

**More Taxpayers Can Benefit  
From the New Offer in Compromise  
Provisions**

**June 2000**

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax return/Return information



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

June 15, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – More Taxpayers Can Benefit From the New Offer in Compromise Provisions

This report presents the results of our review of the Internal Revenue Service's (IRS) new offer in compromise provisions. The overall objective of the review was to determine whether the IRS had implemented Internal Revenue Code (I.R.C.) § 7122<sup>1</sup> as amended by the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>2</sup> § 3462 concerning the offer in compromise program.

In summary, we found the IRS has modified the offer in compromise process to comply with the Section 3462 requirements of the RRA 98 and has taken several steps to expand access to the program. However, we believe the IRS should add guidelines to better prepare taxpayers to supply information for the offer process, allow further flexibility when determining an acceptable offer amount, and encourage taxpayer access to the appeal process. In addition, a management information system should be developed for both the acceptance of offers in compromise based on special circumstances and the results of the independent administrative review of rejected offers.

IRS management agreed with the majority of our recommendations and has initiated corrective actions. However, management does not believe that it is necessary to reject

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<sup>1</sup> 26 U.S.C. § 7122

<sup>2</sup> Pub. L. No. 105-206, 112 Stat. 685, 765

all incomplete offers and plans to continue asking the taxpayer to submit additional information. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 986-5721.

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### **Executive Summary**

An offer in compromise is a proposal by a taxpayer to settle unpaid tax accounts for less than the full amount of the balance due. The Internal Revenue Service (IRS) accepted 30,542 offers and \$312 million to satisfy \$2.3 billion in tax liabilities during Fiscal Year 1999.

Most of Section 3462 of the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> amended Internal Revenue Code (I.R.C.) § 7122<sup>2</sup> to codify that the IRS must have guidelines for processing offer applications. The overall objective of our audit was to determine if the IRS had implemented I.R.C. § 7122 as amended by RRA 98 § 3462 concerning the offer in compromise program.

### **Results**

The IRS has modified the offer in compromise process to implement I.R.C. § 7122 as amended by RRA 98 § 3462. Temporary Treasury regulations<sup>3</sup> issued in July 1999 made a significant change to the IRS' exercise of compromise authority by allowing additional grounds for compromise. The IRS did not interpret the RRA 98 § 3462 provisions as being immediate requirements for all offers. Instead, the IRS' intent was that changes to the offer process and the expansion of acceptance criteria would not be applicable until revised procedures were prepared and implemented. Taxpayers who had offers rejected may submit a new offer for evaluation under the new guidelines.

We also identified additional actions the IRS can take to continue its efforts to improve the offer process.

### **Offer Application Instructions Could Be Improved to Ensure Taxpayers Provide Information Needed for the Evaluation Process**

Instructions with the offer in compromise application indicate that information must reflect the taxpayer's financial situation for the past six months. While these instructions do provide a general explanation of the offer requirements, they do not prepare taxpayers for what may subsequently be asked from them during the evaluation process.

Taxpayers have experienced problems in providing information. According to the automated case control system as of April 20, 1999, there were 766 of 1,719 offers

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<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685, 765

<sup>2</sup> 26 U.S.C. § 7122

<sup>3</sup> Treas. Reg. § 301.7122-1T

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(45 percent) submitted and rejected after the enactment of the RRA 98 because of a failure to provide information.

### **Ensuring Taxpayers Are Allowed the Means to Provide for Basic Living Conditions Could Be Applied Further When Considering the Equity in Assets**

RRA 98 § 3462 requires the IRS to consider the facts and circumstances of each taxpayer when determining how much is allowed for monthly living expenses. As a result, the IRS modified the calculation of collection potential to include as an asset only the portion of a checking account that exceeds the taxpayer's monthly necessary living expenses. However, the IRS could include additional areas. Currently, there are no similar exemptions in the Internal Revenue Manual guidelines for:

- ◆ Cash-on-hand or bank accounts defined as savings accounts.
- ◆ An automobile that is a taxpayer's basic means of transportation, even if it is older and of marginal value.

Appendix IV summarizes 4 taxpayers from our random sample of 83 rejected offers who we believe had circumstances that could be perceived as hardship factors. In our opinion, these cases illustrate the need for more flexibility in how assets are used in the offer calculation.

### **Some Procedures Restrict or Discourage a Taxpayer's Access to the Appeals Process**

RRA 98 § 3462 amended I.R.C. § 7122 to allow a taxpayer to appeal any rejection of a proposed offer in compromise to the Office of Appeals. We believe that certain IRS procedures discourage the broadest application of the appeal process to offers that are not considered acceptable. The temporary regulations deny appeal rights to taxpayers who might disagree as to the reasonableness of the IRS information requests. In addition, the procedure that allows taxpayers the opportunity to withdraw their offer when informed of the IRS' tentative decision to not accept their offer results in taxpayers waiving their review and appeal rights. Finally, issuing letters to taxpayers without explaining the specific reasons why the offer was not accepted may not provide taxpayers with enough information to prepare an effective appeal request.

### **A Management Information System Needs to Be Developed for Offers Accepted Based on Special Circumstances and for the Independent Administrative Review**

The IRS does not have a permanent management information system that provides it information on offers accepted based on a taxpayer's special circumstances or on the

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independent administrative review of rejected offers required by RRA 98 § 3462. Without a management information system, it will be impossible to monitor and manage a consistent application of these offer processes.

### **Summary of Recommendations**

We recommend that the Assistant Commissioner (Collection) revise guidelines to better prepare taxpayers to supply information for the offer process, allow further flexibility when determining an acceptable offer amount, and encourage taxpayer access to the appeal process. In addition, a management information system should be developed for both the acceptance of offers in compromise based on special circumstances and the results of the independent administrative review of rejected offers.

Management's Response: IRS management agreed with the majority of our recommendations and has initiated corrective actions. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: IRS management does not believe that the current process of returning incomplete requests needs to be changed. Although allowing the taxpayer to withdraw the offer may provide an uncomplicated way to close the investigation, we believe that rejecting the offer provides greater assurance that the taxpayer is aware of, and receives, all of his/her appeal rights. Also, we believe that the taxpayer may become confused if the IRS returns the offer without rejecting it. Instead of resubmitting the offer with additional information, the taxpayer may misunderstand and consider the offer as having been closed.

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### Objective and Scope

*Our overall objective was to determine if the IRS had implemented I.R.C. § 7122 as amended.*

*We surveyed all 33 district directors and reviewed a random sample of rejected offers submitted after enactment of the RRA 98.*

The overall objective of our audit was to determine if the Internal Revenue Service (IRS) had implemented Internal Revenue Code (I.R.C.) § 7122<sup>1</sup> as amended by Section 3462 of the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>2</sup> concerning the offer in compromise program.

Our audit included an analysis of the law and regulations, public and IRS explanations of the impact of the RRA 98, and IRS program guidance concerning offers in compromise. We surveyed the 33 IRS district directors to gather specific information on their implementation of the new law and reviewed a randomly selected sample of offer in compromise cases.

The audit was conducted between April and December 1999. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

### Background

*Doubt as to collectibility in full has been the usual reason for accepting an offer in compromise.*

An offer in compromise (offer) is a proposal by a taxpayer to settle unpaid tax accounts for less than the full amount of the balance due. The usual reason the IRS would accept an offer was that it was unlikely the tax liability could be collected in full.<sup>3</sup> The process of determining if an offer is acceptable usually requires a complex financial analysis.

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<sup>1</sup> 26 U.S.C. § 7122

<sup>2</sup> Pub. L. No. 105-206, 112 Stat. 685, 765

<sup>3</sup> Another reason for compromise was doubt that the liability was actually owed by the taxpayer. Since offers on those grounds are relatively rare, they were not included in our audit scope.



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*In general, RRA 98 § 3462 codified that the IRS must have guidelines for processing offer applications that include certain taxpayer rights.*

RRA 98 § 3462 required that offer processing guidelines must include certain taxpayer rights and protections. For example, taxpayers entering into a compromise must be allowed an adequate means to provide for basic living expenses, an offer must not be rejected based solely on the amount of the offer, and there must be an independent administrative review of any rejected proposed offer. RRA 98 § 3462 indicated that, in general, the amendments shall apply to proposed offers in compromise submitted after the July 22, 1998, date of enactment. This was 1 of 10 provisions the IRS had labeled as highly significant areas.

The Congress expected that the offer in compromise regulations would be expanded to allow for additional factors to be considered in determining whether to compromise a tax liability. In addition, the Congress believed that the IRS should make it easier for taxpayers to enter into offer in compromise agreements and be more flexible in working with taxpayers.

*The IRS accepted 30,542 offers in FY 1999 on over \$2.3 billion in liabilities for compromise amounts of about \$312 million.*

During Fiscal Year (FY) 1999, the IRS accepted 30,542 offers and \$312 million to satisfy \$2.3 billion in tax liabilities. The FY 1999 ending inventory of offers in compromise increased to 62,551 from a beginning inventory of 37,946.

### Results

*The IRS has modified the offer in compromise process to be compliant with I.R.C. § 7122 as amended and has made a significant change to the exercise of compromise authority.*

The IRS has modified the offer in compromise process to implement I.R.C. § 7122 as amended by RRA 98 § 3462. Temporary Treasury regulations were issued on July 21, 1999, one year after the law was passed. The regulations made a significant change to the IRS' compromise authority. A taxpayer's assets and future income can now exceed his/her tax liability if collection of the full liability would create economic hardship or be detrimental to voluntary compliance.

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*The IRS processed offers under existing criteria until revised procedures were prepared.*

Our audit also showed that RRA 98 § 3462 was vague as to the effective date and did not specify how the program was to be expanded. Since revised procedures were not available at the date of enactment, the IRS continued to process offers under the existing criteria until changes to the process and expansion of acceptance criteria were prepared and implemented.

*We believe the IRS could have established more comprehensive interim procedures at the outset.*

This approach was satisfactory in the context of complying with the RRA 98 § 3462 provisions. However, we believe the IRS overlooked some initial opportunities to ensure taxpayers were treated consistently and received the full benefit of the changes mandated for the offer program. For example, taxpayers who had an offer rejected were not routinely informed that the acceptance criterion was being revised and they could resubmit the offer if they felt the eventual changes were favorable to them. In addition, the independent administrative review was not implemented concurrently in all offices, and guidance on considering special circumstances under existing authority was not timely distributed. IRS procedures eventually addressed each of these issues, and taxpayers have the right to submit a new offer under the expanded criteria.

*Additional opportunities exist to make offers more attainable and emphasize taxpayer rights.*

We identified additional actions the IRS can still take that would continue its efforts to educate taxpayers, ensure that taxpayers are allowed the means to provide for basic living conditions when considering the equity in assets, fully apply taxpayer appeal rights, and establish a management information system on offers accepted based on special circumstances and the results of the independent administrative review.

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### Offer Application Instructions Could Be Improved to Ensure Taxpayers Provide Information Needed for the Evaluation Process

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*Educating the public about offers was one of the Congress' concerns.*

The Congress indicated that the IRS should do more to educate the taxpaying public about the availability of offer in compromise agreements. The IRS addresses

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this through publications, the IRS web site, taxpayer contact guidelines, and outreach programs. However, the IRS has not educated taxpayers on the subsequent verification of the taxpayers financial situation.

To submit an offer, taxpayers must prepare an Offer in Compromise (Form 656). It indicates that the taxpayer must fill out collection information statements and that additional documentation may be requested from the taxpayer to verify financial or other information concerning the offer.

*The offer instructions do indicate that additional information may be requested, but do not specify the depth of the verification process.*

Instructions with the offer in compromise application indicate that information must reflect the taxpayer's financial situation for the past six months. While these instructions do provide a general explanation of the offer requirements, they do not prepare taxpayers for what may subsequently be asked from them during the evaluation process.

Any, or all, of the information presented by the taxpayer on the collection financial statement may become part of a subsequent information request. For example, IRS guidelines indicate that the taxpayer should be requested to provide information to support asset values, wages, mortgages, insurance policies, and loans.

Taxpayers have experienced problems in providing all the information needed by the IRS. The failure of a taxpayer to provide all the requested information was a common reason for offer rejections. According to the automated case control system, 766 offers submitted after the enactment of the RRA 98 had been rejected by April 20, 1999, because of a failure to provide information. This was the rejection reason for about 45 percent (766 of 1,719) of the post-enactment offers rejected during that time period.

An explanation of the extent of an offer investigation could educate taxpayers about the evaluation process. In addition, this might contribute to eliminating potential offers by taxpayers who have no intention of providing any documentation but who want to see if the IRS will simply accept an offer.

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### Recommendation

The Assistant Commissioner (Collection) needs to:

1. Clarify the instructions on the Form 656 application to be more straightforward about the degree of verification that will be expected from the taxpayer in the offer evaluation process.

Management's Response: IRS management will clarify the instructions in Form 656 to provide more specific information about the extent of verification required of the taxpayer.

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### Ensuring Taxpayers Are Allowed the Means to Provide for Basic Living Conditions Could Be Applied Further When Considering the Equity in Assets

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*A taxpayer's collection potential is based on the assets he/she owns and the amount of his/her income that exceeds necessary living expenses.*

*RRA 98 § 3462 requires the IRS to consider the facts and circumstances of each taxpayer.*

When the IRS is evaluating an offer in compromise, it begins a process to determine if the amount of the taxpayer's offer is adequate to compromise the total amount owed. The IRS determines whether the amount offered reasonably reflects collection potential.

RRA 98 § 3462 requires the IRS to consider the facts and circumstances of each taxpayer when determining how much is allowed for monthly living expenses. As a result, the IRS modified the calculation of collection potential to include as an asset only the portion of a checking account that exceeds the taxpayer's monthly necessary living expenses.

The IRS could modify additional areas. Currently, there are no similar exemptions in the Internal Revenue Manual (IRM) guidelines for:

- ◆ Cash-on-hand or bank accounts defined as savings accounts.
- ◆ An automobile that is a taxpayer's basic means of transportation, even if it is older and of marginal value.

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*Our random sample review of rejected offers included four taxpayers that we believe illustrate why more flexibility is needed.*

In situations where the taxpayer's income does not exceed allowed expenses, it may be unreasonable to expect that these assets could be liquidated and still allow the taxpayer to have adequate means to provide for basic living expenses. These factors increase the difficulty for taxpayers with limited income or assets to fund an acceptable offer.

Appendix IV summarizes 4 cases from our random sample of 83 rejected offers that had circumstances that could be perceived as hardship factors. In our opinion, these cases show the need for more flexibility in how assets are used in the offer calculation.

### Recommendation

The Assistant Commissioner (Collection) needs to:

2. Establish more flexibility in offer in compromise guidelines regarding the consideration of asset equity. Specifically, require that determinations are made on the facts and circumstances of each taxpayer as to whether the inclusion of assets, cash, and bank accounts in the acceptable offer amount would result in the taxpayer not having adequate means to provide for basic living expenses.

Management's Response: IRS management is updating the IRM procedures concerning the treatment of equity in assets that are needed for the production of income or the health and welfare of the taxpayer's family.

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### Some Procedures Restrict or Discourage a Taxpayer's Access to the Appeals Process

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*I.R.C. § 7122 was amended to allow a taxpayer to appeal any rejection of a proposed offer in compromise.*

RRA 98 § 3462 amended I.R.C. § 7122 to allow a taxpayer to appeal any rejection of a proposed offer in compromise to the Office of Appeals. We believe that certain IRS procedures discourage the broadest application of the appeal process for offers in compromise that are not considered acceptable.

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### **The temporary regulations deny appeal rights to taxpayers who might disagree as to the reasonableness of the IRS information requests**

*The temporary regulations have exceptions to when appeal rights are allowed. One exception is when a taxpayer does not submit additional information that the IRS has requested.*

The temporary regulations published in July 1999 include exceptions for when appeal rights would be allowed. For example, the IRS may return the offer to the taxpayer after an independent administrative review if a taxpayer does not submit the requested additional information within a reasonable time period. Returning the documents under these circumstances does not constitute a rejection of the offer and does not entitle the taxpayer to appeal the offer. If documents are returned, the IRS considers the case closed and no further action occurs unless the taxpayer resubmits an offer.

*We believe that taxpayers who have cooperated in the offer investigation, but disagree as to the reasonableness of an information request, should receive appeal rights.*

Although we have neither requested nor received a legal opinion on the issue, we question whether this restriction to the appeals process is warranted. In some instances, taxpayers may provide a significant amount of information but fail to provide all requested information. A disagreement as to the reasonableness of either the content or deadline of information requests should be appealable. The fact that the temporary regulation requires this situation to go through the administrative review process seems to recognize that information requests are subjective decisions. The IRS should continue to guard against frivolous offers and delay tactics, but should not deny appeal rights on genuine offer attempts where there may be disagreement as to what depth of verification is reasonable and necessary.

### **The procedure of providing taxpayers an opportunity to withdraw their offer when informed of the IRS' tentative decision to not accept an offer results in taxpayers waiving their review and appeal rights**

*The IRS procedure is to ask the taxpayer to withdraw an offer if it does not appear acceptable.*

Under IRS procedure, if an offer does not appear acceptable, the taxpayer will be provided an opportunity to withdraw the offer and arrange some other way to resolve his/her balance due situation. The taxpayer is to be informed that withdrawing the offer will forfeit any appeal rights.

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*RRA 98 § 3462 requires an independent administrative review before communicating to a taxpayer that an offer will be rejected.*

*We are concerned that withdrawal requests prematurely communicate the rejection decision and discourage the use of the review and appeal process.*

RRA 98 § 3462 required that review and appeal rights be provided to taxpayers on any offer rejection. The administrative review is to be performed before communicating to the taxpayer that the offer will be rejected. If a withdrawal is obtained, the independent administrative review provision is avoided, in addition to the forfeiture of appeal rights.

A taxpayer must be allowed to voluntarily withdraw an offer from further consideration and processing by the IRS at any time prior to an acceptance or rejection decision being made. However, we believe that providing an opportunity to withdraw in light of the IRS' decision to not accept the offer results in asking the taxpayer to waive his/her review and appeal rights.

Our concern is that a withdrawal request prematurely communicates the rejection decision to the taxpayer. A withdrawal does resume the running of the statutory period for collection sooner, since a rejection letter would not need to be issued and monitored for the allowed appeal period. However, we believe in most situations that taxpayer rights would be better served by subjecting the rejection decision to the independent administrative review and allowing the taxpayer the time to consider if he/she wants to appeal.

**Rejection letters are not required to explain the specific reasons why the offer was not accepted and, thus, may not provide the taxpayer with enough information to prepare an effective appeal request**

During the offer evaluation process, the IRS should advise the taxpayer if an offer amount must be increased, review the calculation with the taxpayer, and provide a list of any additional information needed. If the evaluation process does not result in an offer that can be accepted by the IRS, the taxpayer will receive a letter indicating the offer was rejected. The offer in compromise application states that the IRS will explain the reason or reasons if an offer is rejected.

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*Most rejection letters in our random sample case review did not explain the reasons for rejection in detail.*

*Rejection letters should provide the taxpayer detailed information about the reasons an offer was rejected that would facilitate an appeal request or any further action by the taxpayer.*

The IRS uses a computer letter generating program within the automated case control system to prepare the rejection letter. The program provides one sentence options such as, “Our investigation shows we could collect a larger amount than you offered” for rejecting the offer.

Additional text can be added to the letter to further explain how the IRS made its decision; however, IRS guidelines do not require that the taxpayer be provided with a specific reason for the offer being rejected. The appeal procedures in the rejection letter indicate that in a written statement or written protest, the taxpayer should include a list of the issues he/she does not agree with.<sup>4</sup> Our review of 61 rejection letters showed that 52 (about 85 percent) of the letters did not contain a detailed explanation.

A rejection letter that does not explain why the offer is unacceptable may not provide the taxpayer with enough information to prepare an effective appeal request. In addition, a detailed explanation could facilitate a taxpayer’s effort to obtain professional advice on the issues or could encourage the taxpayer to amend the offer or provide additional information that may make the offer acceptable.

### Recommendation

The Assistant Commissioner (Collection) needs to:

3. Revise the offer in compromise guidelines to encourage taxpayer access to the appeal process on all offers processed by the IRS unless they are determined to solely be attempts to delay the collection process. Specifically, discontinue the option to return an offer if a taxpayer does not provide some requested information, discontinue the

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<sup>4</sup> The taxpayer can make a verbal request for an Appeals conference if the amount of the liability is \$2,500 or less. However, the taxpayer would still need to communicate what he/she disagrees with.



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use of withdrawal requests, and require that a detailed explanation of rejected reasons be provided to the taxpayer.

Management's Response: In addition to explaining the reasons for rejection during the negotiation phase, a copy of the rejection narrative will be included as an attachment to the rejection letter. However, IRS management believes that allowing the taxpayer to withdraw the offer provides an uncomplicated way to close the offer investigation, and that both the taxpayer and the offer process are better served by returning rather than rejecting the proposed offer.

Office of Audit Comment: IRS management does not believe that the current process of returning incomplete requests needs to be changed. Although allowing the taxpayer to withdraw the offer may provide an uncomplicated way to close the investigation, we believe that rejecting the offer provides greater assurance that the taxpayer is aware of, and receives, all of his/her appeal rights. Also, we believe that the taxpayer may become confused if the IRS returns the offer without rejecting it. Instead of resubmitting the offer with additional information, the taxpayer may misunderstand and consider the offer as having been closed.

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### **A Management Information System Needs to Be Developed for Offers Accepted Based on Special Circumstances and for the Independent Administrative Review**

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The IRS does not have a permanent management information system that provides it information on offers accepted based on a taxpayer's special circumstances or on the independent administrative review of rejected offers required by RRA 98 § 3462. Effective management controls include systems for measuring, reporting, and monitoring program performance.

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### Offers accepted based on taxpayers' special circumstances

*Even though the IRS wanted to exhibit fairness and common sense, guidelines were not developed for accepting offers with special circumstances.*

The IRS had never developed comprehensive guidelines explaining acceptable reasons for district directors to use their authority contained in Delegation Order 11 to accept an offer due to special circumstances. In practice, it was rarely used. The ambiguity of when to exercise this authority was reflected in memoranda issued by the IRS Deputy Commissioner and the Assistant Commissioner (Collection) on February 6, 1998. Heads of Office were encouraged to consider using this authority to “better exhibit the organizational concern for fairness and good common sense in working offer in compromise cases.”

There was also no additional guidance, upon the enactment of the RRA 98, on the appropriate use of this authority. As a result, responses to our survey indicated potential inconsistency in how districts viewed this authority. Some districts stated the authority was emphasized, stressed, expanded, and fully used. Other districts stated it was rarely used or that they were cautious in using it.

*Little was known about the prior use of Delegation Order 11 authority to accept offers with special circumstances.*

The absence of a method to gather information on the IRS' consideration of special circumstances in offer applications resulted in very little data being known, on a national level, about this aspect of the compromise program. The IRS did not know how often, or for what reasons, this authority had been used to accept offers with special circumstances. Because there was no requirement to do so, none of the districts had a method to record, track, monitor, or summarize offers accepted using this authority.

*The IRS established a review team to analyze offers processed under the additional basis for compromise.*

In preparing for the consideration of offers under the additional basis for compromise, the Assistant Commissioner (Collection) acknowledged that consistency in administering this program is critical. The Assistant Commissioner issued procedures for a review of all offers with special circumstances processed during FY 2000. A management team was established to analyze these offers to ensure procedures are

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consistently applied, to develop a database of case information, and to track trends.

Since the offer in compromise program already has an automated case control system in place,<sup>5</sup> we believe it would be reasonable to modify this system to gather pertinent information that would allow the IRS to continuously monitor, summarize, and report on the flexibility available in the offer in compromise program.

### **Results of the independent administrative review process**

The interim procedures, as well as the revised IRM, for the independent administrative review process did not include any recordkeeping or reporting requirements. The results of the review are shown by written comments either on the rejection recommendation form, if the reviewer concurred with the rejection, or on a reviewer's report form, if the reviewer identified issues that needed to be addressed.

*Most of the districts had established their own methods for reporting the results of the independent administrative review process to local management.*

In our survey of district offices, two-thirds (22 of 33) of the locations stated that they had established various methods to quantify the activity of the process and/or report the results to local management. On the other hand, 11 districts stated they did not have a method to provide the number of cases that went through the administrative review, the number of cases sent back to the offer investigation groups, and the reasons why cases were sent back.

Our survey indicated that the administrative review process has been effective but may have been inconsistently conducted. For instance, at the time of our survey, 1 district responded it had returned 1 of 204 cases it had reviewed, while a second district responded it had returned 66 of 220 cases it had reviewed. Of 23 locations that could provide data on the results of the administrative review process, 4 responded they had returned from 20 to 30 percent of the cases they had reviewed. At the same time, 10 districts responded

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<sup>5</sup> Automated Offer in Compromise system

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*A method to monitor the results of the independent administrative review is needed to ensure a consistent application and measure the review's impact.*

they had returned less than 5 percent of their reviewed cases.

Accordingly, a consistent method needs to be established on a nationwide basis to record, monitor, and summarize the results of the independent administrative review process. Without such measurement, the impact of the independent administrative review will be unknown, and it will be impossible to monitor and manage a consistent application of this taxpayer protection on a nationwide level. In addition, the production of quantifiable results from the review process may allow the IRS to better demonstrate the effectiveness of the process.

### Recommendation

The Assistant Commissioner (Collection) needs to:

4. Establish a management information system to monitor, summarize, and report, on a national level, about the acceptance of offers in compromise based on special circumstances and the independent administrative review process. As a product of this data gathering, develop a reporting process that can demonstrate to outside stakeholders the impact of the flexibility that the IRS has in the offer in compromise program.

Management's Response: The Collection function will make changes to its management information system to prepare management reports, on a national level, about the acceptance of offers based on special circumstances and results of the independent review process.

### Conclusion

A fundamental reason for the Congress legislating RRA 98 § 3462 was to promote the use of the offer in compromise as a tool to enhance taxpayer compliance. The IRS has taken several steps to expand access to the offer in compromise program and has complied with the amended requirements of I.R.C. § 7122.

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However, the IRS could do more to educate taxpayers about the verification process used to evaluate an offer, provide additional flexibility regarding the consideration of taxpayers' equity in assets, revise guidelines to encourage taxpayer access to the appeal process, and establish a management information system to monitor offers accepted based on special circumstances and on the independent administrative review process.

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### Appendix I

#### Detailed Objective, Scope, and Methodology

The overall objective of our audit was to determine if the Internal Revenue Service (IRS) had implemented the Internal Revenue Code (I.R.C.) § 7122<sup>1</sup> as amended by Section 3462 of the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>2</sup> concerning the offer in compromise program. The following sub-objectives and tests were conducted to accomplish the overall objective.

- I. Determined the impact of the IRS rejecting offers in compromise under traditional guidelines rather than accommodating or suspending offers while new procedures and regulations initiated by RRA 98 § 3462 were pending.
  - A. Analyzed RRA 98 § 3462, the related sections in the Senate Committee Report<sup>3</sup> and House of Representatives Conference Report,<sup>4</sup> and published professional explanations of RRA 98 § 3462 to gauge the impact of these provisions on the offer in compromise program.
  - B. In February 1999, discussed with Collection and IRS Office of the Chief Counsel personnel in the National Office their rationale for not suspending the rejection of all (or selected) offers after the enactment of the RRA 98 (July 22, 1998), while new offer acceptance criteria was pending.
  - C. Requested an opinion from the Treasury Inspector General for Tax Administration Office of the Chief Counsel to clarify areas in RRA 98 § 3462.
  - D. Evaluated the offer in compromise program guidance issued regarding RRA 98 § 3462 to determine if the guidance appeared adequate to implement the requirements and expectations expressed by the Congress.
    1. Guidance primarily included published IRS documents, Assistant Commissioner (Collection) memoranda, Internal Revenue Manual (IRM) 5.8 Offer in Compromise Handbook chapters, and temporary Treasury regulation 301.7122-1T. Guidance was usually identified through discussion with Collection personnel, from the IRS' "National Resource Center RRA '98 Support Site" intranet site, or from the Assistant Commissioner (Collection) intranet site.

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<sup>1</sup> 26 U.S.C. § 7122

<sup>2</sup> Pub. L. No. 105-206, 112 Stat. 685, 765

<sup>3</sup> Senate Report to Accompany H.R. 2676, S.R. 105-174

<sup>4</sup> House of Representatives Conference Report to Accompany H.R. 2676, H.R. 105-599

## **More Taxpayers Can Benefit From the New Offer in Compromise Provisions**

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2. Guidance evaluated ranged chronologically between Assistant Commissioner (Collection) memoranda on July 14, 1998, entitled, "High Impact Issues - Internal Revenue Service Restructuring and Reform Act of 1998," and on November 10, 1999, entitled, "Offer in Compromise Review (Amended)."
- E. Surveyed all 33 IRS district directors nationwide to gather information about offer in compromise procedures in their respective locations after the enactment of the RRA 98. Survey distribution and response was done primarily using the IRS electronic mail system. Responses were received from all locations in both surveys.
1. Issued a survey on April 9, 1999, with nine overall questions.
    - a) While not required by the IRM, what steps, if any, has your district taken to perfect offers and improve its processability? Has this changed as a result of the RRA 98?
    - b) When was the independent administrative review of rejected offers established in your district? Where is the position located organizationally, and what was the reviewer's former position? What do the reviewer's procedures include?
    - c) Knowing that expanded compromise guidelines as explained in the RRA 98 are pending, what local procedure has your district initiated for offers submitted in the interim?
    - d) While waiting for expanded compromise guidelines, has your district suspended offer cases with potential equity and/or hardship attributes? Under what circumstances?
    - e) If an offer is rejected, does your district inform the taxpayer that the offer acceptance criteria are being revised and that he/she can reapply later if he/she so desires?
    - f) What potential equity or hardship attributes have you observed in offer cases that your district has processed since July 22, 1998?
    - g) About how many and what types of taxpayer complaints has your district received (written and/or oral) where a taxpayer expected to get relief and felt his/her offer should have been accepted based on what he/she construed the RRA 98 provisions to mean?

## **More Taxpayers Can Benefit From the New Offer in Compromise Provisions**

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- h) What steps has your district taken to make taxpayers not already involved with the offer in compromise program aware of this option?
  - i) What are your recommendations to assist the IRS in meeting the requirements and intent of the RRA 98 for providing service to taxpayers in the offer in compromise program?
- 2. Issued a follow-up survey on August 3, 1999, with four overall questions.<sup>5</sup>
  - a) Does your district have a method to record, track, monitor, or summarize offers in compromise accepted using Delegation Order 11 special circumstance authority? If yes, please explain the method your district uses.
  - b) If you can tally figures for such offers, how many has your district accepted using Delegation Order 11 authority in Fiscal Years 1999, 1998, and 1997?
  - c) Does your district have a method to record, track, monitor, or summarize the results of your independent administrative review process? If yes, please explain the method your district uses.
  - d) If you can tally figures for such offers, how many proposed offer in compromise rejections have gone through your independent administrative review process since the review process began? How many cases that have gone through your independent administrative review process have the reviewers sent back to the examining officer for further consideration? What were the reasons for cases being returned?
- 3. Contacted district personnel on an as-needed basis to gain clarification or elaboration of survey responses.

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<sup>5</sup> In addition to the 33 district directors, this survey was sent to the director of 1 service center where offer processing was being performed on streamlined cases.



## **More Taxpayers Can Benefit From the New Offer in Compromise Provisions**

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- F. Reviewed a random sample from the nationwide population of rejected offers in compromise that had been submitted after the July 22, 1998, enactment of the RRA 98 to determine if taxpayers had attributes that potentially could have been considered under more flexible acceptance criteria. We looked for factors that could contribute to an unreasonable financial hardship or inequitable situation for the taxpayer, such as a fixed income, advanced age, a disability, the need for care and support during an illness, the need for care and support for dependents, the inability to secure adequate housing, or the inability to liquidate assets without creating hardship.
1. Obtained a data extract from the IRS' Automated Offer in Compromise System (AOIC) that included information for offers in compromise submitted after the July 22, 1998, enactment of the RRA 98 and entered into the AOIC up through April 20, 1999.
  2. Tested the AOIC data received to determine that they were reasonably complete and accurate for purposes of selection of a valid random sample.
  3. Determined that the AOIC data contained 1,719 offer numbers that were recorded as having an IRS received date after July 22, 1998, and had been closed as rejected offers by April 20, 1999. The latest IRS received date for this scope of offers was February 12, 1999.
  4. Using a database random number generator, selected offer in compromise case numbers from the population of rejected offers in a random order and requested closed case files from district offices for the first 216 random offer numbers.
  5. Reviewed 83 rejected offer in compromise files using attribute sampling techniques.
    - a) Defined the attribute as an overall conclusion that the taxpayer had attributes that potentially could have been considered under more flexible offer acceptance criteria. No definition of what more flexible criteria would entail was assumed.

## **More Taxpayers Can Benefit From the New Offer in Compromise Provisions**

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- b) Reviewed offer case files in the order randomly selected. Two selected offer numbers could not be included in the sample. We were told that one file had been destroyed. In the other instance, the case file indicated that the Collection function had not actually conducted a doubt as to collectibility offer investigation.<sup>6</sup> As a result, the sample of 83 offer cases included the first 85 randomly selected offer numbers.
  - c) Discontinued our sample case review at the point where the sample size was statistically valid to support the attribute occurrence rate indicated by the sample results.
    - (1) The population was 1,719 rejected offers.
    - (2) The desired sample confidence level was 95 percent.
    - (3) The desired sample precision was plus or minus 5 percent.
    - (4) The attribute occurrence rate of 6 percent (5 cases) in the sample results was statistically supported by a sample size of 83 cases.
- II. Determined if the IRS was in compliance with I.R.C. § 7122 as amended by RRA 98 § 3462 regarding specific rights afforded to taxpayers who submit offers in compromise.
- A. Evaluated the provisions and explanations of RRA 98 § 3462 and the subsequent offer in compromise program guidance as described in tests I (A and D).
  - B. Evaluated the process of establishing an administrative review of rejected offers using information gathered by survey questions described in tests I (E)(1)(b) and I (E)(2)(c and d).
  - C. Reviewed a random sample from the nationwide population of rejected offers in compromise that had been submitted after the July 22, 1998, enactment of the RRA 98 to determine if the specific provisions in Section 3462 relating to doubt as to collectibility offers had been applied.

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<sup>6</sup> RRA 98 § 3462 contains two provisions that apply to offers that relate only to issues of liability of the taxpayer. These doubt as to liability offers, where the taxpayer does not believe he/she owes the tax amount, represent less than one percent of the total offers submitted according to the AOIC data. Most of the provisions in Section 3462 relate to doubt as to collectibility offers; that is, where the taxpayer claims to not have sufficient assets and income to pay the full amount. For these reasons, we included only doubt as to collectibility offer investigations in our sample review.

## **More Taxpayers Can Benefit From the New Offer in Compromise Provisions**

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1. Reviewed the same 83 offer numbers that were selected under the attribute sampling technique in test I (F).
  2. Determined if it appeared that any offer was rejected solely based on the low dollar amount of the offer, where the taxpayer claimed the allowable living expense schedules were not sufficient for his/her situation, without being administratively reviewed before communicating the rejection to the taxpayer, and without notifying the taxpayer of his/her right to appeal to the Office of Appeals.
- III. Determined if the IRS had adequately educated the public about the availability of and how to apply for an offer in compromise.
- A. Evaluated IRS Publications and the content of the IRS Digital Daily internet site to determine if revisions made after the enactment of the RRA 98 appeared to explain the taxpayer rights and obligations of the IRS in the offer in compromise process.
  - B. Evaluated the updated instructions for a taxpayer's completion of an offer in compromise application to determine if there was a clear explanation of what is required from the taxpayer.

**More Taxpayers Can Benefit From the New  
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**Appendix II**

**Major Contributors to This Report**

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**More Taxpayers Can Benefit From the New  
Offer in Compromise Provisions**

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**Appendix III**

**Report Distribution List**

Deputy Commissioner Operations C:DO  
Chief Operations Officer OP  
Deputy Chief Operations Officer OP  
Assistant Commissioner (Collection) OP:CO  
National Director, Collection Field Operations OP:CO:C  
Director, Collection Redesign OP:CO:R  
Director, Office of Program Evaluation and Risk Analysis M:O  
Director, Office of Special Procedures OP:CO:C:SP  
National Director of Appeals C:AP  
National Director for Legislative Affairs CL:LA  
Office of the Chief Counsel CC  
Office of Management Controls M:CFO:A:M  
Office of the National Taxpayer Advocate C:TA

More Taxpayers Can Benefit From the New Offer in Compromise Provisions

Appendix IV

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Appendix V

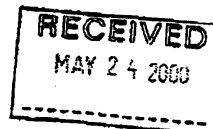
Management's Response to the Draft Report



COMM. I JNER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

May 24, 2000



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Charles O. Rossotti *COR*  
Commissioner of Internal Revenue

SUBJECT: Draft Audit Report – More Taxpayers Can Benefit From the New  
Offer in Compromise Provisions – Urmem 4/13/00

Thank you for the opportunity to respond to your draft report entitled "More Taxpayers Can Benefit From the New Offer in Compromise Provisions." The report is a review of the Internal Revenue Service's (IRS) changes to the Offer in Compromise (OIC) program required by section 3462 of the IRS Restructuring and Reform Act of 1998. We appreciate your efforts to help us continue to improve the OIC program and realize the merit in the majority of your recommendations.

In your report you express concern that anything less than the rejection of an offer limits or discourages a taxpayer's access to an independent review by Appeals. The temporary regulations define three exceptions for when a taxpayer may not appeal the matter to Appeals. However, we feel the taxpayer is given ample opportunity to address any issues. For example, these same temporary regulations require that before an offer is returned because requested information was not submitted timely, an independent administrative review of the proposed return will be completed. In addition, the taxpayer has the right to speak to the offer group manager or seek assistance from the Taxpayer Advocate. Allowing the taxpayer to withdraw the offer provides an uncomplicated way to close the offer investigation if the funding for the offer amount is not obtainable, or when another solution, such as an installment agreement, is agreed upon. In our opinion, both the taxpayer and the offer process are better served by returning rather than rejecting the proposed offer.

Our comments on the specific recommendations in this report are as follows:

IDENTITY OF RECOMMENDATION #1

Clarify the instructions on the OIC (Form 656) application to be more straightforward about the degree of verification that will be expected from the taxpayer in the offer evaluation process.

## More Taxpayers Can Benefit From the New Offer in Compromise Provisions

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### ASSESSMENT OF CAUSE(S)

The instructions on Form 656 advise taxpayers that additional documentation may be requested to verify the information provided with the offer. These instructions, however, do not provide specific information about the documentation that may be needed to verify financial information.

### CORRECTIVE ACTION

Collection has a prototype offer application, Form 656-P, which is used for offers that meet streamlined processing criteria. The Form 656-P identifies a standard set of supporting documents that should be submitted with the offer, based on the completion of specific areas of the collection financial statement. We will clarify the instructions in Form 656 to provide more specific information about the extent of verification required of the taxpayer based on information from the prototype.

### IMPLEMENTATION DATE

Proposed: June 1, 2001

### RESPONSIBLE OFFICIAL

Assistant Commissioner (Collection)

### CORRECTIVE ACTION MONITORING PLAN

The appropriate staff will be required to provide the Assistant Commissioner (Collection) with regular status updates regarding the progress of Form 656 revision.

### IDENTITY OF RECOMMENDATION #2

Establish additional flexibility in OIC guidelines regarding the consideration of asset quality. Specifically, require that determinations are made on the facts and circumstances of each taxpayer as to whether the inclusion of assets, cash, and bank accounts in the acceptable offer amount would result in the taxpayer not having adequate means to provide for basic living expenses.

### ASSESSMENT OF CAUSE(S)

The Internal Revenue Manual (IRM) does not exempt cash on hand, saving accounts, or an automobile that is the taxpayer's basic means of transportation, even if it is older and of marginal value.

### CORRECTIVE ACTION

The IRM guidelines, used to calculate reasonable collection potential for taxpayers with checking accounts, apply to taxpayers with cash on hand or bank accounts. We are, however, updating the IRM procedures with guidelines concerning the treatment of equity in assets that are necessary for the production of income or health and welfare of the taxpayer's family.

## More Taxpayers Can Benefit From the New Offer in Compromise Provisions

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### IMPLEMENTATION DATE

Proposed: October 1, 2000

### RESPONSIBLE OFFICIAL

Assistant Commissioner (Collection)

### CORRECTIVE ACTION MONITORING PLAN

The Assistant Commissioner (Collection) will follow up with the appropriate staff to confirm the IRM revision is completed timely.

### IDENTITY OF RECOMMENDATION #3

Revise the OIC guidelines to encourage taxpayer access to the appeal process on all offers processed by the IRS unless they are determined to solely be attempts to delay the collection process. Specifically, discontinue the option to return an offer if a taxpayer does not provide some requested information, discontinue the use of withdrawal requests, and require that a detailed explanation of rejected reasons be provided to the taxpayer.

### ASSESSMENT OF CAUSE(S)

Temporary regulations provide that where a determination is made to return the offer because the taxpayer failed to provide requested information, return of the offer does not entitle the taxpayer to appeal the matter to Appeals. Although we provide the taxpayer with the information necessary to prepare an effective appeal request during the negotiation phase of the offer process, we do not explain in detail in the rejection letter why the offer was rejected.

### CORRECTIVE ACTIONS

The IRS will continue to follow the temporary regulations by providing an independent administrative review of the proposed return of the offer. This provides a second level review. In addition, the taxpayer has the right to speak to the offer group manager or seek assistance from the Taxpayer Advocate.

In addition to explaining the reasons for rejection during the negotiation phase, we will include specific instructions in our procedures to include a copy of the rejection narrative as an attachment to the rejection letter.

### IMPLEMENTATION DATE

Proposed: January 1, 2001

### RESPONSIBLE OFFICIAL

Assistant Commissioner (Collection)

## More Taxpayers Can Benefit From the New Offer in Compromise Provisions

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### **CORRECTIVE ACTION (S) MONITORING PLAN**

The Assistant Commissioner (Collection) will follow up with the appropriate staff to confirm this requirement is included in the appropriate procedures.

### **IDENTITY OF RECOMMENDATION #4**

Establish a management information system to monitor, summarize, and report, on a national level, about the acceptance of OICs based on special circumstances and the independent administrative review process.

### **ASSESSMENT OF CAUSE(S)**

The IRS did not have, at the time of the review, a system to provide information on offers accepted based on a taxpayer's special circumstances or on the independent administrative review of rejected offers.

### **CORRECTIVE ACTION**

Collection will make changes to the Automated Offer In Compromise (AOIC) system to prepare management reports, on a national level, about the acceptance of offers based on special circumstances and results of the independent review process.

### **IMPLEMENTATION DATE**

Proposed: January 1, 2001

### **RESPONSIBLE OFFICIAL**

Assistant Commissioner (Collection)

### **CORRECTIVE ACTION (S) MONITORING PLAN**

The responsible Collection functional staff will be required to provide status updates to the Assistant Commissioner (Collection) regarding the progress of the programming changes to AOIC.

If you have any questions or need additional information, please call me, or a member of you staff may contact, Harry T. Manaka, Acting Assistant Commissioner (Collection), at (202) 622-5110.