

THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

Internal Revenue Code § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to describe at least 20 of the most serious problems encountered by taxpayers. This year's report describes 21 problems and provides a status update on one other issue, the IRS's Questionable Refund Program (QRP). Each of the most serious problems includes the National Taxpayer Advocate's description of the problem, the IRS's response, and the National Taxpayer Advocate's final comments and recommendations. This format provides a clear picture of which steps have been taken to address the most serious problems and which additional steps the National Taxpayer Advocate believes are required.

The issues described in the report are as follows:

1. Alternative Minimum Tax for Individuals. The National Taxpayer Advocate believes that the most serious problem facing taxpayers today is the complexity of the Internal Revenue Code, and the poster child for tax-law complexity is 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, 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 a nutshell, is today's AMT.

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.

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. It is a problem for taxpayers because the average compliant taxpayer is paying thousands of dollars in extra tax each year to subsidize noncompliance by others. It is a problem for tax administration because the government is failing to collect an estimated \$290 billion in revenue a year that is due (based on 2001 estimates). The National Taxpayer Advocate has long recommended three broad strategies to help close the tax gap: (1) fundamental tax simplification, with an emphasis on making economic transactions more transparent; (2) expanded third-party information

reporting and, in certain situations, tax withholding on non-wage income; and (3) improved IRS compliance initiatives that appropriately balance taxpayer service and enforcement.

This year, we reiterate the importance of those broad strategies and emphasize three specific goals that we think warrant particular attention: (1) improving taxpayer service to meet the needs our nation's taxpayers; (2) ensuring that the IRS's stepped-up enforcement and compliance activity proceeds successfully and without violating taxpayer rights; and (3) revising federal budget procedures to ensure that decisions about IRS funding are made in a way designed to reduce the tax gap by explicitly aiming to maximize compliance with the tax laws, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.

3. Transparency of the IRS. Tax administration benefits from transparency, and the Freedom of Information Act (FOIA) requires the IRS to make certain procedures and guidance available to the public. Nonetheless, the IRS sometimes updates its procedures and guidance without timely making them available to the public. For example, it sometimes does not make available to the public: (1) updates to an internal version of the Internal Revenue Manual (IRM), (2) signed or unsigned memos announcing changes in procedures or guidance, (3) procedures or guidance that serve to clarify or expand upon the IRM, and (4) legal advice that contradicts legal analysis that is available to the public. While not all such nondisclosures violate the FOIA, the National Taxpayer Advocate believes that transparency in tax administration is essential to assure taxpayers that the tax laws are being administered fairly. It is also necessary to ensure that IRS employees, taxpayers, and practitioners know which procedures and guidance are the most current. Moreover, the IRS can benefit from the feedback that an increase in transparency might generate. Although the IRS has generally improved its transparency in recent years, further improvements are needed.

4. True Costs and Benefits of Private Debt Collection. After two years of monitoring the implementation of the IRS's Private Debt Collection (PDC) initiative, the National Taxpayer Advocate is recommending that Congress repeal the IRS's authority to enter into contracts with private collection agencies (PCAs) to collect delinquent federal tax debts. The PDC initiative was premised on three concepts: (1) the initiative would be cost effective, (2) private agencies would only work easy cases, and (3) the IRS is similar to other federal agencies that have used PCAs successfully. The IRS now acknowledges that it can collect these delinquent accounts more efficiently than PCAs. Additionally, the Taxpayer Advocate Service (TAS), which has assisted in monitoring the program, has observed a significant amount of complexity in the cases assigned to PCAs (including unresolved delinquent return investigations) for which PCA employees are not adequately trained. Further, the analogy of the IRS to other federal agencies is a poor one. Unlike other federal agencies, the IRS has a nearly \$2 billion collection budget with thousands of collection employees. In contrast, PCAs at this stage of the initiative are using 75 employees to collect on these accounts, and the IRS is using 65 employees to monitor them. The IRS with its vast resources can do what 75 PCA employees can do.

The initiative also carries hidden costs to customer service, to the transparency of IRS operations, to the principle of consistent treatment for similarly situated taxpayers, and to the IRS's long-term goal of tax compliance. TAS has observed examples of these costs, including poor customer service to multilingual taxpayers, PCA operational plans being withheld from public disclosure, and PCA collection scripts through which PCA employees attempt to manipulate taxpayers. The impact to tax compliance is uncertain. However, the National Taxpayer Advocate believes the IRS has risked much for a small return, if any, on its investment.

5. Early Intervention in IRS Collection Cases. 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. It appears that far too many IRS collection accounts are relegated to “currently not collectible (CNC)” status, or remain in “open” status for prolonged periods, even when taxpayers have attempted to resolve the debts through installment agreements or offers in compromise. The National Taxpayer Advocate recommends the IRS revise its methods of prioritizing and assigning collection cases. The IRS should also do more to initiate meaningful, personal contacts with taxpayers and offer more flexibility in providing realistic payment options to taxpayers trying to resolve their problems.

6. IRS Collection Payment Alternatives. The IRS does not fully utilize the available collection payment alternatives, such as installment agreements and offers in compromise, to resolve delinquent tax accounts. This approach means many account problems are not addressed timely, fostering additional liabilities for the taxpayer and substantial amounts of lost revenue for the government. Virtually any debt-collection operation will acknowledge that as delinquent accounts receivable age, their collection potential declines. Yet it appears that as IRS collection cases age, IRS policies and procedures make it very difficult for taxpayers to obtain reasonable collection alternatives, with the result that the IRS often collects nothing. The National Taxpayer Advocate recommends the IRS revise its policies to ensure that determinations of reasonable collection potential used in case decisions are actually reasonable and realistic. The IRS should establish more flexible installment agreement and offer in compromise acceptance policies to improve revenue collection and help bring taxpayers back into the ranks of the voluntarily compliant.

7. Levies. The IRS levy program is a necessary means of collection and, when used appropriately, is a fundamental component of tax enforcement. The National Taxpayer Advocate recognizes the IRS's need to utilize automation to perform enforcement activities more efficiently, but is concerned that this automation comes at the expense of meaningful personal contact and quality taxpayer service. The IRS should only serve a notice of levy upon third parties after it has taken the necessary steps to ensure that taxpayers will not be needlessly harmed. For example, 84 percent of all Federal Payment Levy Program (FPLP) levies historically have involved Social Security payments to the elderly or disabled, many of whom are fully dependent on these benefits to cover their basic living expenses, yet the IRS does nothing to try to screen out vulnerable, low income taxpayers from this automated process. Other levy release and payment application procedures are ineffective and lead to additional harm for taxpayers. By employing more proactive approaches, such as removing potential hardship cases from FPLP, the IRS can achieve the appropriate balance between enforcement and taxpayer service.

8. Centralized Lien Processing. In 2005, the IRS consolidated 33 geographically dispersed lien units into a single Centralized Case Processing Lien Unit (CCP-LU) located at its Cincinnati campus. The National Taxpayer Advocate is concerned that centralization has encroached on taxpayer rights and has increased the burden on both taxpayers and the IRS. The IRS has continued to experience difficulty timely providing notice of appeal rights and timely releasing liens under the new lien processing structure. Taxpayers and other IRS employees have experienced problems reaching the CCP-LU in the first place. The National Taxpayer Advocate recommends, among other things, that the IRS reexamine whether centralization is more cost effective and provides better service to taxpayers than the previous local lien desk structure and that the IRS conduct a comprehensive cost analysis of the centralized lien processing system.

9. Collection Issues of Low Income Taxpayers. The IRS's collection operations fail to provide the meaningful services that low income taxpayers need to meet their obligations regarding federal tax delinquencies. The IRS frequently does not offer personal contacts and flexible payment options, even though many low income taxpayers require this type of service to fully and timely resolve problems. 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. 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 means to secure adequate representation, low income taxpayers can easily find themselves lost in a tax system that appears indifferent, uncaring, and sometimes hostile.

10. Excess Collections. 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. Both the Taxpayer Advocate Service (TAS) and the Treasury Inspector General for Tax Administration (TIGTA) have found that the IRS routinely moves funds into the XSF with very little research or contact with the taxpayer to ascertain whether a taxable return should be filed, and if so, where such funds should be applied. As a result, the IRS cannot properly determine whether it has collected the correct amount of tax due or owes the taxpayer a refund. The National Taxpayer Advocate recommends that the IRS make meaningful personal contact with taxpayers at the earliest possible stage and conduct substantive research to assist when such contact cannot readily be established. In doing so, the IRS will more effectively fulfill its fiduciary responsibility for these funds, reinforce voluntary compliance, and instill public confidence in the tax system.

11. Small Business Outreach. There are 45 million small business or self-employed taxpayers in the tax system today. These taxpayers use a wide range of services and products, and are increasingly diverse in terms of education, language, and geography. Small business taxpayers must deal with complex tax laws and regulations in order to satisfy their tax obligations and filing requirements. Many of these taxpayers cannot afford professional advice, and the IRS's Small Business/Self-Employed division (SB/SE) is not adequately helping them understand and comply with their tax obligations. The single largest component of the tax gap, about 44 percent, is attributable to underreporting by self-employed taxpayers. The National Taxpayer Advocate urges the IRS to conduct research to assess the characteristics and needs of small business owners and self-employed taxpayers and to develop an integrated strategic plan to enhance the scope and effectiveness of its outreach and education to these taxpayers.

12. Oversight of Unenrolled Return Preparers. Taxpayers are harmed by the absence of a comprehensive federal program to regulate unenrolled return preparers (*i.e.*, those who are not Certified Public Accountants, attorneys, enrolled agents, or enrolled actuaries). The National Taxpayer Advocate has repeatedly raised concerns about the lack of IRS oversight of unenrolled return preparers. However, the IRS has declined to support such a system, and none is currently in place. Nor does the IRS effectively monitor tax practitioners with its current administrative capabilities. Even when a member of the public or an IRS employee identifies potential preparer misconduct, the IRS does not have an effective system to receive and track complaints. In addition, the IRS has collected only 13 percent of net assessed return preparer penalties for the last five fiscal years and only six percent in FY 2006. The National Taxpayer Advocate also recommends that the IRS move forward on revisions to the regulations under

IRC §7216 and reevaluate proposed changes to Circular 230, which would eliminate the ability of unenrolled return preparers to engage in limited practice before the IRS.

13. Correspondence Delays. The IRS's correspondence policy masks systemic delays with quality measures that do not reflect actual correspondence timeliness to taxpayers. In FY 2005, the IRS issued 2.9 million "stall" letters informing taxpayers to expect additional delays beyond the standard 30-day response period. Rather than balancing resources to answer taxpayer correspondence more quickly, the IRS has automated the "delay-notification" process. Meanwhile, taxpayer satisfaction surveys continue to show that lack of "timeliness" is a major source of taxpayer dissatisfaction. TAS has also identified a disparity between the volumes of English and Spanish-language IRS letters, suggesting a lapse in service to the Spanish-speaking population. The National Taxpayer Advocate recommends that the IRS revise its measures for timeliness to reflect reasonable taxpayer expectations, enhance correspondence staffing levels, and take greater strides toward communicating with Spanish-speaking taxpayers in their primary language.

14. Disaster Response and Recovery. Over the years, the IRS has successfully responded to many disasters by, for example, providing and staffing toll-free FEMA phone assistance lines for Hurricane Katrina victims and answered approximately 950,000 calls. However, 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. 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 National Taxpayer Advocate recommends the IRS establish a permanent disaster response team composed of employees and managers with expertise in individual, corporate, and small business tax matters. This team would operate in coordination with the Directors of the Federal Emergency Management Agency and Homeland Security.

15. Concerns about the IRS Office of Appeals. The IRS Office of Appeals has centralized work on appeals of certain examination and collection cases at IRS campuses. While this strategy can reduce cycle time, it emphasizes telephone or correspondence contacts and limits taxpayer opportunities for a local hearing with Appeals. This is especially true for "*pro se*" taxpayers who lack legal representation, may not fully understand the process, and fail to properly submit technical documents and narratives. In addition, Appeals is not aggressively pursuing use of Alternative Dispute Resolution (ADR) programs to resolve cases. The National Taxpayer Advocate urges Appeals to adequately notify taxpayers of the Appeals process and their rights to a face-to-face or local office meeting and to develop short and long-term strategies to promote use of ADR programs.

16. Correspondence Examination. The IRS increasingly uses correspondence examinations for audits of high income individuals, though there are indications that these examinations are better reserved for interviews or field audits. The IRS's reluctance to discuss issues by telephone and the high volume of unassociated mail from taxpayers have led to premature audit closures. The IRS also makes inappropriate use of the combination letter, which compresses the timeframe taxpayers have to resolve disputes, and directs its processing employees to try to persuade taxpayers not to seek face-to-face meetings to pursue their appeal rights. The National Taxpayer Advocate urges the IRS to review the correspondence examination process with these concerns in mind, reduce the volume of unassociated mail, and establish better communication channels to prevent premature closures.

17. IRS Implementation of Math Error Authority Impairs Taxpayer Rights. Taxpayers who are summarily assessed additional tax via a "math error" notice may not be afforded the same

rights as those 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. However, the IRS has exceeded this limited authority by issuing math error notices in cases that go beyond these specified circumstances. In addition, math error notices sent to taxpayers do not include the level of detail that Congress intended. The IRS should improve the notice language and format to ensure that taxpayers understand what changes were made to their tax returns and why, and refresh the training of its employees on the appropriate use of math error authority.

18. Limited English Proficient (LEP) Taxpayers: Language And Cultural Barriers To Tax Compliance. As the LEP population grows, so does the number of LEP individuals in the workforce who are required to file tax returns and need to interact with the IRS. The IRS currently offers limited services for non-English speaking taxpayers, with the majority of those services offered only in Spanish. The National Taxpayer Advocate urges the IRS to expand services to other LEP language groups, educate taxpayers about the availability of these services, and develop a process to determine a taxpayer's language preference at the outset of his or her interaction with the IRS.

19. Taxpayer "No Response" Rates. 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, resulting in downstream consequences for both the IRS and the taxpayer. According to practitioners, taxpayers' reasons for failing to reply to IRS requests are almost as complex as the tax code itself. While the problem of "no response" occurs among individuals, businesses, and tax-exempt organizations, and at all income levels, the IRS does not know the magnitude of the problem. Generally, the IRS does not track the number of taxpayers that do not respond to notices, how many taxpayers try to respond, or how many notices are undelivered. If a taxpayer fails to respond to an initial notice but contacts the IRS later, the IRS must engage in a significant amount of rework, while the taxpayer may have to expend additional time and money. The IRS could reduce costs and ease taxpayer burden by working to improve the taxpayer response rate.

20. Reasonable Accommodations for Taxpayers with Disabilities. Taxpayers with disabilities often find themselves attempting to navigate and comply with a complex tax system that has not been designed to provide equal access. Taxpayers who are blind, deaf, or have other disabilities encounter numerous barriers, such as communicating with the IRS and locating guidance on how to request an accommodation. In addition, the IRS struggles to provide a webpage that is accessible to taxpayers with disabilities and provides little education and outreach to these taxpayers, their caretakers, and employers regarding what deductions and credits they may be entitled to claim. The National Taxpayer Advocate recommends that the IRS create a disability website (containing information about IRS accommodations and deductions and credits available to taxpayers with a disability, their caretakers, and employers) and publicize IRS accommodations on forms, publications, and notices.

21. Injured Spouse Allocations. If married taxpayers file a joint federal tax return claiming a refund and one spouse 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. 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. However, taxpayers who request

injured spouse relief may be burdened by lengthy processing times or IRS calculation errors. The IRS can take as long as 14 weeks to process a request for injured spouse relief and is more likely to make an error when calculating the allocation since the IRS computes the refund manually. The National Taxpayer Advocate urges the IRS to identify and address the reasons for the lengthy processing time and to develop a system of calculating injured spouse allocations automatically, rather than manually.

Status Update: Major Improvements in the Questionable Refund Program and Some Continuing Concerns. The National Taxpayer Advocate is pleased to report that the IRS has significantly improved the Questionable Refund Program (QRP). In our 2005 Annual Report, the National Taxpayer Advocate identified serious problems with the QRP managed by the IRS's Criminal Investigation (CI) function. The central problems included lack of notice to taxpayers whose refunds had been frozen based on suspicion of fraud, a CI policy that froze the future returns of taxpayers suspected of filing fraudulent returns, and a high percentage of innocent taxpayers whose refunds were frozen on a suspicion of fraud but whose refund claims were, with TAS assistance, proven legitimate. In this report, the National Taxpayer Advocate provides a status update to changes to the QRP. In 2006, an IRS Executive Steering Committee developed new procedures which ensure that all taxpayers receive notice of the IRS's inquiry into the refund. Under these procedures, most refund claims reviewed under the QRP will be routed to either the IRS Examination function or the Accounts Management function. The IRS will also take steps to improve the accuracy of the data mining software used in the QRP to improve the accuracy of return selection.

LEGISLATIVE RECOMMENDATIONS

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

KEY LEGISLATIVE RECOMMENDATIONS

1. **Revise Congressional Budget Procedures to Improve IRS Funding Decisions.**

Under existing congressional budget procedures, the IRS is grouped together with the rest of the Department of the Treasury, the Department of Transportation, the Department of Housing and Urban Development and other agencies, and spending for all these programs must fit within a pre-established dollar cap. As a result, the IRS competes dollar-for-dollar against many other federal programs for resources. This procedure makes little sense. The IRS is the Accounts Receivable Department of the federal government. On a budget of about \$10.6 billion, the IRS currently collects about \$2.24 trillion a year. That translates to an average return-on-investment of about 210:1. If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company's bottom line. Since the government is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to fund the IRS at a level that would maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. As the IRS has come under increasing pressure to close the "tax gap," it should be recognized that the IRS suffers from a "resources gap," and the IRS's lack of resources is a significant impediment to its ability to close the tax gap and thereby to reduce the federal budget deficit.

2. Repeal Private Debt Collection Provisions. The American Jobs Creation Act of 2004 authorized the IRS to enter into qualified collection contracts with private collection agencies. In the 2005 Annual Report to Congress, we discussed how the complexity of federal tax law would impose heavy costs and burdens on the IRS to ensure that taxpayer rights would be fully protected. In the Most Serious Problem section of this report, we address both the lack of a sound business case and lack of a tax administration case for the PDC initiative. As discussed in the Most Serious Problem, *True Costs and Benefits of Private Debt Collection*, the National Taxpayer Advocate recommends the repeal of IRC § 6306.

3. Improve Uniform Definition of Qualifying Child. The Working Families Tax Relief Act introduced a uniform definition of a qualifying child, effective for tax years beginning after December 31, 2004. This measure brought about some uniformity for the great majority of taxpayers, who previously had to meet multiple tests just to determine whether they were eligible to claim an exemption, credit, or filing status under the basic family status provisions. The National Taxpayer Advocate recommends slight modifications to the uniform definition of a qualifying child to address certain unintended consequences of the reform.

4. Eliminate (Or Simplify) Phase-Outs. Phase-outs reduce the availability of various tax benefits to taxpayers as their income increases. Phase-outs also add needless complexity to

the Internal Revenue Code. Such complexity is burdensome for taxpayers, reduces the effectiveness of tax incentives, makes it more difficult for taxpayers to estimate their tax liability and pay the correct amount of withholding or estimated taxes, and likely reduces tax compliance. Although policymakers may sometimes adopt phase-outs to reduce the cost to the federal government of providing popular tax benefits, they may be more costly than policymakers realize if they increase noncompliance. The National Taxpayer Advocate recommends that Congress repeal phase-outs. If outright repeal is not possible, Congress should reevaluate existing and proposed phase-outs to ensure they serve their intended purpose without unduly impairing tax administration.

5. Increase the Exempt Organization Information Return Filing Threshold.

Organizations exempt from taxation under IRC § 501(c)(3) (except private foundations) are generally required to file annual information returns with the IRS if their annual gross receipts are normally more than \$25,000. This filing threshold has not been adjusted for inflation for 24 years, resulting in more small exempt organizations being subject to the filing requirement than originally intended. The recently enacted Pension Protection Act of 2006 requires all exempt organizations not subject to the information return filing requirement to file a notice electronically with the IRS setting forth basic information, such as the organization's name, location, and tax identification number. Because all exempt organizations must now report annually to the IRS, small exempt organizations should not be subject to the complex information return filing requirements. We recommend that the exempt organization information return filing threshold be statutorily increased to \$50,000 and that this threshold thereafter be adjusted for inflation, in increments.

6. Improve Return Filing Process. Filing a tax return is a taxpayer's entry point into the federal tax system. Considering that our tax system is based on voluntary compliance, it is in the best interest of both the taxpayer and the IRS to ensure that the filing process runs smoothly. When a taxpayer sits down to prepare a return with a commercial preparer, the taxpayer should not worry that his or her confidential tax information will be used or disclosed inappropriately. Further, if a taxpayer inadvertently designates the wrong account number to receive a refund, the IRS should have the proper authorization to resolve the issue.

7. Improve Offer In Compromise Program Accessibility. By accepting an offer to compromise a tax debt, the IRS collects money it would not otherwise collect and turns a noncompliant taxpayer into a compliant one. Despite offers being a good deal for both taxpayers and the IRS, the number of offers submitted and accepted has been declining in recent years, and fully 45 percent are simply returned to taxpayers without being considered. Recent legislation requires taxpayers who submit "lump-sum" offers to include a *nonrefundable* partial payment with the application of 20 percent of the amount of the offer. The IRS is likely to receive significantly fewer reasonable offers as a result of this requirement. Congress should repeal the partial payment requirement, or if repeal is not possible, it should: (1) provide taxpayers with the right to appeal to the IRS Appeals function the IRS's decision to return an offer without considering it on the merits; (2) reduce the partial payment to 20 percent of current income and liquid assets that could be disposed of immediately without significant cost; and (3) create an economic hardship exception to the requirement.

8. Eliminate Lengthy Collection Extensions of the Statutory Period to Collect Tax.

Prior to January 1, 2000, it was not uncommon for IRS collection personnel to ask taxpayers to extend the applicable collection period in order to guard against an expiration of the collection statute (CSED). Some extensions were for periods as long as ten, 20, 30, 40, or

even 50 years. Through a combination of revisions to the law and changes to IRS policy, IRS collection personnel are now restricted in the extent to which they can ask taxpayers to waive the CSED. However, the changes were not made retroactive. As a result, there are still thousands of taxpayers (by our review in excess of 14,000 taxpayers with approximately 32,000 tax accounts) who granted lengthy CSED extensions in exchange for installment agreements prior to January 1, 2000, and who are still being subjected to collection action. Congress should eliminate the IRS's inventory of lengthy CSED extensions.

9. Limit Levies on Fixed and Determinable Assets. Under present law, the IRS may place a single levy upon a taxpayer's fixed and determinable right to future benefits prior to the CSED to collect against a taxpayer's retirement or disability benefits without any limitation in time. The National Taxpayer Advocate recommends that the IRS's right to levy in this manner be limited to instances in which the taxpayer has engaged in flagrant conduct. This recommendation impacts not only retirees and Social Security beneficiaries but also victims of mass tort litigation. Under present law, the IRS is entitled to update its levy to demand full payment of all assessed and unassessed penalty and interest accruals, up to the full value of the taxpayer's distribution, as though the CSED had never expired. With the proposed change in law, the IRS could levy against a taxpayer's account only up to the dollar amount of taxes, penalties, and interest assessed as of the CSED.

10. Expand Availability of Tax Incentives for Hiring Disabled Workers. Congress has enacted a number of tax incentives designed to encourage employment of taxpayers with a disability. One of these incentives is the impairment-related work expense deduction. This deduction allows taxpayers who have a physical or mental disability to claim a deduction for ordinary or necessary business expenses, even if the expenses do not exceed two percent of the taxpayer's adjusted gross income. However, the number of taxpayers who use the deduction is limited because it can only be taken when taxpayers itemize. Congress should amend Internal Revenue Code § 67(d) to allow taxpayers to take the impairment-related work expense deduction as an above-the-line deduction from gross income or, alternatively, restructure the deduction as a credit against tax.

ADDITIONAL LEGISLATIVE RECOMMENDATIONS

1. Innocent Spouse Relief Fixes. One fundamental problem with the innocent spouse relief rules is that they often require a difficult factual inquiry into what a spouse knew when he or she signed the tax return in question. In her 2005 annual report, the National Taxpayer Advocate recommended that Congress repeal joint and several liability, allocate liability between spouses in accordance with each spouse's income, and reduce the IRS's ability to collect the liability from the nonliable spouse without first attempting to collect from the liable spouse. If Congress decides against adopting this comprehensive approach, the National Taxpayer Advocate recommends that Congress make the following technical changes to the innocent spouse rules: direct the IRS to include the last date to file a petition with the Tax Court in innocent spouse final determination letters; suspend the period for filing a Tax Court petition during bankruptcy; require the IRS to establish a reconsideration process for innocent spouse determinations; provide the Tax Court with jurisdiction to review "community property relief" determinations; provide that a taxpayer may request equitable relief from liabilities at any time the IRS could collect such liabilities; and modify the rules governing the availability of refunds to innocent spouses.

2. Military Issues. Members of the U.S. armed forces, especially those serving in designated combat zones, face some special federal income tax challenges and are entitled

to certain tax benefits due to their service. Increased military action and overseas deployments have highlighted how benefits designed to help U.S. troops can instead have a negative impact on these taxpayers. The National Taxpayer Advocate recommends that Congress amend IRC § 32(c)(2)(B)(vi) to make permanent the provision allowing military personnel the option to include nontaxable combat pay received for service in a designated combat zone as earned income for the purpose of computing the EITC. Additionally, the National Taxpayer Advocate recommends that Congress amend the Code to require a former employer to provide a taxpayer the option of having federal income tax withheld from his or her differential pay.

3. Amend IRC § 6511 to Allow Refund Claims After the Refund Statute Expiration Date When Excess Collection Is Due to IRS Error. The IRS sometimes levies on taxpayer accounts in excess of the tax liability owed. If the taxpayer does not file a refund claim within the statutorily permitted time, the IRS will not honor the claim, even if the mistake is attributable solely to IRS negligence and the taxpayer did not learn of the error prior to the refund statute expiration date. The National Taxpayer Advocate recommends that the IRS be required to send out annual statements to taxpayers under continuous levy showing payments received, penalties assessed, and interest charged. Alternatively, the National Taxpayer Advocate recommends that taxpayers be allowed two years from the date they learned of the excess collection to file a refund claim if the excess collection is due to IRS negligence.

4. Federal Oversight of Quasi-Governmental Retirement Plans. Congress has charged the Department of Labor with oversight responsibility over the administration of retirement plans offered by private entities. The Office of Personnel Management has oversight responsibility over the Civil Service Retirement System and the Federal Employees Retirement System. However, there is no parallel federal agency with oversight responsibility over the retirement plans of quasi-governmental entities. The National Taxpayer Advocate recommends that Congress designate a federal agency to provide oversight with respect to quasi-governmental retirement plans to ensure that they are carrying out their fiduciary duties.

5. Collection Due Process (CDP) and Uneconomical Levies. Recent court decisions have held that an Appeals hearing officer is not required to verify that the IRS conducted a IRC § 6331(j) review prior to proposing a levy action that triggers a CDP hearing. Courts have also held that the Appeals hearing officer is not required to take into account the uneconomical nature of the levy under the CDP “balancing” of the government’s interests against the intrusiveness of the action from the taxpayer’s perspective. The failure to investigate and determine the uneconomical nature of a proposed levy action prior to a CDP hearing on the appropriateness of the levy action can render that hearing meaningless and does not provide the necessary oversight of IRS collection activity that Congress intended. The National Taxpayer Advocate recommends that Congress clarify that the Appeals hearing officer must consider the uneconomical nature of the levy in balancing the government’s interest in efficient tax collection against the taxpayer’s legitimate concern about the intrusiveness of the proposed levy action.

THE MOST LITIGATED TAX ISSUES

Internal Revenue Code § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts and to classify those issues by the category of taxpayer affected. The cases we reviewed were decided during the fiscal year that began on June 1, 2005, and ended on May 31, 2006.

1. Collection Due Process Hearings under Internal Revenue Code §§ 6320 and 6330.

Since 2003, Collection Due Process (CDP) has been the most frequently litigated tax issue in the federal courts. CDP hearings provide taxpayers with an impartial review by the Office of Appeals of the IRS's decision to file a lien or to undertake a levy action. At the hearing, a taxpayer may raise collection alternatives, including spousal defenses under IRC § 6015, and in certain circumstances may dispute the underlying liability. Appeals' determinations are subject to judicial review. In the 195 cases we reviewed, some taxpayers continued to raise frivolous issues. Other cases involved significant issues pertaining to the scope of judicial review – including the standard of review, the application of administrative law and the Administrative Procedure Act, the admissibility of evidence outside of the administrative record, the impartiality of the Appeals hearing officer, and the opportunity to have a face-to-face CDP hearing. Taxpayers wholly prevailed in 15 cases. As a result of one appellate court's ruling, the National Taxpayer Advocate is recommending a legislative change to IRC § 6330 to require the Appeals Officer to determine as part of the CDP hearing whether it would be uneconomical to proceed with levy. (See Additional Legislative Recommendation: *Collection Due Process and Uneconomical Levies*.)

2. Gross Income under Internal Revenue Code § 61 and Related Code Sections. The question of what constitutes gross income remains a source of confusion for many taxpayers. This confusion is illustrated by the 106 cases we identified where gross income was at issue. These cases can be separated into two major categories: (1) income includible in gross income and (2) income specifically excluded from gross income by statute. Some of the statutory exclusions include awards and settlements, disability and Social Security benefits, and discharge of indebtedness income. Although no clear patterns emerged from the cases, it is clear that the meaning of the term "gross income" remains an area of confusion and contention between taxpayers and the IRS.

3. Summons Enforcement under Internal Revenue Code § 7604 and Related Code Sections. Internal Revenue Code §§ 7602(a), 7604(a), and 7609(a) grant the IRS authority to summon the production of books, records or testimony from witnesses when investigating either a civil or criminal tax liability. We identified 101 cases relating to summons enforcement, which is more than double the number of cases we identified in the preceding year. Generally, the burden on the government to demonstrate the validity of the summons is minimal and the burden on the taxpayer to demonstrate the illegality of the summons is formidable. Accordingly, of the 101 cases reviewed, the taxpayers prevailed in only three cases, and five additional cases resulted in split decisions. As the IRS continues to step up its enforcement actions, it appears the IRS will rely heavily on the summons enforcement tool, and we expect federal courts to see continued growth in these cases.

4. Accuracy-Related Penalty under Internal Revenue Code § 6662(b)(1) and (2).

Taxpayers who underpay the required amount of income tax are subject to an accuracy-related penalty if the underpayment is attributable to the taxpayers' negligence or results in a substantial understatement of income tax. The penalty can be avoided if the taxpayer is able to demonstrate reasonable cause for the underpayment. We identified 92 cases that involved either the negligence penalty under IRC § 6662(b)(1) or the substantial understatement penalty under IRC § 6662(b)(2). Taxpayers prevailed in whole or in part in 29 of those cases, arguing either that the underlying income was not taxable or that there was reasonable cause for the underpayment of tax.

5. Failure to File Penalty under Internal Revenue Code § 6651(a)(1) and Failure to Pay Estimated Tax Penalty under Internal Revenue Code § 6654. The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure to timely file a tax return was a result of reasonable cause and not due to willful neglect. The penalty for failure to pay estimated taxes is mandatory unless the taxpayer can meet one of the exceptions listed in the statute. We identified 78 decisions involving these two penalties. In these cases, taxpayers rarely avoided the failure to file penalty based on reasonable cause or the estimated tax penalty based on statutory exceptions. In fact, the IRS prevailed in all but two cases; one other case resulted in a split decision.

6. Frivolous Issues Penalty under Internal Revenue Code § 6673 and Related Appellate-Level Sanctions. The courts may impose penalties against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies. We identified 73 cases involving the IRC § 6673 penalty, including 56 decided at the trial court level (55 by the Tax Court and one by a U.S. district court) and 17 decided by a U.S. Court of Appeals. At the trial court level, the IRS sought imposition of the penalty or the court imposed the penalty *sua sponte* in 42 cases; taxpayers prevailed in only 10 of those cases. In 14 other cases, the court *sua sponte* warned the taxpayer that the penalty likely would be imposed if the taxpayer made similar arguments in the future. The government prevailed in all 17 cases in which taxpayers appealed the imposition of the IRC § 6673 penalty to the applicable U.S. Court of Appeals. Apart from the IRC § 6673 penalty, U.S. Courts of Appeals considered the imposition of separate appellate-level sanctions in at least 25 cases and imposed such sanctions in 22 of those cases.

7. Trade or Business Expenses Under Internal Revenue Code § 162(a) and Related Code Sections. As in previous years, the deductibility of trade or business expenses was one of the ten most litigated tax issues in federal courts. We identified 68 litigated cases that included a trade or business expense deductibility issue. The courts affirmed the IRS position in more than 76 percent of these cases, while taxpayers prevailed less than five percent of the time. The remaining cases resulted in split decisions. Notably, three cases involved taxpayers who were involved in a multi-level marketed tax scheme promising trade or business deductions for numerous personal expenses. In all, at least 50,000 taxpayers participated in this scheme marketed by "Renaissance, The Tax People." The individuals behind this scheme have been arrested and are being prosecuted in federal court.

8. Relief from Joint and Several Liability for Spouses under Internal Revenue Code § 6015. Spouses filing joint federal income tax returns are jointly and severally liable for any deficiency or tax due. IRC § 6015 provides relief from joint and several liability. We reviewed 51 federal court opinions involving relief under IRC § 6015, with 39 decided in favor of the IRS, 10 in favor of the taxpayer, and 2 split decisions. While the courts considered many factors in determining the appropriateness of relief under IRC § 6015, the most

significant this year was whether the requesting taxpayer had actual or constructive knowledge of the deficiency.

9. Family Status Issues Under Internal Revenue Code §§ 2, 21, 24, 32, and 151. Family status disputes involve exemptions, credits, and filing status claimed by taxpayers when they prepare their federal tax returns. These provisions are fundamental components of the tax code, yet they have complicated and sometimes conflicting eligibility standards. Because of this complexity, tax filing can be a difficult and confusing exercise for low and middle income families. Taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts. Litigated cases often include multiple family status issues with similar factual determinations. We identified 46 cases involving these issues. More than two-thirds dealt with multiple family status issues, with the determination of one issue often affecting others; for example, a denial of the dependency exemption will result in the summary denial of the child tax credit and may jeopardize eligibility for head of household filing status and the child and dependent care credit.

10. Charitable Contribution Deduction Issues Under Internal Revenue Code § 170. Subject to certain limitations, taxpayers can take a deduction from their adjusted gross income for contributions of cash or other property to charitable organizations. Contributions must be made to qualifying organizations, and taxpayers must substantiate the contributions. For the 2006 Annual Report to Congress, we identified 26 cases in which the charitable contribution deduction was at issue. The IRS prevailed entirely in 19 cases, and 7 cases produced split decisions. Most cases involved the taxpayer's inability to substantiate the contributions. However, courts applied the *Cohan* doctrine, which allows the court to arrive at a deduction amount in cases where the taxpayer proved a deduction was made but failed to keep precise records.