>19</sup> Beth Lasater and Barbara Elliott, RTI International Center for Research in Education, *Profiles of the Adult Education Target Population*, Information from the 2000 Census 1-9 (Revised Dec. 2005). That is, they have not completed a high school diploma or equivalent. Adults who have completed four or fewer years of secondary schooling constitute 11.3 percent of the target population, or 2.4 percent of the total adult population.

A separate IRS study of the EITC raised questions about how the IRS conducts correspondence examinations and its reluctance to contact taxpayers by telephone. Two of the areas identified as barriers related to IRS correspondence and contacting the IRS.<sup>20</sup>

#### *Toll Free Access*

Internal Revenue Code (IRC) § 7602 authorizes the IRS to examine books and records and take testimony. Oral testimony can produce information not available on any document as well as corroborate return information. To provide oral testimony, however, the taxpayer first has to get through to the IRS. In January 2006, W&I instituted Intelligent Call Management on its toll-free phones to improve the quality of correspondence examinations.<sup>21</sup> This service provides more immediate assistance to the taxpayer by providing a better level of service on unassigned cases and reduces the need for the taxpayer to call several times to seek assistance. In May 2006, the IRS further expanded this service to the taxpayer by introducing new programming for extension-routed calls. This programming allows extension routed calls to roll over to the next available examiner if the assigned examiner is not available. The number of calls answered by a live assistor rose from 14.9 percent in FY 2005 to 39.8 percent in FY 2006.<sup>22</sup>

We applaud the IRS's efforts to improve customer service. However, some taxpayers still cannot reach the IRS employees who are familiar with their cases. In one TAS case, a taxpayer received a correspondence examination letter with an examiner's name and contact telephone number. The taxpayer and examiner were located in Nevada and the non-toll-free telephone number was listed in Ohio. The taxpayer was frustrated with the process and lack of responsiveness and contacted TAS for assistance.<sup>23</sup>

Taxpayers must feel confident that the individual whose name appears on IRS correspondence will answer their questions, review their documentation, and guide them through the process. As noted in the National Taxpayer Advocate's 2005 Annual Report to Congress, "This allows the taxpayer to develop a relationship with the caseworker and may encourage the taxpayer to respond to calls and requests for information."<sup>24</sup>

#### *Unassociated Mail*

In a 2005 TAS focus group, tax practitioners frequently commented that the IRS would request additional information prior to reviewing all relevant case information, and before associating the information the taxpayer had already sent in with the taxpayer's

<sup>20</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 10.

<sup>21</sup> IRS Wage and Investment Division research request response (Sept. 26, 2006).

<sup>22</sup> IRS Wage and Investment Division research request response (Nov. 22, 2006). The Wage and Investment Division Reporting Compliance Correspondence Examination Phone Initiative was recognized by the National Taxpayer Advocate with a National Taxpayer Advocate Team Award for 2006.

<sup>23</sup> Taxpayer Advocate Service Management Information System (TAMIS).

<sup>24</sup> National Taxpayer Advocate 2005 Annual Report to Congress 115.

case.<sup>25</sup> The tax practitioners noted that these circumstances often led to an inefficient, challenging, and frustrating exam process. A number of practitioners mentioned having to send documentation by certified mail in order to have a receipt. Some said the sheer volume of documentation requested is often overwhelming, which makes it difficult to fax responses back to the IRS.<sup>26</sup>

Taxpayers and their representatives continue to express concern over the IRS's failure to acknowledge receipt of correspondence. One representative wrote, "I am becoming increasingly concerned about the difficulty of getting an acknowledgment of my response to the IRS prior to the end of the 30 day period stated in notices.... Please provide a procedure in which taxpayer or practitioner responses are quickly acknowledged as being received. Provide a contact point for taxpayers or practitioners to call if no response is received by the promised date. Allow a quick means, through e-services or elsewhere, for a practitioner to acknowledge receipt of the notice and obtain 2-3 weeks of additional time."<sup>27</sup>

Improved communication could help resolve many difficulties with documentation, non-responsive taxpayers, and audit reconsiderations. Every year, IRS campuses receive millions of taxpayer letters and responses, which clerks sort, route, classify, associate, and control for response by Customer Service Representatives (CSRs) or Tax Examiners (TEs). Taxpayers frequently make multiple contacts in writing or by phone on the same issue, and CSRs and TEs at one location do not have access to incoming correspondence at another location. The IRS's move to computer scanning of taxpayer documents to create electronic images should minimize these problems, reduce response time, and improve case quality by automating manual processes that cause errors.<sup>28</sup> This promising process, called the Correspondence Imaging System (CIS), provides online access to images of taxpayer correspondence so assistants can readily resolve phone and written inquiries. However, the IRS presently uses this system only for amended returns.<sup>29</sup>

### *Personal Contacts*

Increased telephone contact helps taxpayers better understand what supporting documentation is needed to satisfy questionable deductions or credits, and affords taxpayers an opportunity to provide oral testimony and pose questions about the audit process and their rights. IRS examiners must learn to differentiate between various types of targeted communication and find the one that works best in given circumstances.

<sup>25</sup> National Taxpayer Advocate, *Findings from Correspondence Examination Focus Groups, IRS Tax Forums* (Jun. – Sept. 2005), ii.

<sup>26</sup> *Id.*

<sup>27</sup> Systemic Advocacy Management System (SAMS) (Aug. 2006).

<sup>28</sup> IRS Wage and Investment Division Executive Steering Committee Presentation (Mar. 1, 2002).

<sup>29</sup> IRS Wage and Investment Division research request response (Sept. 1, 2006).

The IRS needs to improve communication during the correspondence examination process. For example, the IRS mails customer satisfaction surveys each month to a sample of taxpayers it has audited through correspondence. The customer dissatisfaction rate (*i.e.*, the taxpayer rated satisfaction as either a “1” or “2” on a 5 point scale) for taxpayers examined by correspondence was 37 percent in fiscal year 2006 and 40 percent in FY 2005.<sup>30</sup> The priority for improvement among these dissatisfied customers is fairness of treatment by the IRS.<sup>31</sup> The surveys indicate that taxpayers increasingly perceive the correspondence examination process as confusing and unfair.

The National Taxpayer Advocate voiced her concern over the IRS’s lack of effective communication methods in her 2007 Objectives Report to Congress.

We remain concerned, however, about the Service’s continued bias away from human interaction and toward self-service, both in the taxpayer service and enforcement environments. While self-service and communication through correspondence may make sense and be adequate for many taxpayers, many other taxpayers will not be able to comply unless they receive individualized assistance from a knowledgeable IRS employee either in person or by telephone.<sup>32</sup>

### The “Combo” Letter and Shortened Turnaround

In calendar year 1998, the IRS implemented a new process to reduce the length of correspondence examinations (*i.e.*, cycle time). The IRS combined the initial contact letter and an official examination report (explaining the taxpayer’s appeal rights) into one mailing (the “combo” letter). This system gave the taxpayer a very compressed timeframe to gather information and respond before the IRS issued a statutory notice of deficiency. If the taxpayer was confused by the combo letter, or otherwise failed to secure and submit necessary documentation within the allotted 30 days, he or she lost the opportunity to request a meeting with IRS Appeals. Many taxpayers did not realize that the 30-day appeal opportunity period was running while they were providing documentation on the issue to a tax examiner.

In fiscal year 2004, the compliance examination functions entered into an agreement with the National Taxpayer Advocate not to use the combo letter for EITC audits.<sup>33</sup> This has not deterred the IRS from using the combo letter for other discretionary work. The IRS agreed, in concept, that the combo letter should be reserved for simple issues, such as the penalty for premature withdrawal from an Individual Retirement Account (IRA) and self-employment tax on non-employee compensation payments. However,

<sup>30</sup> Wage and Investment Division correspondence examination response (Nov. 22, 2006). While the difference in customer dissatisfaction rates between fiscal year 2005 and fiscal year 2006 is not statistically significant, the fact that more than a third of all respondents are dissatisfied is disturbing.

<sup>31</sup> Wage and Investment Division correspondence examination research request (Sept. 26, 2006).

<sup>32</sup> National Taxpayer Advocate 2007 Objectives Report to Congress vii.

<sup>33</sup> National Taxpayer Advocate 2003 Annual Report to Congress 87-98.



the current list of projects clearly indicates that audits of more complex matters such as tip income and alimony are initiated with the combo letter.<sup>34</sup> SB/SE also agreed to study the impact of not using the combo letter for other issues. To date, TAS is unaware of any such study.

Even as the IRS continues to use the combo letter, employees do not consistently follow letter procedures. In 20 percent of the cases sampled during a TIGTA review, audits began with letters proposing tax changes rather than the standard audit initiation letters.<sup>35</sup> This approach further reduces the time taxpayers have to respond to IRS inquiries, since audit initiation letters indicate the IRS will wait 30 days for taxpayers to submit substantiation before proposing any changes to a tax return. Unless the IRS follows letter procedures consistently, it risks contributing to taxpayers' perceptions that they are not treated fairly.<sup>36</sup> The National Taxpayer Advocate has repeatedly addressed the need to eliminate combination letters to safeguard taxpayer rights.<sup>37</sup>

### Verification Inconsistencies

Taxpayers and their representatives cite problems with inconsistencies in the acceptance of documentation for correspondence examination issues.<sup>38</sup> The two main problems are inconsistency as to which documents the IRS will accept (a document is accepted in one campus, but not in another) and inflexibility in accepting proof (failure to accept alternative types of documentation when the taxpayer cannot provide the standard documentation).<sup>39</sup> These problems are especially burdensome for low income taxpayers examined for EITC. IRS requirements for acceptable documentation are typically limited to receipts for expenditures, which are not readily accessible by these taxpayers.

In 2004, the IRS tested the use of an EITC certification form offering three options for certifying child residency, a significant cause of EITC disallowance. These options were:

- ◆ Records from school, utility bills, health care provider;
- ◆ Statement or letter from school, utility company, health care provider; or
- ◆ Affidavit of third party with record of or personal knowledge of residency.

<sup>34</sup> Wage and Investment Division correspondence examination research request (Sept. 26, 2006).

<sup>35</sup> Treasury Inspector General for Tax Administration, Ref. No. 2000-10-066, *The Internal Revenue Service Can Improve the Treatment of Taxpayers During Service Center Audits* ii (Apr. 2000).

<sup>36</sup> *Id.*

<sup>37</sup> National Taxpayer Advocate Fiscal Year 2003 Objectives Report to Congress 7; National Taxpayer Advocate 2003 Annual Report to Congress 87-98; National Taxpayer Advocate Fiscal Year 2004 Objectives Report to Congress 11; National Taxpayer Advocate 2004 Annual Report to Congress, at v; National Taxpayer Advocate 2005 Annual Report to Congress 119; National Taxpayer Advocate Fiscal Year 2006 Objectives Report to Congress 33.

<sup>38</sup> National Taxpayer Advocate, *Findings from Correspondence Examination Focus Groups, IRS Tax Forums* (Jan. 2006).

<sup>39</sup> General Accounting Office, GAO-02-449, *Opportunities To Make Recertification Program Less Confusing and More Consistent* 21 (Apr. 2002).

Taxpayers were encouraged to use one of the options in lieu of the standard documentation requested. The study marked the first time affidavits were routinely used for tax administration purposes.<sup>40</sup> Taxpayers in the test were able to prove they met the qualifying child residency requirement by submitting a third party affidavit. The affidavit guides the taxpayer through the process of meeting the child residency test for EITC, and eliminates the need for multiple contacts by correspondence. The results showed that affidavits had the highest acceptance rate<sup>41</sup> and provided a reliable way to substantiate the taxpayers' qualification for EITC.<sup>42</sup> The test suggests alternative documentation is effective in resolving audit issues and meets the IRS's goals of maximizing EITC participation while minimizing erroneous claims.<sup>43</sup>

The National Taxpayer Advocate urges the IRS to use the affidavit form developed for the EITC certification study in all EITC correspondence examinations. In addition, IRS must incorporate the lessons learned from the study into routine practice. Alternative methods are effective for resolving tax issues and should be pursued. The balance between service and enforcement can be achieved by examiners using sound judgment when analyzing all documentation provided by taxpayers.

In addition to improving consistency of acceptable documentation for correspondence examinations, the IRS should continue focusing on the clarity of requests for documentation. We commend the IRS for improvements to Form 886-H, Explanation of Items (request for supporting documentation), used in correspondence examinations. The IRS redesigned the forms in response to feedback from taxpayers who found the old forms confusing.<sup>44</sup> This improvement should serve as a model for partnering with taxpayers and representatives to enhance the quality of examinations.

### Cycle Time Measures Exacerbate Problems and Create Rework

Even though correspondence examinations require minimal resources, some IRS measures, including cycle time and total returns examined, can inadvertently encourage employees to close audits prematurely. For example, correspondence cases for claims are to be resolved within 30 days of receipt, with a goal of maintaining cases in inventory less than 45 days 95 percent of the time.<sup>45</sup> These are unrealistic timeframes for producing records supporting complex cases such as high income nonfilers and issues such as alimony. Taxpayers who prepare their own returns may be overwhelmed by the

<sup>40</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 17 (Oct. 2005).

<sup>41</sup> The overall acceptance rate of documents was 64 percent. Affidavits had the highest acceptance rate of 82 percent, followed by letters with an acceptance rate of 55 percent, and records with a rate of 48 percent. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

<sup>42</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

<sup>43</sup> *Id.* at 2.

<sup>44</sup> *Hearing Before the Subcomm. on Regulatory Affairs, House Comm. on Government Reform. Paperwork Burden Reduction*, 109th Cong. 1st Sess. (May 25, 2005) (testimony of Mark Everson, Commissioner of Internal Revenue).

<sup>45</sup> Wage and Investment Division *Correspondence Imaging System Organizational transition Plan 1* (Aug. 6, 2002).

level of documentation needed to support a deduction or credit and simply agree to a disallowance or fail to respond to IRS communication. Taxpayers who speak English as a second language, are disabled, or cannot afford to hire paid preparers may fall by the wayside in a process that offers little personal contact.<sup>46</sup>

IRS procedures and measures can encourage unresponsive taxpayers as well as premature closures. For example, assume a taxpayer provides documentation to support expenses questioned on a return and also claims that he or she has additional expenses not previously claimed. If the taxpayer does not produce the source documents for additional expenses with the response to the classified issues, the examiner is directed to send a closing letter to the taxpayer.<sup>47</sup> The examiner inserts a special paragraph to advise the taxpayer that he or she can use Form 1040X, Amended U.S. Individual Income Tax Return, to reduce the income indicated as overstated on the original return. Thus, instead of waiting a reasonable time to secure additional information from the taxpayer and resolve the case, the IRS encourages another cycle of examination through the audit reconsideration or claim process.

#### *Audit Reconsiderations*

IRC § 6404(a) grants the IRS the discretionary authority to abate any unpaid tax determined to be excessive. Under this authority, the IRS affords taxpayers an opportunity to present information not previously considered during an examination. An audit reconsideration is the process the IRS uses to reevaluate audit results when additional tax was assessed and remains unpaid.<sup>48</sup> If a taxpayer disagrees with an audit assessment, he or she may request reconsideration and provide new information.

A central reconsideration unit screens incoming correspondence requesting an audit reconsideration. Screeners are to reject any case that closed from a correspondence unit where taxpayer correspondence was received and not worked before the case was closed. If the correspondence could change the audit determination, the IRS returns these requests to the original correspondence exam unit to consider.<sup>49</sup>

Taxpayers are sometimes unable to produce requested documentation within IRS timeframes for a correspondence examination and request a reconsideration once they gather the documents. For example, the correspondence exam procedures for dependency exemptions require the examiner to verify information from the taxpayer to prove he or she meets the support test. That information includes receipts for food, clothing, upkeep of the home, medical and dental bills, schooling, recreation, and personal

<sup>46</sup> See Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Language and Cultural Barriers to Tax Compliance* and Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities*, *infra*.

<sup>47</sup> IRM 4.19.3.20.7.1 (Sept. 1, 2006).

<sup>48</sup> IRM 4.13.1.1 (Oct. 1, 2006).

<sup>49</sup> IRM 4.13.3.2 (Oct. 1, 2006).

items.<sup>50</sup> Taxpayers cannot usually secure records such as these and return them to the IRS within 30 days. Alternatives to this requirement include:

- ◆ Use of the Bureau of Labor Statistics Consumer Expenditures Survey data for specific family size and income levels;<sup>51</sup>
- ◆ An interview with an examiner to provide oral testimony; and
- ◆ A targeted issue support worksheet based on taxpayer records and estimates.<sup>52</sup>

Although the reconsideration process consumes additional time reviewing documentation from taxpayers after an examination closed, it still ensures that taxpayers receive an opportunity to resolve tax matters.

### *Taxpayer Rights*

The IRS encourages resolution of cases in campus operations whenever possible. For example, if a taxpayer requests an Appeals conference in a local office, the campus examiner is directed to phone the taxpayer to assure him or her that the issue can be resolved at the campus. If unable to contact the taxpayer by phone, the examiner is directed to issue Letter 1654, which acknowledges the request for a transfer but encourages the taxpayer to work with the campus to resolve the matter. Only if the taxpayer insists on an interview at a local office is the transfer granted.<sup>53</sup> The National Taxpayer Advocate is concerned that the IRS directs its employees to call taxpayers to persuade them not to pursue their rights to a local appeals hearing, but does not direct its employees to call taxpayers to discuss the merit of their cases.

A TAS case provides insight to why taxpayers eventually lose confidence in the system. The taxpayer requested a face-to-face meeting due to the difficulties and expense of copying and mailing all documents needed to prove medical expenses. The examiner refused to transfer the case. The taxpayer was dealing with family issues related to his illness and stated he did not have time to fight the assessment so he agreed to the proposed deficiency. This was an elderly taxpayer who the TAS case advocate believed had legitimate medical expenses, but who gave up under the weight of the burden placed on him by the IRS.<sup>54</sup>

<sup>50</sup> IRM 4.19.1.5.3.8 (Jan. 1, 2006).

<sup>51</sup> IRM 4.10.4.6.1.3. The Consumer Expenditure Survey (CE) program consists of two surveys collected for the Bureau of Labor Statistics by the Census Bureau – the quarterly Interview survey and the Diary survey – that provide information on the buying habits of American consumers, including data on their expenditures, income, and consumer unit (families and single consumers) characteristics.

<sup>52</sup> The Appeals function utilizes a worksheet to secure support information from taxpayers prior to a conference. The worksheet lists basic household expenses and asks the taxpayer to indicate how much of each estimated expense was paid personally or by others.

<sup>53</sup> IRM 4.19.1.4.14 (Jan. 1, 2006).

<sup>54</sup> Taxpayer Advocate Management Information System (TAMIS).

In another TAS case, the case advocate secured the taxpayer's case file from the examining campus and found the taxpayer had submitted documentation multiple times. The IRS ultimately accepted the return as filed. The examiner had all necessary information and either did not look at it or did not associate it with the case in a timely manner.

Taxpayers with limited English proficiency or who are disabled often fall prey to miscommunication.<sup>55</sup> These taxpayers may need a face-to-face meeting to fully detail requirements for issues such as filing status and dependency exemptions. Correspondence examiners do not have specialized training to address the needs of these taxpayers.

### IRS COMMENTS

The IRS does not agree with the National Taxpayer Advocate's assessment of the Correspondence Examination program.

- ◆ Issues selected for correspondence examination are generally simple and subject to third-party verification;
- ◆ Current procedures provide adequate opportunities for taxpayers to respond or to contact IRS employees;
- ◆ Use of the combination (combo) letter shortens the length of these audits, thereby minimizing a source of taxpayer dissatisfaction. Combo letters do not infringe upon taxpayers' ability to appeal the examination or to petition the Tax Court;
- ◆ We have procedures in place to ensure examination consistency;
- ◆ We do not have sufficient data to warrant more widespread use of affidavits in lieu of standard audit documentation;
- ◆ There are very clearly established timeframes for these examinations that do not encourage or require our employees to close them prematurely; and
- ◆ It is not appropriate for the IRS to use Bureau of Labor Statistics or other similar data to allow a tax benefit when IRS has specific third-party data to indicate the taxpayer is not entitled to that benefit.

### Identifying Appropriate Inventory

For many years, the IRS has relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular returns or types of potential errors. Correspondence examinations are an effective and efficient means of checking income and deductions. Correspondence examinations are generally verification audits and do not require sophisticated tax law interpretation or an in depth inspection of the taxpayer's books and records. In Wage and Investment (W&I), most

<sup>55</sup> For a related discussion of taxpayers with language barriers or disabilities, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities, infra/supra* and Most Serious Problem, *Limited English Proficient (LEP) Taxpayers; Language and Cultural Barriers To Tax Compliance, infra*.

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audits are related to exemption issues, such as the earned income tax credit (EITC), child tax credit, or simple Schedule A issues. A minimal amount of verification is required to substantiate the deduction or credit.

Conducting audits through correspondence examination also provides flexibility to the taxpayer and decreases taxpayer burden. Since most taxpayers work during normal IRS field hours, a face-to-face audit would require the taxpayer to take time off from work. A correspondence audit allows taxpayers the flexibility of preparing for the audit on their own time. If the taxpayer requests a face-to-face audit, and we deem the request appropriate, we will transfer the case to the field. However, if the issues are simple, we retain the latitude to deny taxpayer transfer requests to ensure the best use of our limited field examination resources and to prevent taxpayer “shopping.”

The complexity of the tax issue is considered prior to determining if an examination can be conducted in the correspondence environment. Although we are increasing audits on high income taxpayers, the issues we are using to select returns for audit are not more complex and generally focus on one or two issues, such as alimony or the alternative minimum tax.

The National Taxpayer Advocate states that correspondence examinations have expanded to include non-filer returns and preparer projects. For non-filers, we have a wealth of internal information available, such as Forms 1099 and W-2, to establish income and deductions. Our preparer projects generally address large Schedule A items or credits which can be easily substantiated by a limited number of documents.

Case selection criteria for correspondence examinations are the result of years of research, development, and refinement. Sophisticated filtering and selection criteria are reassessed yearly and appropriate changes are made to improve cases selected for examination. The methodology is mostly rule-based with matching capabilities to third-party data such as the Federal Case Registry, KIDLINK, and information returns data. This allows us to limit our focus to a small number of issues having a high likelihood of error.

### Communication with Taxpayers

The IRS has taken several steps to improve communication with taxpayers. The Internal Revenue Manual (IRM) requires tax examiners to attempt to contact the taxpayer by telephone when additional information is needed if the taxpayer provides a number. Our letters also inform taxpayers about the option to call toll-free at any time during the audit process if they require personal contact to resolve or clarify an issue. Correspondence Examination has also implemented Universal Call Routing that provides toll-free assistance in both English and Spanish. All Correspondence Examination telephone assistors are trained to resolve general and specific case related questions for all Correspondence Examination audit-related programs. A database was developed which contains information on all Correspondence Examination project codes, IRM links, and frequently asked questions with corresponding answers. This provides the

telephone assistors with readily available information to respond to taxpayer questions on a myriad of issues. A Telephone Assistance Guide was also provided to all telephone assistors. As a result, it is not necessary for a taxpayer to speak with the individual tax examiner assigned to their case when they call. Universal Call Routing allows an employee to assist the taxpayer regardless of their geographic location and includes the capability for the employee to view current and past case history. This allows taxpayers a much greater opportunity to contact the IRS about their case, while significantly increasing efficiency in conducting these examinations. In addition, Universal Call Routing has resulted in a significant increase in the telephone level of service (LOS) afforded taxpayers. Our LOS, 69 percent in FY 2005 and 78 percent in FY 2006, has risen to 83 percent through the first month of FY 2007.

Currently, IRS uses the Correspondence Imaging System (CIS) in Accounts Management for mail not specific to Examination. Other modernization priorities prevented IRS from expanding this system to handle Compliance mail. Currently, Examination uses the Correspondence Examination Automated System (CEAS), which does not interface with CIS. However, Collection, Automated Underreporter, and Examination are working on requirements for a new system, Image Delivery for Correspondence, currently planned for delivery in January 2010. This new imaging system will interface with other compliance systems, including CEAS.

In order to track and timely process incoming mail, we date stamp and route it to the correct area to be associated with the case file. The IRM requires that we update the Audit Information Management System (the automated system used by Examination to control and document all case-related actions) to reflect the mail received date within five days of receipt. Although acknowledgement letters are not generated on initial receipt of correspondence, if the taxpayer calls the IRS, any employee can access the Integrated Data Retrieval System and inform the taxpayer if the IRS received mail related to their case. The first interim letter to the taxpayer is issued within 30 days of the correspondence received date (CRD). A subsequent interim letter, if necessary is sent within 70 days of the CRD if the issue remains unresolved. A third interim letter is mailed in the event the issue is not resolved within 115 days.

### The “Combo” Letter

As part of an agreement with the NTA, EITC Examination agreed to add an additional 30-day letter to all Proof of Concept (POC) cases. This test was to determine if the IRS could get a higher response rate on POC EITC cases. A research report titled *Evaluation of Effect of Letter 3826 on Response Rate*, dated August 26, 2005, indicated the additional letter did not increase the response rate. The no-response rate actually increased by four percent. In other words, taxpayers who were given additional time to reply did not make use of the additional time, while the extra letter added 30 days to the average cycle time.

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Examination cycle time, the time it takes the IRS to complete an examination, has consistently been a source of taxpayer dissatisfaction with the audit process. To address this concern, the IRS adopted the “combo letter” for certain kinds of examinations.

We believe the combo letter is appropriate when the IRS has third-party information available to indicate a taxpayer is not entitled to a particular tax benefit. As with premature withdrawals from Individual Retirement Accounts or assessments of unreported self-employment tax, the IRS has third-party information available for many other examination issues, such as duplicate dependents and tip income. In alimony cases, we compare the amount deducted and the amount of income reported by the two related parties. Third-party data from the Social Security Administration, the Federal Case Registry, and KIDLINK are used on issues that involve the child care, child tax, and education credits. Documentation requirements for taxpayers in such cases are not complex, taxpayers that respond timely do not lose their appeal rights, and use of the combo letter reduces the time needed for these examinations by 30 days.

Taxpayers that have appropriate documentation often respond within 30 days. Once a response is received, the IRS stops the audit process until an examiner has an opportunity to evaluate the documentation. The National Taxpayer Advocate indicates that cases move directly to a statutory notice of deficiency in an automated batch process. This is true if the taxpayer does not respond. However, although it is more efficient, not all cases go through the batch process. In W&I, much of the non-EITC related Correspondence Examination work does not involve the batch process. In the Small Business/Self-Employed Division, only two Correspondence Examination programs utilize batch processing. In either instance, the taxpayer has the same amount of time to respond whether a case is initiated through batch processing or not. In addition, if a taxpayer responds, the case is taken out of batch processing while we address any correspondence or issues raised by the taxpayer. Cases that are part of a preparer project or are identified by the Criminal Investigation Division generally have a low response rate because the taxpayers often have no documentation to support their claims. This low response rate is not a reflection of taxpayer confusion; rather, it indicates they cannot substantiate items or deductions.

### Verification Consistency

The IRS has made several changes to ensure taxpayer documentation is evaluated correctly, consistently, and fairly. Within the last year, we implemented a decision support tool that is used for the EITC, filing status, dependent credits, and certain itemized deductions. We also revised IRM 4.19.14.4(1) to emphasize the use of judgment in reviewing the facts and circumstances involved with each issue to determine if the taxpayer’s documentation establishes that the tax paid is substantially correct. To ensure our employees follow IRM requirements, we perform operational reviews in each campus. Additionally, we conduct closed case reviews on an on-going basis.



### Use of Affidavits

The National Taxpayer Advocate's report states that the IRS should use affidavits to allow taxpayers to claim the EITC. While affidavits appear to offer some promise as a way to reduce the burden on eligible taxpayers, our limited scale proof of concept testing did not replicate real world conditions. As a result, many of the potential risks associated with the use of affidavits could not be evaluated. Taxpayers and tax preparers – who completed well over 70 percent of the returns in the study – were unfamiliar with the form or its use. The IRS was not able to ascertain whether widespread use of such affidavits could contribute to intentional erroneous EITC claims because of the ease with which affidavits can be created and submitted.

To prevent the use of false affidavits to verify eligibility criteria, the IRS would need a comprehensive approach to identifying and preventing abuse. At this point, we do not have sufficient information to do this or to understand the costs associated with such a program. Nor do we have data to evaluate the deterrent effect such verification efforts might have on potentially eligible taxpayers. Finally, such a program has the potential to shift current Correspondence Examination resources from direct examination casework to third-party verification activities – a change that may not be warranted or cost effective.

### Cycle Time Measures

We do not agree that cycle time measures encourage employees to close examinations prematurely. Correspondence Examination has very clear timeframes for the taxpayer to respond to the IRS and to allow them to either appeal the audit or petition the Tax Court. The taxpayer receives an Initial Contact Letter with a 30-day suspense period, a 30-day letter with a 30-day suspense period, and a 90-day letter.

As previously noted, correspondence examinations target income, credit, or deduction issues that are readily verifiable by the IRS through third-party information. These issues generally do not involve complex issues or the need for taxpayers to produce sophisticated business or tax documentation. Taxpayers that maintain appropriate documentation to establish the income or expense claimed on their return have adequate time to respond to correspondence examination letters.

### Use of Bureau or Labor Statistics Data

The IRS does not endorse use of Bureau of Labor Statistics (BLS) Consumer Expenditures Survey data for specific family size and income levels to allow certain deductions. The BLS is a sophisticated tool more suited for use by Field Examination when developing income or expenses using an indirect method. In a normal correspondence examination, the IRS has third-party information that indicates a taxpayer is not entitled to a claimed tax benefit. IRS acceptance of BLS statistical norms to allow such claims is not warranted in these circumstances.

In summary, the IRS correspondence examinations properly target issues that are not appropriate for face-to-face field examinations. Procedures and systems are available to support access to IRS employees trained and capable of addressing taxpayer questions or issues. Use of the combo letter reduces taxpayer burden by reducing the time needed for these audits while preserving taxpayer rights. Procedures are in place to ensure and verify consistent treatment of examination issues. The IRS does not have sufficient data to warrant use of affidavits to resolve audit issues. IRS cycle time measures ensure prompt and consistent actions on correspondence examination cases. Finally, it is not appropriate for the IRS to allow deductions or credits based on statistical norms when third-party data specifically indicates a taxpayer is not entitled to a deduction or credit.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

##### Inventory Selection

The National Taxpayer Advocate agrees with IRS that correspondence examinations can be an effective and efficient means of auditing tax returns for **narrowly defined issues**. The IRS states that correspondence examinations target income, credit, or deduction issues that the IRS can readily verify through third-party information. In addition, the IRS maintains these audits generally do not involve complex issues or require taxpayers to produce sophisticated business or tax documentation. While this should be the case for all correspondence examination cases, the National Taxpayer Advocate found the IRS selected for correspondence examination complex issues that require substantial verification or sophisticated tax law knowledge. One example of this situation is alimony.<sup>56</sup>

The National Taxpayer Advocate disagrees with the IRS's classification of alimony as a simple issue that can be substantiated through correspondence examination. Campus procedures for the examination of alimony are extensive.<sup>57</sup> Documentation must include the legal instrument that orders the payment of alimony with all amendments and proof of payment in the form of copies of cancelled checks, money orders, or proof of direct deposit; or court receipts or statements from state or county agencies to which payments were made. Documentation may also include a copy of a deed to verify home ownership for mortgage, real estate taxes and home insurance payments, receipts for living expenses, education and medical expenses.<sup>58</sup> The correspondence examiner must be familiar with legal terminology to interpret the legal instrument.<sup>59</sup> It is clear that alimony requires more than a minimal amount of verification to

<sup>56</sup> Alimony issues typically arise because of discrepancies between the amount deducted as alimony by the payer and the amount reported as income by the payee(s).

<sup>57</sup> IRM 4.19.1.6.21 (Oct. 1, 2004).

<sup>58</sup> IRM 4.19.1.6.21.5 (Oct. 1, 2004).

<sup>59</sup> IRM 4.19.1.6.21.6 (Oct. 1, 2004).

substantiate a deduction, as well as knowledge of legal and tax issues beyond the scope of training provided to a correspondence examiner.

The National Taxpayer Advocate also questions the IRS's characterization of Alternative Minimum Tax (AMT) as simple. Leaving aside the complex computational issues that even the IRS gets incorrect, the AMT involves such technically complex issues as incentive stock options, intangible drilling expenses, and capital gain calculations. Congress, the National Taxpayer Advocate, and the President's Commission on Tax Reform have all labeled AMT a complex provision.<sup>60</sup>

The IRS expansion of correspondence audits to non-filer cases is risky. If the IRS audits these taxpayers based solely on information returns such as Form 1099-MISC, Miscellaneous Income, and W-2, Wage and Tax Statement, it offers non-filers an opportunity to resolve tax liabilities based only on income reported to the IRS. Income from cash transactions or other sources go undetected when the IRS fails to conduct a face-to-face interview and a review of taxpayer records. Instead of promoting voluntary compliance by conducting a thorough examination, the IRS condones unreported income and encourages future noncompliance.

### The “Combo Letter”

The IRS adopted the “Combo Letter” in response to taxpayer dissatisfaction with the length of the examination process. While resolving issues timely is a worthy goal, the combo letter works against taxpayers by reducing the time many taxpayers need to produce documentation for examined issues. The “Combo Letter” is not appropriate for cases involving alimony or any other issue that requires factual development or a review of records. The IRS claims that preparer project cases or cases identified by the Criminal Investigation Division have a low response rate because taxpayers have no documentation to support their claims. The National Taxpayer Advocate sees no empirical evidence to support this claim. On the contrary, these taxpayers may require additional time to produce records or consult with legal or professional advisors.<sup>61</sup>

The IRS states that the “Combo Letter” does not impact taxpayer appeal rights. Due to the shortened time for a response and request to appeal, taxpayer rights are certainly affected. Many taxpayers, particularly low income or limited English proficiency (LEP) taxpayers, may need assistance to respond to tax issues. They may be unaware that the opportunity period for an appeal is running while they seek assistance in documenting the issue for a tax examiner. The IRS study cited in the report did not test taxpayer *comprehension* of the “Combo Letter”. In addition, the study only included taxpayers

<sup>60</sup> The President's Advisory Panel on Tax Reform, Final Report 3 (Nov. 1, 2005).

<sup>61</sup> For additional discussion of IRS Criminal Investigation Division cases, see National Taxpayer Advocate 2005 Annual Report to Congress vol. 2. The TAS Criminal Investigation Refund Freeze Study of a statistically representative number of Questionable Refund Cases (QRP) revealed that over 80 percent of taxpayers got full or partial refunds and 53 percent of taxpayers received full relief.

who did not previously respond to the IRS in the EITC Qualifying Child Residency Certification Study. Accordingly, the test cases were compared to pre-certification cases where the lack of a response or an incomplete response was already an issue.

The National Taxpayer Advocate urges the IRS to reconsider its use of the “Combo Letter.” Shortening the length of an audit and decreasing the percentage of dissatisfied customers should not trump the need to determine the best approach to examining issues while protecting taxpayer rights.

### Verification Inconsistencies

TAS focus group reports cited problems with inconsistencies in the acceptance of documentation for correspondence examination issues.<sup>62</sup> The IRS asserts that it has implemented several changes to ensure that taxpayer documentation is evaluated correctly, consistently, and fairly. The National Taxpayer Advocate applauds these changes and urges the IRS to continue emphasizing use of judgment in reviewing the facts and circumstances of each issue to determine if taxpayer documentation establishes tax per return as substantially correct.

The IRS does not endorse use of Bureau of Labor Statistics (BLS) Consumer Expenditures Survey data as a source of information to allow certain deductions during the correspondence audit process. The National Taxpayer Advocate is perplexed by this statement, given that the IRS uses BLS data for field audits that warrant indirect methods and in the collection context to determine a taxpayer’s ability to pay a delinquent debt. Why not use BLS data for low income taxpayers who have a difficult time pulling records together?

### Use of Affidavits

The certification requirement in the EITC Qualifying Child Study included proof of qualifying child residency in the form of records, a letter on official letterhead, or a third-party affidavit. The study found that the traditional methods used to verify eligibility (*i.e.* records and statements) were not as reliable as affidavits, yet the IRS dismisses the opportunity to pursue this concept.<sup>63</sup>

The IRS reported that the use of affidavits to certify EITC eligibility offers some promise as a way to reduce taxpayer burden, but warned that its limited scale “proof of concept” testing did not replicate real world conditions. The National Taxpayer Advocate disputes this notion. Findings from the EITC Qualifying Child Residency Certification Study were based on extensive data collection from EITC claimants.<sup>64</sup> A

<sup>62</sup> National Taxpayer Advocate, *Findings From Correspondence Examination Focus Groups, IRS Tax Forums* (Jan. 2006).

<sup>63</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

<sup>64</sup> *Id.* at i.

private consulting firm, along with the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA), favorably reviewed the IRS study design.<sup>65</sup>

The study results suggest alternative documentation is effective in resolving audit issues and meets the IRS's goals of maximizing EITC participation while minimizing erroneous claims.<sup>66</sup> The IRS statement that taxpayers and tax preparers in the study were unfamiliar with the form or its use is true; however every tax law change has the propensity to require the use of a new form. Taxpayers accept these changes as a matter of course and adapt to the change. Complacency stifles progress; the challenge to IRS is to integrate the new form or method of doing business into its process when it clearly promotes voluntary compliance.

### Service to Taxpayers

Despite our differing perspectives on the correspondence examination process, the National Taxpayer Advocate is pleased with the IRS's steps to improve communication with taxpayers. Universal Call Routing is revolutionizing the correspondence examination process by enabling telephone assistors to service taxpayers regardless of geographic location or case assignment. The increased level of service is a significant move in the right direction. However, the IRS's ability to sustain or enhance growth depends on staffing. Telephone assistors who serve a dual role as correspondence examiners may be assigned cases that reduce telephone communication with taxpayers as well as the overall level of service. The IRS must balance service and enforcement priorities to maximize compliance, minimize taxpayer burden, and protect taxpayer rights.

### RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- ◆ List a telephone number on all correspondence examination letters for the taxpayer to call if he or she needs the letter reissued in Spanish.
- ◆ For visually impaired and blind taxpayers, make correspondence examination letters available in a format that is readable and understandable (e.g., in Braille). Place a hold on the taxpayer's account while waiting for the accommodating notice. Create a process to allow the taxpayer to request that all further correspondence between the taxpayer and the IRS be communicated in the requested accommodating format.
- ◆ Extend the response time to 45 days in the initial stage of correspondence. Conduct research to determine if using a 30 or 45 day letter or two separate letters

<sup>65</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* i (Oct. 2005).

<sup>66</sup> *Id.* at 2.

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(one at 30 days and a follow-up letter 15 days later) makes a difference in taxpayer response times.

- ◆ Provide specific examples of documentation needed to resolve the issue
- ◆ Develop fill-in forms like the EITC certification form to the greatest extent possible.
- ◆ Acknowledge receipt of correspondence from taxpayers, regardless of whether the information is sufficient to resolve the issue(s).
- ◆ Attempt to reach taxpayers by telephone in all no response cases. Conduct additional address research, including internet and external databases, not just the U.S. Postal Service.
- ◆ Evaluate the correspondence examination process to determine why taxpayers have difficulty understanding what documentation is needed.
- ◆ Eliminate the use of “Combo Letters” in all but the simplest tax cases (*i.e.*, cases with issues that can readily be resolved in one taxpayer contact by a single source document or brief explanation).
- ◆ Develop and implement performance measures to;
  1. reduce the volume of unassociated mail;
  2. reduce the premature closure of audits; and
  3. consider the time it takes to resolve an audit reconsideration in the cycle time computation.
- ◆ Establish a better system of correspondence control so responses can be timely associated with case files.
- ◆ Make sure taxpayers know that the time is running for petitioning the U.S. Tax Court even if additional information is submitted for consideration.
- ◆ Train examiners in the appropriate use of oral testimony.
- ◆ Include information on the Low Income Taxpayer Clinic program in the initial correspondence letter.

**PROBLEM****TOPIC #17****IRS IMPLEMENTATION OF MATH ERROR AUTHORITY IMPAIRS TAXPAYER RIGHTS****RESPONSIBLE OFFICIAL**

Richard J. Morgante, Commissioner, Wage and Investment Division

**DEFINITION OF PROBLEM**

Taxpayers who are summarily assessed additional tax via a “math error” notice may not be afforded the same rights as those who are assessed additional tax through normal IRS deficiency procedures. Math error authority allows the IRS to summarily assess tax *before* a taxpayer has the opportunity to challenge the assessment in the U.S. Tax Court.

Because math error assessments are not subject to judicial review before the tax is paid or collected, the Internal Revenue Code only allows the IRS to use these assessments in specific, narrow circumstances. The IRS has, however, issued math error notices in cases that go beyond these specific narrow circumstances, thus exceeding its limited statutory authority. Even in instances where the IRS has the authority to issue math error assessments, the corresponding math error notices do not adequately explain the error that gave rise to the math error assessment, or the actions required to contest the assessment. When the IRS summarily assesses taxes without authority and issues confusing math error summary assessment notices, taxpayers’ rights are impaired.

**ANALYSIS OF PROBLEM****What is a math error assessment?**

Internal Revenue Code § 6213(b) authorizes the IRS to assess an addition to tax, without issuing a notice of deficiency, where the adjustment is the result of a mathematical or clerical error on the tax return as defined in IRC § 6213(g). This summary assessment authority allows the IRS to assess and collect the additional tax and provides the taxpayer no initial opportunity for review in the Tax Court. A taxpayer receiving a math error assessment may only go to Tax Court if he or she contests the assessment within 60 days *after* the assessment has been made.<sup>1</sup> The IRS issued more than 2.5 million math error notices resulting in deficiencies in calendar year 2005.<sup>2</sup>

The IRS is authorized to make math error assessments *only* in the following circumstances:

- ◆ An error in addition, subtraction, multiplication, or division shown on any return (IRC § 6213(g)(2)(A));

<sup>1</sup> IRC § 6213(b)(2).

<sup>2</sup> The IRS issued 975,581 math error balance due notices to individuals and 1,557,608 math error balance due notices to businesses during 2005. Individual balance due math error notices are defined as notices CP11, CP11A, and CP711. Business balance due math error notices are defined as notices CP101, CP102, CP103, CP104, CP105, CP107, CP132, CP801, and CP802. IRS Office of the Notice Gatekeeper, *Calendar Year 2005 Total Volumes*.

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- ◆ An incorrect use of any table provided by the IRS with respect to any return if other information in the return makes the incorrect use apparent (IRC § 6213(g)(2)(B));
- ◆ An entry on a return of an item which is inconsistent with another entry of the same or different item on that return (IRC § 6213(g)(2)(C));
- ◆ An omission of information which is required to be supplied on the return to substantiate an entry on that return (IRC § 6213(g)(2)(D));
- ◆ An entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on the return (IRC § 6213(g)(2)(E));
- ◆ A correct Taxpayer Identification Number (TIN) not provided on the return as required for:
  - ◆ the Earned Income Tax Credit (EITC)<sup>3</sup> (IRC § 6213(g)(2)(F)),
  - ◆ the child and dependent care credit<sup>4</sup> (IRC § 6213(g)(2)(H)),
  - ◆ the personal or dependent exemption<sup>5</sup> (IRC § 6213(g)(2)(H)),
  - ◆ the child tax credit<sup>6</sup> (IRC § 6213(g)(2)(I)), and
  - ◆ the Hope and Lifetime Learning credits<sup>7</sup> (IRC § 6213(g)(2)(J));
- ◆ A return claiming an EITC for net earnings from self-employment, where the self-employment tax imposed by IRC § 1401 on those net earnings has not been paid (IRC § 6213(g)(2)(G));
- ◆ An omission of information required for recertification of eligibility for the Earned Income Tax Credit (IRC § 6213(g)(2)(K));
- ◆ An entry on the return of a TIN required for the EITC, the child credit, and the child and dependent care credit, when information associated with that TIN indicates the child does not meet the age eligibility requirements for those credits (IRC § 6213(g)(2)(L)); and
- ◆ An entry on the return of a claim for the EITC where the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of that child (IRC § 6213(g)(2)(M)).

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<sup>3</sup> IRC § 32.

<sup>4</sup> IRC § 21.

<sup>5</sup> IRC § 151.

<sup>6</sup> IRC § 24(e).

<sup>7</sup> IRC § 25A (g)(1).



These specific circumstances encompass the entire universe of IRS math error assessment authority. The IRS is authorized to summarily assess taxes in these circumstances, and these circumstances only.<sup>8</sup>

### How are math error assessments different from general IRS assessments?

#### *General Deficiency Procedures*

Under general IRS deficiency procedures, when the IRS examines a tax return and identifies an error that results in an understatement of tax, the IRS notifies the taxpayer of the proposed deficiency.<sup>9</sup> When the taxpayer does not agree with the assessment, the IRS sends the taxpayer a report that describes the return items to be adjusted, the tax (if any) reported on the original return, and the correct tax according to the IRS.<sup>10</sup> The taxpayer has 30 days to accept the proposed adjustments or request an appeal with the IRS Office of Appeals.<sup>11</sup>

If the taxpayer does not respond to the initial notice or does not prevail in the Appeals conference, the IRS will issue the taxpayer a statutory notice of deficiency (SNOD).<sup>12</sup> The SNOD sets forth the proposed deficiency and informs the taxpayer that he or she has 90 days (from the date of the notice) to file a petition in the Tax Court to challenge the proposed deficiency.<sup>13</sup> During this 90-day period, and until the Tax Court's decision is final, the IRS generally may not proceed with assessment and collection procedures against the taxpayer with respect to the subject tax.<sup>14</sup> If the taxpayer does not timely file a petition with the Tax Court, the IRS will assess the proposed deficiency.<sup>15</sup>

In general, the Tax Court is the only judicial forum where a taxpayer can challenge a tax liability before paying the liability in full.<sup>16</sup> A statutory notice of deficiency, however, is required before a taxpayer can litigate a tax dispute in the Tax Court. For this reason,

<sup>8</sup> For additional discussion of the IRS's math and clerical error authority, see National Taxpayer Advocate 2002 Annual Report to Congress 25-31 and 185-197.

<sup>9</sup> A "deficiency" is the amount by which the tax exceeds "the excess of (1) the sum of (A) the amount shown as the tax by the taxpayer upon his return ... plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over (2) the amount of rebates ... made." IRC § 6211(a).

<sup>10</sup> IRM 4.10.8.11 (Aug. 11, 2006).

<sup>11</sup> IRM 4.10.8.11.9 (Aug. 11, 2006).

<sup>12</sup> IRC § 6212(a).

<sup>13</sup> IRC § 6213(a). If a SNOD is addressed to a taxpayer outside the United States, the taxpayer has 150 days to file a petition in Tax Court. *Id.*

<sup>14</sup> IRC § 6213(a).

<sup>15</sup> *Id.*

<sup>16</sup> IRC § 6512(a).

a statutory notice is often called the “ticket” to Tax Court, without which the taxpayer does not have the right to legally challenge a tax liability in that court.<sup>17</sup>

#### *Summary Assessment Procedures*

The IRS does not have to follow its standard deficiency procedures, however, when it makes a summary assessment of tax under math error authority. The IRS must only notify the taxpayer that the assessment has been made and provide an explanation of the error.<sup>18</sup> This “math error” notice is not considered a statutory notice of deficiency and thus does not allow a taxpayer to petition the Tax Court.<sup>19</sup>

Internal Revenue Code § 6213(b)(2) provides, however, that a taxpayer receiving a math error notice has 60 days from the date of the notice to request that the IRS abate the tax. The IRS cannot begin to collect the tax until the taxpayer has agreed to the tax or the 60-day period has ended. If the taxpayer requests that the tax be abated, the IRS must then use the general deficiency procedures under IRC § 6212 if it believes that the additional tax is in fact due.<sup>20</sup>

The taxpayer is not required to explain a request for the abatement of a summary assessment. Instead, the Code requires the IRS to “abate the assessment” “upon receipt of a request.”<sup>21</sup> Unless a taxpayer requests abatement of a math error assessment, however, he or she cannot challenge the assessment through IRS deficiency procedures or petition the Tax Court. Thus, the abatement request is the only procedure available to a taxpayer receiving a math error adjustment for protesting the tax liability without first paying the tax in full.<sup>22</sup>

#### **How did the IRS get the authority to issue math error assessments?**

Congress first authorized the IRS to make math error assessments in the Revenue Act of 1926, which denied the taxpayer the right to appeal to the Board of Tax Appeals where a

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<sup>17</sup> Taxpayers who cannot challenge a tax liability in Tax Court may still have the opportunity to challenge the liability in the United States district court or the United States Court of Federal Claims. These courts have jurisdiction over suits for federal tax refunds. 28 U.S.C. § 1346(a)(1). Unlike in the Tax Court, in order to receive judicial review of a tax liability in one of the refund forums, a taxpayer must first pay the disputed income tax in full and then file a claim for refund with the IRS. See *Flora v. United States*, 362 U.S. 145 (1960) (United States District Court has no jurisdiction of a suit for refund of income tax payments that did not discharge the entire amount of assessment); I.R.C. § 7422(a). If the disputed tax is a divisible tax (such as employment or excise tax), the taxpayer need only pay the amount of tax attributable to a single transaction or event (for example, employment taxes for one employee for one quarter) in order to file suit in one of the courts with jurisdiction over federal tax refund suits. See *Flora v. United States*, 362 U.S. at 171, n. 37 and 175; *Fidelity Bank, N.A. v. United States*, 616 F.2d 1181 (10<sup>th</sup> Cir. 1980) (employment taxes); *United States v. Papandon*, 331 F.3d 52 (2d Cir. 2003) (excise taxes). In these suits, the government generally counterclaims for the balance of the amount of tax in dispute.

<sup>18</sup> IRC § 6213(b)(1).

<sup>19</sup> *Id.*

<sup>20</sup> IRC § 6213(b)(2)(A).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

deficiency was based on a mathematical error, and authorized the IRS to make an assessment and collect the tax due as a result of that error.<sup>23</sup>

In 1976, Congress expanded the IRS's summary assessment authority to include clerical as well as mathematical errors. The Tax Reform Act of 1976 defined for the first time "mathematical or clerical error," which encompassed the first five instances of mathematical or clerical error in the present law listed above.<sup>24</sup> From 1996 through 2001, Congress added the remaining five permissible uses of math error authority to the Code.<sup>25</sup>

When Congress first defined "mathematical or clerical error" in 1976 legislation, it was concerned that the IRS might use its summary assessment authority in ways that would undermine taxpayer rights. Before the 1976 Act was passed, the IRS had been interpreting the term "mathematical error" "to include several types of error which are broader in nature than literal errors of arithmetic." Court opinions, on the other hand, had generally "limited the scope of the term 'mathematical error' to arithmetic errors involving numbers which are themselves correct."<sup>26</sup>

<sup>23</sup> Revenue Act of 1926, enacting IRC § 274(f). See H. Rep. 69-1, 10-11. The Board of Tax Appeals was the predecessor to the United States Tax Court.

<sup>24</sup> A mathematical or clerical error was defined as: (1) an error in addition, subtraction, multiplication, or division shown on any return; (2) an incorrect use of any table provided by the IRS with respect to any return if other information in the return makes the incorrect use apparent; (3) an entry on a return of an item which is inconsistent with another entry of the same or different item on that return; (4) an omission of information which is required to be supplied on the return to substantiate an entry on that return; and (5) an entry on a return of a deduction or credit in an amount which exceeds the statutory limit for that deduction or credit, if that limit is expressed as a specific monetary amount or as a percentage, ratio, or fraction, and if the component items of that limit appear on the return. IRC § 6213(g)(2)(A-E).

<sup>25</sup> See The Small Business Job Protection Act of 1996, P.L. No. 104-188, section 1615(c) (authorizing the use of summary assessment procedures where a taxpayer fails to supply a taxpayer identification number (TIN) for a dependent); The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, P.L. No. 104-193, section 451(c) (authorizing the use of math error procedures where a required TIN was not supplied with respect to the EITC; and where a taxpayer, receiving the EITC on the basis of self-employment income, did not pay self-employment tax on that income); P.L. No. 105-34, sections 1085(a) and 101(d)(2) (authorizing math error assessments for omitted TINs for purposes of the Hope and Lifetime Learning Credits and the Child Tax Credit); The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. No. 107-16, section 303(g) (authorizing summary assessment procedures where data from the Federal Case Registry of Child Support Orders (FCR) indicates that a taxpayer is the noncustodial parent of a qualifying child). Although authorized to do so, the IRS does not currently use math error procedures to make summary assessments in the latter instance. For a detailed discussion of the legislative history of math error authority expansion from 1996-2001, see National Taxpayer Advocate, 2002 Annual Report to Congress, 185-197 (recommending that the definition of mathematical and clerical error be limited to: (1) inconsistent items in which the inconsistency is determined from the face of the return, (2) omitted items, including schedules, that are required to be included with the return, and (3) items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information; and recommending repeal of IRC § 6213(g)(2)(M), which authorizes math error summary assessments for an entry on a return with respect to a qualifying child for the EITC, where a taxpayer has been identified as the non-custodial parent of that child by the FCR.)

<sup>26</sup> H. Rep. 94-658, 289; S. Rep. 94-938, 374. "The [IRS] position is that mathematical error includes the following: errors in arithmetic (such as 2+2=5); errors in transferring amounts correctly calculated on a schedule, form, or another page of Form 1040 to either page 1 or 2 of Form 1040; missing schedules, inconsistent entries and computations (such as cases where total exemptions claimed do not agree with the total used in computing the tax); and errors where the entry exceeds a statutory numerical or percentage limitation (such as a standard deduction claimed in excess of the maximum allowed by the Code)."

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Because of this definitional discrepancy, the IRS requested that Congress statutorily expand math error authority on efficiency grounds. The IRS argued “that the deficiency notice procedure is significantly more costly than the mathematical error procedure” and that it (the IRS) “properly uses this procedure in categories of cases where most taxpayers do not dispute the [IRS’s] conclusions.”<sup>27</sup>

While mindful of these efficiency issues, Congress did not want to authorize the IRS to use summary assessment procedures where it “*may have* erred in its determination.”<sup>28</sup> Congress attempted to balance these considerations by both expanding the IRS’s math error assessment authority, but also “[providing] greater protection for taxpayers who wish to contest [IRS] summary assessments in mathematical error cases by restricting the [IRS’s] powers in such cases,” and “[clarifying] the kinds of cases in which the [IRS] could use its *restricted* summary assessment authority.”<sup>29</sup> IRC § 6213(b) incorporates these taxpayer protections by requiring the IRS to:

- ◆ Explain the asserted error to the taxpayer;
- ◆ Abate the assessment if the taxpayer requests such abatement within 60 days of the date of the notice; and
- ◆ Abstain from collecting on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to the assessment to expire.<sup>30</sup>

To help ensure that the IRS did not exceed its summary assessment authority in the name of administrative convenience, Congress took the unusual step of providing specific examples in the committee reports that illustrate the correct application of math error authority. For instance, where there are inconsistencies on a return, summary assessment procedures are allowed only in “those cases where it is apparent which of the inconsistent entries is correct and which is incorrect.”<sup>31</sup> The reports discussed two examples, one in which a math error assessment is permitted and the other where it is not.

- ◆ In the first example, a taxpayer listed six dependents on the face of the return and entered the number “6” as the total number of exemptions. However, on the second page of the return, the taxpayer entered a dollar amount for the personal and dependent exemptions that was equal to a multiple of “7.” The committees stated that the IRS may treat this as a math error and correct the exemption amount to the multiple of “6.” However, the committees further stated they expected the IRS “will so phrase its notification to the taxpayer as to include questions designed

<sup>27</sup> H. Rep. 94-658, 289; S. Rep. 94-938, 375.

<sup>28</sup> H. Rep. 94-658, 289; S. Rep. 94-938, 375 (emphasis added).

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

<sup>30</sup> *Id.* at 375.

<sup>31</sup> H. Rep. 94-658, 291; S. Rep. 94-938, 376.

to show whether the taxpayer is indeed entitled to the greater number of exemptions.”<sup>32</sup>

- ◆ In the second example, a taxpayer listed three names as dependents but entered “4” in the box for the total number of dependents. The committees stated that it is not clear from the face of the return whether the taxpayer inadvertently omitted a dependent’s name from the face of the return or simply added incorrectly. Here, the committees believed that “the summary assessment procedure is not to be used where it is not clear which of the inconsistent entries is the correct one.”<sup>33</sup>

The committee reports from the 1976 Act also direct the IRS to clearly explain math and clerical error summary assessments to affected taxpayers. The committee reports explain that the IRS is to send math and clerical error notices with detailed, itemized, line-by-line explanations of such errors. The reports also instruct the IRS to word its math and clerical error notices in such a way as to *encourage* taxpayers to respond with information to correct errors resulting in erroneous adjustments.<sup>34</sup>

The specific examples and instructions in the committee reports indicate that Congress was concerned that the IRS might (1) use its summary assessment procedures beyond their limited scope in an attempt to facilitate administrative convenience and (2) fail to adequately explain the errors resulting in summary assessments and how taxpayers could question or challenge such assessments.

### How does the IRS make summary assessments and issue math error notices?

The IRS mails a math error notice to a taxpayer when it identifies a mathematical or clerical error on a tax return. The notice describes why the IRS changed one or more lines on the return and instructs the taxpayer that no action is required if he or she agrees with the change, but to call or write the IRS within 60 days if the taxpayer disagrees with the change.<sup>35</sup> If the taxpayer disagrees with the change and contacts the IRS, the taxpayer’s “protest” of the change is classified as either substantiated or unsubstantiated.

#### *Substantiated Protests*

A substantiated protest occurs when the taxpayer provides supporting information (oral or written) to indicate that the math or clerical error is erroneous.<sup>36</sup> An unsubstantiated protest occurs when the taxpayer does not provide supporting information to show that the IRS erred in determining the math or clerical error.<sup>37</sup> When the taxpayer contacts the IRS with a substantiated protest, the IRS will reverse the error and adjust the

<sup>32</sup> H. Rep. 94-658, 291; S. Rep. 94-938, 377.

<sup>33</sup> *Id.*

<sup>34</sup> H. Rep. 94-658, 288-293; S. Rep. 94-938 374-378.

<sup>35</sup> See IRM 3.14.1-8–3.14.1-14 (Jul. 1, 2006).

<sup>36</sup> IRM 21.5.4.4.4 (Oct. 1, 2005).

<sup>37</sup> IRM 21.5.4.4.5 (Oct. 1, 2006).

taxpayer's account (including releasing any withheld refunds).<sup>38</sup> The IRS will reverse math errors in substantiated protest cases even if the taxpayer does not contact the IRS within 60 days.<sup>39</sup>

#### *Unsubstantiated Protests*

When a taxpayer contacts the IRS with an unsubstantiated protest, the IRS's actions depend on whether the contact takes place before or after the 60 day period has expired. If a taxpayer makes an unsubstantiated protest within 60 days of the date of the math error notice, the IRS customer service representative (CSR) is to:

- ◆ Explain the taxpayer's abatement rights and the consequences of abatement (*i.e.*, the case may be referred to Examination and any applicable refund may be held);
- ◆ Ask whether the taxpayer wishes to request an abatement; and
- ◆ If the taxpayer does request an abatement (and this request may be made orally), the CSR is to restore the original figures on the taxpayer's return (*i.e.*, abate the assessment), place a hold on the taxpayer's account (including a hold on any applicable refunds), and refer the case to Examination – which must make any assessment pursuant to general deficiency procedures.<sup>40</sup>

When a taxpayer contacts the IRS with an unsubstantiated protest after 60 days from the date of the math error notice, the taxpayer cannot challenge the summary assessment through normal deficiency procedures and has lost the opportunity to challenge the assessment in Tax Court.<sup>41</sup> If the taxpayer still wishes to challenge the liability, he or she must pay any tax due and file a claim for refund.<sup>42</sup> Once the taxpayer pays the tax (or if the IRS has already collected the tax by reducing the taxpayer's refund), the taxpayer can challenge a denied refund claim through IRS Appeals.<sup>43</sup> Refund claims not settled in Appeals can be litigated in the United States district courts or the United States Court of Federal Claims.<sup>44</sup>

Table 1.17.1 summarizes the IRS's math error notice processing procedures.

<sup>38</sup> IRM 21.5.4.4.3 (Oct. 1, 2006).

<sup>39</sup> *Id.*

<sup>40</sup> IRM 21.5.4.4.5 (Oct. 1, 2006).

<sup>41</sup> IRC § 6213(b); IRM 21.5.4.4.3 (Oct. 1, 2006).

<sup>42</sup> 28 U.S.C. § 1346(a)(1); IRC § 7422(a); IRM 21.5.4.4.3 (Oct. 1, 2006). The IRS may, at its own discretion, consider a taxpayer's claim without requiring the taxpayer to pay the tax in full, but the IRS is not required to do this.

<sup>43</sup> IRM 21.5.4.4.3 (Oct. 1, 2006); IRM 21.5.3.4 (Oct. 1, 2006).

<sup>44</sup> 28 U.S.C. § 1346(a)(1).

**TABLE 1.17.1, MATH ERROR NOTICE PROCESSING**

Taxpayer Contacts the IRS within 60 Days			
If	and	and	Then
Taxpayer agrees with change			No action required
Taxpayer disagrees with change	Provides substantiation		Math error is reversed
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	A tax balance is due	The assessment is abated, the account is referred to Exam, and deficiency procedures are instituted
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	The taxpayer's refund has been reduced ( <i>i.e.</i> , the IRS has already collected the tax)	The assessment is abated, the refund is held, and the account is referred to Exam

Taxpayer Contacts the IRS After 60 Days			
If	and	and	Then
Taxpayer agrees with change			No action required
Taxpayer disagrees with change	Provides substantiation		Math error is reversed
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	A tax balance is due	Taxpayer must pay the tax liability and file a claim for refund
Taxpayer disagrees with change	Does not provide substantiation (or provides insufficient or inadequate substantiation)	The taxpayer's refund has been reduced ( <i>i.e.</i> , the IRS has already collected the tax)	Taxpayer's "claim" for amount of reduced refund is denied. Taxpayer must challenge the denied claim through IRS Appeals

**Math Error Notice Volume**

From 2003 to 2005, the IRS issued, on average, more than 7.2 million math error notices to individual and business taxpayers each calendar year.<sup>45</sup> An average of 2.8 million notices per year resulted in taxpayers being assessed a balance due.<sup>46</sup> Thus, millions of taxpayers annually are unable to challenge IRS assessments through normal deficiency procedures and in Tax Court unless they proactively request, within 60 days, that the tax summarily assessed on a math error notice be abated.

<sup>45</sup> This figure includes math error notices that resulted in a changed refund, even balance, or a balance due. Individual filer notices are defined as CP10, CP10A, CP11, CP11A, CP12, CP12A, CP12E, CP13, CP13A, CP16, CP711, CP712, and CP713. Business filer notices are defined as CP101, CP102, CP103, CP104, CP105, CP106, CP107, CP111, CP112, CP113, CP114, CP115, CP116, CP117, CP123, CP124, CP125, CP126, CP127, CP131, CP132, CP133, CP268, CP801, CP802, CP811, and CP812.

<sup>46</sup> The IRS sends notices where the adjustment is over a *de minimus* amount. IRS Office of the Notice Gatekeeper, *Annual Master File Notice Volume by CP# and Center report*. Individual filer balance due math error notices are defined as CP11, CP11A, and CP711. Business filer balance due math error notices are defined as CP101, CP102, CP103, CP104, CP105, CP107, CP132, CP801, and CP802.

**TABLE 1.17.2, NUMBER OF BALANCE DUE MATH ERROR NOTICES BY CALENDAR YEAR**<sup>47</sup>

Calendar Year	Individual Filers Receiving Notice	Business Filers Receiving Notice	Total Balance Due Notices
2003	1,249,907	1,612,091	2,861,998
2004	1,339,884	1,568,714	2,908,598
2005	975,581	1,557,608	2,533,189

The inability to challenge an IRS assessment through normal deficiency procedures and in the Tax Court can be a problem for any taxpayer who faces a deficiency because of a math error assessment. This problem is particularly challenging for low income taxpayers, however, because these taxpayers are generally not in a position to pay their taxes in full, as required to challenge an assessment under IRS refund and litigation procedures and in Tax Court. Table 1.17.3 below shows taxpayers earning less than \$40,000 annually receive 49 percent of individual math error notices (based on tax year 2004 data).

**TABLE 1.17.3, DISTRIBUTION OF INDIVIDUAL TAXPAYERS RECEIVING A BALANCE DUE MATH ERROR NOTICE BY ADJUSTED GROSS INCOME, TY2004**<sup>48</sup>

Adjusted Gross Income	Notices	Percentage
Under \$20,000	240,370	24.8%
\$20,000 - \$39,999	235,533	24.3%
\$40,000 and over	492,270	50.9%
<b>Total Balance Due Math Error Notices</b>	<b>968,173</b>	<b>100.0%</b>

**Has the IRS used its summary assessment authority inappropriately?**

The Code authorizes the IRS to use summary math error assessment authority in lieu of normal deficiency procedures in the thirteen instances enumerated in section 6312(g), and in those instances only. Generally, the IRS uses its summary assessment authority properly, but the Taxpayer Advocate Service (TAS) is aware of instances where the IRS has exceeded its limited statutory authority.

<sup>47</sup> IRS Office of the Notice Gatekeeper, *Annual Master File Notice Volume by CP# and Center report*. Changes in the tax law can cause a change in the number of math errors. For example, the Jobs Growth Relief Act of 2003 increased the child tax credit from \$600 to \$1,000 per child and instructed the IRS to advance payment of the increased portion. Pub. L. No. 108-27 § 101. The IRS mailed a check for \$400 per eligible child to taxpayers where prior year data allowed the IRS to reasonably predict eligibility. Taxpayers who received the check were to subtract \$400 per child from the amount of credit claimed on the return, and taxpayers who did not receive a check could claim the full \$1,000 per child. IRS Instructions for Form 1040, 2003 Tax Year. The IRS created a new error code related to the advance child credit (Taxpayer notice code 547, IRM 3.12.3 (Jan. 1, 2004), and this new error accounted for 2.6 million math errors (both reduced refund and balance due) for the 2003 tax year. *Individual Master File data*, Tax Year 2003. Taxpayers would have received these notices in calendar 2004.

<sup>48</sup> IRS, *Individual Master File, Tax Year 2004*. Errors on tax year 2004 returns will, in most cases, result in a math error notice issued in calendar year 2005.



### *Disallowed Business Expenses*

In July 2006, TAS challenged the IRS's use of math error authority to deny expense deductions to non-resident alien students.<sup>49</sup> IRC § 871(c) allows foreign students meeting certain criteria to claim certain expenses as business deductions from scholarship income. However, the IRS summarily denied these deductions to hundreds<sup>50</sup> of eligible taxpayers using math error procedures.<sup>51</sup> Determining the legitimacy of a business expense deduction is not one of the circumstances enumerated in IRC § 6213(g) for which a math error assessment is allowed. Thus, the IRS exceeded its statutory authority by summarily assessing additional tax for these denied § 871(c) deductions.

Three hundred eighty six impacted taxpayers sought TAS assistance. After TAS intervened, the IRS reversed the assessments and agreed to stop using math error authority for assessments attributable to denied IRC § 871(c) deductions and to revise the Internal Revenue Manual to reflect this change. It is unknown, however, how many taxpayers received math error assessments for denied IRC § 871(c) deductions but did not come to TAS for help. And even those who received TAS assistance waited up to 19 months to receive their full refunds.<sup>52</sup>

### *Other TAS Examples*

TAS is also aware of other examples where IRS mistakes in the math error process harmed taxpayers. The IRS used its math or clerical error authority to summarily assess taxes in the following cases:

- ◆ A family experienced an immediate financial hardship when the IRS disallowed the EITC because the IRS had incorrectly entered all the taxpayer's income as interest instead of wages.<sup>53</sup>
- ◆ An 82-year old retiree sought TAS assistance when his refund was delayed for three months because his pension income was entered by the IRS as wages.<sup>54</sup>
- ◆ The IRS processed the Form 1040 of a U.S. citizen living abroad as a Form 1040NR (non-resident). The taxpayer received a letter requesting information about his citizenship as well as a math error notice denying an exemption for

<sup>49</sup> Systemic Advocacy Management System project (2006). The cases involved tax year 2004.

<sup>50</sup> IRS systems do not allow us to identify taxpayers who may have received a math error notice due to this specific tax issue. However, there were 1,338 Form 1040NR (Non-resident) tax year 2004 returns filed that had a Schedule A attached and a math error. Subtracting the 386 known cases, there could be as many as 952 other taxpayers who were denied their refund. IRS, *Individual Master File Tax Year 2004*.

<sup>51</sup> Other related code sections are 8 USCS § 1101(a)(15)(F),(J),(M),(Q) which provides that international students are treated as nonimmigrant aliens, and IRC § 1441(b) which provides for the treatment of a scholarship as income. The employee business expenses being questioned were claimed on IRS Form 2106, *Employee Business Expense* (2005).

<sup>52</sup> The refunds were released in October and November 2006.

<sup>53</sup> Taxpayer Advocate Management Information System (TAMIS) (2006).

<sup>54</sup> *Id.*

a deceased dependent (this was incorrect). With TAS assistance, the taxpayer received his refund plus an interest payment of \$138.00.<sup>55</sup>

- ◆ The IRS summarily assessed a business taxpayer additional tax despite the taxpayer's explanation (which was included with the return) as to why tax was not owed. The taxpayer then contacted the IRS within 60 days of the math error notice to protest the assessment, but the IRS did not abate the tax. The IRS did send the case to the Examination function for review, but did not issue a statutory notice of deficiency to the taxpayer. Instead, the IRS told the taxpayer to pay the disputed tax and file a claim for refund. The IRS actions in this case are in direct violation of IRC § 6213(b).<sup>56</sup>

These cases are only a few examples of math error assessment problems the Taxpayer Advocate Service dealt with in fiscal year 2006.

### Clarity of IRS math error notices

When the IRS identifies a computational or clerical error on a tax return, it must notify the taxpayer of the error.<sup>57</sup> Because taxpayers must proactively challenge a math error assessment within 60 days to use general IRS deficiency procedures and to challenge the assessment in the Tax Court, math error notices must clearly explain the nature of the assessment, how a taxpayer can challenge the assessment, and the time period for making a challenge.

In recent years, the IRS has made its math error notices more clear by listing applicable math errors by tax return line item,<sup>58</sup> and specifically explaining what a taxpayer must

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<sup>55</sup> Taxpayer Advocate Management Information System (TAMIS) (2005).

<sup>56</sup> Taxpayer Advocate Management information System (TAMIS) (2006). TAS was actively working this case at the time this report was published.

<sup>57</sup> IRC § 6213(b).

<sup>58</sup> Beginning in 2005, the IRS implemented a past National Taxpayer Advocate recommendation that math error explanations include a line number reference. See National Taxpayer Advocate 2002 Annual Report to Congress 30. Examples:

- ◆ We lowered the total income on Line 22 of your Form 1040 because income was included that is not taxable. Welfare payments, Workmen's Compensation, etc., are not taxable income. (Taxpayer Notice code 113).
- ◆ We changed the amount of capital gain or loss on Line 14 of your Form 1040. There was an error in the transfer of the amount from Line 18b(2) of your Form 4797, Sales of Business Property, to Line 14 of your Form 1040. (Taxpayer Notice code 123). *Wage and Investment Division Response*, June 2006.

do to challenge the summary assessment.<sup>59</sup> However, further improvements are needed to ensure that notices meet congressional standards.

#### *Congressional Intent Regarding Math Error Notice Clarity*

The committee reports to the Tax Reform Act of 1976 indicate Congress expected the IRS to clearly explain the nature of math error assessments to taxpayers.<sup>60</sup> In fact, the reports explain that Congress expected the IRS to send summary assessment notices that show detailed, itemized, line-by-line explanations of math or clerical errors, and that encourage taxpayers to contact the IRS with questions about the notice and with the information necessary to correct applicable errors.<sup>61</sup> The committee reports provided an example of a single taxpayer who identified himself as “married filing separately,” but used the tax table for single taxpayers to compute the tax shown on his return. The committees noted that a summary assessment would be appropriate to correct this error (incorrect use of a table), but the committees also emphasized the importance of clearly explaining the assessment to the taxpayer and wording the notice to encourage the taxpayer to contact the IRS with the correct information:

It is expected that the notification to the taxpayer will indicate that the taxpayer used the single person’s rate schedule, that the taxpayer checked line 3 on the Form 1040, that such a taxpayer should have used the married persons filing separately schedule, and the notification should show the amount of the difference in tax (indicating the amount from the married persons filing separately schedule minus the amount from the single persons schedule).

The notice to the taxpayer is also to inquire whether the taxpayer is in fact married and is to inquire as to such other information which might enable the taxpayer to determine whether he or she might be eligible for a more favorable tax status even though married.<sup>62</sup>

An actual taxpayer in this situation today would receive a math error notice from the IRS with the following explanation:

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<sup>59</sup> The IRS added revised appeal rights language to the major math error notices in January 2006. The revised language states:

Should you contact us about your account and we cannot reach an agreement about the change we made to your account, you have the right to ask us to reverse the change. In response to your request, we will forward your case to our examination function for an additional review. This action will give you formal appeal rights, including the right to appeal our decision in court.

Our examination function will contact you once they’ve received your request – usually within five to six weeks. At that time, you will receive a complete explanation of our examination process and of your rights.

**Remember** – You need to contact us within 60 days from the date of this letter to request an examination of your return and to retain your right to appeal our decision. We will consider any information you send us, regardless of the 60-day period, but you can only request an examination and keep your right to appeal our decision within that period.

<sup>60</sup> H. Rep. 94-658, at 290-291 and S. Rep. 94-938, at 376-377.

<sup>61</sup> H. Rep. 94-658, 288-293; S. Rep. 94-938, 374-378.

<sup>62</sup> H. Rep. 94-658, at 290-291 and S. Rep. 94-938, at 376-377.

We changed your filing status. We refigured your tax using the married filing separately filing status based on the information on your tax return.<sup>63</sup>

The current IRS explanation does not meet the standard set forth in the committee reports. It does not indicate the tax rate schedule the taxpayer used or the filing status checked, nor does it inquire about the taxpayer's marital status or provide information that allows the taxpayer to determine if the IRS computed his or her tax based on the most favorable rate schedule.

We reviewed the language used for 231 math errors,<sup>64</sup> and found only nine instances where the language provided additional guidance that may help the taxpayer achieve a more beneficial tax situation.<sup>65</sup> These nine types of math errors together accounted for less than one percent of all math errors on tax year 2004 individual returns.<sup>66</sup> In other words, 99 percent of the notices going to individual taxpayers still do not contain the type of information that the Congress anticipated when it initially defined "math or clerical error."

#### *Abatement Request Procedures*

IRS math error assessment notices could also better explain what a taxpayer must do to challenge a summary assessment, when this challenge must be made, and the consequences of failing to challenge the assessment in a timely manner. Current math error notices explain:

You need to contact us within 60 days from the date of this letter to request an examination of your return and to retain your right to appeal our decision. We will consider any information you send us, regardless of the 60-day period, but you can only request an examination and keep your right to appeal our decision within that period.

IRC § 6213(b) provides that taxpayers who fail to request the abatement of a summary assessment within 60 days of the date of the math error notice will not receive a statutory notice of deficiency and will thus lose the opportunity to contest the assessment in Tax Court – and effectively lose the opportunity to challenge the tax liability without first paying the tax. Because both the proactive abatement request and deadline by which this request must be made are critical, the IRS could be more specific about these

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<sup>63</sup> IRM 3.12.3-2 (Jan. 1, 2006).

<sup>64</sup> Taxpayer notice codes in the ranges 101–299, 502–696, 604–748. IRM 3.12.3-2 (Jan. 1, 2006).

<sup>65</sup> The nine instances were taxpayer notice codes 109, 120, 129, 132, 133, 166, 167, 193, and 257. IRM 3.12.3-2 Taxpayer Notice Codes (Jan. 1, 2006). The explanation for notice code 109 says:

We changed your filing status. We refigured your tax using the married filing separately filing status because you can't claim your spouse as an exemption when using single or head of household filing status. Note: You may file Form 1040X, Amended U.S. Individual Income Tax Return, claiming the married filing jointly filing status for a more favorable tax rate. Both you and your spouse must sign Form 1040X.

<sup>66</sup> The occurrences of taxpayer notice codes 109, 120, 129, 132, 133, 166, 167, 193, and 257 totaled 3,289 in TY2004. Total math errors equaled 4.1 million. *Individual Master File, Tax Year 2004*.

items on math error notices. One model of specificity is the IRS's own statutory notice of deficiency. When the IRS issues a SNOD, the header includes the text:

“Last Day to File a Petition With the United States Tax Court: [date]”<sup>67</sup>

Summary assessment notices should be at least as clear as SNODs, because the taxpayer will lose the ability to challenge the summary assessment in Tax Court without proactively requesting an abatement. Including a specific “last day to contact the IRS” date would also help taxpayers avoid any confusion about when the 60-day period begins to run, or if it includes weekends and holidays.

### *Reconciliation Table*

Math error notices contain a reconciliation table that is intended to show the effect of the math error on the taxpayer's tax liability. This table, however, shows only the “bottom line” impact of the error and does little to help the taxpayer understand the changes the IRS has made.

For example, assume a taxpayer made two mistakes on his Form 1040: (1) a computational error summing up two Forms W-2, Employee's Wage And Tax Statement,<sup>68</sup> to arrive at total wages, and (2) an error copying total itemized deductions from the Schedule A to the tax return. The taxpayer would receive a math error notice that contains the following language and table describing these errors:

We changed the total income on Line 22 to include all the forms W-2, W-2g, etc., that were attached to your tax return because there was an error in the total income reported.

We changed the amount claimed as total itemized deductions on Line 40 of your Form 1040 because there was an error on Schedule A, Itemized Deductions. The error was in the:

- ◆ Computation of total itemized deductions on Line 28 of Schedule A and/or
- ◆ Transfer of that amount to Line 40 of your Form 1040.<sup>69</sup>

<sup>67</sup> IRS Letter 531 Notice of Deficiency, (Rev. 4-2006).

<sup>68</sup> Form W-2 is issued by an employer and contains the wages earned and tax withheld during a calendar year.

<sup>69</sup> Taxpayer Notice Codes 114 and 187, Wage & Investment Division Response (Jun. 2006).

**TABLE 1.17.3, RECONCILIATION TABLE FROM BALANCE DUE MATH ERROR NOTICE<sup>70</sup>**

**2005 Tax Return Form 1040 as of [date]**

<b>Line Item On Your Return</b>	<b>Your Figures</b>	<b>IRS Figures</b>
Adjusted Gross Income	\$54,333.00	\$55,333.00
Taxable Income	\$34,215.00	\$35,935.00
Total Tax	\$5,221.00	\$5,646.00
Total Payments		\$5,300.00-
Amount of Underpaid Tax		\$5,346.00
Penalties (computed below, if applicable)		\$ .00
Interest computed through [date] (computed below)		\$ .00
Total amount owed		\$346.00
Minus: Total of all payment you made that are not included in the Total Payments amount shown above	(Enter amount)	
Amount You Owe after subtracting above payments	(Enter amount)	

This table presents a summary of the IRS changes only. It does not show the specific line item that the IRS adjusted, as Congress directed in 1976.

The IRS could improve taxpayers’ understanding of the changes made to the tax return by enhancing the table. The following table is an example of what this might look like. This three-column format is similar to what the IRS requires taxpayers to provide when they file an amended tax return.<sup>71</sup>

<sup>70</sup> CP11 – Math Error with a Balance Due of \$5 or More, IRM 3.14.1-9 Exhibit, (Jul. 1, 2006). The table contains hypothetical figures.

<sup>71</sup> Form 1040X, *Amended U.S. Individual Income Tax Return* (Rev. November 2005). Taxpayers are required to provide any schedule or form relating to the change, for example, a Schedule A if the taxpayer was amending the tax return to itemize deductions. In addition, the taxpayer completes the Form 1040X and must provide three columns of data for the original amount, the net change, and the correct amount. *Instructions for Form 1040X, Amended U.S. Individual Income Tax Return* (Rev. November 2005).

**TABLE 1.17.4, PROPOSED RECONCILIATION TABLE FOR A BALANCE DUE MATH ERROR NOTICE**

Line Item On Your Return	Your Figures	Net Change	IRS Figures
<i>Wages, salaries, tips, etc. (Line 7)</i>	\$54,111.00	\$1,000.00	\$55,111.00
Adjusted Gross Income (Line 37)	\$54,333.00	\$1,000.00	\$55,333.00
<i>Itemized Deductions (Line 40)</i>	\$16,918.00	-\$720.00	\$16,198.00
Taxable Income (Line 43)	\$34,215.00	\$1,720.00	\$35,935.00
Total Tax (Line 63)	\$5,221.00	\$425.00	\$5,646.00
Total Payments (Line 71)	\$5,300.00	0.00	\$5,300.00
Amount of Underpaid Tax	(\$79.00)	\$425.00	\$346.00
Penalties (computed below, if applicable)			\$ .00
Interest computed through [date] (computed below)			\$ .00
Total amount owed			\$346.00
Minus: Total of all payment you made that are not included in the Total Payments amount shown above		(Enter amount)	
Amount You Owe after subtracting above payments		(Enter amount)	

This table contains several improvements to the IRS form currently in use:

- ◆ The table shows the tax form lines changed by the IRS and provides the taxpayer with “before and after” figures. Including these lines is especially important when there is more than one error or a single error has a ripple effect on other figures.<sup>72</sup>
- ◆ Line number references have been added to assist the taxpayer when he or she refers back to a copy of the tax return.
- ◆ A third column has been added showing the net difference in the relevant line items as a result of the IRS’s changes. In this example, the table shows that the increase in taxable income is due to a \$1,000 increase in wages and a \$720 reduction in itemized deductions.

**CONCLUSION**

The IRS faces an enormous challenge each year in processing tens of millions of returns and ensuring that they are complete and accurate. To accommodate that challenge, Congress has authorized the IRS to use summary assessment authority in specified cases of math and clerical errors. This authority allows the tax system to work efficiently when the IRS uses the authority as permitted and adequately explains summary assessments to taxpayers and informs them how to question or challenge a summary assessment. However, when the IRS misuses this authority or does not clearly explain these assessments, the tax system becomes less efficient because taxpayer rights are compromised and the IRS must use resources to handle increased taxpayer questions and problems.

<sup>72</sup> In the hypothetical example presented, the taxpayer made a computation error when he summed the wages from two Forms W-2. Depending on the income level of the taxpayer, such an error could impact his ability to claim the EITC or to itemize deductions.

**IRS COMMENTS**

We do not agree that the IRS math error authority impairs taxpayer rights. The IRS makes every effort to exercise the math error authority granted by the Internal Revenue Code (Code) in strict compliance with the provisions of the law. The National Taxpayer Advocate's report correctly indicates that the IRS made an error in applying this authority to deny certain expense deductions of non-resident alien students. When the Taxpayer Advocate Service (TAS) brought this to our attention, we immediately changed our procedures. The report does not provide sufficient detail to allow us to respond to the other four examples that are included to suggest IRS uses its math error authority beyond what is permitted by the law. However, each of these examples appears to involve an employee mistake as opposed to a systemic or procedural error in the application of the law. We also acknowledge the need to improve math error notices. Three years ago, a multi-functional team that includes the TAS was established to do just that. The team's efforts have already resulted in several enhancements that improve the clarity of these notices and additional improvements are planned.

Each year, the IRS processes millions of individual income tax returns. Errors and omissions on these returns as well as clerical processing errors are an inherent element of returns processing. It is in this vein that Congress granted the IRS authority in § 6213(b) of the Code to assess an addition to tax without issuing a notice of deficiency. This authority is limited to mathematical and clerical errors defined in § 6213(g).

When a math error assessment is made, the taxpayer is notified by mail. This notification advises the taxpayer that an error was identified on his or her income tax return, the action taken by the IRS, and provides the actions that need to be taken if the taxpayer agrees or disagrees within a 60-day time period. This notice also advises the taxpayer he or she must contact the IRS within the 60-day period to protect his or her right to petition the Tax Court. During this protected 60-day period, the taxpayer's account is frozen by the IRS to prevent collection actions.

If the taxpayer agrees with the math error change, generally no further action is necessary unless the change results in a balance due. If the taxpayer disagrees and notifies the IRS within the sixty day period, he or she may either contact the IRS by phone or in writing and provide the substantiation necessary to reverse the assessment in whole or in part or he or she may request an abatement of the assessment without providing any substantiation. The IRS must honor this abatement request. In accordance with the law, these unsubstantiated requests are referred to the Examination function for issuance of a statutory notice of deficiency.

It is important to note the math error procedures authorized by the Code serve as an alternative to deficiency procedures in the limited mathematical or clerical error circumstances provided for in the law. Math error authority is not a method for the IRS to accelerate or initiate collection actions and it does not eliminate any taxpayer rights provided for by the Code.



We agree that the IRS incorrectly used math error procedures to deny certain expense deductions to non-resident alien students. The unallowable item hold process should have been used by IRS to work these questionable expense deductions. This issue affected a limited number of taxpayers and IRS immediately ceased use of math error authority in these cases in July 2006, when the issue was raised by TAS.

The National Taxpayer Advocate cites four other examples that suggest improper use of math error authority by the IRS. We have not been afforded an opportunity to review the specific facts in each of these examples. However, these four cases do not appear to involve systemic application of math error authority beyond what is permitted in the Code. Rather, they seem to involve mistakes by the employees working each case. Regardless, the IRS would welcome more detailed information that will allow us to research and respond to the specific circumstances involved in these four examples. More importantly, with additional information, we will be able to determine if they indicate systemic problems or a need for procedural changes.

We agree that math error notices can be improved. The Tax Reform Act of 1976 requires the IRS to clearly explain math errors identified during original processing and the recourse available to taxpayers to challenge these assessments. Over the last three years, the IRS has made great strides in improving the clarity of all math error notices. The IRS formed the Notice Improvement Initiative Team (NPIIT) comprised of cross-functional representatives from Submission Processing, Accounts Management, Field Assistance, and TAS. The overall goal of NPIIT was to improve the notice process by:

- ◆ Modifying the Taxpayer Notice Codes (TPNCs) to use clear, concise, and reader-focused, return-line (Form 1040 series) specific, non-accusatory language. TPNCs are the descriptive narratives used in the body of math error notices to identify and explain the error(s).
- ◆ Reducing the number of TPNCs to promote their ease of use by IRS and to reduce errors in selecting the correct TPNCs.
- ◆ Establishing a proper sequence for the TPNCs when multiple math errors are present so they match the flow of the return.

The IRS also initiated a new procedure requiring functional Subject Matter Experts and Single Point of Contact employees (people designated in each function to coordinate all notice issues) to jointly review revised notices during the Systems Acceptance Testing process. This will further ensure the accuracy and consistency of these notices.

As a result of these efforts, each TPNC now provides both a descriptive explanation identifying the specific error on the return, and the action taken by IRS to correct the error. All math error notices were revised to include more detailed information on the steps needed for taxpayers to challenge these assessments. In January 2006, appeal rights language was added to a number of the Computer Paragraph (CP) notices (notices that involve selection of optional computer generated standard paragraphs) and the team

will partner with the Office of Chief Counsel to review the appeal rights sections in all other math error notices. In addition, to further clarify the time requirements for challenging math error assessments, by 2009 we expect to have computer programming that will allow the addition of a paragraph with a variable date field. This will enable us to include the specific date for the last day a taxpayer can challenge the assessment.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

By definition, math error assessment authority does not give taxpayers the rights they would otherwise have under general IRS assessment procedures. IRC § 6213(a) provides for certain restrictions on IRS assessments (no collection on the assessment from the time the taxpayer is allowed to petition the Tax Court until the Tax Court's decision is final) and § 6213(b) – the math error assessment provision – provides for “exceptions to [these] restrictions on assessments.” While Congress granted the IRS the authority to issue math error assessments, it also recognized that math error authority would limit taxpayer rights, and it clearly directed the IRS to use the authority appropriately and provide clear math error assessment notices to taxpayers. The National Taxpayer Advocate believes the IRS, while having made significant improvements to the math error notice process, still has some work ahead so that it is administering its math error assessment authority in the way Congress intended.

TAS recognizes and commends the IRS's efforts to quickly stop using math error authority to deny expense deductions to non-resident alien students. TAS also acknowledges that many math error assessment problems may be the result of IRS employee errors rather than faulty processing procedures. TAS believes, however, that when IRS employees erroneously use math error assessment authority, a systemic problem is present. The examples TAS cites suggest that there is not a complete understanding at all levels within the IRS of the strict limitations Congress has placed on the implementation of math error authority. IRS employees who handle math error assessments and notices must understand more than the mere mechanics of notice processing. These employees must also understand how math error assessments differ from general IRS assessments, that math error assessments statutorily limit taxpayer rights, and that math error authority is to be used in the limited circumstances enumerated in the Code, and in those limited circumstances *only*.

Our concern about math error authority implementation goes beyond denying expense deductions to nonresident students (although the example does highlight the concerns raised in this and prior Annual Reports to Congress).<sup>73</sup> Any misuse of statutory authority is a matter of concern, whether it affects a large number of taxpayers or a “limited” number as the IRS suggested.

<sup>73</sup> See National Taxpayer Advocate 2001 Annual Report to Congress 33-34, National Taxpayer Advocate 2002 Annual Report to Congress 25-31, National Taxpayer Advocate 2003 Annual Report to Congress 113-121.

As with all examples of TAS casework cited in this report, the cases are just that – examples. We know about the 386 taxpayers affected by the inappropriate use of math error authority because they came to TAS for assistance. The actual number of taxpayers affected is likely larger, and the rest of these taxpayers, who did not seek our assistance, will never receive the refunds to which they were entitled.

The other examples where taxpayers received math error notices that resulted from IRS processing mistakes emphasize the importance of carefully wording notices so they clearly explain to taxpayers their rights and what they need to do if they disagree with the change made by the IRS. In recent years, the IRS has improved the clarity of these notices by adding line specific references to errors and more detailed information about appeal rights. Yet, these improvements are incremental in light of the congressional intent for math error notices. As noted in our analysis, 99 percent of the notices going to individual taxpayers still do not contain the type of information that the Congress anticipated when it defined “math or clerical error” in 1976.<sup>74</sup>

### RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS take the following steps to improve its administration of math error authority:

- ◆ Math error notices should specify the exact nature of an error so the taxpayer understands clearly what must be corrected to reverse the change to the tax return. For example, if a Social Security number on the return is not valid, the explanation on the notice should identify which taxpayer or claimed dependent is associated with the suspect number.
- ◆ Math error notices should clearly state the date by which taxpayers must contact the IRS to retain the right to petition the Tax Court. We encourage the IRS to investigate options for implementing this improvement in advance of the current 2009 target date.
- ◆ The IRS should revise the reconciliation table on math error notices to include the individual line items that were in error, and show the net difference in line items as a result of IRS changes to the return. The line items shown in the table should also include the line number of the tax return.
- ◆ The IRS should enhance its math error notice employee training to include an overview of the legislative basis for math error authority in training materials for employees involved in math error processing. The training should cover: (1) the differences between a math error assessment and a general assessment; (2) the congressional intent behind the IRS’s math error assessment authority (including examples from the legislative history showing what constitutes a math error and

<sup>74</sup> We also note that while the IRS quickly agreed to stop using math error authority in these nonresident student cases, it took up to four months to release the disputed portion of the refunds, resulting in these taxpayers waiting up to 19 months after filing their tax returns to receive their rightful refund.

## PROBLEMS

what does not); (3) the specific limited allowable uses of math error authority enumerated in IRC § 6213(g); and (4) the statutory requirement to abate a math error assessment at the taxpayer's request.

- ◆ The quality review process for math error notices should be improved by adding a determination that math error authority was applied appropriately. Currently, the quality review process focuses only on processing (for example, determining whether a math error notice contains the correct computer-generated paragraph for the identified return error).

**PROBLEM  
TOPIC #18****LIMITED ENGLISH PROFICIENT (LEP) TAXPAYERS:  
LANGUAGE AND CULTURAL BARRIERS TO TAX COMPLIANCE****RESPONSIBLE OFFICIALS**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Division

**DEFINITION OF PROBLEM**

The IRS provides limited pre-filing, filing, and post-filing assistance to taxpayers who have low literacy levels or for whom English is a second language, which can result in increased hardships, taxpayer burden, and noncompliance among this fast-growing group. Limited English Proficiency (LEP) taxpayers experience difficulties in dealing with the IRS and present unique challenges for tax administrators, including:

- ◆ Language and cultural barriers amplify the complexity of tax laws and IRS procedures;
- ◆ Language barriers hinder LEP taxpayers in filing returns, limiting their ability to meet tax obligations or obtain tax benefits to which they are entitled;
- ◆ Language barriers may also cause taxpayers to turn to tax preparers who are not competent or not scrupulous; and
- ◆ If they do file returns, LEP taxpayers may find post-filing notices, letters, and audit notifications difficult to understand when the communication from the IRS is in a language other than a taxpayer's primary language.

Further, some LEP taxpayers come from cultures where citizens do not trust the tax system or government in general. This sentiment affects their interactions with the IRS and other government agencies. Establishing and maintaining trust between the IRS and the LEP community is an important step in bringing LEP taxpayers into the system and keeping them there.

**ANALYSIS OF PROBLEM****The U.S. LEP Population and the LEP Taxpayer Population**

According to the U.S. Census Bureau's 2005 American Community Survey, nearly 52 million people, or 19 percent of the total population age five and over, reported speaking a language other than English at home.<sup>1</sup> Of those 52 million, approximately 23 million<sup>2</sup> reported speaking English less than "very well" and are considered to be

<sup>1</sup> U.S. Census Bureau, *2005 American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>2</sup> U.S. Census Bureau, *2005 American Community Survey*, Table S1601, Language Spoken at Home.

linguistically isolated and to have limited English proficiency.<sup>3</sup> In 2003, 11 million adults, or five percent of the U.S. population, were considered non-literate in English.<sup>4</sup>

Spanish is the most common language other than English, with 32 million speakers. Almost half of all Spanish speakers, approximately 15 million, reported they spoke English less than “very well.” After English, the five languages most often spoken at home in the United States are Spanish, Chinese, French, Tagalog, and Vietnamese.<sup>5</sup>

**TABLE 1.18.1, TOP TEN LANGUAGES OTHER THAN ENGLISH SPOKEN AT HOME IN 2005<sup>6</sup>**

Language spoken at home	Number of Speakers	Number who speak English less than “very well”	Percentage who speak English less than “very well”
Spanish	32,184,293	15,396,674	48 %
Chinese	2,300,467	1,263,972	55 %
French	1,383,432	308,453	22 %
Tagalog	1,376,632	453,666	33 %
Vietnamese	1,142,328	707,372	62 %
German	1,120,256	217,499	19 %
Korean	983,954	581,711	59 %
Russian	812,404	415,347	51 %
Italian	802,436	224,053	28 %
Arabic	686,986	245,685	36 %

Between 1990 and 2000, the number of Spanish speakers grew by about 62 percent, Vietnamese speakers almost doubled, and Russian speakers nearly tripled.<sup>7</sup> The LEP population is expected to continue to increase along with the immigrant population. The Census Bureau projects the Hispanic population alone will rise to almost 48 million by 2010 and exceed 102 million by 2050.<sup>8</sup>

Immigrants and LEP individuals make up a large and growing segment of the U.S. labor force, which will potentially interact with the IRS or seek information about tax obligations. In 2005, foreign-born workers comprised almost 15 percent of the overall work

<sup>3</sup> U.S. Census Bureau, *Summary File 3, 2000 Census of Population and Housing, Technical Determination B-32* (March 2005). Reports vary in the use of census numbers when defining LEP taxpayers. Although some reports use the number of persons who self-identify as speaking English “not well” or “not at all” as LEP individuals, the Census Bureau defines a linguistically isolated household as one in which no person 14 years old or older is able to speak English “very well.” Due to the highly technical nature of tax law and IRS procedures, this report will follow the Census Bureau’s interpretation of a linguistic isolated household and consider those who speak English less than “very well” as having limited English proficiency (LEP).

<sup>4</sup> National Center for Education Statistics, *National Assessment of Adult Literacy; A First Look at the Literacy of America’s Adults in the 21<sup>st</sup> Century 4* (Dec. 2005).

<sup>5</sup> *Id.*

<sup>6</sup> U.S. Census Bureau, 2005 *American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>7</sup> U.S. Census Bureau, *Census 2000 Brief, Language Use and English-Speaking Ability: 2000 3* (Oct. 2003).

<sup>8</sup> U.S. Census Bureau, *US Interim Projections by Age, Sex, Race and Hispanic Origin*, Table 1a (March 2004).

force. Hispanics accounted for about 49 percent of these workers while Asians made up another 22 percent.<sup>9</sup> As the number of immigrant workers increases, so does the number of those who are self-employed. Immigrant self-employment increased from 10.9 percent of the total self-employed population in 1994 to 14.7 percent in 2003.<sup>10</sup> One estimate projects that immigrants will generate all of the net growth in the nation's labor force in the next 20 years.<sup>11</sup>

### The IRS Demographic Assessment

The IRS's demographic assessment uses census figures where LEP individuals are identified as speaking English "not well" or "not at all."<sup>12</sup> Using this definition, the IRS put the LEP population in 2003 at 12.3 million.<sup>13</sup> For the reasons stated below, we believe this stratification inaccurately reflects the LEP population because it omits 9.8 million individuals who identified themselves as speaking English "well" in 2003.<sup>14</sup>

The 2000 census data on ability to speak English represents the person's own perception about his or her ability. Respondents were not instructed how to interpret the response categories: "Very well," "Well," "Not well," and "Not at all."<sup>15</sup> Further, this question only covers the ability to speak English, not reading skills or reading comprehension. Because of the highly legal and technical nature of the Internal Revenue Code and IRS processes, we believe it is accurate to add those persons who identified themselves as speaking English "well" to the LEP category.

The Treasury Inspector General for Tax Administration (TIGTA) agrees that individuals who speak English "well" should be considered part of the LEP population, stating that this group was included in its reports because TIGTA wanted to show "...the maximum number of LEP persons who could benefit from having documents translated into non-English languages."<sup>16</sup> In addition, the census defines a "linguistically isolated" household as one in which no person 14 years old or older is able to speak English "Very well." In 2000, the Census Bureau listed 4.4 million households encompassing 11.9 million people as linguistically isolated. This is nearly 52 percent higher than

<sup>9</sup> U.S. Department of Labor, *Labor Force Characteristics of Foreign-Born Workers Summary* (April 2006).

<sup>10</sup> Small Business Administration, *Self-Employment Business Ownership Rates in the United States: 1979-2003* (Dec. 2004).

<sup>11</sup> National Conference of State Legislatures, *Immigrants in the Workforce: Some Fast Facts* (Aug. 2005).

<sup>12</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 9 (Feb. 2006).

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

<sup>14</sup> U.S. Census Bureau, 2003 *American Community Survey*, Custom Table, PCT020 Nativity by Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>15</sup> U.S. Census Bureau, *Summary File 3, 2000 Census of Population and Housing, Technical Determination B-32* (March 2005).

<sup>16</sup> Treasury Inspector General for Tax Administration, Ref. No. 2003-40-163, *Limited English Proficient Taxpayers Need Improved Written Products to Help Them Understand and Comply With Tax Laws* 6 (Aug. 2003).

the 2.9 million households and almost 55 percent higher than the 7.7 million people described as linguistically isolated in 1990.<sup>17</sup>

### Barriers to LEP Taxpayer Compliance and Obtaining Assistance for LEP Taxpayers

#### *Language Barriers*

To meet the needs of an expanding LEP population, the IRS must train its workforce and provide the necessary tools to assist these taxpayers in meeting tax obligations and obtaining benefits. This assistance must go beyond the basic information in brochures and publications. It must reach taxpayers throughout the “life” of a tax return, including post-filing requests for information as well as the examination and collection processes. While the IRS has increased the number of products (including notices, forms, and brochures) and services available to LEP taxpayers, improvements are still needed.

Although some translated notices are available, the IRS does not attempt to determine the taxpayer’s spoken language at the outset of his or her interaction with the IRS. As a result, in FY 2005 only 0.6 percent of all computer-generated letters sent to taxpayers were in Spanish.<sup>18</sup> Receiving correspondence in a language that the taxpayer cannot understand may delay or prevent a response. By waiting until later in the examination or collection process to determine the taxpayer’s language preference, the IRS may be sending the taxpayer crucial initial notices that he or she cannot understand. This failure to communicate could result in missed deadlines, hardships, and diminished taxpayer rights. Statutory notices of deficiency, for example, require responses within specified timeframes. Taxpayers who disagree with the deficiencies, but cannot fully understand the notice because of limited English proficiency, may not meet the timeframes. They would then face the extra burden of having to pay the tax first and file a claim before the issue can be taken to court.<sup>19</sup>

#### *Cultural Barriers*

Limited English Proficient taxpayers may face significant barriers in learning about IRS services and tax obligations because of beliefs and perceptions brought from their native countries. Many of these taxpayers come from countries where the governments and tax systems are rife with corruption and fraud. Some taxpayers have never participated in a tax system at all before coming to the United States. Misunderstanding and mistrust of the IRS can lead LEP taxpayers to fail to seek out and use IRS services, not respond to IRS communications, or simply disappear from the tax system and become part of

<sup>17</sup> U.S. Census Bureau, *Census 2000 Brief, Language Use and English-Speaking Ability: 2000* 10 (Oct. 2003).

<sup>18</sup> IRS Office of the Notice Gatekeeper, Integrated Data Retrieval System (IDRS) Cumulative Notice Volume, FY 2005. The Notice Gatekeeper records all IRS letters generated through the IDRS system. The IRS sent 16,225,293 C-letters (IDRS generated letters based on standard letter templates) in FY 2005 and of this total, only 98,407 were in Spanish. See Most Serious Problem, *Correspondence Delays*, *supra*.

<sup>19</sup> IRC § 6213. The notice of deficiency starts the 90-day (or 150 days if the notice is addressed to a person outside the United States) statutory period within which the taxpayer can petition the United States Tax Court for a redetermination of the deficiency without first having to pay the proposed increase in tax.



the underground economy. A study prepared for the IRS found frustration with the IRS and the U.S. tax system among parts of the Hispanic population, including small business owners, because there is little information or understanding of the benefits of paying taxes and many believe “the wealthy” receive unfair advantages within the system.<sup>20</sup> The study also found certain segments of the Hispanic community believe the IRS shares information with U.S. Citizenship and Immigration Services (USCIS).<sup>21</sup> It is important for the IRS to reach out to these immigrants with targeted messages that build trust within the LEP communities and reverse these negative perceptions. To accomplish this, the IRS must tailor outreach and communications to fit each LEP community.

These impressions and beliefs about the U.S. tax system can quickly spread throughout the immigrant population. Immigrants often gravitate to particular regions and metropolitan areas, where they gather and create communities of family, friends, churches, shops, and community centers, all of which provide a network of familiarity and help them adapt to life in the United States.<sup>22</sup> For example, surveys have shown that Hispanics may hold diverse views, values, and beliefs, yet they share a range of attitudes and experiences that set them apart from the non-Hispanic community.<sup>23</sup> Research indicates that most Hispanic taxpayers would not seek information from the IRS directly, but would turn to their tax preparers because they trusted the preparers and felt they were more familiar with their “personal histories.”<sup>24</sup>

Taxpayers in LEP communities are often targeted by preparers who prepare inaccurate and even fraudulent returns. Many of these preparers remain open only through April 15, then close their doors, leaving taxpayers without follow-up assistance when they need it. Because these taxpayers place so much trust in their preparers, the taxpayers often know very little about how the returns were prepared and cannot explain some of the items listed. Somali and Bosnian immigrants recently have been targets of unscrupulous preparers who allegedly used inflated or fictitious deductions in these LEP taxpayers’ returns.<sup>25</sup> One such preparer in the Midwest targeted recent immigrants from various African countries, including Somalia. The U.S. Department of Justice (DOJ)

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<sup>20</sup> GlobalHue, *Qualitative Hispanic Market Research* 9 (May 2003).

<sup>21</sup> GlobalHue, *Hispanic LEP Taxpayer Research Quantitative Report* 67 (Jun. 2003).

<sup>22</sup> IRS Wage and Investment Research Group 2, Project 2-04-16-2-043E, *Hispanic Language/Ethnic Islands Data and Their Implication on Tax Administration* 9 (Nov. 2004).

<sup>23</sup> Robert Suro, ET AL., 2002 National Survey of Latinos, Pew Hispanic Center/Kaiser Family Foundation 6 (Dec. 2002).

<sup>24</sup> GlobalHue, *Qualitative Hispanic Market Research* 11 (May 2003).

<sup>25</sup> Press Release, Department of Justice, Federal Judge Shuts Down Second Tax Preparer Who Targeted Bosnian Immigrants in Bogus Tax-Refund Scheme (March 2, 2006). Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (Mar. 10, 2006).

asserts he prepared more than 3,300 returns since 2002, causing an estimated loss of over \$8 million to the U.S. Treasury.<sup>26</sup>

### Downstream Effects of Language and Cultural Barriers

Failure to provide necessary customer service at the beginning of the tax filing process can often lead to increased contact with taxpayers further downstream. As Senator Max Baucus, the Ranking Member of the Senate Committee on Finance, recently stated, “Taxpayer service gives taxpayers the opportunity to get their tax obligations right the first time, so expensive enforcement action is unnecessary.”<sup>27</sup> While all taxpayers are vulnerable to the effects of reduced or nonexistent customer service, LEP taxpayers have a greater chance of surfacing in the compliance arena because of their limited sources of tax information and limited knowledge of the tax system. Since the IRS does not capture data on the preferred language of taxpayers, it is impossible to determine how many or what percentage of LEP individuals receive post-filing notices or end in tax controversies.

However, recent Department of Justice injunctions against tax preparers who targeted immigrants offer insight into how these taxpayers end up further downstream in the tax compliance process.<sup>28</sup> A Minnesota preparer, who prepared fraudulent returns for Somali and other African immigrants, sent taxpayers scrambling for help once they discovered their returns were under investigation. The IRS expended resources from its Criminal Investigation and Examination functions to audit the returns and the Office of Appeals worked cases not settled in Examination. Some taxpayers eventually turned to the U.S. Tax Court in hopes of resolving their disputes. Because these immigrants had little or no knowledge of the U.S. tax system, they sought help from Low Income Taxpayer Clinics (LITC) and the Local Taxpayer Advocate’s (LTA) office.<sup>29</sup> After hearing about these problems in the community, Taxpayer Advocate Service employees visited local community organizations and educated these taxpayers about applicable tax laws and the information needed for their audits. One LITC alone, Mid-Minnesota Legal Assistance, represented 104 taxpayers with problems associated with this preparer.<sup>30</sup>

<sup>26</sup> Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (March 10, 2006). Press Release, Department of Justice, Justice Department Asks Federal Court to Bar Minnesota Man from Preparing Tax Returns for Others (Feb. 7, 2006).

<sup>27</sup> Letter from Sen. Max Baucus, Ranking Member, Senate Committee on Finance, to Sens. Christopher Bond and Patty Murray, Chairman and Ranking Member, Senate Appropriations Subcommittee on Transportation, the Treasury, the Judiciary, and Housing and Urban Development (Jun. 16, 2006), available at <http://www.senate.gov/~finance/press/Bpress/2005press/prb061906.pdf>.

<sup>28</sup> Press Release, Department of Justice, Federal Judge Shuts Down Second Tax Preparer Who Targeted Bosnian Immigrants in Bogus Tax-Refund Scheme (March 2, 2006). Press Release, Department of Justice, Federal Court Bars Second Minnesota Man From Preparing Tax Returns For Others (Mar. 10, 2006).

<sup>29</sup> At least 41 of these cases were worked by the Minnesota Local Taxpayer Advocate’s office. The TAS case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases in organization code 041 received on or after 10/01/2004 and having SOMAL in the local use field, or with a Primary Core Issue Code (PCIC) between 610 -640 (Examination Issues) and a search for Somali names, or with a PCIC of 950 (Criminal Investigation) and a search for Somali names.

<sup>30</sup> Telephone Interview with Director, Mid-Minnesota Legal Assistance (Oct. 18, 2006).

According to the LITC Director, the clinics represented these taxpayers in Examination, Appeals, Collection, and filed petitions in Tax Court. In some cases, the LITC represented the taxpayer throughout the entire process. Even though these taxpayers knew little of the tax system or how their taxes were prepared, some found these tax issues worked against them when they applied for U.S. citizenship.<sup>31</sup>

These cases illustrate that the consequences of failing to provide customer service for LEP taxpayers extend beyond taxes and the IRS. These taxpayers, who may have been drawn to unscrupulous preparers because they could not obtain LEP services from the IRS, must now attempt to resolve their issues with even fewer IRS resources available in their primary languages at the tax controversy stage.<sup>32</sup>

### IRS Response to These Barriers: IRS Multilingual Initiative

On August 11, 2000, President Clinton signed Executive Order 13166, *Improving access to Services for Persons with Limited English Proficiency*.<sup>33</sup> The order directed all federal agencies to "... develop and implement a system by which LEP persons can meaningfully access those services consistent with, and without unduly burdening, the fundamental mission of the agency." In response, the IRS created the Multilingual (MLI) Strategy Office to provide executive oversight of the agency-wide multilingual strategy.<sup>34</sup>

The IRS had previously established the Multilingual Initiative to comply with the IRS Reform and Restructuring Act of 1998 (RRA 98), which required the IRS to establish Spanish telephone help lines and prompted the IRS to create an External Civil Rights Unit (ECRU) to investigate alleged violations of Title VI of the Civil Rights act of 1964.<sup>35</sup> To stress the IRS's commitment to assisting non-English speaking taxpayers in meeting their responsibilities, the Commissioner issued a Multilingual Policy Statement on October 18, 1999, solidifying the IRS's commitment to provide its workforce with the tools to serve a diverse population.<sup>36</sup>

In the past few years, the IRS has made progress in expanding services to the LEP community, specifically Spanish-speaking taxpayers. In addition to creating a Spanish language website translating over 240 documents into Spanish,<sup>37</sup> other LEP services include:

- ◆ Some notices generated in Spanish at the taxpayers' request;

<sup>31</sup> *Id.*

<sup>32</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 102, 109 (Feb. 2006). Over-the-phone (OPI) interpreter assistance is only listed as being offered at Taxpayer Assistance Centers and is not offered as a service to customers using the IRS's toll-free phone lines.

<sup>33</sup> Exec. Order No. 13166, 65 Fed. Reg. 50121 (Aug. 11, 2000).

<sup>34</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 12 (Feb. 2006).

<sup>35</sup> Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

<sup>36</sup> IRS Policy Statement, P-6-41 (Oct. 18, 1999).

<sup>37</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 60 (Feb. 2006).

- ◆ Toll-free phone assistance at six call sites around the country;
- ◆ Customer service kiosks in 38 locations; and
- ◆ Over-the-phone interpreters (OPI) at all Taxpayer Assistance Centers.<sup>38</sup>

The IRS has completed Phase II of the LEP Needs Assessment<sup>39</sup> aimed at identifying LEP taxpayers and assessing current products and services both internally and with feedback from external stakeholders.<sup>40</sup> While it is too soon to determine how the IRS will use this research, it does show the IRS is attempting to understand the demographics of the LEP population and identify opportunities for improvement. We applaud this effort. The question remains, however, whether the IRS will have the necessary resources to implement the resulting recommendations.

#### IRS Response to Barriers: Language Assistance Policy

The IRS identified only Spanish as a “regularly encountered”<sup>41</sup> language in the recent demographic assessment by the MLI Strategy Office.<sup>42</sup> As such, the IRS adopted the following Language Assistance Policy:<sup>43</sup>

- ◆ For Spanish-speaking customers, the IRS will offer oral language assistance comprised of various options and written language assistance (document translations), including the translation of “Vital Documents;”
- ◆ For areas heavily populated with non-English speaking taxpayers who speak languages other than Spanish, the IRS will offer limited oral language assistance but no written assistance; and

<sup>38</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 60 (Feb. 2006).

<sup>39</sup> *Id.* at 158. External stakeholder source information includes Low Income Taxpayer Clinic (LITC) Director and LEP Customer Surveys, Tax Practitioner Surveys, EITC Grassroots LEP Participant Survey, LEP Random Digit Dialing Telephone Survey, and SEPC, Field Assistance, ACS and Accounts Management Customer Satisfaction Surveys.

<sup>40</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 12-13 (Feb. 2006)

<sup>41</sup> Department of Justice Guidance to Federal Financial Assistance Recipients Regarding Title VI Prohibition Against National Origin Discrimination Affecting Limited English Proficient Persons, 67 Fed. Reg. 117 (June 18, 2002). This guidance provides no specific definition of “regularly encountered” individuals, but rather provides four factors agencies should use when assessing how to provide meaningful access to programs and services. The four factors include: (1) The number or proportion of LEP persons eligible to be served or likely to be encountered by the program or grantee; (2) the frequency with which LEP individuals come in contact with the program; (3) the nature and importance of the program, activity, or service provided by the program to people’s lives; and (4) the resources available to the grantee/recipient and costs. However, the guidance cautions agencies that the flexibility given in addressing the needs of the LEP populations served “does not diminish, and should not be used to minimize, the obligation that those needs be addressed.”

<sup>42</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 20 (Feb. 2006). See also Memorandum from Mark Matthews, Deputy Comm’r for Services and Enforcement to Divisional Commissioners (Oct. 24, 2005).

<sup>43</sup> Memorandum from Mark Matthews, Deputy Comm’r for Services and Enforcement to Divisional Commissioners (Oct. 24, 2005).

- ◆ For languages not designated as “regularly encountered,” the IRS may provide assistance to community volunteers or limited over-the-phone interpreter services within resource constraints. The IRS will not offer written language assistance.

### *Written Communication*

Executive Order 13166 requires all federal agencies to develop and implement a system by which LEP individuals can meaningfully access services without unduly burdening the fundamental mission of the agency.<sup>44</sup> Per the Executive Order, the Department of Justice issued guidance and provided a framework for federal agencies to carry out this mission, including determining what documents should be considered for translation.<sup>45</sup> Using this guidance, the IRS has designated 108 documents as “vital.”<sup>46</sup> The IRS defines vital documents as either “required by law or critical to the receipt of a federal benefit or service.”<sup>47</sup> The IRS plans to translate these vital documents only into Spanish, its sole designated “regularly encountered” language. This policy, which precludes the translation of vital documents into any language but Spanish, leaves millions of LEP taxpayers struggling to understand their tax obligations and navigate the tax controversy process. For example, the IRS offers no written language assistance or translated notices to approximately 1.3 million people who speak Chinese and identify themselves as speaking English less than “very well.”<sup>48</sup> The IRS recognizes the Asian population as the second fastest growing LEP population segment in the U.S., yet does not include any Asian languages in its translation policy.<sup>49</sup>

The IRS has translated a limited number of documents into other languages, mostly for education and outreach purposes.<sup>50</sup> Individuals who speak languages other than English or Spanish must look outside the IRS for help in translating forms, notices, and letters, many which directly impact taxpayer rights. Expecting LEP taxpayers to find their own translators to interpret forms, notices, and publications places a burden upon these taxpayers. Further, not being aware of the complexity or importance of IRS forms and notices, these LEP taxpayers may seek help from others, such as their school-age children, who only have limited English skills or who cannot comprehend and translate complex IRS issues.

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<sup>44</sup> Exec. Order No. 13166, 65 Fed. Reg. 50121 (Aug. 11, 2000).

<sup>45</sup> Department of Justice Guidance to Federal Financial Assistance Recipients Regarding Title VI Prohibition Against National Origin Discrimination Affecting Limited English Proficient Persons, 67 Fed. Reg. 117 (Jun. 18, 2002).

<sup>46</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 70 (Feb. 2006). Form 2688, which is listed as a vital document for translation, is now obsolete and superseded by Form 4868.

<sup>47</sup> *Id.*

<sup>48</sup> U.S. Census Bureau, *2005 American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>49</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 19 (Feb. 2006).

<sup>50</sup> *Id.* at 70.

The IRS has translated over 240 documents into Spanish.<sup>51</sup> While this figure includes 87 of the 108 “vital” documents, the IRS has yet to translate several other “vital” documents that are essential to the examination or collection process and the protection of taxpayer rights.<sup>52</sup>

**TABLE 1.18.2, SAMPLE OF VITAL DOCUMENTS NOT CURRENTLY TRANSLATED INTO SPANISH<sup>53</sup>**

Document Title	Product Type	Product Number	Legislative Requirement
Notice of Deficiency <sup>54</sup>	Letter	531(DO) 531(SC)	IRC 6212/6155/6303
CP 2000 – AUR Notice of Proposed Tax Changes <sup>55</sup>	Notice	CP 2000	IRC 6212
Notice of Intent to Levy and Notice of Your Right to a Hearing <sup>56</sup>	Notice	CP-90	IRC 6331/6320
LT 11 Notice of Intent to Levy <sup>57</sup>	Notice	LT 11	IRC 6330/6331

As noted earlier, the IRS defines “vital documents” as those that are “required by law or critical to the receipt of a federal benefit or service.”<sup>58</sup> Following this definition without consideration for IRS-specific rights may lead the IRS to omit documents for translation that impact taxpayer rights or provide taxpayer protections. It is clear from the list

<sup>51</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 19 (Feb. 2006).

<sup>52</sup> *Id.* The IRS designated these documents as vital but has not yet translated them. In lieu of translating Notice CP-90, the IRS added a statement informing the taxpayer where (telephone number) he or she can obtain assistance in Spanish.

<sup>53</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 71-77 (Feb. 2006).

<sup>54</sup> The statutory notice of deficiency is required by IRC § 6212 when the IRS determines there is a deficiency, which is generally the excess of the amount the IRS contends is the correct tax over the amount the taxpayer showed on the return. Meeting prescribed timeframes is important because per IRC § 6213 the taxpayer has 90 days from the date of the letter to file a petition in Tax Court challenging the proposed tax deficiency (or 150 days if addressed to a person who resides outside the United States). Failing to meet these statutory guidelines would require the taxpayer to first pay the tax and file a claim for a refund before litigating the issue.

<sup>55</sup> CP 2000 is a notice that informs the taxpayer of a proposed change to tax liability because of income that is not identifiable or apparently not fully reported on the return. It may also include credits and deductions that appear overstated. If the taxpayer’s response does not resolve the issue, there is no response, or the notice is undeliverable, a Statutory Notice under IRC § 6212 will be issued. The taxpayer would then fall under the prescribed timeframes for IRC § 6213.

<sup>56</sup> This notice informs taxpayer that IRS intends to issue a levy against any federal payments due the taxpayer, such as SSA benefits or OPM retirement benefits, because the taxpayer still has a balance due on his or her tax account. If the taxpayer does not agree with the proposed action, the taxpayer has the right to file a Collection Due Process (CDP) hearing request. The request for a CDP hearing must be filed within 30 days of the notice for full CDP rights.

<sup>57</sup> This notice, as required under IRC §§ 6330 and 6331, informs a taxpayer that the IRS intends to levy on his or her property or rights to property 30 days after the date of the letter unless the taxpayer pays, makes arrangements to pay, or files for a CDP hearing, if available. Examples of property include bank accounts, wages, commissions, business assets, cars and other income and assets.

<sup>58</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 70 (Feb. 2006).

above that the IRS has adopted a narrow view of the term “federal benefit or service.” Fundamental statutory taxpayer rights, such as the right to be heard in Tax Court or have a Collection Due Process (CDP) hearing, are indeed “fundamental benefits or services.” Thus, the IRS’s current translation policy does not comply with Executive Order 13166.

#### *Telephone, Automated, and Face-to-Face Assistance*

The IRS has attempted to remove some of the barriers that LEP taxpayers face by offering several bilingual services, including telephone assistance, self-service kiosks,<sup>59</sup> web sites, and face-to-face contacts.<sup>60</sup> However, the overwhelming majority of this assistance is in Spanish; for example, telephone assistance is only available in English and Spanish.<sup>61</sup> The IRS offers a Spanish language website<sup>62</sup> and self-service kiosks that assist taxpayers in English and Spanish, but does not offer these services in any other language.<sup>63</sup>

All Taxpayer Assistance Centers (TACs) provide over-the-phone interpreter service (OPI) in over 144 languages.<sup>64</sup> Undocumented immigrants and other taxpayers without government issued identification, however, have difficulty entering TACs in government buildings and therefore have limited access to this service. In 2004, out of 41,446 calls interpreted in 52 languages, 96 percent of the (OPI) contacts were in Spanish.<sup>65</sup> Not only does this statistic indicate a greater need for Spanish language assistance, it also may indicate a lack of awareness, outreach, or access for this service to the non-Spanish speaking LEP population, in light of U.S. population demographics.

### **IRS Response to Barriers: Outreach, Education, and Volunteer Services**

#### *Stakeholder Liaison and SPEC*

The IRS’s Wage and Investment (W&I) division provides outreach and education to taxpayers through its Stakeholder, Partnership, Education and Communication (SPEC) function. The Small Business/Self-Employed (SE/SE) division provides similar services through the Stakeholder Liaison in its Communication, Liaison, and Disclosure (CLD) organization.<sup>66</sup>

<sup>59</sup> Email from Deputy Director, Field Assistance, W&I (Oct. 2, 2006). The IRS is in the process of phasing out the limited-use self-service kiosks currently in use.

<sup>60</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 69 (Feb. 2006).

<sup>61</sup> *Id.* at 102.

<sup>62</sup> Available at <http://www.irs.gov/Espanol>.

<sup>63</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 108 (Feb. 2006). The IRS does operate a kiosk at one location that assists taxpayers in Chinese, Vietnamese, and Korean in addition to English and Spanish.

<sup>64</sup> *Id.* at 102, 109 (Feb. 2006). Over-the-phone (OPI) interpreter assistance is only listed as being offered at Taxpayer Assistance Centers and is not offered as a service to customers using the IRS’s toll-free phone lines.

<sup>65</sup> *Id.* at 111-112.

<sup>66</sup> For a further discussion of SB/SE education and outreach, see Most Serious Problem, *Small Business Outreach*, *supra*.

The IRS offers only seven multilingual products to small businesses. All seven are translated into Spanish; two are translated into Mandarin Chinese and one into Korean.<sup>67</sup> SPEC has 17 products to assist in outreach to individual LEP taxpayers. All are translated into Spanish, but only one, Publication 4269, the I Speak Language Identification Card, is translated into any other language.<sup>68</sup> Although we suspect that more LEP outreach actually occurs, the internal assessment of these organizations by the IRS's MLI Strategy Office reports no other activities to educate or assist the LEP taxpayer population.<sup>69</sup> In an environment where the number of individual and business LEP taxpayers is increasing, the IRS should be making a concerted effort to reach these taxpayers at the beginning of the tax process to avoid costly compliance efforts downstream.

#### *Low Income Taxpayer Clinics (LITC)*

The Low Income Taxpayer Clinic (LITC) program, administered by the Office of The Taxpayer Advocate, provides matching IRS grants to organizations that provide representation to low income taxpayers involved in a controversy with the IRS or that offer outreach and education on tax rights and responsibilities to English as a second language and LEP taxpayers.<sup>70</sup> These clinics are an important resource to LEP taxpayers struggling to understand their tax obligations or navigate the controversy process. The LITCs help level the playing field for LEP taxpayers who might otherwise be unable to understand IRS notices, forms, and processes.<sup>71</sup> In calendar year 2006, 129 of the 150 LITCs offered assistance to LEP taxpayers in 47 different languages.<sup>72</sup>

#### *Volunteer Income Tax Assistance (VITA)*

The Volunteer Income Tax Assistance (VITA) Program, which the IRS administers, provides free tax return preparation and electronic filing (e-filing) to underserved groups of individual taxpayers, including low income, elderly, disabled, and LEP taxpayers.<sup>73</sup> These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply the tax law.<sup>74</sup> The IRS has focused on expanding VITA through increased recruitment of social service, nonprofit, corporate, financial,

<sup>67</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 113-114 (Feb. 2006).

<sup>68</sup> Information received from IRS *Policy Analyst, Customer Assistance, Relationships, and Education, W&I* (Nov. 7, 2006). The I Speak Language Identification card, translated into 38 languages, is used at VITA sites to allow LEP taxpayers to point to the language they speak so volunteers can find the best method of assistance.

<sup>69</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006* 113-114 (Feb. 2006).

<sup>70</sup> IRC § 7526.

<sup>71</sup> *Taxpayer Advocate Report and Low Income Tax Clinics, Hearing Before the Subcomm. on Oversight of the Comm. on Ways and Means*, 107<sup>th</sup> Cong. 1<sup>st</sup> Sess. (July 12, 2001) (statement of Leslie Book, Assistant Professor of Law and Director, Federal Tax Clinic, Villanova University School of Law, ).

<sup>72</sup> IRS Pub. 4134, *Low Income Taxpayer Clinic List* (March 2006).

<sup>73</sup> IRS, *Free Tax Return Preparation for You by Volunteers*, at <http://www.irs.gov/individuals/article/0,,id=107626,00.html> (last visited Oct. 19, 2006).

<sup>74</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-004, *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided* 7 (Nov. 2005).



educational, and government organizations (partners) to provide greater assistance to the LEP community.<sup>75</sup> In FY 2005, over 14,000 VITA and Tax Counseling for the Elderly (TCE) sites prepared over 2.1 million tax returns.<sup>76</sup> Many VITA sites serving the LEP population are run by trusted individuals who have ties to that community. This partnership helps establish trust between these taxpayers and the IRS, thus encouraging continued voluntary compliance.

### LEP Best Practices: What is Possible?

The Social Security Administration (SSA) has implemented a comprehensive LEP program that is impressive in its scope and shows it is possible for a government agency to address the needs of the LEP population. The SSA collects written and spoken language preference for individuals who apply for:

- ◆ Retirement, Survivors and Disability Insurance;
- ◆ Supplemental Security Income; and
- ◆ Social Security numbers.<sup>77</sup>

This primary data, captured directly from individuals contacting the SSA, allows the agency to determine precisely where LEP assistance is needed most. It also streamlines contacts by allowing SSA employees to identify language preference during the initial contact and arrange for interpreters at the outset. The SSA also conducts LEP focus group testing and has an online comment and suggestion system to respond to the public's concerns.<sup>78</sup>

Based on overall workload comparison, the IRS would seem to have the potential for contact with a larger number of LEP individuals as shown in the following table.

<sup>75</sup> Treasury Inspector General for Tax Administration, Ref. No. 2006-40-004, *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided 2* (Nov.2005).

<sup>76</sup> IRS Statistics of Income, *Internal Revenue Service Taxpayer Assistance and Education Programs for Individual Taxpayers, by Type of Assistance Program, Fiscal Year 2005*, Table 23.

<sup>77</sup> SSA, *Social Security Administration's Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP)*, at <http://www.ssa.gov/multilanguage/LEPPlan2.htm> (Sept. 2004).

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

**TABLE 1.18.3, FY 2003 SOCIAL SECURITY ADMINISTRATION AND IRS WORKLOAD COMPARISON**

	Total Claims Processed (SSA) or Tax Returns Received (IRS)	Total Toll-Free Calls Handled
Social Security Administration	16,402,361 <sup>79</sup>	54,800,000 <sup>80</sup>
Internal Revenue Service	222,271,428 <sup>81</sup>	88,509,631 <sup>82</sup>

Since the SSA captures language preference data directly from its customers, it can accurately report foreign language preference and project future demand. In FY 2003, the SSA reported 13,258 individuals preferred to conduct business in Vietnamese when discussing their Social Security insurance claims.<sup>83</sup> The IRS does not collect language preference data from taxpayers but instead uses census data to project potential LEP taxpayers. This data shows over 707,000 individuals who speak Vietnamese identify themselves as speaking English less than “very well.”<sup>84</sup> A conservative estimate that half of these individuals are in the work force and have a tax filing requirement leaves the IRS with more than 300,000 potential contacts from taxpayers that speak this language. The SSA has 40 brochures and publications translated into Vietnamese.<sup>85</sup> In its FY 2006 Multilingual Initiative Customer Base Report, the IRS lists no forms, notices, letters, or publications translated to Vietnamese.<sup>86</sup>

<sup>79</sup> SSA, *Social Security Administration’s Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP)*, at <http://www.ssa.gov/multilanguage/LEPPlan2.htm> (Sept. 2004). Total claims processed include Retirement and Survivors insurance claims, SSI Aged insurance claims, Initial Disability insurance claims, and Social Security number requests.

<sup>80</sup> SSA, *Social Security Administration’s Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP)*, at <http://www.ssa.gov/multilanguage/LEPPlan2.htm> (Sept. 2004).

<sup>81</sup> IRS Data Book, *Number of Returns filed, by Type of Return and State, Fiscal Year 2003*, Table 3.

<sup>82</sup> IRS Statistics of Income, *Internal Revenue Service Taxpayer Assistance and Education Programs, by Type of Assistance Program, Fiscal Year 2003*, Table 23.

<sup>83</sup> SSA, *Social Security Administration’s Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP)*, at <http://www.ssa.gov/multilanguage/LEPPlan2.htm> (Sept. 2004). This figure does not include requests for Social Security numbers.

<sup>84</sup> U.S. Census Bureau, 2005 *American Community Survey*, Table B16001, Language Spoken at Home by Ability to Speak English for the Population 5 Years and Older.

<sup>85</sup> SSA, *Social Security Information in Other Languages*, at <http://www.ssa.gov/multilanguage/> (last visited June 22, 2006).

<sup>86</sup> IRS, *Multilingual Initiative Customer Base Report FY 2006 69-70* (Feb. 2006). This report does state a limited number of education and outreach documents are available in Vietnamese, but does not list the specific document number or type. However, Publication 1546, *The Taxpayer Advocate Service of the IRS - How to Get Help With Unresolved Tax Problems*, is available in Vietnamese (as well as English, Spanish, Chinese, Korean, and Russian).

The SSA not only has a separate web site for Spanish speakers,<sup>87</sup> but also a link from its main web site to a “Multilanguage Gateway”<sup>88</sup> that offers help in 14 other languages.<sup>89</sup> The SSA has publications translated into 15 languages other than English. Although the number of publications differs depending on the language, over 25 publications are available in most of the 15 languages.<sup>90</sup>

The Social Security Administration also offers free interpretation services both in person and by phone.<sup>91</sup> This service is available throughout the duration of an individual’s business with the agency. If an issue cannot be handled or completed over the phone, the SSA will make an appointment for the individual at a local office and arrange for an interpreter to be there. The agency actively promotes the interpreter service on its Multilanguage Gateway web site and distributes “interpreter service policy” posters to all Social Security field offices. The poster contains the Social Security interpreter policy translated into 19 languages and alerts the LEP community that this service is available.<sup>92</sup>

In addition to offering interpretation services, the SSA has carried out an aggressive hiring initiative aimed at achieving the right mix of employee language skills to serve the LEP population. For instance, in FY 2003 almost one-third of all newly hired SSA employees were bilingual.<sup>93</sup> In its approach to providing public information and increased access to agency services across a broad spectrum of the LEP population, the SSA seems to recognize the value of educating, improving access, and building public confidence among this often overlooked demographic group.

### IRS COMMENTS

The IRS does not agree that there is a lack of service for Limited English Proficient (LEP) taxpayers. The IRS provides an extraordinary number of services in Spanish that are on a par with those offered by any other agency in government. In addition, IRS-sponsored volunteer services are available to LEP taxpayers in many languages other than Spanish. Finally, the IRS has adopted a strategic approach to further expand these services to the LEP communities most in need.

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<sup>87</sup> Available at <http://www.ssa.gov/espanol/>.

<sup>88</sup> Available at <http://www.ssa.gov/multilanguage/>.

<sup>89</sup> SSA, *Social Security Information in Other Languages*, at <http://www.ssa.gov/multilanguage/> (last visited June 22, 2006). The 14 languages other than Spanish include Arabic, Armenian, Chinese, Farsi, French, Greek, Haitian-Creole, Italian, Korean, Polish, Portuguese, Russian, Tagalog, and Vietnamese.

<sup>90</sup> SSA, *Social Security Information in Other Languages*, at <http://www.ssa.gov/multilanguage/> (last visited June 22, 2006). The two languages with the fewest publications available are Greek (6) and Arabic (5).

<sup>91</sup> SSA, *If You Need an Interpreter*, at <http://www.ssa.gov/multilanguage/langlist1.htm> (last visited June 22, 2006).

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

<sup>93</sup> SSA, *Social Security Administration’s Plan for Providing Access to Benefits and Services for Persons with Limited English Proficiency (LEP)*, at <http://www.ssa.gov/multilanguage/LEPPlan2.htm> (Sept. 2004).

## PROBLEMS

SECTION  
ONE

Current services for LEP taxpayers encompass a wide array of telephone, correspondence, volunteer, small business, Internet, forms and publications, walk-in, and initial contact assistance.

In FY 2006, IRS assistors answered 2.3 million toll-free calls in Spanish. An additional 1.1 million calls were resolved through our Spanish-language automated telephone response systems. These services are provided from six telephone call sites (Austin, Dallas, Denver, Fresno, Jacksonville, and Puerto Rico) employing over 700 Spanish-speaking employees. Enterprise Queue, a sophisticated call routing technology, was rolled out in 2006 that enables the IRS to more efficiently route a Spanish-speaking caller to the first available Spanish-speaking IRS assistor anywhere in the country. By 2009, we project that fully ten percent of the IRS's total telephone workforce will be bilingual. These figures, both in terms of the number of employees and number of calls answered, compare very favorably with the Spanish-language telephone services offered by the Social Security Administration.

TeleTax, the IRS's toll-free automated telephone service, is available in English and Spanish 24 hours a day, seven days a week. TeleTax provides helpful pre-recorded tax messages on 145 topics. These messages are also available on the web in Spanish on [IRS.gov/espanol](http://IRS.gov/espanol). They cover many topics including who must file, highlights of tax changes, education credits, Individual Retirement Accounts, Earned Income Tax Credit, what to do if you can't pay your tax. TeleTax can also help Spanish-speaking callers check the status of their tax refunds.

As noted in our response to the Most Serious Taxpayer Problem on Correspondence Delays, although the IRS receives very few pieces of correspondence written in Spanish, each IRS functional area has staff trained and skilled to process Spanish correspondence. Taxpayers that write to the IRS in Spanish receive a response from the IRS in Spanish.

There are currently 275 IRS-sponsored community coalitions and numerous Volunteer Income Tax Assistance and Tax Counseling for the Elderly partners that provide outreach and free volunteer tax services for individual taxpayers in languages other than English. These partners offer a variety of tax related products and services in over 25 languages including press releases, tax fact sheets, radio broadcasts, articles in community newspapers, television broadcasts, EITC toolkits, flyers, marketing products, and free tax return preparation. The languages include Albanian, Arabic, Bengali, Cantonese, Chinese, Chukese, Creole, German, Hindi, Hmong, Ilocano, Japanese, Korean, Native Alaskan, Mandarin, Polish, Russian, Samoan, Spanish, Tagalog, Turkish, Ukrainian, Urdu, Vietnamese, and others.

The IRS also hosts Hispanic Small Business Forums for the Spanish-speaking business community. To date, nine Forums have been held in California, South Carolina, New Jersey, New York, and Florida. The IRS also has 19 Spanish-language publications dedicated to tax issues affecting small businesses.

The IRS's world-class website includes a Spanish-language webpage (<http://www.irs.gov/espanol>) which is only one click away from the IRS.gov homepage. The Spanish landing page has recently been revised and for 2007 will include new, direct links to online tools (EITC Assistant, Free File, Where's my Refund, and the Withholding Calculator) and to topical information such as split refunds, disaster assistance, and IRS news releases. Web content available in Spanish mirrors IRS.gov and includes forms and publications, information for self-employed and small business owners, warnings about tax scams that victimize taxpayers, information on the EITC and other credits, links to other useful websites, and much more.

The IRS currently has over 250 LEP tax-related products in its Forms, Publications, and Products repository. In addition to Spanish, Publication 850, English/Non-English Glossary of Words and Phrases Used in Publications Issued by the IRS is scheduled for release this year in Chinese, Vietnamese and Korean. Publications 179, 547(SP), 596(SP), 579(SP) and 584(SP) are all products that benefit Spanish-speaking taxpayers in need of assistance with IRS filing instructions and procedures. For example, Publication 579(SP) is a partial Spanish translation of Publication 17, Your Federal Income Tax, which is slated for full translation in the future.

An Over-the-Phone-Interpreter (OPI) service is available at IRS Taxpayer Assistance Centers (TAC) across the nation. This system offers interpreter service in 144 languages for TAC walk-in customers.

We are also making a concerted effort to reach LEP taxpayers at the beginning of the examination and collection process. Once a taxpayer notifies the IRS that he or she speaks Spanish, every effort is made to communicate with him or her in Spanish. Spanish-speaking examination and collection employees are available to answer taxpayer calls. Several vital Correspondence Examination letters are available in or include information in Spanish. Several Collection letters have an information block that advises taxpayers if they need assistance in Spanish they can call a toll free number. And, for designated zip codes and areas in Puerto Rico, virtually all letters are translated to Spanish.

With regard to the National Taxpayer Advocate's comments on the Notice of Deficiency, the Office of Chief Counsel issued an opinion on March 3, 2006, that states there is no statutory or regulatory requirement for the IRS to provide taxpayers with a Spanish translation of the Letter 531 (Notice of Deficiency). Nonetheless, the translation of Letter 531 is under active consideration by the Multilingual Initiative Executive Council. Further, a Spanish version of the comparable Letter 3219 (Notice of Deficiency 90 Day Letter) was created in April 2000 for use by our Correspondence Examination and Automated Underreporter functions. When a taxpayer notifies the IRS that he or she speaks Spanish and a notice of deficiency is required, the Spanish version of Letter 3219 is issued.

## PROBLEMS

Through its Multilingual Initiative Strategy Office, the IRS assesses language needs, develops policies, monitors delivery of products and services, and cross-functionally trains its multilingual staff. As a foundation for this initiative the IRS published a Multilingual Policy signed by Commissioner Rossotti in October 1999. The MLI Strategy Office is responsible for implementing this policy for the IRS, as well as meeting the requirements of Executive Order 13166, Improving Services for Persons with Limited English Proficiency (LEP), signed by the President in October 2000. In 2003, a continual process to obtain direct LEP taxpayer and stakeholder feedback was implemented. Through this formal LEP Needs Assessment Process, the IRS has conducted extensive research and worked with external stakeholders to gain a better understanding of language assistance needs. Based on this research, in October 2005, the Deputy Commissioner for Services and Enforcement issued the IRS Language Assistance Policy. This policy provides the foundation for our current multi-tiered strategy that focuses on delivery of LEP products and services to the largest customer base, which is Spanish, and provides a strategy for expanding services in other languages.

Research shows that Spanish speakers continue to be the overwhelming majority representing 73 percent of the total LEP population. This is an approximately 20 percent increase over 2000 census data. The next highest language priorities are Chinese, Vietnamese, Korean, and Russian, which combined represent 11 percent of the LEP population. As noted below, the IRS has plans to target the needs of these groups. The remaining 16 percent of the LEP population is comprised of over 100 other language groups. These LEP taxpayers are currently provided services through OPI systems located in our TACs and through the local community education and outreach efforts outlined above.

Research from the LEP Needs Assessment was also used to develop the IRS Multilingual Initiative Strategic Plan. The FY 2006 – 2007 plan prioritized five improvement projects:

- ◆ Increasing LITC in isolated ethnic communities;
- ◆ Expanding communications in isolated ethnic communities;
- ◆ Expanding the Espanol website;
- ◆ Developing an integrated communications plan to disseminate basic tax information; and
- ◆ Developing a basic tax information DVD.

In furtherance of these Servicewide initiatives, the 2007-2008 Wage & Investment Strategy and Program Plan includes Operational Priorities to improve the quality, delivery, and accessibility of LEP products and services, including:

- ◆ Laying the foundation for translating forms and publications into the other IRS-priority languages (Chinese, Korean, Vietnamese, and Russian);
- ◆ Expanding the availability of tax products in Spanish and the other IRS-priority languages through the Virtual Translation Office;

- ◆ Increasing the accessibility of OPI interpreter services at our TACs;
- ◆ Using research to pinpoint specific isolated LEP community locations and targeting local education, outreach and communication messages for these groups; and
- ◆ Expanding and enhancing electronic options.

The Small Business/Self Employed Division has initiated similar efforts in support of the Multilingual Initiative Strategic Plan by establishing the SB/SE MLI Advisory Team. This team will manage and advance multilingual initiatives in SB/SE through a research-based assessment of SB/SE LEP taxpayer needs and, in concert with the MLI Strategy Office, explore options for meeting those needs.

Also noteworthy is the IRS's effort to comply with Presidential Executive Order 13166 by establishing the Virtual Translation Office (VTO) in April 2006. The VTO will increase the quality and quantity of written tax information for LEP taxpayers and the preparers, volunteers and others that assist them. The VTO also serves as a central focal point that produces, reviews, and manages official IRS translations and elevates and standardizes translation consistency across the IRS. In conformance with the IRS Language Assistance Policy, these efforts will focus initially on Spanish language translations and then target the other strategic priority Chinese, Korean, Vietnamese and Russian languages.

The National Taxpayer Advocate's assertion that the needs of non-Spanish speaking LEP taxpayers are being neglected fails to recognize the much greater need for Spanish assistance. Data included in the National Taxpayer Advocate's own analysis reveal that fully 96 percent of current OPI interpreter service users choose Spanish, even though this system supports over 140 other languages. While we do not dispute the need to expand non-English services offered for Asian and other non-Hispanic populations, IRS efforts in this area are subject to the same budget constraints as any other IRS program. We have chosen to focus primarily on Spanish, where the most taxpayers can benefit, while laying the strategic groundwork for expanding these services to other priority languages.

In summary, the IRS currently delivers a robust variety of telephone, correspondence, volunteer, small business, Internet, forms and publications, walk-in, and initial contact services in Spanish and supports a large number of local volunteer groups in providing outreach, education and tax assistance in over 25 additional languages. We have an office totally dedicated to assessing the needs of LEP taxpayers and to developing fiscally prudent strategies to meet those needs. A new Virtual Translation Office is in place. In addition, current plans call for expanding Spanish-language services for the LEP population most in need and targeting future initiatives in Chinese, Vietnamese, Korean and Russian.

**TAXPAYER ADVOCATE SERVICE COMMENTS**

The National Taxpayer Advocate recognizes and commends the IRS for the services it offers Limited English Proficiency (LEP) individuals who speak Spanish. The Spanish-language web site, including the revisions for 2007, is an impressive and important tool for reaching out to the Spanish-speaking community. We also recognize the IRS's achievements in partnering with volunteer organizations and in translating numerous notices into Spanish.

Despite these impressive efforts, the National Taxpayer Advocate finds it unacceptable that the statutory notice of deficiency is still not translated into Spanish. Regardless of the lack of a statutory or regulatory requirement for the translation, the significance of this notice for taxpayer rights and due process cannot be understated. The notice of deficiency provides the taxpayer with a 90 day window to petition the United States Tax Court to protest a deficiency in tax before it is assessed and before it is paid.<sup>94</sup> Understanding the importance of this notice, the Multilingual Initiative Executive Council should take immediate steps to translate this notice into Spanish and seriously consider translation into other languages as well.

Additionally, The National Taxpayer Advocate agrees with the Chief Counsel's response to the IRS dated March 3, 2006, stating there is no statutory or regulatory authority requiring to provide a Spanish translation of Letter 531 Statutory Notice of Deficiency. However, the National Taxpayer Advocate believes this sentence from Chief Counsel's response was taken out of context by the IRS. In fact, when the Chief Counsel response is read in its entirety, it supports the National Taxpayer Advocate's recommendation that Letter 531 be translated into Spanish. After stating that there is no statutory or regulatory authority requiring the IRS to provide Letter 531 in Spanish, the response goes on to state that it is IRS policy to assist taxpayers in understanding their tax rights and responsibilities, regardless of what their primary language may be, and in response to this policy, the MLI Executive Council determined that the statutory notice of deficiency would be translated into Spanish, in its entirety, as it is essential that a taxpayer be able to read the adjustment shown on the notice. Therefore, when Chief Counsel's response is read in its entirety, it is clear that it is consistent with the National Taxpayer Advocate's recommendation.

The National Taxpayer Advocate remains concerned that the IRS does not recognize the importance of determining a taxpayer's language preference at the outset of his or her interaction with the IRS, before he or she moves further into the tax controversy process. The number of IRS notices and letters translated into other languages is irrelevant if the

<sup>94</sup> The statutory notice of deficiency is required by IRC § 6212 when the IRS determines there is a deficiency, which is generally the excess of the amount the IRS contends is the correct tax over the amount the taxpayer showed on the return. Meeting prescribed timeframes is important because per IRC § 6213 the taxpayer has 90 days from the date of the letter to file a petition in Tax Court challenging the proposed tax deficiency (or 150 days if addressed to a person who resides outside the United States). Failing to meet these statutory guidelines would require the taxpayer to first pay the tax and file a claim for a refund before litigating the issue.



IRS never sends these notices to the taxpayers who would benefit from the translation. The IRS should allow a taxpayer to specify a language preference on his or her tax return that would be posted to the taxpayer's account during processing. This indicator would prompt all subsequent letters and notices to be mailed in Spanish and in other languages as the translations become available. In addition, the language preference question should be asked again in the first examination and collection notice. This approach would enhance the IRS's ability to tailor future interaction with the Examination and Collection functions and allow them to coordinate contacts with bilingual employees.

The National Taxpayer Advocate acknowledges the importance of partnering with volunteer and community organizations, but the IRS should not allow such groups to become substitutes for basic IRS customer service and outreach. While these organizations provide a valuable service, they also have geographic limitations and cannot reach every LEP taxpayer needing assistance. Expecting LEP taxpayers to locate and use volunteer and community-based organizations for the simplest of tasks solely based on limited English proficiency places an increased burden on these taxpayers.

In its response, the IRS states the National Taxpayer Advocate fails to recognize the much greater need for Spanish assistance and cites our analysis that 96 percent of current over-the-phone interpreter service (OPI) users are Spanish speaking. The National Taxpayer Advocate does recognize that Spanish speakers represent the largest segment of the LEP taxpayer population. However, we disagree with the IRS's interpretation of our analysis. We stated that this statistic indicates a greater need for Spanish language assistance, but also pointed out that it may signify a lack of awareness or access to this service among the non-Spanish speaking LEP population, or a lack of IRS outreach to this population. If the only awareness and outreach of this service to the LEP community is delivered in Spanish, then the results are not unexpected. Increasing awareness of the service to other non-Spanish speaking LEP language groups would likely increase its usage in other languages. Moreover, the IRS has not explained why this interpreter service is only available in Taxpayer Assistance Centers (TAC) and is not available to customers using the toll-free telephone line, where it would benefit a larger segment of the LEP population. If this decision is largely resource driven, then the IRS should vigorously make its case – which is compelling – to Congress. The National Taxpayer Advocate will lend her support to such an initiative.

### RECOMMENDATIONS

To ensure that taxpayers with low literacy levels, or for whom English is a second language, receive the necessary information to meet their tax obligations, we recommend the IRS do the following:

- ◆ Research and test whether educating taxpayers about the availability of the over-the-phone interpreter service (OPI) would increase its usage as well as increase requests for interpreters in other languages;

## PROBLEMS

SECTION  
ONE

- ◆ Expand over-the-phone interpreter service to include the toll-free sites and post-filing compliance functions, and expand outreach and awareness to the LEP community about this service;
- ◆ Clarify that the definition of a “vital” document includes any document that impacts taxpayer rights, provides taxpayer protection, or proposes to assess a tax or levy on taxpayer property;
- ◆ Increase the number of “regularly encountered” languages to mirror other government agencies of similar size and customer base, such as the Social Security Administration, and translate all vital documents into these languages; and
- ◆ Develop a process to determine the language spoken by taxpayers at the outset of their interaction with the IRS to ensure effective communications occur throughout the “life” of a tax return.<sup>95</sup>

<sup>95</sup> The National Taxpayer Advocate previously made this recommendation in the 2002 Report to Congress. See National Taxpayer Advocate 2002 Report to Congress 93.

**PROBLEM****TOPIC #19****TAXPAYER “NO RESPONSE” RATES****RESPONSIBLE OFFICIALS**

Richard J. Morgante, Commissioner, Wage and Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

Deborah Nolan, Commissioner, Large and Mid-Size Business Division

Steven Miller, Commissioner, Tax Exempt and Government Entities Division

**DEFINITION OF PROBLEM**

The IRS relies almost exclusively on standardized paper correspondence to communicate with taxpayers. In many instances, taxpayers do not respond to IRS notices or requests for information, with downstream consequences for both the IRS and the taxpayer. The IRS could potentially avoid some of these downstream effects by attempting other methods of making meaningful contact with taxpayers, thereby encouraging them to respond.

**ANALYSIS OF PROBLEM****The Problem of No Response**

The problem of no response occurs among all types of taxpayers – individuals, businesses, and tax-exempt organizations – and at all income levels. While most of the IRS’s attention to the problem has focused on examinations, particularly in the Earned Income Tax Credit (EITC) arena (which this discussion will cover), the problem extends far beyond audits.<sup>1</sup>

While the IRS experiences numerous problems with taxpayers who do not respond, similar problems exist for practitioners. In focus group discussions and surveys conducted with practitioners and Low Income Taxpayer Clinics (LITCs), respondents indicated they experience problems with taxpayers who respond to their requests in an untimely manner or not at all.<sup>2</sup> However, each group has come up with different ways of addressing the problem.

*What is a “No Response?”*

When the IRS sends a taxpayer a notice or other correspondence, a number of outcomes are possible:

- ◆ The taxpayer receives the notice and responds to the IRS;

<sup>1</sup> For a discussion of the effect of IRS failure to make personal contact in routine collection cases involving low income taxpayers, see Most Serious Problem, *Collection Issues of Low Income Taxpayers, supra*.

<sup>2</sup> Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through informal survey of Low Income Taxpayer Clinics (LITCs). The Low Income Taxpayer Clinic (LITC) Program is a grant program under IRC § 7526 in which qualified organizations receive matching federal grants to represent low income taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers.

- ◆ The taxpayer receives the notice and does not respond to the IRS;
- ◆ The taxpayer receives the notice and partially responds to the IRS; or
- ◆ The notice is undeliverable.

A “no response” is an instance where the IRS sends a taxpayer a notice and the taxpayer receives it but does not respond. This situation is different from a partial response, in which the taxpayer attempts to respond but does not respond fully. This partial response is also considered a “default with correspondence.”<sup>3</sup> A notice that is undeliverable is one that is mailed to the taxpayer but cannot be delivered because the taxpayer’s address is incorrect.<sup>4</sup>

#### *The Magnitude of the No Response Problem*

The IRS does not know the magnitude of the no response problem. The IRS does not generally track the number of taxpayers that do not respond to notices, how many taxpayers try to respond, or how many notices are undelivered.<sup>5</sup> The one group of taxpayers whose response rates the IRS does track, and has attempted to improve, is the EITC population.

#### **EITC Correspondence Examinations**

The IRS’s Revenue Protection Strategy (RPS) guides the processing of most tax returns selected for EITC examination by correspondence.<sup>6</sup> The IRS sends the taxpayer a series of letters with information requests, and the case continues through an automated batch process.<sup>7</sup> The exam begins with an initial contact letter explaining the audit process and the issues under examination, and requesting documentation specific to these issues.<sup>8</sup>

If the taxpayer does not respond within the given period, the IRS issues a second letter, commonly referred to as the 30-day letter, which includes an examination report showing

<sup>3</sup> For a discussion of “default with correspondence,” see notes 28 -30, *infra* and accompanying text.

<sup>4</sup> The definition of “undeliverable” is provided for purposes of this discussion. The IRM does not contain a definition of the term “undeliverable.”

<sup>5</sup> Response received to OD research request states that the IRS does not track this information.

<sup>6</sup> IRM 25.12.1.5, *Revenue Protection Strategy* (Dec. 1, 2000). The revenue protection strategy is a program developed to focus on problematic tax returns and is built on a four-pronged approach to address the returns: Understanding, Prevention, Detection, and Enforcement.

<sup>7</sup> IRM 4.19.1.12, *Batch Processing Overview* (Oct. 1, 2004). Batch processing is an IRS-developed, multi-functional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the batch system, the correspondence exam unit can process specified cases with minimal to no involvement by a tax examiner until a taxpayer reply is received.

<sup>8</sup> A correspondence examination (audit) is handled through written correspondence (rather than a face-to-face meeting), normally can be completed in a few hours, is limited in scope to a few issues and does not include a review of detailed account records. See Most Serious Problem, *Correspondence Examination, supra*.

the tax liability resulting from the adjusted issues.<sup>9</sup> The taxpayer has the opportunity to send documentation to the IRS to verify the issues, agree with the exam report, or appeal the tax by returning a form included with the 30-day letter. If the taxpayer does not respond to the 30-day letter, the IRS issues a statutory notice of deficiency (SNOD) also known as the 90-day letter. The taxpayer has 90 days from the date of this notice to petition the United States Tax Court.<sup>10</sup>

If the taxpayer does not respond to a notice of deficiency, the IRS will close the case and assess the taxpayer's account for the tax, interest, and any penalties. Because the batch processing system automatically moves cases through creation, statutory notice, and closing unless the IRS receives a taxpayer response, the taxpayer's failure to respond to any of the IRS's letters leads to the correspondence examination closing with no involvement from an IRS examiner.<sup>11</sup>

In tax year 2003, approximately 22 million taxpayers claimed the EITC.<sup>12</sup> In fiscal year 2005, the IRS closed nearly 534,000 EITC correspondence exams.<sup>13</sup> Table 1.19.1 shows the outcomes of these cases. Of the EITC correspondence exam cases closed in 2005, over 60 percent closed as the result of some form of no reply.<sup>14</sup>

<sup>9</sup> The IRS generally gives a taxpayer 30 days to respond to the initial letter. If the taxpayer sends documentation, and the IRS review determines it is inadequate, the taxpayer receives another letter requesting additional information. If the IRS receives documentation from a taxpayer but is unable to review it timely, the IRS generally sends an interim letter acknowledging receipt and giving a reply date. IRM 4.19.1.4.9, *Taxpayer Replies* (Apr.25, 2005). If a reply is thirty days old or older, then an acknowledgement letter is sent advising taxpayer that a reply was received and an answer will be issued within thirty days. IRM 4.19.1.4.10, *Monitoring Overage Replies* (Jan. 1, 2001). When possible, all correspondence should be addressed before a statutory notice of deficiency is issued to a taxpayer. If the assessment statute expiration date is close to expiring, the IRS may not address all taxpayer correspondence before issuing a statutory notice of deficiency. IRC §§ 6501, 6503; IRM 25.6.23.8 (Feb. 1, 2006).

<sup>10</sup> IRC § 6213.

<sup>11</sup> IRM 4.19.1.12 (Apr. 7, 2005). These cases are referred to as no-reply or no response cases.

<sup>12</sup> For TY 2003, EITC claims totaled approximately \$39 billion. EITC Program Office, *EITC Fact Sheet*.

<sup>13</sup> AIMS Closed Case Database (Correspondence audit defined by using Employee Group Codes for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7).

<sup>14</sup> In fiscal year 2005, 61.2 percent of cases closed as no response (35.9 percent), undeliverable (6 percent), or default with correspondence (19.3 percent). As discussed earlier, a default with correspondence is a situation in which the taxpayer attempts to respond to an IRS notice but does not respond fully.

TABLE 1.19.1, FY 2005 EITC CORRESPONDENCE EXAMS BY TYPE OF CLOSURE<sup>15</sup>

Type of Closure	Number of Cases	Percentage of Total
No Response <sup>16</sup>	191,712	35.9%
Undeliverable <sup>17</sup>	31,951	6%
No Change without Adjustment <sup>18</sup>	98,184	18.4%
No Change with Adjustment <sup>19</sup>	19,718	3.7%
Agreed <sup>20</sup>	76,370	14.3%
Appealed/Petitioned <sup>21</sup>	4,146	0.8%
Default with correspondence <sup>22</sup>	103,007	19.3%
Other <sup>23</sup>	8,747	1.6%
<b>Total</b>	<b>533,835</b>	<b>100%</b>

*Is a "No Response" Really a No Response?*

In FY 2005, the IRS closed approximately 40 percent of EITC correspondence exams as a "no response" or "undeliverable," indicating the taxpayer did not respond to the exam notice.<sup>24</sup> In 2004, the Wage and Investment division (W&I) research unit conducted an EITC Pre-Refund Audit Non-Response Survey to determine reasons for the high non-response rate.<sup>25</sup> The survey involved employees and volunteer representatives who came in direct contact with EITC taxpayers when they sought assistance.<sup>26</sup> The results suggest that most taxpayers categorized as non-responsive did try to make contact with the IRS.<sup>27</sup> According to the results of the survey, 87 percent of taxpayers attempted some form of contact, with 68 percent of taxpayers mailing or faxing the requested documents. Only 13 percent of taxpayers made no efforts to respond. The survey results

<sup>15</sup> AIMS Closed Case Database (Correspondence audit defined by using Employee Group Codes for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7).

<sup>16</sup> Disposal Code 10 and Technique Codes 6 & 7.

<sup>17</sup> Disposal Code 13.

<sup>18</sup> Disposal Code 2.

<sup>19</sup> Disposal Code 1.

<sup>20</sup> Disposal Codes 3, 4 & 9.

<sup>21</sup> Disposal Codes 7 & 11.

<sup>22</sup> Disposal Code 10 and Technique Code 2. Default with correspondence is a situation in which the taxpayer attempts to respond to an IRS notice but does not respond fully.

<sup>23</sup> Disposal Codes 8 & 12.

<sup>24</sup> AIMS Closed Case Database.

<sup>25</sup> W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E (Mar. 2004).

<sup>26</sup> The individuals surveyed included IRS employees from TAS and Appeals, and Low Income Taxpayer Clinic (LITC) representatives. Taxpayers themselves were not surveyed; rather, the survey collected information from taxpayer representatives about taxpayers' actions.

<sup>27</sup> W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E 6 (Mar. 2004).

indicate the IRS is failing to accurately handle taxpayers’ attempts to engage in the audit process, thereby affecting taxpayers’ ability to prove their EITC claims.

Some cases that the IRS categorizes as “no response” do not actually represent a taxpayer’s failure to respond. An additional 19.3 percent of EITC correspondence audits close as “default with correspondence,” indicating that the taxpayer tried to engage in the audit process but ultimately left the system.<sup>28</sup> This is a slight increase over FY 2004 numbers.<sup>29</sup> IRS research shows that in many of these instances, the taxpayer has unsuccessfully attempted to contact the IRS or has not received the IRS notice.<sup>30</sup>

#### *Failure to Receive Correspondence*

The EITC Qualifying Child Residency Certification Study (hereinafter referred to as “certification study”) conducted for tax year 2004, looked into the problem of taxpayers who do not receive IRS correspondence.<sup>31</sup> Approximately six percent of the letters the IRS issued as part of the 2004 certification study were returned as undeliverable.<sup>32</sup> In a follow-up telephone survey of a random sample of taxpayers in the certification study, almost half of the taxpayers could not be reached.<sup>33</sup> Approximately seven percent of those surveyed indicated they had lived at their current addresses for less than six months. The highly mobile nature of the EITC population suggests that failure to receive correspondence may be one reason why some taxpayers do not respond to the IRS.

Although the IRS has not conducted related research in areas other than the EITC, it is likely that similar problems are present in other IRS programs. Given the large number of cases the IRS closes because the taxpayer failed to respond, provided an incomplete reply, or did not receive the notice, it is important to understand why the taxpayer did not respond or respond completely, and the impact of these closures on both the IRS and the taxpayer.

<sup>28</sup> AIMS Closed Case Database W&I and SB/SE.

<sup>29</sup> In FY 2004, 15.7 percent of EITC correspondence audits closed as “default with correspondence.” AIMS Closed Case Database.

<sup>30</sup> W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E (Mar. 2004).

<sup>31</sup> The IRS conducted the first certification study from December 2003 through April 2004 for tax year 2003. The IRS conducted a second certification study from December 2004 through April 2005 for tax year 2004, with some modifications from the 2003 test. The 2004 certification study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child residency eligibility through available data. The 25,000 taxpayers in the test group were compared with a similarly sized control group with characteristics similar to the test group. The study sought to determine the impact of a residency certification requirement on: the amount of EITC claimed including the amount of erroneous claims; the number of children claimed; taxpayer participation in the EITC; taxpayer burden; and the amount of erroneous claims that were prevented from being paid to ineligible taxpayers. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 4-5 (Oct. 2005).

<sup>32</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 23 (Oct. 2005).

<sup>33</sup> *Id.* at 7 & 23.

### Why Don't Taxpayers Respond to the IRS?

To improve the taxpayer response rate, it is important to understand why taxpayers do not respond to the IRS. However, the IRS has conducted only limited research into the reasons for non-responses. The available information on the issue is mainly anecdotal but does shed some light on taxpayer behavior.

#### *EITC Audit Reconsideration Study*

The Taxpayer Advocate Service (TAS) EITC Audit Reconsideration Study, released in December 2004, focused on identifying ways to improve the accuracy and effectiveness of EITC audit reconsiderations and the overall EITC correspondence exam process, including minimizing burden to taxpayers.<sup>34</sup> In the cases examined, taxpayers cited documentation difficulties as a reason for the audit reconsideration in 45 percent of the cases and communication challenges as a cause in 42 percent of the cases.<sup>35</sup> With regard to communication challenges, the taxpayers' reason for not responding or responding late to the IRS notice could not be determined in 74 percent of these cases.<sup>36</sup> The reasons identified for the no response or late response in the remaining cases include:

- ◆ Taxpayer did not understand the notice;
- ◆ Taxpayer lost documents; and
- ◆ Difficulty or delay in obtaining documents.<sup>37</sup>

#### *EITC Audit Barriers Study*

The Taxpayer Advocate Service initiated a project and is now working jointly with the EITC Program Office and W&I Research to identify the most significant barriers that taxpayers encounter during the EITC correspondence examination process. The research team has completed the first phase of its research, consisting of focus group interviews with LITC representatives who have assisted taxpayers undergoing EITC correspondence exams.<sup>38</sup> The team used the results of the interviews to design a survey, which was sent to a representative sample of taxpayers who recently experienced EITC correspondence audits to quantify the impact these barriers have on taxpayers. The study should help TAS and the IRS identify areas of improvement for the audit process.

<sup>34</sup> For a detailed discussion of the study and its results, see National Taxpayer Advocate 2004 Annual Report to Congress vol. 2. Audit reconsideration is an IRS process available to a taxpayer who meets certain eligibility criteria when the taxpayer disagrees with an IRS assessment made during an audit or disagrees with an Automated Substitute for Return (ASFR) the IRS created when the taxpayer did not file his or her own return.

<sup>35</sup> National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 19.

<sup>36</sup> *Id.* at 21.

<sup>37</sup> *Id.* at 22.

<sup>38</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). For this study, eight LITC attorneys were interviewed about barriers EITC taxpayers face because of an examination of their tax return. The specific LITC sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of an LITC.



While the study is still underway, initial results from the focus groups suggest that the IRS's reliance on correspondence causes problems for many EITC taxpayers. Specifically, the focus groups indicated taxpayers sometimes cannot understand many of the IRS letters they receive.<sup>39</sup> Also, some EITC taxpayers are more comfortable visiting an IRS walk-in site than calling or writing the IRS to resolve a problem. This preference stems in part from language barriers and trust issues experienced by some low income taxpayers.<sup>40</sup> This research, although still preliminary, illustrates the IRS's need to reevaluate the way it interacts with taxpayers to help them better understand their tax obligations in an examination context, and avoid downstream problems for both taxpayers and the IRS.

#### *Practitioners – First Hand Experience with No Response*

Because practitioners suffer from the same problem of unresponsive taxpayers as the IRS, their interaction with taxpayers can shed some light on why taxpayers do not respond and how to increase responses.<sup>41</sup>

According to practitioners, taxpayers' reasons for failing to reply to IRS requests are almost as complex as the tax code itself. A taxpayer may become intimidated or overwhelmed by the tax process. Many taxpayers do not understand their rights and remedies, which leads them to just ignore the issue.<sup>42</sup> This may be particularly true of taxpayers who cannot pay what the IRS indicates they owe and are not aware that alternatives such as offers in compromise or installment agreements can help them resolve their liabilities.<sup>43</sup>

Some taxpayers may realize they took incorrect positions on their returns, accept the results, and not respond to the IRS.<sup>44</sup> Others may choose not to respond because they do not understand what the IRS is asking for or cannot provide the type of information requested. Still others may be suspicious or fearful of the government in general. Some taxpayers may never get the notice simply because they have moved and left no forwarding address, or the forwarding address has expired.<sup>45</sup>

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<sup>39</sup> Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC)*, From Interviews with Low Income Tax Clinics (Sept. 2005).

<sup>40</sup> *Id.* Practitioners explained that some like to look someone in the eyes to gauge whether to trust someone or how much trust to place in the answer provided.

<sup>41</sup> *Id.*

<sup>42</sup> Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the Modernized IRS: A View From the Trenches*, 2005 TNT 113-38 (June 14, 2005).

<sup>43</sup> Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

<sup>44</sup> Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, 203 TNT 121-27 (June 24, 2003).

<sup>45</sup> Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

### *Low Income Taxpayers*

The transient nature of the low income population means that many of these taxpayers do not receive IRS notices or requests for information.<sup>46</sup> Taxpayers who do receive IRS correspondence may be confused about what information the IRS is requesting because of language and literacy issues or a lack of clarity in the notices.<sup>47</sup>

For low income taxpayers in particular, even if they want to respond to an IRS request for information, they have difficulty providing the necessary documents. Many taxpayers do not keep adequate records and may be embarrassed or afraid to admit they do not have the information. This can be an especially difficult problem for taxpayers who are self-employed.

Low income taxpayers also have particular difficulty gathering records for the IRS even if they want or are able to respond to IRS requests for information. Many of these taxpayers do not use standard financial institutions and are thus unable to provide copies of bank or credit card statements. Much of the information is more than a few months old and in the hands of someone other than the taxpayer (such as a school or doctor's office), making it difficult and time consuming for taxpayers to obtain. If a taxpayer moves often, which is common among the low income population, the necessary school, medical, and other records may not reflect his or her correct address.<sup>48</sup> These circumstances make it difficult for the taxpayer to provide the IRS with the information needed to support a claim.

Many practitioners have indicated that even if their clients have no problems obtaining documents, serious life issues such as financial, health, work, and family concerns often take priority over responding to the IRS.<sup>49</sup>

### **Does a No Response Mean a Taxpayer is Not Eligible for Relief?**

The TAS EITC Audit Reconsideration Study empirically demonstrates that 43 percent of taxpayers who sought reconsideration of correspondence examinations that disallowed the EITC in whole or in part received additional EITC as a result of the audit

<sup>46</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 23 (Oct. 2005) (discussing highly mobile nature of EITC population).

<sup>47</sup> For a more detailed discussion, see Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities*, *infra* and Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Multilingual and Cultural Barriers*, *supra*.

<sup>48</sup> Taxpayer Advocate Service, *Communicating with Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys.

<sup>49</sup> *Id.*

reconsideration.<sup>50</sup> Where the taxpayer received additional EITC, he or she received, on average, 96 percent of the EITC amount claimed on the original return.<sup>51</sup> Moreover, when TAS employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased significantly in direct proportion to the number of phone calls made by the TAS employee.<sup>52</sup>

*The EITC Audit Reconsideration Study found that taxpayers who do not respond to notices are typically no less entitled to prevail in an audit than taxpayers who respond timely.* The results of the study demonstrate that IRS failure to address the no response rate harms taxpayers.

### The Costs of No Response

The problem of no response creates downstream costs for both the IRS and the taxpayer.<sup>53</sup> If a taxpayer fails to respond to an initial notice and later contacts the IRS, the IRS must engage in a significant amount of rework. Failure to resolve a taxpayer case at the outset may result in the taxpayer requesting audit reconsideration, contacting TAS, calling the IRS toll-free number, or visiting a Taxpayer Assistance Center when the IRS attempts to collect money the taxpayer claims he or she does not owe. This later contact by the taxpayer results in two or more IRS employees who must touch the taxpayer's case instead of one employee resolving the case at the time of the initial notice.

Failure to respond may cost a taxpayer additional time and money in other ways as well. Some taxpayers who need assistance may receive it free from TAS or an LITC, but others may have to pay preparers to resolve their cases. Those who choose to not seek assistance and fail to respond can lose certain appeal rights.<sup>54</sup> The loss of the ability to

<sup>50</sup> See National Taxpayer Advocate 2004 Annual Report to Congress Vol. II, at 29. For the EITC Audit Reconsideration Study, the team reviewed a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002 and January 31, 2003. Ultimately, 679 cases (340 Examination and 339 TAS) had mostly complete data and were analyzed in detail for this study. Analyses segmented data by Examination and TAS involvement, in addition to summarizing the total dataset. See National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, at 9.

<sup>51</sup> See National Taxpayer Advocate 2004 Annual Report to Congress Vol. II, at 29.

<sup>52</sup> *Id.* at 35-37.

<sup>53</sup> Downstream costs refer to additional activity “downstream” that results when an initial action (*i.e.*, processing a tax return, resolving a tax dispute, answering a tax law question, or conducting an audit) is not conducted correctly or to the satisfaction of the taxpayer. This additional activity, which may cost the IRS and the taxpayer both time and money, would not have occurred if the initial action operated correctly and effectively. Examples of downstream costs include a tax dispute that goes to Appeals because the dispute could not be resolved during regular processing, a case that comes to TAS because it was not resolved during routine processing, or an original audit that results in an audit reconsideration.

<sup>54</sup> A taxpayer has 90 days from the mailing of a notice of deficiency (150 days if the taxpayer is located outside of the IRS) to file a petition with the Tax Court. Failure to timely file a petition will prevent the court from having jurisdiction over the taxpayer's case. IRC § 6213. The 90 day time period is critical because the Tax Court is a taxpayer's only opportunity to contest the tax in court without first paying the amount of the liability. If a taxpayer is unable to have his or her case heard in Tax Court, his or her only other option is to pay the amount of the liability and file a claim for refund. IRC § 7422.

take a case to the IRS Office of Appeals or the U.S. Tax Court is one of the most severe downstream costs to the taxpayer resulting from his or her failure to respond to the IRS.

In some cases, a failure to respond may ultimately cause a taxpayer to fall out of the tax system entirely. If a problem in one year goes unresolved, the taxpayer may be afraid to file returns in future years or become overwhelmed by their outstanding tax issue.<sup>55</sup> This fear may cause the taxpayer to drop out of the tax system, which leads to further problems for both the IRS and the taxpayer. The IRS could avoid some of these additional costs and ease taxpayer burden by working to improve the taxpayer response rate.

### IRS Efforts to Improve the Taxpayer Response Rate

While the IRS must improve how it deals with taxpayers, the IRS has successfully altered some of its processes to increase the response rate. In particular, the IRS has significantly changed the EITC examination process in the areas of communication, correspondence, and case assignments.

#### Communication

The IRS has made a concerted effort to improve its communication with taxpayers. Most importantly, the IRS realizes live contact with taxpayers not only improves the exam process, but also encourages taxpayers to respond to requests for documentation. The focus on improving communications has resulted in the IRS encouraging examiners to contact taxpayers to explain what information is needed to complete their examination *before* sending them a letter.<sup>56</sup>

In January 2006, W&I began using Intelligent Call Management (ICM) on its toll-free phone lines.<sup>57</sup> ICM is designed to improve the quality of correspondence examinations and provide a better level of service by directing incoming calls to the first available assistant at any of the W&I call sites.<sup>58</sup> In May 2006, the IRS further expanded the use of ICM by introducing similar programming to calls in which the taxpayer dials the extension for a particular examiner.<sup>59</sup> The new programming allows calls placed to a specific extension to be directed to the next available examiner if the assigned examiner is not available. ICM will also direct calls from Spanish-speaking taxpayers to bilingual employees, and should ensure that all calls are handled more efficiently.

<sup>55</sup> Taxpayer Advocate Service, *Communicating With Taxpayers Focus Group* (draft report); responses received through interviews with LITC attorneys. One practitioner notes that the clients who have the most difficulty when the IRS asks for information are nonfilers. Explaining further, the practitioner noted that if someone hasn't filed taxes in a while, the person is afraid and doesn't know how to resolve the problem.

<sup>56</sup> IRS Wage and Investment Division, Response to Research Request (Nov. 17, 2006); IRM 4.19.1.4.9.

<sup>57</sup> IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

<sup>58</sup> *Id.* See also IRM 1.4.19.3 (Jun. 1, 2006).

<sup>59</sup> IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

While the IRS has seen an increase in the number of correspondence examination calls answered by a live assistor in FY 2006, ICM only solves part of the problem.<sup>60</sup> The system helps ensure that taxpayers who *choose to call* the IRS receive prompt assistance. However, ICM does not *increase the likelihood* that a taxpayer will call the IRS or the IRS will call the taxpayer. To increase the likelihood that a taxpayer will call the IRS or that the IRS will call the taxpayer, the IRS must make additional changes. The TAS EITC Audit Reconsideration study demonstrates that the IRS and the taxpayer receive better results – in terms of both time and money – if the IRS calls the taxpayer instead of sitting back and waiting for the taxpayer to call.

### *Correspondence*

The IRS has also improved the correspondence it sends to taxpayers during the EITC exam process. Beginning in fiscal year 2005, the IRS eliminated the combination letter for EITC examinations.<sup>61</sup> Previously, the IRS sent one letter that simultaneously denied the credit claimed on the tax return, asked the taxpayer to substantiate the EITC, and triggered the opportunity for the taxpayer to take his or her case to Appeals.<sup>62</sup> This combination letter was very confusing for many EITC taxpayers. Now, taxpayers subject to an EITC correspondence exam receive two separate notices. The first notice informs the taxpayer that his or her EITC claim is under examination and requests information to substantiate the claim. If the taxpayer fails to respond to the first notice or provides insufficient information, he or she receives a second letter, known as the 30-day letter. This letter sets forth any proposed adjustments to the return and gives the taxpayer the opportunity to appeal the IRS’s decision.

In conjunction with eliminating the combination letter in EITC examinations, the IRS created Publication 3498-A, The Examination Process (Examinations By Mail). This new publication outlines the correspondence exam process and provides a “tear off” form the taxpayer can use to request an appeal of an IRS decision.

### *Case Assignments*

The IRS has made additional changes that affect not only examinations but all W&I casework. In early 2007, W&I will provide W&I and SB/SE Examination employees with a “universal view” of any taxpayer case.<sup>63</sup> For processing year 2007, W&I and SB/SE Campus Examination employees will be able to identify specific items needed to

<sup>60</sup> The number of correspondence examination calls answered by a live assistor rose from 48.7 percent in FY 2005 to 62.5 percent in FY 2006. IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006).

<sup>61</sup> National Taxpayer Advocate 2003 Annual Report to Congress 87-98. The IRS still uses the combination letter for other discretionary work. For a detailed discussion of the current use of the combination letter, see Most Serious Problem, *Correspondence Examination*, *supra*.

<sup>62</sup> For a detailed discussion of the combination letter, see National Taxpayer Advocate 2003 Annual Report to Congress 87-98.

<sup>63</sup> Universal access will be available for all cases except those with prior correspondence or cases that are currently assigned. IRS Wage and Investment Division, Response to Research Request (Nov. 14, 2006).

resolve a taxpayer's case, and provide this information to the taxpayer.<sup>64</sup> This system will allow taxpayers to more easily receive assistance and may eliminate some of the frustration they experience when they call the IRS but cannot obtain help or are bounced around from one employee to another.

### Recommendations for Improving the Response Rate

Despite this progress, there is still significant room for improvement in the way the IRS communicates with all taxpayers, not just those claiming EITC. The first step is for the IRS to understand the magnitude of the problem of no response. As noted previously, the IRS does not keep adequate records on the response rate of various notices or requests for information. The IRS does not track the number of notices for which taxpayers do not respond, respond only in part, or are returned as undeliverable. Until the IRS captures this information, it is impossible to understand the extent to which its notices go unread or unanswered.

Once additional data is available on the no response rate, the IRS should develop a targeted strategy aimed at increasing the response rate, including studies or surveys to find out why some taxpayers do not respond. The study should not be limited to the audit process and should look at all aspects of IRS activities involving communication with taxpayers and all types of taxpayers – individual, business, tax-exempt, etc. Moreover, we believe the IRS should develop a strategic goal of lessening the percentage of taxpayers who do not respond to notices or requests for information.

#### *Communication*

The IRS still needs to improve its communication with taxpayers. The IRS should encourage its employees to call taxpayers to follow up on issues instead of simply sending them a letter. The IRS could expand the use of the predictive dialer, currently in limited use by the collection functions, and attempt to contact taxpayers instead of sitting back and waiting for taxpayers to call.<sup>65</sup> Personal contact may help alleviate some of the confusion and fears associated with dealing with the IRS, and encourage taxpayers to respond to IRS requests. TAS procedures require that when a case advocate needs additional information from a taxpayer or representative, the advocate must make two attempts to obtain the information or documents.<sup>66</sup> This is not to say that IRS examiners should phone taxpayers in every examination. The IRS should train its examiners

<sup>64</sup> IRS Wage and Investment Division, Response to Research Request (Nov. 14, 2006). A processing year is the year in which a tax return is processed by the IRS.

<sup>65</sup> A predictive dialer system automatically calls individuals and transfers the call and account information to an assistor if the individual answers the phone. Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit Risk, September 2003, 46; see also Treasury Inspector General for Tax Administration, *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 1, footnote 1, (June 2003). For a discussion of IRS use of the predictive dialer, see 2004 Annual Report to Congress 234.

<sup>66</sup> IRM 13.1.7.10.3.17 (Apr. 1, 2003). The second follow-up attempt must be made in writing and must provide the consequences of a no response or partial response.

to identify instances in which calling the taxpayer will help clarify an issue or obtain a response. This type of targeted communication with taxpayers will ultimately save time and money.

The IRS can also increase its outreach and education efforts to encourage taxpayers to respond to the IRS. The 2006 certification test attempted to increase the response rate among taxpayers eligible to claim the EITC as well as those receiving certification notices.<sup>67</sup> One of the messages for qualifying taxpayers was “reply to any IRS correspondence about your EITC to get the credit you deserve.”<sup>68</sup> While the results of the 2006 certification test are still unclear, the IRS did try to encourage taxpayers to respond to IRS notices, and explored working with community groups to communicate this information to taxpayers.

Outside of the EITC, the IRS could design an outreach campaign aimed at explaining the consequences of not responding to letters and notices and encouraging taxpayers to open them. By informing taxpayers about the consequences of ignoring IRS notices, the IRS may help some taxpayers understand the need to open IRS notices and respond.

### Correspondence

While the elimination of the combination letter for EITC was an important first step, the IRS still uses the letter in other discretionary work that is much more complex than the letter was initially intended for.<sup>69</sup> To improve the quality of IRS correspondence and safeguard taxpayer rights, the IRS should stop sending the combination letter once and for all.

Further, the IRS can continue to simplify and improve its correspondence in several ways. Much correspondence is written in boilerplate language that is not targeted to the taxpayer’s specific situation and can be confusing. The IRS should attempt to draft correspondence that specifies exactly what is happening in a taxpayer’s case and what he or she must do to resolve the issue. Notices should explain to the taxpayer exactly what issues are being examined. Any requests for information should be limited only to those issues under examination and explain why the IRS is requesting specific information, with examples when possible. The IRS should also include forms the taxpayer can fill in to provide the requested information. One possibility would be for the IRS to adopt the residency form with the option to use an affidavit, as used in the 2004 certification study for purposes of EITC examinations.<sup>70</sup> If previous documentation was

<sup>67</sup> The 2006 certification test was conducted from December 2005 through April 2006 for tax year 2006.

<sup>68</sup> Wage and Investment SPEC Communications and Marketing, *W&I Communication Strategy – Earned Income Tax Credit (EITC) FY2006*, 2 (Jan. 24, 2006).

<sup>69</sup> IRS Wage and Investment Division, Response to Research Request (Sept. 26, 2006); Most Serious Problem, *Correspondence Examination*, *supra*.

<sup>70</sup> For a discussion of the affidavit used in the 2004 certification study, see notes *infra* 78 - 79 and accompanying text.

insufficient, follow-up correspondence should explain exactly why the documentation was not enough to support the taxpayer’s case and what more is needed.

Language barriers create problems for many taxpayers who do not understand the IRS notices they receive.<sup>71</sup> While many IRS notices are available in both English and Spanish, the IRS should make efforts to print them in other languages as well. The IRS could also help overcome language barriers by allowing taxpayers to specify (possibly on their tax returns) the language in which they want to receive correspondence. Taxpayers could choose in which language they would like to receive IRS correspondence. This approach may prevent taxpayers from ignoring correspondence because they are unable to read it.

Disabled taxpayers face similar barriers.<sup>72</sup> Taxpayers can receive a notice in Braille if they call and request it from the IRS Alternative Media Center, but the IRS does not widely publicize this service and has no clear procedures for placing a hold on the taxpayer’s account while waiting for the accommodating notice.<sup>73</sup> Further, there is no way for a taxpayer to request that the IRS send all future correspondence in Braille. The IRS should consider putting language – in Braille – on envelopes indicating that they contain important IRS correspondence, and providing a telephone number to call for more information.

When requesting documentation, the IRS should consider providing taxpayers an adequate sized self-addressed stamped envelope to return the information.<sup>74</sup> Additionally, the IRS should inform taxpayers (and their authorized representatives) that use of the envelope speeds processing and ensures the documentation reaches the right department. Many LITCs have adopted this approach with their own clients, and it has proven successful in encouraging taxpayers to follow up with the requested documentation.

The IRS can also make further efforts to locate updated addresses for taxpayers whose notices are returned as undeliverable. Currently, the IRS uses a software database to locate updated taxpayer information in limited instances.<sup>75</sup> The IRS should also consider conducting basic Internet research to find addresses and ensure taxpayers receive their notices.

<sup>71</sup> See Most Serious Problem, *Limited English Proficient (LEP) Taxpayers: Multilingual and Cultural Barriers*, *supra*.

<sup>72</sup> See Most Serious Problem, *Reasonable Accommodations for Taxpayers with Disabilities*, *infra*.

<sup>73</sup> IRM 21.3.6.4.1 (Oct. 1, 2006); IRM 21.3.6.4.2 (Oct. 1, 2006).

<sup>74</sup> SB/SE Research, *TEC Practitioner Focus Group Interviews, 2004*, 6-7 (Jan. 2005).

<sup>75</sup> CNNMoney.com, *ChoicePoint to Work for the “Taxman”* (June 28, 2005) available at [http://money.cnn.com/2005/06/28/news/economy/choicepoint\\_its/index.htm](http://money.cnn.com/2005/06/28/news/economy/choicepoint_its/index.htm).



### Documentation

As discussed previously, many taxpayers are unable to meet the IRS requirements for acceptable documentation.<sup>76</sup> This can cause taxpayers to become discouraged and simply ignore the IRS request entirely. As part of the 2004 certification study, the IRS piloted the use of affidavits to allow taxpayers to prove they met the qualifying child residency requirement.<sup>77</sup> The study results indicate that the affidavit was the most effective and accurate means of proving eligibility and taxpayers preferred using the affidavit to providing documents, records, or letters.<sup>78</sup> Given the effectiveness of the affidavit, and taxpayers' willingness to use the new form, we believe the IRS should expand use of the affidavit to all EITC examinations. Allowing all EITC taxpayers subject to a correspondence exam to submit affidavits to substantiate their claims for qualifying child can help resolve exams early. This approach may also encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information.

### IRS COMMENTS

The IRS recognizes that problems result for taxpayers when they do not respond to IRS notices and letters requesting information concerning their federal tax liabilities. The IRS has taken significant steps to improve response rates, specifically in our Correspondence Examination program.

### Communications

To improve our ability to reach taxpayers, the IRS uses a software database to locate and update taxpayer information on undeliverable mail. Address updates are received weekly from the United States Postal Service via the National Change of Address (NCOA) program, which maintains the most current taxpayer mailing address.

To refine the information available on no response rates, in January 2007 IRS will add a new technique code to AIMS (the automated systems used to control and track examinations) to indicate if the taxpayer called for information or orally agreed to the assessment but did not send any correspondence. This information will enable the IRS to better determine the actual no response rate by tracking data for taxpayers who reply by telephone but do not send in correspondence.

<sup>76</sup> The problems with documentation are also discussed in TAS's recent EITC Audit Reconsideration study. National Taxpayer Advocate 2004 Annual Report to Congress Vol. 2. Documentation difficulties or deficiencies with the original audit were the cause of audit reconsideration in 45 percent of the cases examined during the period of July 1, 2002 through January 31, 2003.

<sup>77</sup> The 2004 certification study marked the first time IRS examination routinely used affidavits for tax administration purposes. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 8 (Oct. 2005).

<sup>78</sup> IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005*, 33 (Oct. 2005). The 2004 certification study was the first time the IRS used the affidavit. Because the affidavit was new, taxpayers may have been very cautious when filling it out, which may have affected the accuracy rate. For a complete discussion of the use of the affidavit during the 2004 certification study, see IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* (Oct. 2005).

In 2006, the IRS also implemented two new telephone enhancements to give taxpayers flexibility when responding to the IRS. Universal Call Routing provides toll-free assistance in both English and Spanish. All Correspondence Examination telephone assistants are trained to resolve general and specific case related questions for all Correspondence Examination audit-related programs. Universal Call Routing allows an employee to assist the taxpayer regardless of their geographic location and includes the capability for the employee to view current and past case history. This allows taxpayers a much greater opportunity to contact the IRS about their case, while significantly increasing efficiency in conducting these examinations. Universal Call Routing has resulted in a significant increase in the telephone level of service (LOS) afforded taxpayers. Our LOS, 69 percent in FY 2005 and 78 percent in FY 2006, has risen to 83 percent through the first month of FY 2007. In addition, Extension Call Routing enables tax examiners (TEs) to put their specific extension number on all of their assigned cases, thereby allowing callers to reach their assigned TE. If the call is not answered live by the assigned TE, instead of just going to voice mail the call is routed to an available TE who can assist the taxpayer with any question concerning their case.

To improve the effectiveness of examination telephone operations, IRS established two new performance measure targets in the Wage and Investment (W&I) Strategy and Program Plan for FY2007 - FY2008. Correspondence Examination Level of Service measures the percentage of examination initial contact calls answered by TEs. Correspondence Exam Customer Accuracy (Telephones) measures the accuracy of the resolution of correspondence examination telephone calls. These performance goals will help us ensure the quality of taxpayers' experience when contacting the IRS by telephone regarding their correspondence examination.

To further ensure contact with the taxpayer, Correspondence Examination requires TEs to call the taxpayer when additional information is needed to resolve the case. This guidance is provided in IRM 4.19.1.4.1.9. TEs are instructed to call the taxpayer "if the taxpayer's telephone number is available, to request additional information needed instead of sending a letter." The IRM also states, "telephone contact should also be attempted, if warranted, after issuance of Notice of Deficiency if less than 15 days until default and information submitted is not sufficient to make a change."

### Correspondence

Examination cycle time, the time it takes the IRS to complete an examination, has consistently been a source of taxpayer dissatisfaction with the audit process. To reduce cycle time, the IRS adopted the "combo letter" for certain kinds of examinations.

As discussed in more detail in our response to the Correspondence Examination section of the National Taxpayer Advocate's report, we believe the combo letter is appropriate when the IRS has third-party information available to indicate a taxpayer is not entitled to a particular tax benefit. Documentation requirements for taxpayers in such cases are

not complex, taxpayers that respond timely do not lose their appeal rights, and use of the combo letter reduces the time needed for these examinations by 30 days.

In an effort to improve the rate of taxpayer responses, as well as to enhance the overall quality of communications, the IRS has revised the following notices and publications:

- ◆ Form 8862, Information to Claim Earned Income Credit After Disallowance, used by the taxpayer to recertify, was revised, resulting in a decrease to the time needed to complete the form by 50 percent.
- ◆ Computer Paragraph (CP) 27, EIC Potential for Taxpayer without Qualifying Children, is generated for any taxpayer potentially eligible for EITC without a qualifying child even when a recertification indicator is on Masterfile. The IRS also reprogrammed its systems not to reject electronically filed Forms 1040 or 1040A that claim EITC without qualifying children, when the recertification indicator is present and Form 8862 is not attached.
- ◆ CP74, You've Successfully Re-Certified for EIC, was recently developed to inform taxpayers that they have been recertified for EITC. The recertification indicator is now automatically released when the taxpayer verifies their EITC. This allows the taxpayer's refund to generate timely the following year.
- ◆ CP79, Taxpayer Inquiry, Earned Income Credit Eligibility Requirement, sent to the taxpayer to explain the recertification process, was revised using taxpayer feedback.
- ◆ CP79A, Earned Income Credit Two Year Ban, was revised to display the next year a taxpayer would be eligible to claim the EITC again.
- ◆ Publication 596, Earned Income Credit, contains a new chapter on information concerning recertification and the recertification process. This chapter was added to assist the taxpayer in determining if and when the Form 8862 is required. The EITC web page on IRS.gov links to the new recertification chapter and also includes links to Form 8862 and letters CP79 and CP79A.
- ◆ Forms 886-H Series, Supporting Documents for Taxpayers Claiming: EIC on the Basis of a Qualifying Child(ren), Dependency Exemptions or Head of Household Filing Status, was revised to properly address changes in the tax law as a result of the Uniform Definition of a Qualifying Child. A team that includes members of the Taxpayer Advocate Service (TAS), W&I Compliance, Small Business/Self Employed (SB/SE) Compliance, Single Point of Contact, and the EITC Office are working to further improve the clarity of these forms so that the taxpayer will clearly understand what they should send in, when, and why.
- ◆ Publication 3498A, The Examination Process, is being revised to enhance the language to adequately address premature Appeals concerns. Analysts working on the revision team include members from TAS, W&I Compliance, SB/SE Compliance, Appeals and the EITC Office.

- ◆ Other Notices - In September 2006, the IRS updated several publications in English and Spanish to promote awareness of the EIC refund eligibility: Publication 962 and 962E (Spanish); Publication 4194 English/Spanish and Publication 3211M. Each publication included the new "I take credit campaign" message. Additionally, in 2006, the IRS delivered several messages in its W&I Communication Strategy to encourage taxpayers to respond to EITC related notices.

In order to overcome language barriers for Limited English Proficient (LEP) taxpayers, the National Taxpayer Advocate suggests the very costly initiative of adding a "language indicator" on all tax forms. This would require significant training, computer programming, and data entry to update taxpayers' files. In addition to being very costly, there is insufficient evidence such a change would actually improve the response rate. Issues related to LEP taxpayers are addressed in more detail in our response to the Language and Cultural Barriers section of the National Taxpayer Advocate's report.

The IRS has procedures in place to accommodate visually impaired taxpayers. IRM 21.3.1.5, Request for Copy of Notice in an Alternative Media Format, provides procedures for TEs to place a hold on the taxpayer's account until a notice can be sent in Braille. A more detailed discussion of this issue is contained in our response to the Reasonable Accommodations section of the National Taxpayer Advocate's report.

Notices and letters generated by Correspondence Examination TEs explain to taxpayers what items are disallowed and what additional information is needed to support the disallowed item. A self-addressed stamped envelope is not included with notices and letters as this is extremely costly to the government. Additionally, the IRS encourages taxpayers to call its toll-free assistance lines to resolve their tax issues. As noted above, the IRS enhanced AIMS to document telephone contacts, improved its examination telephone system, and established performance goals to ensure access and accuracy for taxpayers that choose to respond by telephone.

#### Documentation

The National Taxpayer Advocate suggests that onerous documentation requests by the IRS cause taxpayers to give up and ignore an IRS notice or letter entirely. To remedy this problem, the use of affidavits is suggested for all EITC examinations in lieu of traditional documentation. As addressed in more detail in our response to the Correspondence Examination section of the National Taxpayer Advocate's report, previous testing of affidavits to establish EITC qualifying child residency requirements did not replicate the "real world" conditions under which affidavits might be used. Although affidavits appear to offer some promise as a way to improve response rates, they may generate additional erroneous claims that the IRS would have to examine. Further, to prevent use of false affidavits the IRS would need a comprehensive approach to identifying and preventing their abuse. Thus, while data from the EITC certification tests indicates some potential usefulness for affidavits, the data is insufficient to warrant use of similar affidavits for all EITC examinations.

Even though we do not have sufficient data to support acceptance of affidavits, in some cases we do allow our TEs to accept alternative documents when standard documentation is unavailable. For example, we worked closely with the Tax Exempt and Government Entities Division to determine acceptable documentation for the Native American population since traditional documentation is often not available.

In summary, the IRS has taken significant steps to improve taxpayer response rates:

- ◆ We utilize the NCOA program to obtain the best and most current taxpayer mailing address.
- ◆ We improved our AIMS system to better measure the no-response rate.
- ◆ We enhanced our telephone system and implemented new performance measures to improve the taxpayer's experience when responding by phone.
- ◆ We require our TEs to initiate telephone contact when additional information is needed or 15 days prior to default when a Statutory Notice of Deficiency has been issued.
- ◆ We use the combo letter to reduce taxpayer burden by reducing cycle time.
- ◆ We improved the clarity of several notices and publications and have procedures in place to accommodate visually impaired taxpayers.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for recognizing the problems that arise when a taxpayer does not respond to an IRS notice or letter. We are also pleased that the IRS has taken steps to improve response rates, particularly in the Correspondence Examination program. Requiring examiners to call taxpayers when the IRS needs additional information to resolve their cases is an important step in ensuring that taxpayers do not simply fall through the cracks of the examination process.

We are encouraged by the improvements to AIMS, which will more accurately capture whether a taxpayer contacts the IRS in regards to a notice. This will help the IRS to develop a more precise view of how many taxpayers do not respond. However, we believe there is room for additional improvement. The first step is to understand the magnitude of the problem of no response and develop a targeted strategy aimed at increasing the response rate. We look forward to working with the IRS in its efforts to improve taxpayer response rates.

As noted previously, we are pleased by the recent telephone enhancements that allow the IRS to better respond to taxpayer calls without having to transfer taxpayers or send them to voicemail. The new performance measures for correspondence examination calls will also help improve the quality of a taxpayer's experience when he or she contacts the IRS for assistance.

## PROBLEMS

While these changes improve service for those taxpayers who do call the IRS for assistance, they still do not increase the likelihood that taxpayers *will call* the IRS when they receive a notice or letter. To increase the likelihood that a taxpayer will contact the IRS, the IRS should increase its outreach and education efforts to encourage taxpayers to respond to correspondence.

We are disappointed that the IRS continues to use the combination letter in certain types of examinations. The combo letter gives taxpayers conflicting instructions – simultaneously telling them to communicate with exam while also telling them to fill out a request for an appeals conference if they do not agree with the result. It should come as no surprise that taxpayers do not respond to such conflicting instructions. We are concerned that the IRS’s refusal to eliminate the combo letter is driven, in part, by an attempt to minimize the number of appeals conferences in order to reduce costs and accelerate assessments. Even if that is not the intention, it is clearly the effect and it serves to undermine a taxpayer’s *meaningful* right to an administrative appeal. We believe eliminating the “combo” letter is important to improving both the quality of IRS correspondence and taxpayer rights, and we will continue to work for the elimination of the combination letter.<sup>79</sup>

We are pleased that the IRS is reviewing notices and publications in an effort to enhance the overall quality of its communications with taxpayers. Here too, however, there is still room for improvement, particularly when the IRS communicates with taxpayers who may face additional barriers in their interaction with the IRS. Limited English Proficiency (LEP), visually impaired, and low income taxpayers may have greater difficulty in responding to IRS requests. Although some of our suggestions for improving the response rate among these taxpayers may mean additional costs, they may also help eliminate downstream costs to both the taxpayer and the IRS.

Taxpayers who are unable to meet IRS requests for documentation may become discouraged and ignore the IRS request. For this reason, and to improve the resolution of IRS examinations, we believe the IRS should expand the use of the affidavit to all EITC examinations. Based on the EITC certification study, the IRS should also test the effectiveness of other methods of proof to determine which are most accurate and best suited for meeting IRS and taxpayer needs. The IRS can continue to gather data regarding the use of affidavits while expanding their use to all EITC examinations in the near future.

**RECOMMENDATIONS**

To improve the taxpayer response rate and help reduce downstream costs for both taxpayers and the IRS, we recommend that the IRS do the following:

<sup>79</sup> See Most Serious Problem, *Correspondence Examination*, *supra*.

- ◆ Accurately track the no response rate to IRS notices and letters in order to understand the magnitude of the problem of no response.
- ◆ Develop a targeted strategy aimed at increasing the taxpayer response rate, including studies or surveys to find out why some taxpayers do not respond.
- ◆ Increase outreach and education efforts to encourage taxpayers to respond to the IRS, including:
  - ◆ Examining the 2006 EITC certification test in which one message to qualifying taxpayers was “reply to any IRS correspondence about your EITC to get the credit you deserve”;<sup>80</sup>
  - ◆ Design an outreach campaign aimed at explaining the consequences of not responding to notices and letters and encouraging taxpayers to open mail from the IRS.
- ◆ Continue to review IRS correspondence and publications to ensure that taxpayers understand what the IRS is requesting.
- ◆ Consider changes to communication that would assist LEP, disabled, and low income taxpayers, such as:
  - ◆ Allow taxpayers to specify in what language they want to receive communication from the IRS;
  - ◆ Put language in Braille on envelopes indicating that the letter contains important IRS correspondence and providing a telephone number to call for more information; and
  - ◆ Include a self-addressed stamped envelope with letters requesting information from a taxpayer.
- ◆ Expand use of the residency affidavit to all EITC examinations while continuing to monitor its effectiveness relative to other forms of documentation.

<sup>80</sup> Wage and Investment SPEC Communications and Marketing, *W&I Communication Strategy – Earned Income Tax Credit (EITC) FY 2006 2* (Jan. 24, 2006)

**PROBLEM****TOPIC #20****REASONABLE ACCOMMODATIONS FOR TAXPAYERS WITH DISABILITIES****RESPONSIBLE OFFICIALS**

Kevin M. Brown, Deputy Commissioner, Services and Enforcement  
 Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
 Richard J. Morgante, Commissioner, Wage and Investment Division  
 Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division  
 Steven T. Miller, Commissioner, Tax Exempt and Government Entities  
 Sarah Hall Ingram, Chief, Appeals  
 Nancy J. Jardini, Chief, Criminal Investigation  
 Donald L. Korb, Chief Counsel

**DEFINITION OF PROBLEM**

Taxpayers with disabilities often find themselves attempting to navigate and comply with a complex tax system that was not designed to provide equal access. Taxpayers who are blind, deaf, or have other disabilities encounter numerous barriers unique to these groups. These barriers can discourage taxpayers with a disability from complying with their tax responsibilities, or from initiating any contact with the IRS.

Disabilities impact all areas of our society – people of every economic background, age, race, and creed. The U.S. Census Bureau reports 51.2 million people, representing 18 percent of the population, as having some type of disability<sup>1</sup> and of this group 32.5 million, or 12 percent of the population, have severe disabilities.<sup>2</sup> The elderly community has the highest rate of disabled individuals when compared with other age groups: 72 percent of people age 80 and over have some type of disability.<sup>3</sup> Most likely, this number will increase as the population continues to age.<sup>4</sup> These statistics demonstrate how important it is for the IRS to provide accommodating services to taxpayers with disabilities.

Disabled taxpayers generally encounter three major barriers when attempting to comply with and navigate the tax system. These barriers are:

- ◆ **Communication Barriers:** Individuals with a disability often use different skills to communicate effectively. They may require a translator, materials in an alternative format, or materials that can be accessed with assistive technology. The type of accommodation a taxpayer needs to communicate effectively will vary according to the taxpayer's disability.

<sup>1</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html).

<sup>2</sup> *Id.*

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

<sup>4</sup> CDC, *Public Health and Aging: Trends in Aging – United States and Worldwide*, at <http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5206a2.htm>. Between 2000 and 2030, the number of U.S. citizens 80 years of age or older is expected to increase from 9.3 million to 19.5 million.



- ◆ **Education and Outreach to the Disabled Community:** The IRS needs to increase its efforts to educate taxpayers with disabilities about the helpful services available to them, when and whether to file a tax return, and other issues such as tax deductions or credits. Moreover, the Small Business/Self-Employed(SB/SE) Operating Division should reach out to disabled taxpayers who are attempting to set up a small business. SB/SE also needs to improve its outreach to owners of small businesses about tax incentives available for complying with The Americans with Disabilities Act.<sup>5</sup>
- ◆ **Problems with Deductions and Credits:** Taxpayers with disabilities may be eligible for a variety of tax deductions and credits, but these provisions of the tax code are often complex and confusing to the most sophisticated tax professionals, let alone a lay person who may face obstacles in obtaining IRS resources. Further, due to the complexity of the tax system, small business owners may have difficulty understanding when they can take deductions and credits for expenses incurred as a result of complying with The Americans with Disabilities Act.<sup>6</sup>

### ANALYSIS OF THE PROBLEM

#### Background: Persons with Disabilities in the U.S.

Persons with disabilities are the largest protected class in the United States. This group is diverse in age, race, and economic standing.

- ◆ 51.2 million Americans, 18 percent of the population, have some level of disability;
- ◆ 32.5 million Americans, or 12 percent of the population, have severe disabilities;
- ◆ 10.7 million Americans age six and older need daily assistance with one or more activities of life, such as taking a bath or using the telephone;
- ◆ 1.8 million Americans age 15 and older report being unable to see;
- ◆ 2.6 million Americans age 15 or older report some difficulty having their speech understood by others; and
- ◆ 14.3 million Americans have limitations on their cognitive function, or an emotional or mental illness.<sup>7</sup>

The median income for Americans who have a non-severe disability is \$22,000, compared to \$25,000 for those who do not have a disability. Twenty-six percent of Americans with a severe disability fall below the poverty line, compared with 11 percent of those with a non-severe disability and six percent with no disability. Thirty-three percent of Americans between the ages of 25 and 64 who have non-severe disabilities, and 22 percent of those with severe disabilities have graduated from college, compared to

<sup>5</sup> 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990). See also Most Serious Problem, *Small Business Outreach*, *supra*.

<sup>6</sup> 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990).

<sup>7</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html).

the 43 percent who do not have disabilities and have graduated from college. Thirty-six percent of Americans between the ages of 15 and 64 with a severe disability have a computer and 29 percent use the Internet at home, compared with 61 percent of Americans who do not have a disability and have a computer and 51 percent who use the Internet at home. Finally, 2.6 million veterans receive compensation for service related disabilities.<sup>8</sup> Clearly, persons with disabilities constitute a large and diverse segment of the U.S. population.

### Communication Issues

#### *Visually Impaired and Blind Taxpayers*

There are 1.8 million people aged 15 or older who report being unable to see. Many of these individuals utilize large print, audio, Braille, adaptive technology, adaptive equipment, and other devices to communicate in a sighted world.<sup>9</sup> The IRS provides forms and publications in PDF and HTML formats,<sup>10</sup> which may be compatible with assistive technology.<sup>11</sup> However, not all IRS documents are compatible with assistive technology, and this gap impedes or impairs taxpayers' ability to read these documents.<sup>12</sup> The IRS has also established the Alternative Media Center (AMC), which will provide forms, publications, and even notices in a variety of formats that are usable for the visually impaired or blind taxpayer.<sup>13</sup> However, many taxpayers are unaware of these services, because they are not well publicized and can be difficult for taxpayers to find.<sup>14</sup> Visually impaired and blind taxpayers may also have difficulty reading IRS correspondence sent directly to them, and may be burdened by their inability to immediately read the notice or even realize they have received an IRS notice.

#### *Forms and Publications in Accommodating Formats*

Although the IRS has taken steps to provide forms and publications in alternative formats, the IRS is not taking steps to make people aware of this service. Because the AMC produces 555 forms in PDF talking format, and 345 forms and publications in

<sup>8</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html).

<sup>9</sup> American Federation of the Blind, *Computer Use*, at <http://www.afb.org/Section.asp?SectionID=15&DocumentID=1367#comp> (last visited Sept, 11 2006). Just over 1.5 million people with limited vision use computers and 196,000 of the 1.5 million have severe vision limitations.

<sup>10</sup> IRS, *Accessible IRS Tax Products*, at <http://www.irs.gov/formspubs/article/0,,id=96151,00.html>.

<sup>11</sup> Freedom Scientific, at <http://www.freedomscientific.com/> (last visited Sept. 12, 2006). This company sells screen reading programs (JAWS) and screen magnification programs (Magic) for the blind and visually impaired.

<sup>12</sup> See, e.g., IRS Instructions for Form 5884, *Work Opportunity Credit*, (1981). This is an example of an old form that has not been redesigned to comply with Section 508.

<sup>13</sup> IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

<sup>14</sup> IRS, *Accessible IRS Tax Products*, at <http://www.irs.gov/formspubs/article/0,,id=96151,00.html>. How to request forms, publications, or notices in Braille or other alternative formats is not advertised on the IRS's accessibility website.

text only files and Braille ready format,<sup>15</sup> taxpayers can request any form, publication, notice, or bill in Braille or an alternative format.<sup>16</sup> However, the IRS does not advertise this service anywhere on its website or the AMC website, or address the service in publications.<sup>17</sup> With virtually no advertising, this service is difficult to locate and is significantly under-utilized.<sup>18</sup> The IRS should promote this service on its accessibility website and require it to be mentioned on every IRS form, publication, and notice.

### Correspondence

IRS correspondence also creates a unique challenge for visually impaired and blind taxpayers. For instance, many visually impaired and blind taxpayers hire sighted individuals to help them sort their mail but those with low incomes may not be able to afford daily assistance and may hire someone weekly or even more irregularly, or may rely on unscheduled volunteers or family members for assistance. This lag time between when the taxpayer receives the notice and the time he or she can identify and understand it may place a burden on the taxpayer.

Some IRS notices come with a relatively short turnaround time, and taxpayers who are visually impaired or blind may experience a burden trying to respond timely. For instance, taxpayers must respond to a CP 2000 notice within 30 days of receiving it. This timeframe could create a burden for the visually impaired or blind taxpayer since the taxpayer may not realize he has received a notice until his reader reviews the correspondence. Failure to respond to notices can result in serious consequences for the taxpayer; therefore, it is imperative that the notice be available in a format the taxpayer can read and understand. As noted previously, taxpayers can receive a notice in Braille if they call and request it from the AMC, but again, this service is not widely publi-

<sup>15</sup> Text only files are electronic files that contain only a basic character set of letters, numbers and punctuation. Text files do not display fonts, images, icons or any other graphical information. These files can be opened and edited in any text-editing program such as Microsoft Word, WordPerfect, WordPad and Notepad. Braille Ready Format (.brf) files are text-only files which have been formatted specifically for embossing. Embossing, which produces a raised image on paper by striking the other side, is the most commonly used method for producing Braille. These files can be sent directly to any personal or commercial Braille embosser using the DOS print command or through Braille translation software.

<sup>16</sup> IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

<sup>17</sup> IRS, Pub. 907, *Tax Highlights for Persons with Disabilities* (2005); IRM 21.3.6.4.1 (Oct. 1, 2006); IRM 21.3.6.4.2 (Oct. 1, 2006); IRS *Tax Topics 102, Tax Assistance for Individuals with Disabilities and the Hearing Impaired*, (2005), and IRS, *Tele Tax 105 Public Libraries – Tax Information Tapes and Reproducible Tax Forms 1-800-829-4477*. The IRS has inconsistent information on how to request forms, publications, notices, and bills in alternative formats. For example, IRM 21.3.6.4.1 (Oct. 1, 2006), tells the IRS employee to order the material in an accommodating format through the desktop integration system, which is the correct process. The TeleTax topic actually gives the taxpayer incorrect information on how to request a Braille or large print publication or form: “Braille materials for the visually impaired are available at any of the 142 regional libraries in conjunction with the national library service for the blind and physically handicapped. To locate your nearest library write to the National Library Service for the Blind and Physically Handicapped, Library of Congress at 1291 Taylor Street, NW, Washington, D.C. 20542.” Not only is the information inconsistent, but it is very difficult to find. In fact, it is not even advertised on the Alternative Media Center website.

<sup>18</sup> Systemic Advocacy Management Information System (SAMS). A blind taxpayer submitted an issue on SAMS saying IRS employees could not provide information on how to obtain tax bills in Braille.

cized.<sup>19</sup> Also, the IRS does not have a process that allows the taxpayer to request that all further correspondence be sent in the accommodating format.

### *Technology and Section 508 Compliance Issues*

Congress enacted § 508 of the Rehabilitation Act in an effort to eliminate barriers in information technology.<sup>20</sup> This legislation requires federal agencies to make all electronic materials available to people with disabilities.<sup>21</sup> The impact of not having information technology available to federal employees and the general public can be detrimental to effective government and individual rights. For instance, it can be a barrier to obtaining and utilizing necessary information quickly and easily.

Section 508 requires the IRS, as well as all other federal agencies and departments, to make electronic and information technology equally accessible to federal employees and all members of the public. Thus, people with disabilities must have use of and access to electronic and information technology that is comparable to the use and access enjoyed by people who do not have a disability.<sup>22</sup>

This legislation has a significant impact on the visually impaired and blind community since these individuals rely heavily on assistive technology to use computers and access information.<sup>23</sup> The development of this assistive technology has opened a whole new world for disabled individuals. If documents are designed correctly, the visually impaired and blind can access them on the Internet easily and quickly, whereas many of these materials were previously available only in print and were difficult to access in an accommodating format. However, with new technology, different challenges occur. Websites must be designed in a manner that is compatible with the screen reader, screen magnification, or other assistive technology programs. If sites and documents are not

<sup>19</sup> IRM 21.3.6.4.1 (Oct. 1, 2006); and IRM 21.3.6.4.2 (Oct. 1, 2006).

<sup>20</sup> 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998 (Pub. L. No. 105-220, (Aug. 7, 1998).

<sup>21</sup> 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998 (Pub. L. No. 105-220, (Aug. 7, 1998), provides

(a) REQUIREMENTS FOR FEDERAL DEPARTMENTS AND AGENCIES.—(1) ACCESSIBILITY.—(A) DEVELOPMENT, PROCUREMENT, MAINTENANCE, OR USE OF ELECTRONIC AND INFORMATION TECHNOLOGY.—When developing, procuring, maintaining, or using electronic and information technology, each Federal department or agency, including the United States Postal Service, shall ensure, unless an undue burden would be imposed on the department or agency, that the electronic and information technology allows, regardless of the type of medium of the technology— (i) individuals with disabilities who are Federal employees to have access to and use of information and data that is comparable to the access to and use of the information and data by Federal employees who are not individuals with disabilities; and (ii) individuals with disabilities who are members of the public seeking information or services from a Federal department or agency to have access to and use of information and data that is comparable to the access to and use of the information and data by such members of the public who are not individuals with disabilities.

<sup>22</sup> 29 U.S.C. 794d, as amended by the Workforce Investment Act of 1998, (Pub. L. No. 105-220, (Aug. 7, 1998).

<sup>23</sup> American Federation of the Blind, *Computer Use*, at <http://www.afb.org/Section.asp?SectionID=15&DocumentID=1367#comp>. Just over 1.5 million people with limited vision use the Internet and 196,000 of the 1.5 million have severe vision limitations.

properly designed, the user will either have difficulty navigating the site or program, or will be unable to access the site entirely.

The IRS has made significant strides in developing § 508 compliant websites, but it can still make improvements. It is unclear how many IRS sites fail to comply with § 508 because the IRS does not track this information. Many older IRS sites have not been redesigned. Moreover, it is not realistic or cost effective to redesign and update these old inaccessible websites. However, publicizing the procedure for taxpayers to request forms and publications in accommodating formats would provide another way to obtain usable documents.

We were unable to identify any formal procedures for taxpayers to comment on the difficulties they may have when attempting to navigate and use the IRS's website. Even though the IRS's accessibility webpage contains a comment section, it does not ask for specific comments on § 508 compliance issues.<sup>24</sup> Further, even if taxpayers make comments, the IRS has no formal procedures for determining if they have merit, or implementing steps to address issues that do have merit. Such a mechanism is an essential element of full compliance with § 508, because otherwise the IRS will have difficulty knowing if taxpayers encounter barriers when navigating and using the IRS website.

In addition to improving the number of § 508 compliant documents, the IRS could make a number of adjustments that would make its external website more accommodating to disabled taxpayers.<sup>25</sup> For example, the IRS could offer several options that would allow the taxpayer to manipulate the site to meet his or her individual needs, such as fonts, color, and speech option. Developing a website that provides these accommodations may help prevent or resolve these problems and ultimately save the IRS money and resources.

Moreover, not only should the IRS improve the accessibility of its websites, but it should also be conscientious about writing § 508 requirements into contracts with private companies, since private firms are otherwise not required to be § 508 compliant. It is true that the IRS may not be in violation of § 508 by entering into an agreement with a company that does not have an accessible website, such as the e-file sites that

<sup>24</sup> IRS, *Alternative Media Center*, <http://www.irs.gov/help/page/0,,id=13148,00.html>.

<sup>25</sup> National Institutes Of Health, *Elderly* at <http://nihseniorhealth.gov/>.

participate in the Free File program.<sup>26</sup> Even if this is within the letter of the law, however, is it really within the spirit of the law? Moreover, is the IRS promoting good public policy by *not* requiring its contractors to provide equal access to all taxpayers? The IRS should make a business decision to contract only with private companies that will guarantee equal access. If private companies cannot provide services with equal access, the IRS should provide the service (or access) itself – maintaining the sound principle that all taxpayers are entitled to equal access to IRS services.

### *Barriers Facing Deaf and Hard-of-Hearing Taxpayers*

Deaf and hard-of-hearing taxpayers also face unique challenges when attempting to communicate effectively. For example, many of these taxpayers use American Sign Language (ASL) as their primary language.<sup>27</sup> Communicating with people by using other methods – such as writing notes – can be difficult and confusing, and lead to misunderstanding between the taxpayer and the hearing person. Also, a deaf or hard-of-hearing taxpayer who uses ASL as a primary language may have difficulty understanding printed material since it is not in his or her primary language.<sup>28</sup>

### *American Sign Language as a Primary Language*

The most significant barrier deaf and hard-of-hearing taxpayers experience when attempting to navigate and utilize the tax system is communicating with the IRS. For example, when a deaf person enters a Taxpayer Assistance Center (TAC), and the taxpayer only speaks ASL, the taxpayer and IRS assister may have to communicate by passing notes to one another. This approach can lead to confusion since the taxpayer's primary language is ASL and it may be difficult for him or her to understand what the IRS employee is communicating.<sup>29</sup> The IRS could provide an ASL video relay service in its TACs to

<sup>26</sup> The IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies known collectively as the “Free File Alliance.” The agreement had a three-year term that ended last year, and in October 2005, the IRS and the Free File Alliance agreed to extend the contract for four years with some modifications. The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to a minimum of at least 60 percent of all taxpayers and the 2005 agreement prevents Free File companies, in the aggregate, from making free services available to more than 70 percent of all taxpayers. Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at [www.irs.gov/efile/article/0,,id=103626,00.html](http://www.irs.gov/efile/article/0,,id=103626,00.html); Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at [www.irs.gov/pub/irs-efile/free\\_file\\_agreement.pdf](http://www.irs.gov/pub/irs-efile/free_file_agreement.pdf).

<sup>27</sup> Rosenberg Amy (1999) *Writing Sign Languages*. Masters Thesis, University of Kansas at <http://www.signwriting.org/forums/research/rese013.html> (last visited Nov. 16, 2006). The National Association of the Deaf reports that there are 28 million people who report having some hearing impairment; two million of them are deaf, meaning they cannot hear speech; and 300,000 people who consider themselves culturally “Deaf,” which means they consider American Sign Language their primary language and live in a Deaf community.

<sup>28</sup> National Association of the Deaf, at <http://www.nad.org/site/pp.asp?c=foINKQMBF&b=99566>.

<sup>29</sup> Hoffmeister, R. J., De Villiers, P. A., Engen, E., & Topol, D. (1997). *English Reading Achievement and ASL Skills in Deaf Students*. Proceedings of the Annual Boston University Conference on Language Development, 21(1), 307-318; Nover, S. M., Christensen, K. M., & Cheng, L. R. L. (1998). Development of ASL and English Competence for Learners Who Are Deaf. *Topics in Language Disorders*, 18(4), 61-72; and Prinz, P. M. & Strong, M. (1998). ASL Proficiency and English Literacy within a Bilingual Deaf Education Model of Instruction Topics in Language Disorders, 18(4), 47-60.

assist with communication and translate between the deaf or hard-of-hearing taxpayers and IRS employees.<sup>30</sup> Unfortunately, no TAC has this technology available.

The language barrier also extends to IRS forms and publications. Again, deaf individuals who use ASL as their primary language often have difficulty understanding written materials since they are not in their primary language. To minimize this barrier, the IRS could provide answers to some of the most frequently asked tax questions in ASL and post them on its website as a streaming video.

### Education and Outreach to Taxpayers with Disabilities

#### *Helpful Services*

The IRS does offer some services to taxpayers with disabilities, such as the AMC.<sup>31</sup> However, the IRS must do more to inform taxpayers about these services as well as improve its outreach to this group of taxpayers and educate them about the tax laws and tax administration.

The IRS should expand its accessibility website to include information on tax deductions and credits for disabled taxpayers and how to request IRS materials in an alternative format. Centralizing all this information in one location, with links to other appropriate sites, is more logical than scattering it throughout the IRS site. Such information can be difficult for all taxpayers to find, but the search may be even more difficult and frustrating for those with disabilities.

In addition to providing information on the Internet, the IRS should maintain and improve accessibility to its TACs and toll-free telephone number. Many taxpayers with a disability do not have access to the internet or assistive technology because of its cost, and they prefer personal contact with the IRS.<sup>32</sup> Also, it is essential that all IRS employees – especially employees at TACs and those staffing the toll-free number – are trained on IRS services for taxpayers with disabilities, so they can make appropriate referrals.

#### *When To File*

Taxpayers with a disability, when interviewed in focus groups, expressed confusion about when to file a tax return, and how filing a return would impact social security benefits.<sup>33</sup> This confusion indicates that the IRS needs to increase its outreach to this group.

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<sup>30</sup> National Center on Accessibility Information Technology in Education at <http://www.washington.edu/accessit/articles?111>.

“The Video Relay Service (VRS) is similar to the [Telephone Relay Service] (TRS), but a relay operator provides translation between spoken word and American Sign Language (ASL), rather than spoken word and text. The hearing user communicates by voice, the non-hearing user communicates by video using ASL, and the relay operator serves as a liaison, communicating by voice to the hearing party and by video using ASL to the non-hearing party. VRS is an important alternative to the original TRS, since many individuals with hearing impairments prefer ASL as their primary method of communication.”

<sup>31</sup> IRS, *Accessible IRS Tax Products*, at <http://www.irs.gov/formspubs/article/0,,id=96151,00.html>.

<sup>32</sup> IRS, *TAB II Draft Report on Taxpayers with Disabilities: A Focus Group Project* (Jun. 13, 2006).

<sup>33</sup> *Id.*

Publication 907, *Tax Highlights for Persons with Disabilities*, briefly addresses the issue of Supplemental Security Income (SSI) payments but offers no information on how filing a return may or may not impact a taxpayer's SSI.<sup>34</sup> At a minimum, the IRS should include a reference in Publication 907 on where to obtain more information, such as a Social Security Administration website or toll-free number.

#### *Tax Deductions and Tax Credits*

Tax deductions and credits can be helpful to millions of disabled taxpayers, their caretakers, or businesses owners who comply with the ADA's accessibility standards by making their facilities accommodating. The IRS has not conducted research to identify the specific needs of this population, nor has it developed or implemented a campaign to educate taxpayers with disabilities. There is one exception: the Stakeholder Partnership Education and Communication (SPEC) organization in the Wage and Investment (W&I) division has set an example for the IRS by developing a disability toolkit. This toolkit is designed to educate SPEC's community-based partners, such as Goodwill Industries, who have direct contact with the disabled community, and provide guidance on how to establish work groups within the community, that will assist disabled taxpayers with tax preparation, financial literacy, and asset building. Currently, this toolkit is only available internally, but SPEC intends to make it available to the public. SPEC has also created a page on its internal (IRS intranet) website devoted entirely to disability issues, with information on outreach and education.<sup>35</sup>

#### *Taxpayers with Disabilities and Their Caretakers*

Several tax deductions and tax credits have been designed to assist disabled taxpayers and their caretakers. Unfortunately, the IRS has conducted little outreach to inform and explain these deductions and credits to taxpayers.

- ◆ **Medical Expenses:** Taxpayers can take certain medical and dental deductions for themselves, their spouses, and dependants. This deduction is limited to expenses that total more than 7.5 percent of the Adjusted Gross Income (AGI).<sup>36</sup>
- ◆ **Impairment Related Work Expenses:** This deduction applies to individuals with a physical or mental disability that functionally limits employment or substantially limits one or more major life activities.<sup>37</sup> Taxpayers eligible for this deduction are not subject to the two percent AGI threshold for work-related expenses that applies

<sup>34</sup> IRS, Pub 907, *Tax Highlights for Taxpayers with Disabilities* (2005). "Social security benefits do not include SSI payments, which are not taxable. Do not include these payments in your income." Supplemental Security Income home page available at <http://www.socialsecurity.gov/notices/supplemental-security-income/> (last visited on Nov 3, 2006). Supplemental Security Income (SSI) is a federal supplemental income program designed to assist the aged, blind, and disabled person who has little or no income. This program provides money for basic human needs, such as food, clothing, and shelter.

<sup>35</sup> IRS, *Wage and Investment Insider*, [http://win.web.irs.gov/spec/SPEC\\_disability.htm](http://win.web.irs.gov/spec/SPEC_disability.htm).

<sup>36</sup> IRC § 212.

<sup>37</sup> IRC § 67(d).



to other taxpayers.<sup>38</sup> However, this deduction can only be used if the taxpayer itemizes deductions rather than taking the standard deduction.

- ◆ **Child and Dependent Care Credit:** The taxpayer can take this credit if he or she pays a person to provide care to a dependant under the age of 13, a dependent who is over the age of 13 but unable to care for him or herself, or a spouse who is unable to care for him or herself. This credit is up to 35 percent of the taxpayer's dependent care expenses, with a maximum of \$3,000 for one qualifying individual and \$6,000 for two or more qualifying individuals.<sup>39</sup>
- ◆ **Credit for the Elderly or Disabled:** A taxpayer can claim this tax credit if he or she is age 65 or older, or is permanently unable to work and receives disability.<sup>40</sup>

#### *Small Business and Self-Employed Taxpayers*

Congress has created two major incentives for business owners to make their businesses accommodating to disabled customers and employees. The Disability Access Credit<sup>41</sup> and the deduction for removing barriers for the disabled and elderly<sup>42</sup> were designed to alleviate some of the financial burden businesses may experience when complying with the Americans with Disabilities Act.<sup>43</sup> These incentives are available in the following circumstances:

- ◆ **Disability Access Credit:** Small businesses can use this tax credit for expenses incurred by complying with the ADA, which may include architectural adaptations, equipment acquisitions, and services such as sign language interpreters.<sup>44</sup> This tax credit can be claimed up to 50 percent of the first \$10,000 eligible expenses that exceed \$250.
- ◆ **Deduction for Removing Barriers for the Disabled and Elderly:** This deduction allows a business of any size to deduct expenses, up to \$15,000 per year, associated with the removal of architectural or transportation barriers in connection with a trade or business that comply with applicable accessibility standards.<sup>45</sup>

These incentives are useful for encouraging and supporting businesses to be more accessible to the disabled and elderly consumer. However, SB/SE has done very little to educate taxpayers about these incentives. SB/SE's website contains only one

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<sup>38</sup> IRC §§ 67(a) and 67(b)(6).

<sup>39</sup> IRC § 21.

<sup>40</sup> IRC § 22.

<sup>41</sup> IRC § 44.

<sup>42</sup> IRC § 190.

<sup>43</sup> 42 U.S.C. §§ 12101 et seq (1990); PL 101-336 (Jul. 26, 1990).

<sup>44</sup> IRC § 44.

<sup>45</sup> IRC § 190.

brief discussion of these issues.<sup>46</sup> The discussion is unclear and does not provide any examples of which expenses would qualify for these incentives.<sup>47</sup> In addition, the information is difficult to locate. Again, it would make more sense to consolidate these materials on a designated disability website. SB/SE's lack of outreach may be a factor in the low number of taxpayers who actually apply for these incentives.<sup>48</sup>

Moreover, SB/SE has conducted even less outreach and education for small businesses owners and self-employed individuals who have a disability. It is important that the IRS becomes more active in outreach to taxpayers with a disability because some professionals believe that being self-employed or owning their own small businesses is an increasing trend in the disability community.<sup>49</sup> One of the most significant barriers facing disabled individuals who are attempting to start their own business is the inaccessibility of business materials.<sup>50</sup> Thus, the IRS should ensure that it is not a barrier to disabled individuals entering business, but is instead a resource for these entrepreneurs. To help accomplish this goal, the IRS should have a small business and self-employment section on its accessibility webpage.

### Problems With Deductions and Credits

Not only has the IRS done a poor job of educating disabled taxpayers about these deductions and credits, but many of them are complex and difficult for taxpayers to understand. This process is even more difficult for persons with disabilities because of the lack of accommodating resources and poor communication from the IRS.

#### *Disability Access Credit*

One of the most beneficial tax credits for small businesses is the Disability Access Credit (DAC).<sup>51</sup> This credit was created to help eliminate some of the cost of providing accommodations for employees. The credit applies to businesses that have 30 or fewer

<sup>46</sup> IRS, *Know the Rules Regarding Tax Incentives for Improving Accessibility for the Disabled*, at <http://www.irs.gov/businesses/small/article/0,,id=113382,00.html>.

<sup>47</sup> *Id.*

<sup>48</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* (Dec. 2002). Although the GAO report does not directly connect the low numbers of eligible businesses who claim the Disability Access Credit, Deduction for Removing Barriers for the Disabled and Elderly, and Work Opportunity Credit to lack of outreach and education, it strongly recommends that federal agencies, including the IRS, increase its outreach and education efforts.

Academic disability researchers, businesses, disability groups, and other interested parties we interviewed proposed various options to increase the awareness and usage of the incentives, including (1) expanding and improving federal outreach through better coordination and clarification of incentive requirements; (2) increasing the maximum amount allowed to be claimed; and (3) expanding eligibility to cover more workers with disabilities, businesses, and types of accommodation.

<sup>49</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>.

<sup>50</sup> *Id.*

<sup>51</sup> IRC § 44.

full-time employees, or have less than one million dollars in gross yearly proceeds.<sup>52</sup> The business is allowed a credit in the amount of half of the cost of the access expenditure for the first \$10,000 eligible expenses that exceed \$250. Thus, the maximum allowable credit would be \$5,000.<sup>53</sup> Although this credit is very beneficial for businesses, only a small proportion of corporations and individuals with affiliations with business claim this useful credit.<sup>54</sup>

Unclear IRS guidelines may be one reason that few businesses claim this credit. For example, there is some concern that businesses with fewer than 15 employees cannot take this credit, because its intent is to alleviate the financial burden the ADA places on businesses,<sup>55</sup> and the ADA only applies to businesses with 15 or more employees.<sup>56</sup> The IRS should clarify its position on this issue, or taxpayers may be discouraged from taking the credit for fear of taking it incorrectly.<sup>57</sup>

The lack of IRS guidance concerning what type of equipment and devices are eligible for the DAC make it difficult for businesses to determine when they can take the DAC. The IRS has provided some guidance on other types of expenditures that qualify for the DAC, such as removing architectural barriers that prevent a business from being accessible, hiring interpreters, and providing qualified readers and taped text for blind and visually impaired employees. However, there are no such examples on what types of equipment and devices would qualify for this credit. The only guidance the IRS has provided on this issue includes the following: businesses must show that the devices were reasonable and necessary for the effective treatment of communication with people with disabilities.<sup>58</sup> This vague IRS determination of what type of devices and equipment are eligible for the DAC<sup>59</sup> does not seem to be supported by the statute and legislative history.<sup>60</sup> Moreover, this interpretation contradicts the General Accounting Office (GAO, now the Government Accountability Office) report, which suggests a broader application of these tax incentives.<sup>61</sup>

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<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* (Dec. 2002).

<sup>55</sup> IRS, Form 8826, *Disability Access Credit*, (2005); *see also* 136 Cong. Rec. E2679-02 (1990).

<sup>56</sup> 42 U.S.C.A § 12111(5)(A).

<sup>57</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* 25 (Dec. 2002). “IRS guidelines do not clearly state whether a business that is not required by title I of the ADA to accommodate an employee can use the credit for these expenditures.”

<sup>58</sup> IRC § 44 and IRS, Form 8826, *Disability Access Credit* (2005).

<sup>59</sup> Technical Advice Memorandum, TAM 200031001, 2000 WL 33120112, IRS TAM (Aug 4, 2000).

<sup>60</sup> IRC § 44; *see also* 136 Cong. Rec. E2679-02 (1990).

<sup>61</sup> General Accounting Office, GAO 03-39, *Business Tax Incentives* 25, 27 (Dec. 2002).

### *Impairment-Related Work Expenses*

The Impairment-Related Work Expense deduction applies to taxpayers who have a physical or mental disability that functionally limits their employment or substantially limits one or more life activities, such as performing a manual task, including walking, speaking, breathing, learning, and working.<sup>62</sup> Determining what expenses are eligible for this deduction can be complicated and difficult. For instance, Publication 907, Tax Highlights for Persons with Disabilities, only provides one example of when this deduction would be allowable.<sup>63</sup> This publication refers the taxpayer to Publication 529, Miscellaneous Deductions, for more detailed information on the deduction.<sup>64</sup> The information provided in Publication 529, however, is equally brief and provides the taxpayer with the same example as Publication 907. Moreover, the one publication that does provide another example, Publication 17, Your Federal Income Tax (For Individuals),<sup>65</sup> is not referenced in either Publication 907 or 529.

Searching IRS publications in an effort to comply with the tax code can be burdensome for any taxpayer, but this burden is even more significant for a taxpayer with a disability. Therefore, the IRS should revise Publication 907 to include references to all relevant publications on the issues addressed. In addition, the IRS should include more examples in Publication 907 so the taxpayer can have a clearer understanding of what deductions are included in Impairment Related Work Expenses.

### **IRS COMMENTS**

The IRS acknowledges the growing need for services for taxpayers with disabilities. The barriers listed in the National Taxpayer Advocate's report are important and the IRS has already taken numerous actions to address them. Through our use of the Teletypewriter and Telecommunications Device for the Deaf (TTY/TDD), the IRS Alternative Media Center (AMC), and outreach and education efforts, the IRS has made significant strides in serving the needs of the disabled community.

### *Access to IRS Assistance, Forms, and Publications*

Hearing impaired callers who use TTY/TDD may choose a relay service to receive telephone assistance. Information on this service is provided in the Form 1040 instructions; Publication 17, Your Federal Income Tax; on the IRS website, <http://www.irs.gov>; and many other IRS publications. The IRS maintains dedicated toll-free telephone lines for this purpose. Hearing impaired taxpayers may call and

- ◆ Order tax forms and publications;

<sup>62</sup> IRC § 67(d). See also Key Legislative Recommendation, *Impairment-Related Work Expense Deduction*, *infra*.

<sup>63</sup> IRS, Pub 907, *Tax Highlights for Taxpayers with Disabilities* (2005). The example provided is the expense a taxpayer incurs for hiring attendant care at his or her workplace.

<sup>64</sup> IRS, Pub 529, *Miscellaneous Deductions* 13 (2006).

<sup>65</sup> IRS Pub 17, *Your Federal Income Tax* 137 (2006).

- ◆ Find out what they owe;
- ◆ Order a transcript of their tax return or account;
- ◆ Determine if the IRS has adjusted their account or received a payment;
- ◆ Find out where to send their tax return or payment;
- ◆ Request more time to pay or set up an installment agreement;
- ◆ Find out if they qualify for innocent spouse relief;
- ◆ And much more.

The AMC was initially established as a resource to provide Braille and other alternative formats for IRS employees with vision disabilities. In recent years, however, the AMC has also worked to provide these same services to taxpayers. AMC initiatives, such as Digital Talking Books, Talking Tax forms, Electronic Braille, Hard Copy Braille, Large Print, and Tactile Graphics have all benefited our visually impaired employees and taxpayers.

In addition, the IRS is also committed to making every document on IRS.gov accessible to the widest possible audience. Currently, most visitors are able to view IRS.gov using popular browsers and the following features: text descriptions provided for images and pictures; cascading style sheets used to format page content; HTML versions of many of the forms and publications; and direct links to main sections of each page for those using screen readers. The Accessibility link of IRS.gov allows taxpayers to download Talking Tax Forms and forms in Braille and Text formats.

To ensure IRS forms, publications and written communications are accessible to persons using special assistive technology, the IRS works with skilled accessibility contractors and IRS accessibility specialists. These efforts ensure that to the extent feasible, documents are accessible to persons using special assistive technology, including screen reading software, refreshable Braille displays, and voice recognition software. As stated in the National Taxpayer Advocate's report, the AMC produces 555 forms in PDF talking format, and 345 forms and publications in text files and Braille-ready format for taxpayers. In addition, taxpayers can request any form, publication, notice or bill in Braille or an alternative format.

The IRS continues to make a concentrated effort to provide more products and services in ways that have the broadest possible impact. For example, the IRS worked closely with two major blindness advocacy groups to determine public acceptance for the Digital Talking Book format. The IRS is also working with these groups to test the utility of "automated calculations" in tax forms. In addition, new publications and forms created in Adobe Acrobat 5.0, which is compliant with § 508 of the Rehabilitation Act, will be posted on the IRS.gov Accessibility site as they are published.

*IRS.gov*

The National Taxpayer Advocate states that although the IRS's Accessibility webpage contains a comment section, it does not ask for specific comments on Section 508 compliance issues and there is no formal process for determining if any such comments have merit. There are relatively few comments received annually. The IRS currently has procedures in place to assist taxpayers with IRS.gov accessibility issue comments. And, although the IRS does not specifically solicit § 508 comments or have formal procedures in place for dealing with them, any such feedback received is escalated and considered on a case-by-case basis.

At present, visitors to IRS.gov are able to view its content using the most popular browsers. Nevertheless, the IRS does see potential value in the National Taxpayer Advocate's recommendations to enhance the website by offering a speech option, providing some content in American Sign Language (ASL) via streaming video, and allowing taxpayers to manipulate the site to accommodate their individual needs. With the requirement that IRS.gov accommodate a broad user base in the general population, the IRS established the policy of supporting a comprehensive set of web browser/operating system combinations and must ensure that the site works properly with all browser/operating system combinations currently supported. We will explore the feasibility of adding these additional features as funding becomes available.

*Education and Outreach*

IRS education and outreach organizations, such as Stakeholder Partnerships Education and Communication (SPEC), target taxpayers with disabilities through partnerships with national and local organizations. Beginning in 2004, SPEC focused on obtaining research, working with external organizations, and developing employee training and other initiatives to better serve the disabled community. As a result, three research projects were initiated that provided customer demographics and other profile data to define these customers and their needs. National partnerships were formed with the National Disability Institute, World Institute on Disability, Department of Health and Human Services Office of Disability, Department of Education, Goodwill Industries International, Easter Seals, National Council on Independent Living, DisabilityInfo.gov, and others. Disability specific workgroups have been developed within 301 IRS-supported community based partnerships that provide EITC, free tax preparation, and asset building opportunities. As a result of these efforts, in 2006, 200 local partners made 330,000 education/outreach contacts and prepared 17,000 returns for persons with disabilities.

The IRS has also increased its efforts to educate taxpayers with disabilities regarding tax deductions and credits. In 2004, IRS worked with national partners to launch a disability initiative in 13 cities branded the "TaxFacts" campaign. Key objectives of this campaign were to engage affiliates of these partners to educate their customers on available tax deductions and credits and to develop a disability strategy within the IRS' local community based partnership. In 2006, this initiative, now titled the "Real Economic

Impact Tour,” included 30 cities and for 2007 will expand to 54 cities. The IRS also developed Publication 3966, *Living and Working with Disabilities*, which provides a summary of existing tax credits and benefits that may be available to qualifying taxpayers with disabilities, parents of children with disabilities, and businesses or other entities wishing to accommodate persons with disabilities. This publication directs the user to other publications that are available in alternative formats. To date, over 1 million copies of this publication have been distributed and the product is available on many of the IRS’ national partners’ websites.

The IRS agrees that taxpayers with disabilities need access to IRS products and services and that taxpayers need to understand the specific tax law provisions that affect the disabled. The IRS offers TTY/TDD toll-free telephone service for hearing impaired taxpayers. The IRS uses its AMC to provide Braille and other alternative formats for visually impaired IRS employees and taxpayers alike. IRS.gov includes an Accessibility webpage and enables taxpayers with disabilities to visit the site using the most popular browsers. The IRS will continue to review its policies and programs to determine the feasibility of offering additional adaptive technologies, such as those suggested by the National Taxpayer Advocate. The IRS will also explore additional opportunities to partner with interest groups representing persons with disabilities or those that employ the disabled to share appropriate tax related information through fact sheets, forums, and other communication vehicles.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

##### Access to IRS Assistance, Forms, and Publications

The National Taxpayer Advocate acknowledges and commends the IRS’s effort to reach out to the deaf and hard-of-hearing community by offering the TTY/TDD relay service. However, this service still forces deaf and hard-of-hearing taxpayers who use ASL as their primary language to rely on the written word – their second language – which could result in miscommunication between the IRS employee and the taxpayer. Some deaf or hard-of-hearing taxpayers may be able to hook up a videophone and communicate with a translator by ASL. However, in order to use this service the taxpayer must have the appropriate TV and high speed Internet, and although the videophone can be obtained for free, the other items can be costly. Therefore, this service would not be accessible to taxpayers who have limited income. If the IRS provided video relay service in the TACs, which currently provide no accommodations for deaf taxpayers, all deaf or hard-of-hearing taxpayers who use ASL could communicate in their primary language. Currently, deaf and hard-of-hearing taxpayers who attempt to utilize a TAC are forced to communicate with an IRS employee by passing notes. This arrangement can be confusing to the taxpayer and lead to miscommunication between the IRS employee and the taxpayer. The IRS has a responsibility to ensure that all taxpayers have equal access to the services that it offers, and clearly we have not achieved this goal with respect to the deaf and hard-of-hearing community.

## PROBLEMS

The National Taxpayer Advocate commends the IRS's strides in providing accessible forms, publications, notices, and bills to taxpayers. However, many taxpayers are unaware of AMC services. As noted above, the IRS gives taxpayers inconsistent information regarding IRS services and does not even advertise some services on the IRS web page. The IRS should publicize this service on every form, publication, or notice that is provided or sent out to a taxpayer, including information on how to request IRS materials in an accommodating format, much like TAS's information is included on these materials. Further, when the taxpayer does discover this service and requests an accommodation, the IRS offers no way for the taxpayer to request all further IRS communications be made in the same accommodating format.

The National Taxpayer Advocate recognizes the challenges faced by the IRS in attempting to conform to Section 508 of the Rehabilitation Act. However, the National Taxpayer Advocate also recognizes the importance of complying with the law and providing equal access to IRS information to taxpayers with disabilities, as the statute requires. Although the IRS is working toward complying with this legislative mandate, much work remains. For instance, not only is it important that new information be designed to be § 508 compliant, but that old, noncompliant information is removed from IRS.gov. The IRS should also reconsider its policy of partnering with companies that are not required to and do not voluntarily meet the § 508 standards, such as those that make up the Free File Alliance.

### IRS.gov

The National Taxpayer Advocate finds it unacceptable that the IRS has no process for addressing taxpayers' comments regarding § 508 compliance issues. The most likely reason the IRS receives few taxpayer comments regarding § 508 compliance is because it does not specifically solicit these types of comments. For the IRS to identify § 508 issues and provide a truly accessible website, it must hear taxpayers' comments regarding the barriers they face when navigating IRS.gov with accommodating software or devices.

The National Taxpayer Advocate understands the IRS's funding limitations, but recognizes the growing need of providing a user-friendly website for taxpayers with disabilities and the elderly population. This type of website has been developed by other government agencies and should be an achievable goal for the IRS as well.<sup>66</sup>

### Education and Outreach

As stated previously, the National Taxpayer Advocate commends SPEC's efforts and accomplishments in reaching out to taxpayers with a disability and involving community organizations in this outreach and education effort. Further, the National Taxpayer Advocate recognizes the importance of partnering with these community organizations,

<sup>66</sup> National Institutes Of Health, *Elderly* at <http://nihseniorhealth.gov/>.



but believes these organizations should not become substitutes for basic IRS customer service and outreach. While these organizations provide a valuable service, they also have geographic limitations and cannot reach every taxpayer with a disability needing assistance. For instance, it is commendable that 200 local partners made 330,000 education/outreach contacts and prepared 17,000 returns for persons with disabilities in 2006. Still, there are 51.2 million Americans with some type of disability, and while the outreach is impressive, it reaches only a small fraction of this population.<sup>67</sup> It is imperative that the IRS provide essential customer service and outreach to this population. Moreover, expecting taxpayers with disabilities to locate and use these organizations for the simplest of tasks is extremely burdensome to these taxpayers.

The National Taxpayer Advocate recognizes the IRS's involvement in the "Real Economic Impact Tour," which TAS is also partnering in, and the development of IRS Publication 3966, *Living and Working with Disabilities*. However, this and other IRS information addressing issues concerning disabled taxpayers is scattered all over IRS.gov and various community groups' websites. Instead of burdening a taxpayer with a disability who may not have access to the internet or may have difficulty navigating it, with the task of locating this information, the IRS should consolidate all the disability information on one centralized website. This would make it quick and easy for a taxpayer with a disability to obtain this information and allow the IRS to ensure the information is in an accessible format. Moreover, this website can solicit comments from disabled taxpayers by providing an email comment box.<sup>68</sup>

#### *Small Business Outreach and Education*

Although the IRS conducts education and outreach to taxpayers with a disability regarding possible tax deductions and credits, it appears SB/SE has done little or no education and outreach to small businesses regarding tax incentives for hiring or accommodating employees or customers with disabilities, or to taxpayers with disabilities who are attempting to start their own businesses. Nor has the IRS provided any examples of such outreach in its response to our concerns. This type of information is desperately needed because of confusion surrounding some of these tax incentives, for which the IRS has provided few IRS examples to clarify in what circumstances the incentives are available. Also, the IRS should reach out to taxpayers with a disability who are attempting to start their own business, since other federal agencies report that self-employment or owning a small business is an increasing trend in the disability community.<sup>69</sup>

<sup>67</sup> U.S. Census Bureau, *Question and Answer Center*, at [http://www.census.gov/Press-Release/www/releases/archives/facts\\_for\\_features\\_special\\_editions/006841.html](http://www.census.gov/Press-Release/www/releases/archives/facts_for_features_special_editions/006841.html).

<sup>68</sup> For an example of how taxpayer comments can be solicited and efficiently received, see the TAS Systemic Advocacy Management System (SAMS) website at <http://www.irs.gov/advocate/article/0,,id=117703,00.html>.

<sup>69</sup> Department of Labor, *Business Ownership - Cornerstone of the American Dream*, at <http://www.dol.gov/odep/pubs/business/business.htm>.

## PROBLEMS

SECTION  
ONE

The IRS has taken steps towards offering accommodations to taxpayers with disabilities and reaching out to this community. However, the IRS still struggles to provide the full array of accommodations necessary for these taxpayers to have equal access to IRS information, inform taxpayers about these accommodations, and conduct outreach and education to taxpayers with disabilities, their caretakers, and employers.

**RECOMMENDATIONS**

The National Taxpayer Advocate recommends the IRS take the following steps to provide assistance, enhance access and promote tax compliance for taxpayers with disabilities:

- ◆ The IRS should develop a way to identify if a taxpayer has a disability and what type of disability the taxpayer has, in order to correspond with the taxpayer in a format that is easiest for the taxpayer. The IRS should develop a process to determine the taxpayer's preferred format for correspondence at the outset of interaction with the IRS, such as Braille, large print, or audio. This approach would ensure effective communication throughout the "life" of a tax return.
- ◆ The IRS should install video relay service in its Taxpayer Assistance Centers (TACs). This would allow taxpayers who are deaf or hard-of-hearing and whose primary language is American Sign Language (ASL) to communicate in their primary language.
- ◆ IRS.gov should include speech options, providing vital IRS information in ASL via streaming video and allowing taxpayers to change the font size and color on the site.
- ◆ The IRS should contract only with private companies that will guarantee all taxpayers equal access to information under § 508, and should provide the access (or service) itself if contractors cannot.
- ◆ The IRS should include information on all of its forms, publications, and notices about how taxpayers with a disability can request IRS materials in an alternative format.
- ◆ The IRS should design an area of IRS.gov that is solely dedicated to issues surrounding disability. This site should address what accommodations are available to taxpayers with a disability, what tax deductions or tax credits these taxpayers and their caretakers may be eligible for, and a comment section to allow the taxpayer to inform the IRS that a website, form or publication is not 508 compliant and to make other suggestions for service improvement. This website should also allow the user to change the font size and font color, and offer a speech option. SB/SE should have a section on this website to provide information to taxpayers with a disability who are self-employed or starting their own businesses.
- ◆ SB/SE should include on its current website more detailed information regarding the deductions and credits small businesses may be entitled to, either for hiring

employees with a disability, providing accommodations to employees with disabilities, or removing architectural barriers for taxpayers with disabilities.

- ◆ SB/SE should develop a specific outreach and education strategy beyond the Internet. This strategy should be modeled after SPEC's outreach and education efforts.

**PROBLEM**

TOPIC #21

**INJURED SPOUSE ALLOCATIONS****RESPONSIBLE OFFICIALS**

Richard J. Morgante, Commissioner, Wage &amp; Investment Operating Division

Kathy K. Petronchak, Commissioner, Small Business/Self Employed Operating Division

**DEFINITION OF PROBLEM**

If married taxpayers file a joint federal tax return claiming a refund, and one of the spouses has an outstanding federal tax debt, unpaid child support, debts owed to other federal agencies (*e.g.*, student loans from the Department of Education), or state income tax obligations, the IRS will offset the couple's refund against these debts.<sup>1</sup> These non-tax debts are tracked by the Treasury Department's Financial Management Service (FMS), which administers the Treasury Offset Program (TOP).<sup>2</sup> The spouse who is not liable for the debt can avoid having his or her portion of the refund offset against the debt by filing Form 8379, Injured Spouse Allocation, with the IRS.

There are three major issues concerning injured spouse allocations that can place an unnecessary burden on taxpayers. First, the IRS's processing time for injured spouse allocations is lengthy and sometimes the processing is done incorrectly.<sup>3</sup> For example, injured spouse allocations are still worked manually, increasing the likelihood of errors and slowing the processing of the allocation. Second, although the status of a debt at FMS changes daily, the IRS only receives these updates weekly, which can cause incorrect debt indicators on taxpayer accounts.<sup>4</sup> Finally, the community property question on the Form 8379 is not designed to determine where the taxpayer is domiciled – the IRS's standard for residency – but instead focuses on where the taxpayer is living.<sup>5</sup> Since community property laws vary from state to state, taxpayers who answer this question incorrectly could be adversely impacted.

<sup>1</sup> IRC § 6402.

<sup>2</sup> The Treasury Offset Program is a centralized database system managed by the Financial Management Service (FMS) and Debt Management Service (DMS). The purpose of this program is to collect delinquent debts owed to federal and state agencies. Department of the Treasury, Treasury Offset Program at <http://fms.treas.gov/debt/top.html> (last visited Aug. 30, 2006).

<sup>3</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-40-001 *Injured Spouse Guidance is not Consistent*, 5 (October 2004). (The Treasury Inspector General for Tax Administration (TIGTA) previously determined that the IRS takes about 10 or 11 weeks to process an injured spouse claim when it is filed with a return, significantly longer than the IRS takes to process a refund without an injured spouse claim).

<sup>4</sup> IRM 21.4.6.4 (7) (Oct. 1, 2006).

<sup>5</sup> IRS Form 8379, *Injured Spouse Allocation* (Jan. 2006).

**ANALYSIS OF PROBLEM****Background**

The IRS may offset a taxpayer's overpayment against outstanding federal tax liabilities before issuing a refund to the taxpayer.<sup>6</sup> While the IRS first applies the overpayment to outstanding federal tax liabilities, it makes any remaining amount available to FMS for offset through the Treasury Offset Program (TOP).<sup>7</sup> Nontax debts may include unpaid child support, debts owed to other federal agencies (*e.g.*, student loans from the Department of Education), and state income tax obligations.<sup>8</sup> When a couple files a joint return and a portion or all of the refund is offset under IRC § 6402, the nondebtor spouse may apply for "injured spouse" relief to receive his or her share of a joint refund.

For the injured spouse to obtain relief, he or she must timely file a Form 8379, Injured Spouse Allocation.<sup>9</sup> Once the injured spouse files Form 8379, the IRS's Wage and Investment (W&I) division conducts the following analysis to determine to what extent joint overpayments should be offset against separate liabilities:

- (1) Identify the source of the overpayment;
- (2) Characterize all or part of it as separate or community property under applicable state law;
- (3) Offset at least 50 percent to the extent it is community property; and

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<sup>6</sup> IRC § 6402(a); IRM 25.18.5.1 (Feb. 15, 2005); IRM 21.4.6.4 (Oct. 1, 2006).

<sup>7</sup> IRC § 6402(c), (d), (e); IRM 21.4.6.2 (Oct. 1, 2006).

<sup>8</sup> IRM 21.4.6.2 (Oct. 1, 2006).

<sup>9</sup> The IRS does not view Form 8379 as a claim for refund by an injured spouse, but rather, as additional information for a jointly filed claim for refund (which may be made on the jointly filed income tax return). Thus, that jointly filed claim must be filed the later of three years from the time the return was filed or two years from the time the tax was paid. *See* IRC § 6511. When a husband and wife file a joint claim for refund but the nondebtor spouse does not include Form 8379, if the IRS partially disallows the claim for refund, the IRS sends a separate notice of claim disallowance to each spouse. *See* IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201(d), 112 Stat. 685, 740 (1998). The nondebtor spouse will have two years from the date the notice of claim disallowance is issued to file Form 8379 with the IRS to administratively contest the allocation of the refund. The two-year period for filing Form 8379 after a claim for refund has been disallowed arises from the two years in which a taxpayer has to file suit in a United States district court or the Court of Federal Claims to contest the allocation of the refund. *See* IRC § 6532(a)(1). The IRS would rather have a taxpayer file Form 8379 in that two-year period to try to resolve the matter administratively than to file suit. A taxpayer should be wary, though, because a pending administrative reconsideration of a disallowed claim does not suspend the two-year period for filing suit, and if a taxpayer fails to timely file suit he or she would not be able to contest an IRS decision to uphold the disallowance in the courts. The two-year period can be extended if agreed upon in writing between the taxpayer and the IRS. *See* IRC § 6532(a)(2). If the IRS grants the claim for refund in full but then some or all of the refund is offset, the nondebtor spouse has an unlimited period in which to file Form 8379 because the IRS did not send a notice of claim disallowance. IRM 21.4.6.5.9.8 (Oct. 1, 2006) has been updated on SERP, which taxpayers cannot access, to reflect this new guidance. Further, as of this writing, this update is not available to taxpayers on [www.irs.gov](http://www.irs.gov). *See* Most Serious Problem, *Transparency of the IRS*, *supra*.

- (4) Analyze state law to determine if (a) more than 50 percent of any community property may be offset, and (b) any separate property of either spouse may be offset.<sup>10</sup>

### W&I and TAS Injured Spouse Task Force

In April 2005, W&I asked the Taxpayer Advocate Service (TAS) to partner with the division to investigate the current processes and procedures for handling Forms 8379. The goal of the project is to determine the factors that impede service to taxpayers and result in a high volume of referrals to TAS.<sup>11</sup> The resulting task force reviewed statistically valid samples of approximately 600 W&I cases and approximately 600 TAS cases for a variety of factors. W&I's results were not complete at this writing, but TAS's results helped identify and validate the problems described above. The task force will conduct an in-depth analysis of the data to ultimately recommend and implement improvements to Injured Spouse policies, processes, and procedures as determined necessary. The National Taxpayer Advocate commends W&I for its work on this study.

### Processing Time

Taxpayers are burdened by the lengthy time frame for processing injured spouse allocations and are sometimes harmed by IRS mistakes. The lengthy process begins when the taxpayer sends a Form 8379 attached to his or her original return; even though the injured spouse allocation and the joint return are filed together, they are processed separately. The normal processing time for a tax return is six weeks (three weeks if filed electronically).<sup>12</sup> The standard processing time for an injured spouse allocation is between 11 and 14 weeks.<sup>13</sup> Even if the original return with a Form 8379 is filed electronically, the processing time is still eleven weeks.<sup>14</sup> The main reason for this delay is the IRS's manual, rather than automated, calculation of the injured spouse's allocation. Moreover, IRS processing errors can make an already lengthy process even longer. Some of these errors include:

- ◆ The IRS not recognizing the Form 8379 when it is attached to an original return;<sup>15</sup>

<sup>10</sup> Rev. Rul. 80-7, 1980-1, I.R.B. 17, Rev. Rul. 85-70, Rev. Rul. 85-70, 1985-22, I.R.B. 6, Rev. Rul. 2004-71, 2004-30, I.R.B. 74, Rev. Rul. 2004-72, 2004-30, I.R.B. 77, Rev. Rul. 2004-73, 2004-30, I.R.B. 80, Rev. Rul. 2004-74, 2004-30 I.R.B. 84.

<sup>11</sup> Taxpayer Advocate Management Information System (TAMIS), Injured Spouse Receipts, PCIC 340 (FY 2006).

<sup>12</sup> IRS, *Form Instructions 1040* (2005), and IRS, *Tax Topics 152 – Refunds – How Long They Should Take* available at <http://www.irs.gov/taxtopics/tc152.html>.

<sup>13</sup> IRS, *Tax Topics 203 - Failure to Pay Child Support, Federal Non-Tax and State Income Tax Obligations* available at <http://www.irs.gov/taxtopics/tc203.html>.

<sup>14</sup> IRS, *Form Instructions 1040* (2005).

<sup>15</sup> Taxpayer Advocate Management Information System (TAMIS). There were 421 returns, out of a representative sample of 581 returns, where a Form 8379 was attached to the taxpayer's original return (95 percent confidence interval 72.5 percent +/-3.6 percent); 199 of the 421 returns were filed on paper (95 percent confidence interval 47.3 percent +/- 4.8 percent); and 17 of the 199 returns or 8.5 percent were not recognized by the IRS as having a Form 8379 attached (95 percent confidence interval).

- ◆ Errors in calculating the allocation;<sup>16</sup> and
- ◆ Inaccurate debt indicators.

**TABLE 1.21.1, NUMBER OF CASES WITH INACCURATE DEBT INDICATORS<sup>17</sup>**

	Total Sample Size	No Debt Indicator Placed On Taxpayer's File	Freeze on taxpayer's refund was released — the refund was offset by FMS against a non-tax debt or a tax debt	Offsets were tax debts	Offsets were non-tax debts	Offset was both a tax debt and a non-tax debt	Offsets were subsequently reversed
<b>Number of Cases</b>	581	96 out of 581 cases	73 out of 96 cases	44 out of 73 cases	28 out of 73 cases	1 out of 73 cases	67 out of 73 cases
<b>Percentage</b>	N/A	16.5% +/- 3.0%	76% +/- 8.5%	60.3% +/- 11.2%	38.4% +/- 11.2%	1.4% +/- 2.7%	91.8% +/- 6.3%

The Taxpayer Advocate Service (TAS) has seen an 81.3 percent increase in its injured spouse caseload from FY 2005 to FY 2006. In FY 2004 TAS received 6,129 injured spouse cases, in FY 2005 TAS received 6,283 injured spouse cases, and in FY 2006 the total rose to 11,599.<sup>18</sup> Clearly, the dramatic increase in FY 2006 indicates a problem with injured spouse claims.

### Manual Processing

Taxpayers can only file Form 8379 electronically if it is filed with an original return.<sup>19</sup> Further, although the taxpayer may file the form electronically, W&I calculates the injured spouse allocation manually and enters the computation into an electronic version of Form 8379-A, the injured spouse worksheet, as opposed to developing and utilizing an automated system.<sup>20</sup> This manual process increases the likelihood of error when calculating the injured spouse allocation.

**EXAMPLE:** Taxpayer filed Form 8379 with the original return claiming an overpayment of \$7,000 but the IRS calculated the injured spouse allocation at \$3,560 and offset the remaining \$3,440 against a TOP debt. The taxpayer contacted TAS. After reviewing the IRS's calculation, TAS determined the IRS had not properly recorded the number of Earned Income Tax Credit (EITC) qualifying children, as

<sup>16</sup> Taxpayer Advocate Management Information System (TAMIS).

<sup>17</sup> *Id.* The percentages provided in the table have a 95 percent confidence interval.

<sup>18</sup> Taxpayer Advocate Management Information System (TAMIS), Injured Spouse Receipts, PCIC 340, FY 2004, FY 2005, and FY 2006.

<sup>19</sup> IRM 21.4.6.5.9.2(5) (Oct. 1, 2006).

<sup>20</sup> IRM 21.4.6.5.11 (Oct. 1, 2006).

reported by the taxpayer, on the IRS's internal injured spouse worksheet, and had incorrectly allocated the EITC. TAS disputed the IRS's calculation, recomputed the worksheet, and obtained for the taxpayer an additional refund of \$2,500.<sup>21</sup>

If the IRS adopted an automated calculation system, similar to those used by tax preparation software firms to compute the electronic Form 1040, Individual Income Tax Return, it could reduce or eliminate errors in injured spouse allocations such as the one just described. Moreover, automation might also improve the rate at which W&I is able to process allocations. Currently, even when the taxpayer files a Form 8379 electronically, processing the allocation still requires an average of ten weeks.<sup>22</sup> The use of an automated calculation system could significantly benefit taxpayers and the IRS by reducing both the frequency of calculation errors and the processing time. Ultimately, this improvement may also save the taxpayer and the IRS time and money.

#### Inaccurate Debt Indicators

The Financial Management Service (FMS), a bureau of the Department of the Treasury, administers the Treasury Offset Program (TOP).<sup>23</sup> The TOP is a centralized offset program, administered by the FMS, to collect delinquent debts owed to federal agencies and states (including past-due child support).<sup>24</sup> When the creditor-agencies report these debts to FMS, they are entered into a database system, which may be updated daily.<sup>25</sup>

The IRS, on the other hand, receives FMS information only on a weekly basis. Once received, the debt report is entered into an IRS computer system, which maintains a record of "debt indicators" on taxpayer accounts to identify the existence of a tax debt, a non-tax debt, or both. As a result, the lag time between daily FMS debt updates and weekly IRS debt indicator updates can lead to errors in identifying refunds subject to TOP offset.<sup>26</sup>

This situation can be problematic because the debt indicator is the basis upon which the IRS makes an initial decision about processing an injured spouse allocation. Thus, an incorrect debt indicator may cause a processing error. For example, when a taxpayer files a Form 8379 with the original return, the IRS freezes the overpayment until it manually processes the Form 8379. If there is no debt indicator shown on the IRS account, the IRS releases the freeze without computing the injured spouse allocation. If the IRS debt indicator is incorrect – *i.e.*, FMS's database shows a debt whereas the IRS's

<sup>21</sup> Taxpayer Advocate Management Information System (TAMIS).

<sup>22</sup> Treasury Inspector General for Tax Administration, Ref. No. 2005-40-00 *Injured Spouse Guidance is not Consistent*, 5 (October 2004). The ten-week average was determined by a TIGTA analysis of 70,238 claims for injured spouse relief that were e-filed.

<sup>23</sup> IRM 21.4.6.2 (Oct. 1, 2006).

<sup>24</sup> IRC § 6402(c), (d), and (e); 31 U.S.C. § 3720A.

<sup>25</sup> IRM 21.4.6.34 (7) (Oct. 1, 2006).

<sup>26</sup> IRM 21.4.6.4 (7) (Oct. 1, 2006).



database does not – FMS will apply the overpayment to the outstanding agency debt.<sup>27</sup> At this point, the injured spouse must contact the IRS to reverse the offset and reissue the amount allocable to the injured spouse.

**EXAMPLE:** A taxpayer filed a Form 8379 with the original joint tax return claiming a total refund of \$2,500.00. When the IRS processed the Form 1040, it placed a freeze on the account in order to manually process the Form 8379 and allocate the joint refund. There was no debt indicator set on the IRS’s records, and the IRS released the freeze without computing the injured spouse allocation. The FMS database, however, did show a non-tax debt, resulting in FMS offsetting the overpayment. The taxpayer contacted TAS, which arranged for the injured spouse allocation and a refund of \$2,500.<sup>28</sup>

### Form 8379 May Result in Incorrect Community Property State Determination

The question posed to taxpayers on Form 8379 to determine if state community property laws apply to their situation is misleading. The form asks if the person’s main home is in a community property state.<sup>29</sup> However, this single question is not enough to accurately ascertain whether the taxpayer is subject to a state’s community property laws. Rather, the IRS should be asking where the taxpayer is domiciled. Where a taxpayer currently resides may not necessarily be his or her domicile. While there is no definition of “domicile” in the Code, the IRS defines the concept of “domicile” in regulations to mean an individual’s fixed or permanent home, where an individual acquires a domicile by living there, even for a brief period of time, with no definite present intention of moving.<sup>30</sup> Moreover, when the IRS disallows community property benefits, it uses the following standard explanation for the IRS examiner’s adjustment:

Domicile is your place of historical residence and/or fixed and permanent abode. Merely residing in a new location for a period of time does not constitute the establishment of a domicile. Since you have not established that you were domiciled in a community property country or state during the taxable year, community property benefits are not allowed.<sup>31</sup>

**EXAMPLE:** The IRS processed an injured spouse allocation and refunded \$600 to the taxpayer. The taxpayer disputed this amount through TAS, claiming he moved from a non-community property state to a community property state during the course of the year and the majority of his wages were earned in the

<sup>27</sup> Taxpayer Advocate Management Information System (TAMIS).

<sup>28</sup> *Id.*

<sup>29</sup> IRS Form 8379, *Injured Spouse Allocation* (Jan. 2006).

<sup>30</sup> Treas. Reg. § 20.0-1(b)(1); § 25.2501-1(b).

<sup>31</sup> IRM Exhibit 4.10.10-2.

non-community property state. TAS referred the inquiry to W&I, which recalculated the injured spouse allocation and refunded an additional \$500.<sup>32</sup>

The IRS could avoid similar situations by revising Form 8379, to ask where the taxpayer is domiciled, as opposed to merely asking the location of his or her main home.

### Eliminating Injured Spouse Issues

The National Taxpayer Advocate made recommendations in the 2001 and 2005 Annual Reports to Congress that would eliminate joint and several liability, and require married taxpayers to file tax information in separate columns on a joint return.<sup>33</sup> This split column tax return would identify separate items of income, deduction, credit, and payment for each spouse. Providing the IRS with income, deductions, credits, and payments in split columns would eliminate the need for one spouse to request injured spouse relief to prevent the IRS from offsetting his or her refund against a spouse's separate liabilities, since the IRS would have enough information to allocate a refund at the outset. This approach would allow the IRS to automatically ensure that one spouse's share of an overpayment will not be offset against the other spouse's separate liability.<sup>34</sup>

### IRS COMMENTS

The Debt Collection Improvement Act of 1996 (DCIA) requires the federal government to withhold or reduce certain federal payments to recipients to satisfy delinquent non-tax debts owed to the United States. The Financial Management Service (FMS), a bureau of the Department of Treasury, administers the DCIA in part through the Treasury Offset Program (TOP). Through the TOP, FMS may reduce a federal tax refund to satisfy any past-due child support, federal non-tax debts such as education loans, or state income tax debts. However, before certifying an overpayment to FMS for refund, the IRS will first apply any overpayment against past-due federal tax debts. Once an offset occurs by either agency, the taxpayer will receive a notice identifying the amount of the original refund, the amount of the offset, the agency receiving the payment, and the address and telephone number of the agency.

In some cases, the IRS or FMS will reduce an overpayment resulting from a joint return where one of the spouses is not responsible for the debt. In that case, the taxpayer who is not responsible for the debt may file Form 8379, Injured Spouse Allocation, and request an allocation of the overpayment. If the taxpayer indeed qualifies as an "injured spouse", the taxpayer will receive his or her portion of the refund.

<sup>32</sup> Taxpayer Advocate Management Information System (TAMIS).

<sup>33</sup> National Taxpayer Advocate 2001 Annual Report to Congress 129; National Taxpayer Advocate 2005 Annual Report to Congress 407.

<sup>34</sup> National Taxpayer Advocate 2005 Annual Report to Congress 431.

### Processing Time

As noted in the National Taxpayer Advocate's report, the IRS's processing time for injured spouse allocations can take from eight to 14 weeks. The instructions advise taxpayers that it takes the IRS approximately 14 weeks to process paper Forms 8379 and approximately 11 weeks to process electronically filed Forms 8379 that are filed with the joint return. If the Form 8379 is filed after the IRS has processed the joint return, it takes approximately 8 weeks.

In order to allocate an overpayment, the IRS must process the taxpayer's joint income tax return first, which generally takes six weeks for a paper return and three weeks for an electronically filed return. At that point, the IRS must manually allocate each spouse's income, adjustments to income, standard deduction or itemized deductions, number of exemptions, other taxes and federal income tax withheld. Through the allocation, the IRS determines the amount of tax owed by each spouse and any overpayment due to each.

### Increase in TAS's Caseload

The IRS acknowledges the marked increase in the Taxpayer Advocate Service's injured spouse caseload in FY 2006 and believes at least part of that increase was due to the IRS's assistance to individuals affected by Hurricanes Rita, Katrina and Wilma. Beginning around September 2005, the IRS' Accounts Management (AM) Division dedicated employees at four of our Individual Master File (IMF) sites (two campus locations and two toll-free call sites) to answer the Federal Emergency Management Assistance (FEMA) disaster phone lines for approximately 90 days. To reduce the impact on other taxpayers, AM either reassigned much of these two campuses' workload through the Correspondence Imaging System or transshipped work to other campus locations throughout the nation. Unfortunately, this included the injured spouse inventory. The decrease in available employee resources to work these cases impacted inventory levels and the percentage of aged cases nationwide. This impact carried through the 2006 filing season. We do not anticipate these problems recurring in 2007.

We do not believe that TAS's increased injured spouse caseload for FY 2006 was due to IRS making more errors on these cases. The FY 2006 accuracy rate for all Adjustments cases based on National Quality Review System data was 88.1 percent, with injured spouse allocation case accuracy at 87.1 percent. This is an improvement over FY 2004 when the Adjustment's Accuracy rate was 84.9 percent and FY05 when it was 85.7 percent.

### Injured Spouse Allocation Task Force

To improve how the Wage & Investment Division (W&I) and TAS work injured spouse cases, the two organizations formed a joint IRS-TAS Injured Spouse Allocation task force (ISATF) in mid-2005 to study injured spouse cases in W&I and TAS. The objectives of ISATF were to:

- ◆ Identify processing improvement opportunities in the Injured Spouse program;

- ◆ Recommend and implement changes to overcome the identified problems;
- ◆ Determine the reasons for the high volume of referrals of Injured Spouse issues to TAS;
- ◆ Identify actions W&I and/or TAS may take to reduce the number of injured spouse case referrals to TAS; and
- ◆ Determine if employees in W&I and TAS are correctly identifying TAS criteria.

This study is still underway. Both functions have analyzed approximately 600 cases each and are working now to understand the data that has been gathered.

### IRS COMMENTS

The IRS agrees that the allocation process should be automated. However, the IRS does not agree that an automated calculation system similar to those used by tax preparation software firms will dramatically improve processing time for injured spouse allocations. This is because of the cyclical nature of the IRS's workload. Each year, the IRS receives a majority of Forms 8379 from March through July. During that same time period in FY 2006, the IRS received more than 50 percent of its annual correspondence and adjustments receipts and answered more than 50 percent of the 33 million assistor calls in the toll-free system. Peak volumes significantly affect the time frames for processing injured spouse allocations. In the future, we hope to process the Forms 8379 included with original tax returns at the same time we process the original returns, thereby significantly reducing the time involved. However, due to other competing systems modernization needs of the IRS, this change may not be realized until 2009 or beyond.

We also disagree that married taxpayers who file a joint income tax return should itemize their individual tax information in separate columns on a joint return. In FY 2004, the IRS processed 132,226,042 individual income tax returns, of which 51,975,649 or 39 percent, were joint returns. Data recently collected in the ongoing study of injured spouse allocations shows that less than one percent of taxpayers filing a joint return file for the injured spouse relief. Although separate reporting would improve injured spouse processing, it would increase the complexity of the tax return preparation and create additional burden on the majority of joint return filers that are not affected by injured spouse issues.

Finally, we disagree with the recommendation that we use the term "domicile" on Form 8379. Although the legally correct term, we believe it may confuse many taxpayers who use the form. However, we will revisit this issue when we revise Form 8379 in January 2008.

In summary, the IRS believes the increase in TAS injured spouse workload can be primarily attributed to reduced AM staffing that was redirected to FEMA disaster assistance work. A joint IRS-TAS task force is currently assessing the spike in TAS injured spouse receipts and IRS is committed to working with TAS to develop joint solutions to the

problems identified through this effort. Pending the outcome of that effort, the IRS does not currently endorse the National Taxpayer Advocate's automation proposal, we disagree with the proposal to add separate columns for each spouse on the joint return, and we need to further assess the suggested wording change for Form 8379.

### TAXPAYER ADVOCATE SERVICE COMMENTS

#### Processing Time

The IRS has advised taxpayers it can take anywhere from 11 to 14 weeks to process an injured spouse allocation, depending on how the taxpayer submitted the request for injured spouse relief. However, the IRS's processing time for injured spouse allocations often exceeds this range. W&I's own case sample demonstrates that processing a request for injured spouse relief often takes longer than the IRS's standard timeframe.<sup>35</sup> Therefore, the IRS should conduct further research to identify what factors are causing this lengthy process and then address the identified issues.

#### Increase in TAS's Caseload

The Taxpayer Advocate Service has seen a significant increase in its injured spouse caseload over the past three years. While W&I suggests the increase is a result of having to move employees off injured spouse cases to address the issues surrounding the 2005 Gulf Coast hurricanes, the IRS also did not adequately staff its phones for the 2006 filing season, resulting in a backlog of processing. Moreover, these factors do not explain why W&I's processing time exceeds the 11 to 14 week timeframe almost one-third of the time.<sup>36</sup> W&I should work with TAS to investigate further why TAS's caseload has grown so much over the past three years.

#### Injured Spouse Allocation Task Force

As noted above, TAS is pleased to participate with W&I in the injured spouse allocation task force. Wage & Investment's partnership is an important step in identifying and remedying challenges surrounding the injured spouse process. The National Taxpayer Advocate encourages the task force to continue working towards the common goal of improving the processing of injured spouse allocations.

#### TAS Proposals

Developing an automated system to calculate the injured spouse allocations, rather than calculating them manually, could reduce the processing time. The National

<sup>35</sup> IRS, *Wage and Investment – Taxpayer Advocate Service Joint Task Force Injured Spouse Case Processing Interim Report, Draft Report* (Dec. 2006). W&I Accounts Management Receipts reviewed 600 cases. These cases were selected from cases received during a 12-month period beginning June 1, 2004 through May 31, 2005. Thirty-four percent of the W&I sample cases were processed outside the established timeframes. The overall confidence interval for the total volume of out of processing time returns is plus or minus 3.6 percent.

<sup>36</sup> *Id.*

## PROBLEMS

Taxpayer Advocate recognizes W&I's high accuracy rate for injured spouse allocation cases, but believes an automated system will improve accuracy even more while minimizing processing time. Automation may not be the sole solution to the processing time issue, but it would make it easier to process the Form 8379 at the same time as the original return. For example, software similar to what tax preparation firms utilize would calculate the injured spouse allocation immediately and allow the return processing to continue, thereby reducing both the processing time and the potential for errors. The National Taxpayer Advocate recognizes the IRS's challenge in modernizing multiple systems. However, upgrading the injured spouse processing system sooner, rather than later, immediately frees up IRS employees to do other work and will almost certainly benefit the taxpayer.

Contrary to the IRS's response, having a husband and wife fill in separate columns on their joint return and identifying separate income, deductions, credits, and payments would simplify many areas of tax law, such as eliminating joint and several liability and special relief rules such as innocent and injured spouse. Currently, the only way to completely avoid injured spouse issues is for the couple to file separately, which means the taxpayers loses many significant benefits they would otherwise be entitled to receive. Since most taxpayers receive income information in a form that is separate or easily allocated, we do not believe our proposal imposes significant burden.

Asking the taxpayer where he or she is "domiciled" on Form 8379, rather than asking where the taxpayer's main home is located, would yield a more accurate answer as to the taxpayer's place of residency. Further, if the IRS is concerned that taxpayers will not understand what the word domicile means, it can simply place a definition on the form. This would be easy, since "domicile" is a legal term, defined in the regulations to mean an individual's fixed or permanent home, where an individual acquires a domicile by living there, even for a brief period of time, with no definite present intention of moving.<sup>37</sup> Asking the taxpayer where he or she is domiciled is the most accurate question for determining the taxpayer's place of residency.

#### RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following steps to improve the processing of injured spouse allocations:

- ◆ Wage & Investment should begin tracking the following issues so processing problems can be identified and addressed.
  - ◆ The average cycle time for injured spouse allocations where the Form 8379 is filed electronically;
  - ◆ The average cycle time for injured spouse cases where the Form 8379 was filed separately;

<sup>37</sup> Treas. Reg. § 20.0-1(b)(1); § 25.2501-1(b).

- ◆ The average cycle time for injured spouse allocations where the Form 8379 is filed attached to the original return;
  - ◆ The number and type of errors made when processing injured spouse allocations;
  - ◆ The number and type of errors made as a result of calculating injured spouse allocations manually; and
  - ◆ The number of Forms 8379 that contained taxpayer errors and the type of taxpayer errors.
- ◆ The IRS should calculate injured spouse allocations automatically rather than manually, which would reduce both errors and processing time.
  - ◆ The IRS should clarify the community property question on Form 8379 to ask where the taxpayer is domiciled, rather than where the taxpayer's main home is located. This change would yield a more accurate answer as to the taxpayer's place of residence.
  - ◆ The IRS should design a split column joint tax return that would separate spouses' income, deductions, credits, and payments. Adopting this recommendation would eliminate most problems surrounding injured spouse relief.

## TOPIC #22

**STATUS UPDATE: MAJOR IMPROVEMENTS IN THE QUESTIONABLE REFUND PROGRAM AND SOME CONTINUING CONCERNS**
**RESPONSIBLE OFFICIALS**

Nancy Jardini, Chief, Criminal Investigation

Richard J. Morgante, Commissioner, Wage & Investment Division

Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division

**DEFINITION OF PROBLEM**

In the 2005 Annual Report to Congress, the National Taxpayer Advocate described serious problems with the administration of the Questionable Refund Program (QRP) by the IRS's Criminal Investigation (CI) function.<sup>1</sup> The QRP principally uses data mining software on the IRS's Electronic Fraud Detection System (EFDS) to cull the millions of refund claims filed by taxpayers each year in order to identify claims with questionable data elements.<sup>2</sup> The returns that are identified as having questionable elements are subjected to a verification process, whereby CI attempts to verify the accuracy of the information contained in the return. In the 2005 report, we detailed the results of a year-long statistically representative study of Taxpayer Advocate Service (TAS) QRP cases,<sup>3</sup> which included some significant findings:

- ◆ Tens of thousands of taxpayer refunds were permanently frozen due to CI's suspicion of fraud – without notice provided to the affected taxpayers or asking the taxpayers to provide documentation to support their claims.
- ◆ In 80 percent of the cases in the TAS study in which CI made a “fraud” determination, CI ultimately agreed after TAS intervention to release all or part of the refunds. In 66 percent of the cases, these taxpayers received the full amount of the original refund claimed or more. In additional 14 percent of cases, taxpayers received a partial refund.
- ◆ The median Adjusted Gross Income (AGI) of those taxpayers whose refunds were frozen was \$12,850, and the median refund received was over \$3,500 (*i.e.*, the taxpayers were in a low economic stratum).

<sup>1</sup> National Taxpayer Advocate 2005 Annual Report to Congress 25-54. Volume II of the 2005 Annual Report to Congress presented the results of a research study conducted on QRP cases received by TAS.

<sup>2</sup> Data mining is the application of database technology and techniques to uncover hidden patterns and subtle relationships in data. Government Accountability Office, *Data Mining: Federal Efforts Cover a Wide Range of Uses*, GAO-04-548 (May 4, 2004). The Electronic Fraud Detection System is the primary information system used to support the Criminal Investigation (CI) Division's Questionable Refund Program. Treasury Inspector General for Tax Administration, *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified*, Ref. No. 2006-20-108 (Aug. 9, 2006).

<sup>3</sup> In the TAS QRP study, we selected 500 TAS QRP cases to review and 27 of those cases were eliminated for failing to fall within the sample parameters. Thus, a total of 473 cases were used in the study. A sample size of at least 384 cases was required to obtain a 95 percent confidence level in the results of the review. A 95 percent confidence level means that the conclusions with respect to the sample have a 95 percent likelihood of being applicable to the population from which the sample was drawn.



- ◆ Nearly 75 percent of the taxpayers with frozen refunds had claimed the Earned Income Tax Credit (EITC) and ultimately, a majority of these taxpayers received the claimed EITC benefits.

As a result of the QRP study, members of Congress expressed concerns about the manner in which the QRP was being operated,<sup>4</sup> and the IRS Commissioner committed to making major changes to the QRP.<sup>5</sup> Since that time, the IRS has indeed made significant changes to the QRP and plans still more changes. It has taken the problems in the QRP seriously and worked hard to improve the program. Working with a variety of IRS functions, the Assistant Deputy Commissioner (Services and Enforcement) has made the improvement of the QRP a top priority. In this report, we will detail the changes that have been made. Additionally, because the QRP remains the number one reason taxpayers seek the assistance of the Taxpayer Advocate Service, we set forth our concern that some of the root causes of the problems associated with the QRP have not yet been addressed.<sup>6</sup>

## ANALYSIS OF THE PROBLEM

### Background

The Taxpayer Advocate Service first addressed problems with the QRP in 2003 after TAS's own inventory of frozen refund cases increased by 170 percent from 2002 to 2003.<sup>7</sup> CI began nationwide use of data mining techniques as part of the QRP in March 2003.<sup>8</sup> By Fiscal Year (FY) 2005, TAS had 28,639 QRP frozen refund cases in its inventory, an increase of over 400 percent from FY 2002. The large number of CI cases in TAS's inventory and the high incidence of full relief in these cases led TAS to undertake a study of its CI frozen refund cases. The results of the study are described in detail in Volume II of the National Taxpayer Advocate's 2005 Annual Report to Congress.

<sup>4</sup> Members of Congress wrote to the Secretary of the Treasury and to the Internal Revenue Commissioner raising questions about the Questionable Refund Program, including Senator Charles E. Grassley in correspondence to the Secretary dated January 20, 2006; Senator John Kerry and Senator Barack Obama in correspondence to the Commissioner dated January 19, 2006; Senator Harry Reid, Senator Max Baucus and Senator Patty Murray in correspondence to the Secretary dated January 21, 2006; and Congressman Charles B. Rangel and Congressman John Lewis in correspondence dated January 25, 2006.

<sup>5</sup> IRS News Release, *New Steps Taken To Improve Questionable Refund Program* (Feb. 6, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154285,00.html>.

<sup>6</sup> In fiscal year 2006, TAS received over 20,000 cases from taxpayers complaining about their refund claims which were frozen as part of the QRP. Taxpayer Advocate Management Information System (2006). In FY 2005, TAS received over 28,000 QRP cases. National Taxpayer Advocate 2005 Annual Report to Congress 31. While there were 8,000 fewer cases in 2006, a significant decrease in QRP cases was expected because for the 2006 filing season CI was without its Electronic Fraud Detection System, which allows CI to cull millions of tax returns by computer driven search techniques.

<sup>7</sup> In FY 2002, TAS received 5,509 QRP frozen refund cases, while in FY 2003 TAS received 15,118 QRP cases, an increase of over 170 percent. National Taxpayer Advocate 2005 Annual Report to Congress 32.

<sup>8</sup> Criminal Investigation officials informed TAS that data mining was instituted as part of the QRP in 2003 but did not believe that data mining was the cause of TAS's increased case load. Criminal Investigation presentation on the Questionable Refund Program (March 2005).

The problems with CI's operation of the QRP, as identified in the 2005 Annual Report to Congress, were systemic in nature and revolved around five root causes:

- ◆ The data mining selection process used in the QRP resulted in too many legitimate refund claims being frozen.
- ◆ Once refunds were held for verification process, taxpayers waited too long for resolution of their refund claims.
- ◆ CI did not provide notification to taxpayers whose refunds were frozen, so taxpayers did not have an opportunity to substantiate their claims.
- ◆ CI automatically froze refund claims of taxpayers believed to have committed fraud in a prior year. This policy dramatically expanded the inventory of frozen refund cases without much indication that the policy deterred fraud.
- ◆ Internal IRS procedures created systemic delays in the resolution of taxpayer inquiries.

### Comprehensive Agreement to Change the QRP

As a result of the TAS study, the IRS agreed to dramatically alter the QRP procedures. The Commissioner established an Executive Steering Committee consisting of representatives from CI, TAS, the Examination functions of the Wage & Investment Division (W&I) and the Small Business/Self-Employment Division (SB/SE), the Accounts Management function in W&I, and Modernization & Information Technology Services. Although the Committee has not finished its work, it has already established and implemented changes to the QRP that we believe strike an appropriate balance between the government's interest in preventing fraud and taxpayers' right to notice and an opportunity to be heard.<sup>9</sup>

### *Notification to Affected Taxpayers and Opportunity to Be Heard*

The IRS is subject to a statutory requirement to provide notice to taxpayers whose refund claims have been denied.<sup>10</sup> However, under the QRP as operated prior to the 2005 TAS study, taxpayers whose refunds were frozen generally did not receive notice of either the IRS's determination to freeze a refund or the IRS's conclusion as to the

<sup>9</sup> The changes to the QRP are based in part on a Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures, negotiated and agreed to by the National Taxpayer Advocate and the other business units participating on the Commissioner's Executive Steering Committee. The National Taxpayer Advocate believes that the IRS has acted in good faith in carrying out the changes set forth in the memorandum.

<sup>10</sup> IRC § 6402(k) provides: In the case of a disallowance of a claim for refund, the Secretary shall provide the taxpayer with an explanation for such disallowance.

existence of fraud.<sup>11</sup> CI did not send notices of claim disallowance when it froze taxpayer refunds. Taxpayers would receive notice about their refund claims only if CI referred a case to the Examination functions or, in some cases, if a taxpayer contacted the IRS to inquire about the status of the refund.<sup>12</sup> Additionally, once CI placed a freeze upon a refund, it retained control over the release of that freeze, so that if the Examination functions made a determination favorable to taxpayers, CI would still retain the authority to decide whether the freeze would be released.

### *Revised Refund Notice Procedures*

Under the revised QRP procedures, taxpayers who have not received their refunds will receive multiple notices and opportunities to rebut the IRS's conclusions with respect to the refund claim. The first notice (CPO5) is sent to taxpayers approximately 35 days after CI places a hold on a refund claim and provides notice that the claim is under review due to concerns about information provided on the tax return. Taxpayers are advised to allow at least three weeks before contacting the IRS about the refund, and information about receiving assistance from TAS is provided in the letter.

After the issuance of the CPO5, frozen refunds will follow one of four paths:

1. The refund may be released if the taxpayer can provide substantiating information;
2. CI may send a letter (Letter 4115C) seeking additional information from the taxpayer, and if the taxpayer does not respond or responds with inadequate information the case will be referred to the IRS Accounts Management function, which will issue a claim disallowance letter;<sup>13</sup>
3. The refund may be sent to one of the Exam functions which will apply deficiency procedures as described below, and if the taxpayer inquires about his or her refund before the case reached Exam, an explanatory letter (Letter 4116C) will be issued; or
4. The case is retained by CI for further investigation as a possible fraudulent scheme.

<sup>11</sup> In the mid 1990s, CI did provide notice of its actions to taxpayers. The IRS testified before the House Ways and Means Committee as follows:

When we have delayed a refund in whole or in part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund will be sent within eight weeks unless we determine additional contact with the taxpayer is necessary to verify the claim.

*Fiscal Year 1996 IRS Budget Request, Hearing Before the House Ways and Means Committee, 103rd Congress (Feb. 27, 1995).* However, CI deviated from these standards in years subsequent to 1995. As part of the study, TAS learned that well over 200,000 taxpayers with frozen refunds never received any type of notice of CI's actions and CI took no action to resolve the disputed refund claims other than to place the claims in frozen status.

<sup>12</sup> For example, in fiscal year 2004, CI referred approximately 45,000 cases to the Examination functions. IRS Responses to TAS Information Requests, dated July 22, 2005 and July 29, 2005. On the other hand, CI concluded that fraud was present in connection with over 118,000 QRP refund claims. Treasury Inspector General for Tax Administration, Ref. No. 2006-20-108, *The Electronic Fraud Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified* (Aug. 9, 2006).

<sup>13</sup> IRC § 6402(k) requires the IRS to provide notice to taxpayers when it disallows their refund claims.

Under the revised QRP procedures, CI can no longer hold a QRP refund indefinitely. The IRS has established a 70-day time frame within which CI must either make the affirmative determination that the case requires further criminal investigation or take the affirmative step of routing the frozen refunds through one of the first three treatments described above. These treatments are discussed in more detail below.

Under the new QRP procedures, refund claims will be released within 70 days of the refund freeze unless CI takes an action to route the refund claim through another treatment. Thus, the default treatment will result in a refund release unless there is a basis to conduct further inquiry into the refund claim. This is an important change to the QRP procedures, which places the burden on CI to identify the basis for the continued hold on the refund.

In cases where the IRS continues to have questions about the validity of income or withholding credits reported, it will send Letter 4115C to taxpayers requesting verification to support the income and withholding claimed on the return. This contact provides an important opportunity for taxpayers to come forward and provide support for their refund claims. If the taxpayer does not respond to Letter 4115C within 45 days, the case is sent to the W&I Accounts Management function, which will issue a claim disallowance letter. The taxpayer receiving the disallowance letter will have the opportunity to request an independent review by the Office of Appeals.

In cases where CI's concerns about the legitimacy of the claim relate to credits other than withholding credits, such as the Earned Income Tax Credit or any other issue, CI will send the cases to one of the Examination functions in either SB/SE or W&I (collectively referred to as Exam). If the taxpayer inquires about his or her refund after the determination has been made to send the case to Exam, the IRS will send Letter 4116C, which informs the taxpayer that the case will be sent to Exam within 60 days. Within 30 days of receiving the case, Exam will either release the refund or send Letter 566H, which Exam uses to request documentation of the questionable items on the return. If the taxpayer substantiates the questioned items, the refund will be released. If Exam determines that the taxpayer's response is insufficient or if there is no taxpayer response, Exam will send an audit report disallowing all or part of the claimed refund. If the taxpayer does not respond to the audit report, provide additional information, or request an Appeals hearing, the IRS will send a Notice of Deficiency to the taxpayer, allowing the taxpayer to file a petition in the United States Tax Court if the taxpayer disagrees with Exam's position.<sup>14</sup>

#### *Automatic Refund Freezes in Subsequent Years*

Under the QRP as run prior to the TAS study, CI's policy after determining the presence of fraud was to automatically freeze a taxpayer's refund claims in subsequent years until the taxpayer had filed a specified number of legitimate returns. The IRS had little

<sup>14</sup> IRC §§ 6212 through 6215 establish deficiency procedures pursuant to which the taxpayer receives a notice of the proposed deficiency and allows the taxpayer 90 days to file a petition with the U.S. Tax Court.

current data showing that persons flagged for filing false refund claims were especially likely to continue to file false claims in future years. This is partly because taxpayers who file false claims and do not receive the claimed refund realize that the IRS is on to them. It is partly because initial IRS determinations of fraud are sometimes wrong, so subsequent freezes were based on an inaccurate premise that the taxpayer previously filed a false refund claim. The ultimate effect of this policy of freezing future refund claims automatically, without review, was to increase the IRS's inventory of frozen refunds significantly without much indication that the policy served to deter refund fraud.<sup>15</sup>

Under the revised QRP procedures, CI will no longer automatically freeze the future refund claims of taxpayers whose refund claims are frozen in the present year, except in a few categories of cases. This change will ease the burden on taxpayers affected by the QRP whose tax return related problems did not stem from an intent to defraud the government by filing a false return.

#### *IRS Pre-Refund Program Office*

As part of the restructuring of the QRP, the IRS is establishing a Pre-Refund Program Office that will manage the different programs devoted to refund claims.<sup>16</sup> Creating a combined Pre-Refund Program Office has a number of benefits. This step will enable the IRS to run some of its pre-refund screens simultaneously, thereby reducing the time taxpayers must wait for their refunds. For example, taxpayers whose refunds are selected through CI's data mining software as part of the QRP are often subsequently routed to the Exam functions which then subject the refund claims to separate data base applications, such as the Dependent Database, in order to identify issues that require further review by the Exam functions.<sup>17</sup> The IRS believes the consolidated program will allow either running the data mining and Dependent Database simultaneously, which would reduce the time refunds are frozen, or running the Dependent Database prior to or in lieu of CI's data mining software, which would move taxpayers to the examination and deficiency process first, instead of freezing the refunds in CI's inventory, only to be moved to Exam after months elapse.

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<sup>15</sup> The 2005 TAS QRP study concluded that among TAS QRP cases there was a small probability (six percent) of a taxpayer repeatedly submitting refund returns indicative of fraud. National Taxpayer Advocate 2005 Annual Report to Congress Vol. II, 16.

<sup>16</sup> Summary of Results: Pre-Refund Program Strategy (July 25 – 26, 2006).

<sup>17</sup> The Dependent Database contains information from the U.S. Department of Health and Human Services about dependents such as information about the persons with whom children reside. Treasury Inspector General for Tax Administration, *Dependent Database Information is Complete and Examination Cases are Accurately Scored*, Ref. No. 2003-40-91 (Mar. 2003). IRS describes the Dependent Database as follows:

The Dependent Database (DDb) is a tool that identifies non-compliant Earned Income Tax Credit (EITC) and dependent issues through the use of internal and external data elements and provides the ability to freeze refunds. The database is rule driven. If a rule condition is met as returns are processed through the DDb rule filtering process, the rule "fires" and the return is flagged for examination. Most of the selected returns are worked as pre-refund audits, which involve EITC claims. IRS, *Dependent Database*, available at <http://www.irs.gov/privacy/article/0,,id=163758,00.html>.

The role of the Pre-Refund Program Office is not yet fully developed; however, it appears that CI will retain ownership of the day-to-day decision making in the QRP. We believe that the QRP program should be administered by the civil tax functions in the IRS, because the nature of the work to be performed under the revised QRP, *i.e.*, interacting with taxpayers to obtain substantiating documentation, is the day-to-day work of these functions. In appropriate cases, these functions can make criminal referrals to CI as it does under regular examination procedures.<sup>18</sup>

Moreover, it makes sense to establish a central screening program through which each refund return passes. The various IRS functions – both civil and criminal – could develop appropriate screens for their respective tax administration mission. Each tax return’s unique “score” would determine where the case should first be worked. This approach ensures that taxpayers’ returns are subject to the correct amount of scrutiny but not to multiple and inappropriate delays.

#### *Old Inventory of Frozen Refunds*

As part of our discussions with CI for the 2005 Annual Report, we learned that CI had in excess of 216,000 frozen refund cases of varying age in which CI had taken no action other than to freeze the refunds. The IRS committed to work through this inventory of cases by creating a task force of IRS personnel to issue notices to the affected taxpayers and to assess the merits of each fraud determination.<sup>19</sup> If taxpayers do not come forward with evidence substantiating their refund claims, the IRS will disallow the refund using a claim disallowance notice or by referring the case to Exam as appropriate. To date, about 50,000 refund claims have been released, about 69,000 cases have been referred to Accounts Management (AM) for claim disallowance after the taxpayers were given notice and offered a chance to come forward with substantiating evidence, about 28,000 cases were referred to Exam, about 40,000 cases were referred by CI to AM or Exam but were returned to CI for a variety of reasons and are still being worked, and about 29,000 returns were determined to involve taxpayers with problems in multiple years and are still under consideration.<sup>20</sup>

#### **TAS’s Remaining Concerns**

The changes to the QRP are significant, and we applaud the IRS for these efforts. The QRP process changes described above improve the procedures for those taxpayers whose refunds are held for scrutiny. However, we also believe the IRS should do more to ensure the selection process that identifies these taxpayers is improved so that fewer legitimate claims are unnecessarily subject to the QRP. There can be serious conse-

<sup>18</sup> For example, Exam employees have the ability to make a referral to CI through its internal referral procedures. IRM 4.1.5.1.1 (Oct. 24, 2006).

<sup>19</sup> With respect to this old inventory, the IRS issued Letter CP05A informing these taxpayers that the IRS has concerns with the claimed refund and asking the taxpayers to come forward with evidence substantiating the claimed refund.

<sup>20</sup> Criminal Investigations, Questionable Refund Program (Dec. 2006).

quences for taxpayers whose refunds are subject to QRP scrutiny, even in cases in which taxpayers ultimately receive full refund relief. At least among cases reviewed as part of the 2005 TAS QRP study, taxpayers whose refunds were frozen had a median Adjusted Gross Income (AGI) of \$12,850 and the median refund was over \$3,500 – fully 27 percent of their AGI for the year.<sup>21</sup> These are not taxpayers who can afford to be without such a substantial portion of their income. Moreover, taxpayers who received full refund relief waited an average of 8½ months for their refunds.<sup>22</sup>

The 2005 TAS CI study analyzed cases in which CI froze a taxpayer's refund claim and the taxpayer sought assistance from TAS. In this sample, CI ultimately agreed that the taxpayers were entitled to a full or partial refund in 80 percent of the cases (a full refund in 66 percent and a partial refund in 14 percent of the cases). Moreover, it is not at all clear that the remaining 20 percent of the taxpayers committed fraud; rather, it is only clear that these taxpayers did not receive the claimed refund. Because the QRP principally uses data mining as its source for questionable refund claims, it is reasonable to ask whether the rules which govern CI's data mining software are more over-inclusive than they need to be, and, if so, whether these rules can be more narrowly drawn.

#### *Improving Data Mining Filters*

The 2005 TAS QRP study demonstrated flaws not just in the lack of notice to affected taxpayers but also in the process by which CI makes its fraud determinations, a process which begins with the use of data mining software. As a result of the study, the IRS agreed to improve the accuracy of its data-mining software so that fewer valid refund claims are frozen.<sup>23</sup> To improve its data mining software, we have suggested that the IRS conduct research on a random sample of its frozen refund inventory. By sampling its frozen refund inventory, the IRS will learn important information that will assist it in both eliminating incorrect fraud determinations and identifying fraudulent schemes that the IRS is not detecting with its current approach. This iterative research should involve contacting taxpayers so that the IRS can determine whether the taxpayers can offer substantiation for their refund claims. This contact should not come from CI, which would likely have a chilling or intimidating effect on the taxpayer's willingness to communicate; rather, the contact should be made by assistants trained to communicate with taxpayers. Therefore, we have suggested that TAS should be involved in working with the IRS as a liaison with the taxpayers in the sample.

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<sup>21</sup> National Taxpayer Advocate 2005 Annual Report to Congress 26.

<sup>22</sup> *Id.*

<sup>23</sup> IRS News Release, New Steps Taken To Improve Questionable Refund Program (Feb. 6, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154285,00.html>.

## UPDATE

The importance of involving taxpayer input in arriving at the correct answer has been demonstrated in previous IRS research efforts.<sup>24</sup> In other legal contexts, allowing citizens an opportunity to tell their side of the story is so fundamental as to be a constitutional requirement.<sup>25</sup> However, under the old QRP procedures, CI would make a determination about taxpayer fraud without notice to the taxpayer or opportunity to be heard.<sup>26</sup> One of the consequences of such a one-sided process, as the 2005 TAS study demonstrated, is a high percentage of incorrect fraud determinations. By not involving taxpayers in the cases it is using to test its data mining software, the IRS is likely to make the same mistakes again and import those mistakes into its data mining rules.

At this time, however, IRS has agreed only to review a sample of case files *without* contacting the taxpayer. This approach ignores the lessons of the 2005 QRP study. We assume that when CI makes fraud determinations, it has some basis to do so in nearly all of its cases, including in the 80 percent of the fraud determinations in the TAS study which ultimately proved to be incorrect. One of the most important findings of the 2005 TAS QRP study, which has been illustrated in other TAS research studies as well, is that when we interact with taxpayers they can often provide substantiation for the claimed refund. Thus, the process currently being used to improve the filters ignores the taxpayers' side of the story, and will not result in needed improvements to the software.

We are particularly concerned about the changes being made to the data mining software for the 2007 filing season. Data mining software operates on the application of thousands of program rules which are re-written each year based on data collected from the prior year's fraud determinations. Thus, the data mining software for any given year will only be as effective in identifying fraudulent returns as the prior year's fraud determinations. Because the Electronic Fraud Detection System (EFDS) was not available for the 2006 filing season, the data mining software for the 2007 filing season will be based on the fraud determinations from the 2005 filing season. However, these cases were decided prior to the implementation of the new QRP procedures, and based on the results of the 2005 TAS study of the QRP, we do not believe these cases provide a reliable basis to establish rules for the data mining software. Thus, we are doubly concerned about the reliability of the data mining filters for the 2007 filing season – we are

<sup>24</sup> The 2004 joint TAS-IRS Earned Income Tax Credit (EITC) Audit Reconsideration Study, which studied EITC denials in the audit reconsideration process, provides evidence of the importance of taxpayer contact in arriving at the right conclusion. Of the taxpayers who came to TAS for assistance, 45 percent ultimately received additional EITC benefits, even though the IRS had initially denied the taxpayers' claims. However, the correct answer was only obtained through taxpayer contact and interaction. National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, 9. Studies such as the TAS QRP study and the TAS-IRS EITC Audit Reconsideration study demonstrate the importance of person-to-person contact with taxpayers for enabling taxpayers to articulate the basis for claimed refunds or other credits.

<sup>25</sup> For example, in *Goldberg v. Kelly*, 379 U.S. 254, 90 S.Ct. 1011, 25 L.Ed.2d 287 (1970), the Supreme Court held that the termination of citizens' benefits under the Aid to Families with Dependent Children program required pre-termination hearings with notice and opportunity to be heard for recipients.

<sup>26</sup> By analogy to the prosecution of criminals in other contexts, we believe that the likelihood of CI accurately predicting fraud under this one-sided approach would be akin to the likelihood of a judge determining guilt or innocence solely on the basis of an indictment, without hearing the side of the accused.



concerned that CI is using a flawed methodology to improve the filters by not involving taxpayers in its review of prior fraud determinations, and we are concerned that it is choosing from among a population of cases that were decided under procedures that produced too many “false positive” findings of fraud.

#### *Resource Commitment – the 2007 Filing Season and Beyond*

Under the revised QRP procedures, CI must determine whether to retain the case for further investigation to determine if it is part of a fraudulent scheme or release the refund, refer the case to the Exam function and or attempt to verify the taxpayers’ refund claims and refer the cases which cannot be verified to Accounts Management for claim disallowance.

While we applaud this approach because it eliminates “default” freezes, we are concerned that these other functions are not prepared for the significant volumes of new cases they will receive in the 2007 filing season and beyond. It appeared to us that Exam’s resources were stretched under the old QRP procedures when CI sent less than half of its frozen refund cases to Exam and when CI was not under a specific time limit to take action on the cases.<sup>27</sup> Although the IRS handled CI cases under the new procedures during the 2006 filing season, the 2006 filing season was not an indication of the case volumes that Exam and Accounts Management will experience in 2007 and beyond because EFDS, which allows the IRS to accomplish numerous functions in the QRP (such as running its data mining software, delivering thousands of cases at a time to the Operating Divisions, and generating automatic reports of case activity), was not available for the 2006 filing season. However, it will be available for the 2007 filing season.<sup>28</sup> Thus, Exam and Accounts Management should be planning for tens of thousands of additional cases in their inventories.

To gauge the extent to which the new QRP procedures are working or not working, we asked Local Taxpayer Advocates (LTAs) across the country to provide examples of cases from the 2006 filing season in which the procedures failed. We received dozens of cases from LTAs, and the dominant complaint among them was that while CI had referred the case to Exam, Exam had no record of the case in its inventory.<sup>29</sup> To probe the root causes of these problems and to determine what preparations were being made for the 2007 filing season, we posed a number of questions to CI, the Exam functions,

<sup>27</sup> In fiscal year 2004, CI referred approximately 45,000 cases to the Examination functions. IRS Responses to TAS information requests, dated July 22, 2005 and July 29, 2005. On the other hand, CI concluded the existence of fraud on over 118,000 QRP refunds, leaving over 70,000 frozen refund cases that were not referred to Exam. Treasury Inspector General for Tax Administration, *The Electronic Fraud Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified*, Ref. No. 2006-20-108 (Aug. 9, 2006).

<sup>28</sup> Treasury Inspector General for Tax Administration, *A Complete Certification and Accreditation is Needed to Ensure the Electronic Fraud Detection System Meets Federal Government Security Standards*, Ref. No. 2006-20-178 (Sept. 29, 2006).

<sup>29</sup> Eighty-five examples were provided by LTAs from cases listed on the Taxpayer Advocate Management Information System (TAMIS). For FY 2006, TAS received over 19,000 complaints from taxpayers about the QRP.

and Accounts Management as part of this Annual Report to Congress process. While the IRS has worked very cooperatively with TAS officials on the Executive Steering Committee and has shared information as part of that process, the IRS does not yet have the management reports in place to be able to identify the types of problems described above, much less resolve them expeditiously.

We understand that implementing these changes is hard work. However, to ensure that the problems that taxpayers used to experience with CI do not become the same problems that taxpayers experience in the future with Exam and Accounts Management, the IRS needs to acknowledge the increased work loads on these functions and provide these functions adequate resources to complete the work assigned to them.

### CONCLUSION

We reiterate our praise for the IRS's efforts to reform the QRP. Clearly, the IRS agrees that the QRP as previously administered created an unnecessary burden for taxpayers. Taxpayers are now receiving notice as to why their refunds are delayed, and they are being provided an opportunity to provide substantiating evidence to support their refund claims. However, the IRS must work harder to improve the data mining filters that are responsible for identifying these questionable returns at the outset. We believe this process can only be effective if the IRS is willing to study cases that its filters wrongly flagged and incorporate the learned experience to improve its data-mining filters for the future. TAS has offered its Research function and its case advocates for the IRS to assist in this process. To date, the IRS has been unwilling to involve taxpayers in this process. Additionally, now that much of the work load of the QRP cases is falling on Exam and Accounts Management, the IRS needs to ensure that these functions can plan adequately for this substantial amount of new work and needs to provide the necessary resources for these functions to adjust to the new work load.

### IRS COMMENTS

The IRS has made significant improvements to the process of identifying and stopping questionable refunds, and has many other process improvements planned for the 2007 filing season. In particular, the IRS has implemented new policies and procedures that include an enhanced taxpayer notification system; improved freeze management processes; a new inventory control and resource utilization system; development of a Concept of Operations (CONOPS) for the workload transfer process; a quality assurance system; and a new Pre-Refund Program Office that will evaluate and manage pre-refund strategies and resources across the agency.

### Taxpayer Notification

Taxpayers are being properly notified of Criminal Investigation Division (CI) refund freezes and afforded due process. Additionally, questionable accounts are now referred

to either Examination or Accounts Management (AM) once the verification process has been completed. Four new notices have been created:

- ◆ The first notice (CP05) began in April. It is sent to all taxpayers whose refund is being delayed by CI *beyond* the initial 2 week re-sequencing period. It advises the taxpayers that their refund is being delayed for further review of the income, income tax withholding, or business income reported on the return. The notice further advises taxpayers that the IRS will contact them once the review is completed and at that time the taxpayer will either receive their refund or will be asked for additional information. Over 103,000 of these notices were issued in the 2006 filing season. There have been approximately 200 responses (.2 percent response rate) from taxpayers and 17,500 have been returned as undeliverable.
- ◆ If the Criminal Investigation Division (CI) verifies that a refund is questionable, the taxpayer receives a second notice. This notice is sent by CI on certain accounts (4115C) or by Examination (566H) if refundable credits, such as EITC are involved. Both letters explain why the IRS believes the refund claim is questionable and provide the taxpayer an opportunity to submit additional supporting documentation. CI has sent over 17,000 4115C letters. There have been approximately 800 responses (4.7 percent response rate) and 1,100 undeliverable.
- ◆ The third notice (4116C) is issued to taxpayers who inquire about their refund while it is in the transfer phase to Examination. This notice explains that their account is being transferred to Examination and that he or she will be contacted within 60 days. Over 1,700 of these letters have been sent.
- ◆ With respect to old inventory (refunds frozen prior to the 2006 filing season), the first notice to the taxpayer is a CP05A (AM work) or 566H. These notices explain that the IRS has found their refund questionable and provide the taxpayer an opportunity to submit additional supporting documentation. Approximately 70,000 of these notices have been sent.

In addition to these new notices, taxpayers who fail to substantiate the income or withholding after receiving these notifications will receive either a Certified Claims Disallowance Letter (105C) from Accounts Management or a Statutory Notice of Deficiency (90 Day letter) from Examination.

### Freeze Management

Taxpayers' refunds can be frozen in two ways, either by a CI control placed on the account because of a previous year false return having been filed (Z Freeze) or by CI intercepting or stopping the refund from being issued (P Freeze). Only a portion of those returns hitting the data mining flags are frozen. A freeze occurs only after analysts have assessed the return and placed it in queue for employment verification.

Several actions were taken in 2006 to address the concerns regarding aging of accounts with frozen refunds.

- ◆ In February, CI implemented a policy requiring that the verification of employment, and therefore the reported income, be completed within 70 days of stopping the refund. Otherwise, the refund is released.
- ◆ In April 2006, a policy was implemented to restrict the use of the TC 918, which freezes the entire taxpayer's account.
- ◆ In June 2006, a master file programming change was implemented to systemically release the refund after 70 days if the account had not been updated to indicate the refund was false.
- ◆ In June 2006, a master file programming change was implemented to remove the CI controls on workload transferred to AM or Examination.
- ◆ In June 2006, CI implemented a procedural change to assess unpostable returns at the receiving site versus transferring returns to the controlling FDC. This allowed for better control and quicker verification.

#### **Workload Transfer Process**

Since early 2006, the QRP Working Group has made substantial progress in identifying and resolving QRP inventories. Actions were initiated that are expected to result in 88 percent of Old Inventory cases closed or in process in AM or Examination by January 31, 2007. Virtually all cases are expected to be closed by September 30, 2007. Enhanced roles and responsibilities have been identified and implemented for the Fraud Detection Centers, AM, and Examination.

#### **Electronic Fraud Detection System, Data-Mining, and Sampling**

With respect to the Electronic Fraud Detection System (EFDS), CI agrees that we need to partner with the Taxpayer Advocate Service (TAS) as we go forward to modify the data model. This will include sharing with TAS the projected outcomes from proposed modifications to the model. CI agrees with the National Taxpayer Advocate's suggestions to utilize research, sampling, and quality control processes to ensure that the IRS has a higher predictor of outcomes, with acceptable false positive and "no change" rates. With respect to the 2007 filing season, CI believes that the false positive rate should be at or close to the historical rate of five to six percent, consistent with the Exam "no change" rate. Also, given the many process improvements made to the program regarding freeze management and taxpayer notification, the potential for negatively impacting legitimate taxpayers for excessive periods of time has lessened substantially.

CI concurs with the National Taxpayer Advocate's recommendation that a sample review of frozen refund returns could be valuable in increasing the effectiveness of the QRP program. A study should be designed to include a statistically valid sample of all frozen refunds. A sample should be jointly analyzed by TAS and the IRS after returns have been subjected to the Processing Year 2007 QRP process. This would best utilize resources to ensure that we are evaluating results based on the new procedures.

With respect to data-mining, it should be noted that data mining does not cause refunds to be frozen or automatically determine returns to be fraudulent. Also, only returns determined to be actually fraudulent are used in the model-building algorithm; automatic refund freezes from prior year determinations are not used in building the model. In accordance with IRS policy, the only immediate consequence for a return being flagged is that the refund is delayed for two weeks (re-sequenced). Data mining predicts which refund returns have a likelihood of being fraudulent, and subsequently, CI personnel verify whether the refund is indeed questionable and, therefore, subject to further investigation.

The enhancements, changes, and improvements made to the QRP will reduce unnecessary hardships for taxpayers while at the same time improve the ability of the IRS to identify and stop questionable refunds.

#### TAXPAYER ADVOCATE SERVICE COMMENTS

We agree that the IRS has made significant improvements to the QRP and commend the IRS on the speed with which it undertook these changes. We look forward to working with the IRS on further refinements to QRP and on improving the data mining software. We are pleased that CI has agreed to conduct a sample review of its frozen refund returns. However, we reiterate the importance of working directly with taxpayers when sampling its frozen refund cases as part of the data mining improvement process. Moreover, we believe that CI will find it instructive and helpful if we jointly review those cases from TAS's 2005 study in which taxpayers received full or partial refund relief but CI originally verified as fraudulent. Information obtained from this review will most certainly help CI improve its filters to avoid false positives. Finally, we commit to working for the continued improvement of the QRP program through our participation in the Executive Steering Committee and our work with the Pre-Refund Program Office.