Introduction: Legislative Recommendations

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

The chart that appears immediately following this Introduction summarizes congressional action on legislative recommendations the National Taxpayer Advocate proposed in her 2001 through 2006 Annual Reports.[1] The Office of the Taxpayer Advocate places a high priority on working with the tax-writing committees and other interested parties to try to resolve problems encountered by taxpayers. In addition to submitting legislative proposals in each annual report, the National Taxpayer Advocate meets regularly with members of Congress and their staffs, testifies at hearings on the problems faced by taxpayers, and presents legislative and administrative recommendations to mitigate those problems. As shown in the chart referenced above, many of the recommendations included in our annual reports have received considerable congressional attention. The Office of the Taxpayer Advocate continues to work to ensure that each legislative recommendation we have made receives due consideration. The following discussion details recent legislation incorporating the National Taxpayer Advocate's proposals.

On December 26, 2007, the President signed into law the Consolidated Appropriations Act, 2008. Based on a 2002 proposal of the National Taxpayer Advocate, the Act appropriates funds to the IRS to establish and administer a Community Volunteer Income Tax Assistance matching grants demonstration program for tax return preparation assistance.[2]

In the 110th Congress, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 was enacted in May 2007. This legislation included two provisions based on proposals recommended by the National Taxpayer Advocate:[3]

- **Increase Preparer Penalties under IRC § 6694.** Section 8246 increases the preparer penalty for understatement of a taxpayer's liability under both IRC § 6694(a) and (b). The National Taxpayer Advocate proposed an increase in penalties under subsection (a) to $1,000 and under subsection (b) to $5,000. The legislation went beyond the National Taxpayer Advocate's proposal by also setting the penalty amounts as the greater of the above-referenced dollar amounts or 50 percent of the income derived. The legislation also differed by raising the standards of conduct.[4]

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1 An electronic version of the chart is available on the Taxpayer Advocate Service website at http://www.irs.gov/advocate/article/0,,id=97404,00.html. The electronic version of the chart will be periodically updated to reflect recent legislative action and any necessary enhancements.

2 H.R. 2764, 110 Cong., Div. D, Tit. 1 (Signed by President on Dec. 26, 2007); National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.

3 Pub. L. No. 110-28, 121 Stat. 194 (May 25, 2007).

4 National Taxpayer Advocate 2003 Annual Report to Congress 270-301. Similar language was also included in H.R. 2345, 110th Cong. § 105 (2007). For a detailed discussion of the recent changes to IRC § 6694, see Most Serious Problem: Preparer Penalties and Bypass of Taxpayers' Representatives, *supra*. *See also* IRS Notice 2008-13 (Jan. 2, 2008).

- **Married Couples as Business Co-Owners.** Section 8215 is based on the National Taxpayer Advocate's proposal to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC, and file one Schedule C or F and two Schedules SE if certain conditions apply.[5]

In addition, a number of legislative recommendations made by the National Taxpayer Advocate in previous annual reports were included in S. 1219, the Taxpayer Protection and Assistance Act of 2007 , which was referred to the Senate Finance Committee in April 2007.[6] Specifically, S. 1219 included the following proposals:

- **Grant Program for Return Preparation.** Based on a 2002 proposal of the National Taxpayer Advocate, § 2 of the bill authorizes the Secretary to make grants to provide matching funds for the development, expansion, or continuation of qualified return preparation clinics.[7] This provision was included in the Consolidated Appropriations Act, 2008, as discussed above.
- **Regulation of Return Preparers.** Section 4 of the bill authorizes the Secretary of the Treasury to promulgate regulations establishing a system to regulate compensated unenrolled return preparers. Preparers would be required to take an initial exam and renew eligibility every three years, at which point they would be required to demonstrate completion of continuing education requirements. This bill was modeled on the National Taxpayer Advocate's proposal initially published in the 2002 Annual Report to Congress.[8]
- **Increased Preparer Penalties.** Section 4(e) of the bill increases preparer penalties in IRC § 6695 (a) through (c) from $50 to $1,000, or in the case of three or more in one calendar year, to $500 per occurrence. The National Taxpayer Advocate proposed to raise these penalties as well as others.[9]
- **Public Awareness Campaign on Registration Requirements.** Section 4(g) requires the Secretary to conduct a public awareness campaign on the return preparer registration requirements. The National Taxpayer Advocate proposed a similar campaign in her 2002 Annual Report to Congress.[10]

The National Taxpayer Advocate's proposals related to the Alternative Minimum Tax (AMT) were addressed in several bills in the 110th Congress.[11] The following bills included provisions calling for the repeal of the AMT: S. 14, S. 55, S. 1040, H.R. 1366, and H.R. 3970,

5 National Taxpayer Advocate 2002 Annual Report to Congress 172-184; National Taxpayer Advocate 2004 Annual Report to Congress 401-402.

6 S. 1219, 110th Cong. (2007).

7 National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.

8 *Id.* at 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

9 National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

10 National Taxpayer Advocate 2002 Annual Report to Congress 216-230.

11 National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385. *See also*, National Taxpayer Advocate 2003 Annual Report to Congress 5-19; National Taxpayer Advocate 2006 Annual Report to Congress 3-5.

all of which were referred to the appropriate committees. In addition, S. 102 and H.R. 1942 included provisions eliminating adjustment items for personal exemptions, the standard deduction, deductible state and local taxes, and/or miscellaneous itemized deductions.[12]

Several bills in the 110th Congress included provisions based on the National Taxpayer Advocate's proposal to require brokers to keep track of an investor's basis, transfer basis to a successor broker, and report basis information (and proceeds generated by any sale) to the taxpayer and the IRS.[13] The following House bills were referred to the Ways and Means Committee: H.R. 878, H.R. 2147, and H.R. 3970. The following Senate bills were referred to the Finance Committee: S. 601 and S. 1111.[14]

The National Taxpayer Advocate recommended in the 2006 Annual Report to Congress that Congress repeal the IRS's authority for its Private Debt Collection (PDC) initiative. Based on this proposal, H.R. 695, the Taxpayer Abuse and Harassment Prevention Act of 2007, included language repealing IRC § 6306, which authorizes the agency to enter into private debt collection contracts.[15] Section 2 of H.R. 3056, the Tax Collection Responsibility Act of 2007, and § 1(b) of S. 335 contained similar provisions.[16]

Finally, in the 2006 Annual Report to Congress, the National Taxpayer Advocate recommended a statutory increase in the exempt organization information return filing threshold to $50,000.[17] While the threshold was not statutorily increased, the IRS recently announced that it will increase the filing threshold for organizations required to file Form 990-N (the e-postcard) from $25,000 to $50,000 in tax year 2010.[18]

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

12 S. 14, 110th Cong. § 7 (2007); S. 55, 110th Cong. § 2 (2007); S. 102, 110th Cong. § 1 (2007); S. 1040, 110th Cong. § 104 (2007); H.R. 1366, 110th Cong. § 2 (2007); H.R. 1942, 110th Cong. § 2 (2007); H.R. 3970, 110th Cong. § 1021 (2007).

13 National Taxpayer Advocate 2005 Annual Report to Congress 433-441.

14 H.R. 878, 110th Congress § 2 (2007); H.R. 2147, 110th Cong. § 401 (2007); H.R. 3970, 110th Cong. § 1221 (2007); S. 601, 110th Cong. § 2 (2007). S. 1111, 110 Cong. § 302 (2007).

15 H.R. 695, 110th Cong. § 2 (2007).

16 H.R. 3056, 110th Congress § 2 (2007); S. 335, 110th Cong. § 1(b) (2007).

17 National Taxpayer Advocate 2006 Annual Report to Congress 483-495. Pursuant to IRC § 6033(a)(3)(A)(ii), an exempt organization is exempt from filing an information return with the IRS if its annual gross receipts are not normally more than $5,000. The IRS has periodically increased the filing threshold pursuant to discretionary exception authority granted in IRC § 6033(a)(3)(B). The most recent adjustment was made in 1982, when the IRS administratively increased the threshold to $25,000 for tax years ending on or after December 31, 1982. IRS Announcement 82-88, 1982-25 I.R.B. 23.

18 IRS News Release IR-2007-204, IRS Releases Final Form 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transitional Relief (Dec. 20, 2007). *See also*, Key Legislative Recommendations: *Legislative Recommendations to Reduce the Compliance Burden on Small Exempt Organizations, infra.*

Key Legislative Recommendations

Taxpayer Bill of Rights and *De Minimis* "Apology" Payments

The United States tax system is based on a social contract between the government and its taxpayers — taxpayers agree to report and pay the taxes they owe and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so. The National Taxpayer Advocate believes that it is in the best interests of taxpayers and tax administration for this unspoken agreement to be articulated in a formal Taxpayer Bill of Rights, which should incorporate a clear statement of taxpayer rights as well as a statement of taxpayer obligations. Moreover, since the U.S. tax system is a mature system, the rights and obligations articulated in the Taxpayer Bill of Rights should be generally derived from provisions that are already part of the tax laws or procedures. Further, a fair and just tax system should acknowledge IRS mistakes and delays in taxpayer issue resolution, and where such situations cause excessive expense or undue burden on the taxpayer, make a *de minimis* "apology" payment. Accordingly, the National Taxpayer Advocate recommends that Congress enact a Taxpayer Bill of Rights setting forth the fundamental rights and obligations of U.S. taxpayers. Congress should require the Secretary to publish these fundamental rights and obligations in a document that also links specific statutory protections to the Taxpayer Bill of Rights. The National Taxpayer Advocate also recommends that Congress grant the National Taxpayer Advocate the discretionary, nondelegable authority to compensate taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer, and the taxpayer meets the IRC § 7811 definition of significant hardship.[19] Discretionary payments should be excluded from gross income and range from a minimum of $100 up to a maximum of $1,000, indexed for inflation.

Measures to Address Noncompliance in the Cash Economy

Income from the "cash economy" – income from legal activities that is not reported to the IRS by third parties – is the type of income most likely to go unreported. Unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over $100 billion per year. Because significant noncompliance by some taxpayers is not fair to those who timely pay their taxes, we must do more to address this problem. We can improve voluntary compliance by making it easier for taxpayers to understand and meet their tax obligations, and enhancing the tools available to the IRS for enforcing the tax laws when necessary, in ways that are minimally intrusive, impose the least possible burden, and protect taxpayer rights. Based on these considerations, as well as a survey of existing tax compliance research, the National Taxpayer Advocate proposes Congress adopt the following measures to address noncompliance in the cash economy:

1. Increase use of the IRS's electronic payment system for estimated tax payments;
2. Authorize voluntary withholding agreements;

[19] IRC § 7811(a)(2).

3. Eliminate the corporate exception to information reporting for small corporations, if the IRS's National Research Program shows significant noncompliance;
4. Accelerate the taxpayer identification number validation process;
5. Provide for withholding on payments to noncompliant contractors;
6. Require information reporting by financial institutions on credit and other "payment card" receipts; and
7. Require financial institutions to report all accounts to the IRS by eliminating the $10 minimum on interest reporting.

Home Office Business Deduction

The tax laws regarding the home office deduction are considered by many to be too complex and the recordkeeping responsibilities associated with the deduction to be too time-consuming. It is questionable whether most taxpayers who are eligible to take the deduction actually do so. In addition, the process of reporting the deduction differs based on the type of business conducted and whether the taxpayer is an employee or self-employed. Congress should amend IRC § 280A to create an optional standard home office deduction. The legislative provision would direct the Secretary of the Treasury to draft regulations which calculate the deduction by multiplying an applicable standard rate, as determined and published by the Commissioner of the IRS on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in IRC § 280A(c).

Eliminate Tax Strategy Patents

Tax strategy patents grant private citizens monopolies on the application of our public tax laws. They may mislead taxpayers into believing the government has approved them, undermine congressionally-created tax incentives, create conflicts of interest between tax advisors and their clients, increase tax compliance costs, and reduce respect for the tax system along with tax compliance. They have little, if any, redeeming value. They provide additional incentives for tax advisors to "invent" tax minimization strategies, an activity with no redeeming social value. While tax strategy patents have the potential to increase the amount of publicly available information about tax strategies, they are more likely to stifle public discussion of strategies by those who fear they might be sued for infringement. The National Taxpayer Advocate recommends that Congress either bar tax strategy patents or limit their enforceability. If Congress does not bar them, it should require the United States Patent and Trademark Office (PTO) to send any tax strategy patent applications to the IRS so that it can quickly address any abuse they may present and help the PTO identify obvious tax strategies that should not be eligible for patents.

Extend Exempt Organizations' Advance Ruling Periods in Cases of Extreme Application Processing Delays

An advance ruling provides that an organization will be treated as a publicly supported organization for its first five taxable years. Delays in processing Forms 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, result in some organizations receiving advance ruling letters only months before the advance ruling period ends. Organizations unable to obtain a favorable determination letter until shortly before the expiration of the advance ruling period are likely to have difficulty garnering financial support and to consequently be reclassified as private foundations. Private foundations are subject to various operating restrictions and excise taxes for failure to comply with such restrictions, making private foundation status far less favorable than public charity status. The National Taxpayer Advocate recommends that Congress provide for the extension of the advance ruling period by one year when, as a result of a delay of 270 days or more in the processing of an exemption application, an advance ruling letter is issued not more than eight months prior to the end of the advance ruling period.

Legislative Recommendations to Reduce the Compliance Burden on Small Exempt Organizations

More than 73 percent of public charities reported annual expenses of less than $500,000 in 2004. Approximately half of all exempt organizations have all-volunteer staffs and another third have fewer than ten employees. The National Taxpayer recommends that Congress lessen the burden on these small exempt organizations by: amending the Code to provide that non-private foundations with gross receipts not normally more than $25,000 may submit a short-form application for recognition of IRC § 501(c)(3) status (*i.e.*, a Form 1023-EZ), requiring the IRS to continue to offer a separate short-form ("EZ") version of Form 990 that may be filed by small exempt organizations in lieu of the long-form Form 990 or parts thereof, and requiring the IRS to create a broad-based, formal, and ongoing voluntary compliance program for exempt organizations similar to those offered in the areas of employee plans, tax-exempt bonds, and Indian tribal governments by September 30, 2008.

Taxpayer Protection from Third Party Payer Failures

In recent years, a number of third party payers have gone out of business or embezzled their customers' funds. Because employers remain liable for payroll taxes, self-employed and small business taxpayers who fall victim to these situations can experience significant burden. This burden includes not only being forced to pay the amount twice – once to the third party payer that absconded with or dissipated the funds, and a second time to the IRS – but also being liable for interest and penalties. Some small businesses may not be able to recover from these setbacks and will be forced to cease operations. This issue demonstrates the vital need for taxpayer protection in the payroll service industry, particularly for small business taxpayers that hire smaller third party payers. The National Taxpayer Advocate recommends that Congress amend the Code to define a third party payer; make a third party payer jointly and severally liable for the amount of tax collected from client employers but not paid over to the Treasury, plus applicable interest and penalties; authorize the IRS to require third party payers to register with the IRS and be sufficiently bonded; include third party payers within the definition of a "person" subject to the Trust Fund Recovery Penalty (TFRP); and clarify that TFRP survives bankruptcy when the debtor is not an individual.

Additional Legislative Recommendations

Expand Definition of Taxpayer Identification Number (TIN) to Include Internal Revenue Service Numbers (IRSN)

The IRS assigns a temporary tax identification number (TIN), referred to as an IRSN, to victims of identity theft while the IRS determines who is the true owner of the Social Security number in dispute. Under current regulations, identity theft victims who file tax returns using IRSNs cannot claim an exemption or the earned income tax credit (EITC) because the IRS does not consider an IRSN to be a valid TIN. The IRS's policy of denying tax benefits, such as an exemption or the EITC, to a taxpayer using an IRSN is inequitable and perpetuates the harm suffered by an identity theft victim. The National Taxpayer Advocate recommends that Congress amend IRC §§ 151(e), 32(c)(1)(F), and 32(c)(3)(D) to require a taxpayer to provide a valid TIN or IRSN in order to claim an exemption and the EITC. This recommendation would enable an identity theft victim who files a tax return using an IRSN to claim an exemption or the EITC.

Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers

Internal Revenue Code § 6713 has historically been identified as the civil counterpart to the criminal penalty imposed on tax return preparers under IRC § 7216. Like IRC § 7216, IRC § 6713 provides a broad prohibition against the use and disclosure of tax return information. The current statutory framework seemingly requires that exceptions be made either to both the criminal and civil statutes or to neither. The Treasury Department is understandably reluctant to subject preparers to criminal sanctions except for egregious conduct, so it has used its regulatory authority to carve out broad exceptions from the general prohibition on the use or disclosure of tax return information set forth in IRC § 7216. The National Taxpayer Advocate believes taxpayer protections would be stronger if Treasury is given the flexibility to promulgate regulations applicable only to the civil penalty without concern that the criminal penalty would also apply.

Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions.

In her 2006 Annual Report to Congress, the National Taxpayer Advocate proposed the following changes to IRC §§ 6015 and 66 to make the so-called "innocent spouse" provisions consistent and fair:

1. Direct the IRS to include the last date to file a petition with the Tax Court in innocent spouse final determination letters;
2. Suspend the period for filing a U.S. Tax Court petition during bankruptcy;
3. Require the IRS to establish a reconsideration process for innocent spouse determinations;
4. Provide the Tax Court with jurisdiction to review community property relief determinations under IRC § 66(c);
5. Provide that a taxpayer may request equitable relief from liabilities at any time the IRS could collect such liabilities; and
6. Expand the availability of refunds to taxpayers granted innocent spouse relief.

In this report, we reiterate these recommendations and make an additional one. While taxpayers may raise IRC § 6015 relief in a Collection Due Process, deficiency, or bankruptcy proceeding or a refund suit, a number of recent United States District Court opinions have held that such relief cannot be raised as a defense in a collection suit in district court. Congress should amend IRC §§ 6015 and 66 to clarify that taxpayers may raise relief under those sections as a defense in a proceeding brought under any provision of Title 26 (including §§ 6213, 6320, 6330, 7402, and 7403) or any case under title 11 of the United States Code.[20]

Referral to Low Income Taxpayer Clinics

The National Taxpayer Advocate has discussed at length the impact that representation has on the outcome of a taxpayer's case, particularly in EITC examinations.[21] One opportunity for taxpayers to obtain representation before the IRS is through the Low Income Taxpayer Clinics (LITCs). However, the Treasury Standards of Conduct for IRS employees prohibit the recommendation or referral of specific attorneys or accountants. The Office of Government Ethics' Standards of Ethical Conduct for Employees in the Executive Branch further limit IRS employees' ability to refer taxpayers to representatives. The National Taxpayer Advocate recommends amending IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to Low Income Taxpayer Clinics receiving funding under this section. This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance.

Consent-based Disclosures of Tax Return Information Under Internal Revenue Code Section 6103(c)

When closing on a mortgage, borrowers often must consent to disclose certain tax information in order to verify their income. In practice, this consent often involves signing a *blank* copy of Form 4506-T, *Request for Transcript of Tax Return*, which gives the lender access to four years of tax information for 60 days from the date on the form. However,

20 *See* Most Litigated Issue: Relief from Joint and Several Liability Under IRC § 6015, *infra.*

21 *See also Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws, infra*, vol. 2, *infra.*

the information disclosed is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. The National Taxpayer Advocate recommends that IRC § 6103(c) be amended to limit the disclosure of tax returns and tax return information requested through taxpayer consent solely to the extent necessary to achieve the purpose for which consent was requested. Congress should further amend IRC § 6103(p)(3)(C) to require the Treasury to include in the Secretary's annual disclosure report to the Joint Committee on Taxation detailed information about the number and types of disclosures pursuant to taxpayer consent. To provide a deterrent to misusing taxpayer return information obtained pursuant to a IRC § 6103(c) consent, IRC §§ 7213A and 7431 should be amended to apply criminal and civil sanctions.

Home Care Service Workers

Home Care Service Workers (HCSWs) help disabled or elderly persons with personal care or household chores. Generally, state and local government health and welfare programs determine that a Home-Care Service Recipient (HCSR) is eligible to receive in-home support services, and the HCSR receives services from an HCSW in accordance with the terms of the program. Notwithstanding the governments' supplying of funds for and often-extensive involvement in the programs, HCSWs generally are considered domestic employees of HCSRs. Because HCSRs in these programs are elderly and disabled, and thus likely are not able to fulfill the complicated payment and reporting requirements imposed on employers, a variety of third party payroll reporting and payment arrangements have arisen. These arrangements may cause problems for the HCSRs, who are among the least able taxpayers to successfully navigate IRS account resolution and collection processes. The National Taxpayer Advocate reiterates her 2001 recommendation and recommends that Congress amend IRC § 3121(d)(3) to provide that a HCSW is the statutory employee of the administrator of the HCSW funding (defined as states, localities, their agencies, or intermediate service organizations, regardless of the original funding source).

National Taxpayer Advocate Legislative Recommendations with Congressional Action

Alternative Minimum Tax

Repeal the Individual AMT

National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate 2004 Annual Report to Congress 383-385.

Repeal the AMT outright.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 55	Baucus	1/4/2007	Referred to the Finance Committee
	S 14	Kyl	4/17/2007	Referred to the Finance Committee
	S 1040	Shelby	3/29/2007	Referred to the Finance Committee
	HR 1366	English	3/7/2007	Referred to the Ways & Means Committee
	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
Legislative Activity 109th Congress	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 437	English	2/6/2001	Referred to the Ways & Means Committee
	S 616	Hutchinson	3/26/2002	Referred to the Finance Committee
	HR 5166	Portman	7/18/2002	Referred to the Ways & Means Committee

Index AMT for Inflation

National Taxpayer Advocate 2001 Annual Report to Congress 82-100.

If full repeal of the individual Alternative Minimum Tax (AMT) is not possible, it should be indexed for inflation.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	HR 1942	Garrett	4/19/2007	Referred to the Ways & Means Committee
Legislative Activity 109th Congress	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	Passed House 12/7/2005; Placed on Senate Legislative Calendar 12/13/2005.
Legislative Activity 108th Congress	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 5505	Houghton	1/3/2003	Referred to the Ways & Means Committee

Eliminate Several Adjustments for Individual AMT

National Taxpayer Advocate 2001 Annual Report to Congress 82-100.

Eliminate personal exemptions, the standard deduction, deductible state and local taxes, and miscellaneous itemized deductions as adjustment items for individual Alternative Minimum Tax purposes.

	Bill Number	Sponsor	Date	Status
Legislative Activity 110th Congress	S 102	Kerry	1/4/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 1861	Harkin	10/7/2005	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 1939	Neal	5/12/2003	Referred to the Ways & Means Committee

Private Debt Collection				
Repeal Private Debt Collection Provisions National Taxpayer Advocate 2006 Annual Report to Congress 458-462	Repeal IRC § 6306, thereby terminating the PDC initiative.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 335	Dorgan	1/18/2007	Referred to the Finance Committee
	HR 695	Van Hollen	1/24/2007	Referred to the Ways & Means Committee
	HR 3056	Rangel	7/17/2007	10/15/2007 Referred to Senate committee

Tax Preparation and Low Income Taxpayer Clinics				
Matching Grants for LITC for Return Preparation National Taxpayer Advocate 2002 Annual Report to Congress vii-viii.	Create a grant program for return preparation similar to the Low Income Taxpayer Clinic (LITC) grant program. The program should be designed to avoid competition with VITA and should support the IRS' goal (and need) to have returns electronically filed.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 2764 EAH	Lowey	12/26/2007	Signed by the President 12/26/2007
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
	S 1967	Clinton	8/2/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.
Legislative Activity 108th Congress	S 476	Grassley	2/27/2003	Referred to the Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment- referred to Senate
	HR 3991	Houghton	3/19/2001	Referred to the Ways & Means Committee
	HR 7	Baucus	7/16/2002	Reported by Chairman Baucus, with an amendment referred to the Finance Committee

Regulation of Income Tax Return Preparers National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Create an effective oversight and penalty regime for return preparers by taking the following steps:: ◆ Enact a registration, examination, certification, and enforcement program for federal tax return preparers; ◆ Direct the Secretary of the Treasury to establish a joint task force to obtain accurate data about the composition of the return-preparer community and make recommendations about the most effective means to ensure accurate and professional return preparation and oversight; ◆ Require the Secretary of the Treasury to study the impact cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance; and ◆ Require the IRS to take steps within its existing administrative authority, including requiring a checkbox on all returns in which preparers would enter their category of return preparer (i.e., attorney, CPA, enrolled agent, or unenrolled preparer) and developing a simple, easy-to-read pamphlet for taxpayers that explains their protections.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Public Awareness Campaign on Registration Requirements National Taxpayer Advocate 2002 Annual Report to Congress 216-230.	Authorize the IRS to conduct a public information and consumer education campaign, utilizing paid advertising, to inform the public of the requirements that paid preparers must sign the return prepared for a fee and display registration cards.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006-Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336 9/15/2006-Placed on Senate Legislative Calendar under General Orders. Calendar No. 614.
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee

Increase Preparer Penalties National Taxpayer Advocate 2003 Annual Report to Congress 270-301.	Strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1219	Bingaman	4/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	S 685	Bingaman	3/21/2003	Referred to the Finance Committee
	S 882	Baucus	4/10/2003	S. 882 was incorporated into HR 1528 as an amendment and HR 1528 passed in lieu of S. 882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Ways & Means Committee
Small Business Issues				
Health Insurance Deduction/Self-Employed Individuals National Taxpayer Advocate 2001 Annual Report to Congress 223; National Taxpayer Advocate 2004 Annual Report to Congress 388-389.	Allow self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 2239	Bingaman	10/25/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 663	Bingaman	3/17/2005	Referred to the Finance Committee
	S 3857	Smith	9/16/2006	Referred to the Finance Committee
Legislative Activity 108th Congress	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	S 2130	Bingaman	4/15/2002	Referred to the Finance Committee
Married Couples as Business Co-owners National Taxpayer Advocate 2002 Annual Report to Congress 172-184.	Amend IRC § 761(a) to allow a married couple operating a business as co-owners to elect out of subchapter K of the IRC and file one Schedule C (or Schedule F in the case of a farming business) and two Schedules SE if certain conditions apply.			
Legislative Activity 110th Congress	**Public L. No: 110-28 (2007)**			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 842	Kerry	4/9/2003	Referred to the Finance Committee
	HR 1640	Udall	4/3/2003	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee

Income Averaging for Commercial Fishermen National Taxpayer Advocate 2001Annual Report to Congress 226.	Amend IRC § 1301(a) to provide commercial fishermen the benefit of income averaging currently available to farmers.			
Legislative Activity 108th Congress	**Public L. No.: 108-357 § 314 (2004).**			
Election to be treated as an S Corporation National Taxpayer Advocate 2004 Annual Report to Congress 390-393.	Amend IRC § 1362(a) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, U.S. Income Tax Return for an S Corporation.			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Regulation of Payroll Tax Deposits Agents National Taxpayer Advocate 2004 Annual Report to Congress 394-399.	Require payroll services to meet certain qualifications to protect businesses that use payroll service providers from tax deposit fund misappropriation or fraud.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1773	Snowe	7/12/2007	Referred to the Finance Committee
Legislative Activity 109th Congress	S 3583	Snowe	6/27/2006	Referred to the Finance Committee
	S 1321	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Tax Gap Provisions				
Reporting on Customer's Basis in Security Transaction National Taxpayer Advocate 2005 Annual Report to Congress 433-441.	Require brokers to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B.			
Legislative Activity 110th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 878	Emanuel	2/7/2007	Referred to the Ways & Means Committee
	S 601	Bayh	2/14/2007	Referred to the Finance Committee
	S 1111	Wyden	4/16/2007	Referred to the Finance Committee
	HR 2147	Emanuel	5/3/2007	Referred to the Ways & Means Committee
	HR 3996 PCS	Rangel	10/30/2007	Placed on Senate Calendar 11/14/2007
Legislative Activity 109th Congress	S 2414	Bayh	3/14/2006	Referred to the Finance Committee
	HR 5176	Emanuel	4/25/2006	Referred to the Ways & Means Committee
	HR 5367	Emanuel	5/11/2006	Referred to the Ways & Means Committee
IRS Promote Estimated Tax Payments Through EFTPS National Taxpayer Advocate 2005 Annual Report to Congress 381-396.	Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614

Study of Use of Voluntary Withholding Agreements

National Taxpayer Advocate
2004 Annual Report to Congress 478-489;
National Taxpayer Advocate
2005 Annual Report to Congress 381-396.

Amend IRC § 3402(p)(3) to specifically authorize voluntary withholdings agreements between independent contractors and service-recipients as defined in IRC § 6041A(a)(1).

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614

Joint and Several Liability

Tax Court Review of Request for Equitable innocent Spouse Relief

National Taxpayer Advocate
2001 Annual Report to Congress 128-165.

Amend IRC § 6015(e) to clarify that taxpayers have the right to petition the Tax Court to challenge determinations in cases seeking relief under IRC § 6015(f) alone.

Legislative Activity 109th Congress — **Public L. No: 109-432, § 408 (2006)**

Collection Issues

Return of Levy or Sale Proceeds

National Taxpayer Advocate 2001 Annual Report to Congress 202-214.

Amend IRC § 6343(b) to extend the period of time within which a third party can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. This amendment would also extend the period of time available to taxpayers under IRC § 6343(d) within which to request a return of levied funds or sale proceeds.

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	S 1321 RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 3991	Houghton	3/19/2002	defeated in House
	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate

Reinstatement of Retirement Accounts National Taxpayer Advocate 2001 Annual Report to Congress 202-214.	Amend the following Internal Revenue Code sections to allow contributions to individual retirement accounts and other qualified plans from the funds returned to the taxpayer or to third parties under IRC § 6343: ◆ §401 – Qualified Pension, Profit Sharing, Keogh and Stock Bonus Plans ◆ §408 – Individual Retirement Account, SEP-Individual Retirement Account ◆ §408A – Roth Individual Retirement Account			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1321RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
Legislative Activity 107th Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Consolidation of Appeals of Collection Due Process Determinations National Taxpayer Advocate 2004 Annual Report to Congress 451-470.	Consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases.			
Legislative Activity 109th Congress	**Pub. L. No. 109-280, § 855 (2006).**			
Partial Payment Installment Agreements National Taxpayer Advocate 2001 Annual Report to Congress 210-214.	Amend IRC § 6159 to allow the IRS to enter into installment agreements that do not provide for full payment of the tax liability over the statutory limitations period for collection of tax where it appears to be in the best interests of the taxpayer and the Service.			
Legislative Activity 108th Congress	**Public L. No. 108-357, § 833 (2004).**			
Penalties & Interest				
Interest Rate and Failure to Pay Penalty National Taxpayer Advocate 2001 Annual Report to Congress 179-182	Repeal the failure to pay penalty provisions of IRC § 6651 while revising IRC § 6621 to allow for a higher underpayment interest rate.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Interest Abatement on Erroneous Refunds National Taxpayer Advocate 2001 Annual Report to Congress 183-187.	Amend IRC § 6404(e)(2) to require the Secretary to abate the assessment of all interest on any erroneous refund under IRC § 6602 until the date the demand for repayment is made, unless the taxpayer (or a related party) has in any way caused such an erroneous refund. Further, the Secretary should have discretion not to abate any or all such interest where the Secretary can establish that the taxpayer had notice of the erroneous refund before the date of demand and the taxpayer did not attempt to resolve the issue with the IRS within 30 days of such notice.			

	Bill Number	Sponsor	Date	Status
Legislative Activity 109th Congress	HR 726	Sanchez	2/9/2005	Referred to the Ways & Means Committee
Legislative Activity 108th Congress	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
First Time Penalty Waiver National Taxpayer Advocate 2001 Annual Report to Congress 188-192.	Authorize the IRS to provide penalty relief for first-time filers and taxpayers with excellent compliance histories who make reasonable attempts to comply with the tax rules.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107th Congress	HR 1528	Houghton		Introduced in the House
	HR 3991	Houghton	3/19/2002	defeated in House
Federal Tax Deposit (FTD) Avoidance Penalty National Taxpayer Advocate 2001 Annual Report to Congress 222.	Reduce the maximum Federal Tax Deposit penalty rate from ten to two percent for taxpayers who make deposits on time but not in the manner prescribed in the Code.			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
	S 1321RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Legislative Activity 108h Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Legislative Activity 107h Congress	HR 586	Lewis	2/13/2001	4/18/02 passed the House w/ an amendment - referred to Senate
	HR 3991	Houghton	3/19/2002	defeated in House
Family Issues				
Uniform Definition of a Qualifying Child National Taxpayer Advocate 2001 Annual Report to Congress 78-100.	Create a uniform definition of "qualifying child" applicable to tax provisions relating to children and family status.			
Legislative Activity 108th Congress	**Public L. No. 108-311, § 201 (2004).**			
Means Tested Public Assistance Benefits National Taxpayer Advocate 2001 Annual Report to Congress 76-127.	Amend the IRC §§ 152, 2(b), and 7703(b) to provide that means-tested public benefits are excluded from the computation of support in determining whether a taxpayer is entitled to claim the dependency exemption and from the cost of maintenance test for the purpose of head-of-household filing status or "not married" status.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee

Credits for the Elderly or the Permanently Disabled National Taxpayer Advocate 2001 Annual Report to Congress 218-219.	Amending IRC § 22 to adjust the income threshold amount for past inflation and provide for future indexing for inflation.			
Legislative Activity 107th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 2131	Bingaman	4/15/2002	Referred to the Finance Committee
Electronic Filing Issues				
Direct Filing Portal National Taxpayer Advocate 2004 Annual Report to Congress 471-477.	Amend IRC §6011(f) to require the IRS to post fill-in forms on its website and make electronic filing free to all individual taxpayers.			
Legislative Activity 109th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 1321RS	Santorum	6/28/2005	9/15/2006: Committee on Finance. Reported by Senator Grassley with an amendment in the nature of a substitute and an amendment to the title. With written report No. 109-336. 9/15/2006 Placed on Senate Legislative Calendar under General Orders. Calendar No. 614
Office of the National Taxpayer Advocate				
Confidentiality of Taxpayer Communications National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Strengthen the independence of the National Taxpayer Advocate and the Office of the Taxpayer Advocate by amending IRC §§ 7803(c)(3) and 7811. Amend IRC § 7803(c)(4)(A)(iv) to clarify that, notwithstanding any other provision of the Internal Revenue Code, Local Taxpayer Advocates have the discretion to withhold from the Internal Revenue Service the fact that a taxpayer contacted the Taxpayer Advocate Service (TAS) or any information provided by a taxpayer to TAS.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Access to Independent Legal Counsel National Taxpayer Advocate 2002 Annual Report to Congress 198-215.	Amend IRC § 7803(c)(3) to provide for the position of Counsel to the National Taxpayer Advocate, who shall advise the National Taxpayer Advocate on matters pertaining to taxpayer rights, tax administration, and the Office of Taxpayer Advocate, including commenting on rules, regulations, and significant procedures, and the preparation of amicus briefs.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Other Issues				
Disclosure Regarding Suicide Threats National Taxpayer Advocate 2001 Annual Report to Congress 227.	Amend IRC § 6103(i)(3)(B) to allow the IRS to contact and provide necessary return information to specified local law enforcement agencies and local suicide prevention authorities, in addition to federal and state law enforcement agencies in situations involving danger of death or physical injury.			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

Attorney Fees National Taxpayer Advocate 2002 Annual Report to Congress 161-171.	Allow successful plaintiffs in nonphysical personal injury cases who must include legal fees in gross income to deduct the fees "above the line." Thus, the net tax effect would not vary depending on the state in which a plaintiff resides.			
Legislative Activity 108th Congress	**Public Law 108-357, § 703 (2004).**			
Attainment of Age Definition National Taxpayer Advocate 2003 Annual Report to Congress 308-311.	Amend IRC § 7701 by adding a new subsection as follows: "Attainment of Age. An individual attains the next age on the anniversary of his date of birth."			
Legislative Activity 108th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	HR 4841	Burns	7/15/2004	7/21/04 Passed House – 7/22/04 Received in the Senate
Home-based Service Workers National Taxpayer Advocate 2001 Annual Report to Congress 193-201.	Amend IRC § 3121(d) to clarify that home-based service workers (HBWs) are employees rather than independent contractors.			
Legislative Activity 107th Congress	**Bill Number**	**Sponsor**	**Date**	**Status**
	S 2129	Bingaman	4/15/2002	Referred to the Finance Committee

KLR #1

Taxpayer Bill of Rights and *De Minimis* "Apology" Payment

Problem

The United States tax system is based on a social contract between the government and its taxpayers – taxpayers agree to report and pay the taxes they owe and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will do so. Without that unspoken agreement, tax administration in a modern democratic society could not function. Thus, the government's ability to raise revenue through voluntary tax compliance – the most efficient and economical form of tax compliance – rests on taxpayers' belief that the government will honor its end of the social contract.[1]

The National Taxpayer Advocate believes that it is in the best interests of taxpayers and tax administration for this unspoken agreement to be articulated in a formal Taxpayer Bill of Rights. Although Congress, in three major pieces of legislation, has expressly identified numerous rights that are crafted to ensure a fair and just tax system and protect all taxpayers from potential IRS abuse, there is no single document that sets forth these rights in simple, clear language.[2]

Taxpayer rights do not exist in a vacuum. That is, a tax system that embeds rights also expects its taxpayers to conduct themselves in such a manner as to ensure those rights are not abused. To this end, the Taxpayer Bill of Rights should incorporate not only a clear statement of taxpayer rights but also a statement of taxpayer obligations.[3] Moreover, since the U.S. tax system is a mature system, the rights and obligations articulated in the Taxpayer Bill of Rights should be generally derived from provisions that are already part of the tax laws or procedures.

Further, as federal tax laws and procedures become more complex and as the IRS becomes more compartmentalized, the likelihood increases that the IRS will make mistakes and cause delays in taxpayer issue resolution, and that such mistakes and delays could harm taxpayers. A fair and just tax system should acknowledge those mistakes and delays, and where such situations cause excessive expense or undue burden on the taxpayer, make

1 We use the term "voluntary" tax compliance here to draw a contrast with enforced tax compliance. It is far more expensive for the government to raise revenue if it must audit taxpayers one at a time and then initiate legal action to compel the payment of tax or impose levies or liens against a taxpayer's property. Frequent resort to enforced compliance is also bad for our civic culture. The government fares best in performing its tax collection responsibilities if it perpetuates the social contract and demonstrates clearly its desire and ability to uphold its end of the bargain.

2 *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988) (containing the Taxpayer Bill of Rights); Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996); and Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).

3 *Taxpayers' Rights and Obligations – Practice Note*, OECD Centre for Tax Policy and Administration, August 2003, 3 *at* http://www.oecd.org/dataoecd/4/16/14990856.pdf.

a *de minimis* "apology" payment. There exists today no such remedy under the Internal Revenue Code.

Example

The IRS assessed a liability on a taxpayer for an incorrect tax year based on an item of income the taxpayer was entitled to exclude from gross income. The IRS has since levied the taxpayer's wages, lost the audit reconsideration request the taxpayer filed, and determined the audit reconsideration appeal period has expired in spite of the IRS's own error in processing the request. Over an extended period of years the taxpayer secured a power of attorney and sought TAS assistance in an attempt to rectify the initial IRS mistakes. The taxpayer is no longer able to work due to declining health, and has spent years and incurred a significant cost burden trying to resolve these tax issues, but to no avail. With time having passed, the taxpayer spending money to rectify the problem, and multiple errors on the part of the IRS, simply returning the erroneously levied wages will not make the taxpayer whole. In such a situation, the National Taxpayer Advocate believes an apology payment would be appropriate.[4]

Recommendation

Recommendation 1: Taxpayer Bill of Rights

The National Taxpayer Advocate recommends that Congress enact a Taxpayer Bill of Rights that sets forth the fundamental rights and obligations of U.S. taxpayers, as follows:

Taxpayer Rights include:

- Right to be Informed (including adequate legal and procedural guidance and information about taxpayer rights)
- Right to be Assisted
- Right to be Heard
- Right to Pay No More than the Correct Amount of Tax
- Right of Appeal (administrative and judicial)
- Right to Certainty (including guidance, periods of limitation, no second exam, and closing agreements)
- Right to Privacy (including due process considerations, least intrusive enforcement action ,and search and seizure protections)
- Right to Confidentiality
- Right to Representation

4 Taxpayer Advocate Management Information System (TAMIS).

- Right to Fair and Just Tax System (Offer in Compromise, Abatement, TAS, Apology and other compensation payments)

Taxpayer Obligations include:

- Obligation to be honest
- Obligation to be cooperative
- Obligation to provide accurate information and documents on time
- Obligation to keep records
- Obligation to pay taxes on time

Congress should require the Secretary to publish these fundamental rights and obligations in a document that also links specific statutory protections to the Taxpayer Bill of Rights.

Recommendation 2: *De Minimis* Apology Payments

The National Taxpayer Advocate also recommends that Congress amend Internal Revenue Code (IRC) § 7811 to grant the National Taxpayer Advocate the discretionary, nondelegable authority to compensate taxpayers where the action or inaction of the IRS has caused excessive expense or undue burden to the taxpayer, and the taxpayer meets the IRC § 7811 definition of significant hardship.[5] Discretionary payments should range from a minimum of $100 up to a maximum of $1,000, indexed for inflation.

Unless otherwise provided by specific appropriation, authorize the Secretary of the Treasury to allocate no more than $1 million per year to "apology" payments.

Amend IRC § 7803(c)(2)(B)(ii) to require the National Taxpayer Advocate to include in her Annual Report to Congress a section summarizing the awards made under this amendment.

Amend the Code to exclude these "apology" payments from gross income.

5 IRC § 7811(a)(2).

Present Law

Recommendation 1: Taxpayer Bill of Rights

The Internal Revenue Code does not currently contain a concise and explicit list of taxpayer rights and obligations. However, Congress has enacted specific provisions that are crafted to ensure a fair and just tax system and protect all taxpayers from potential IRS abuse.[6] Moreover, scattered throughout the Code are specific obligations imposed on taxpayers.[7]

Prior to the enactment of the original Taxpayer Bill of Rights (TBOR 1), there was no statutory requirement that the IRS provide a written explanation of the rights of the taxpayer and the obligations of the IRS during the tax dispute resolution process. The TBOR 1 added a specific requirement that the IRS, when it contacts a taxpayer concerning the determination or collection of any tax, explain in writing and in simple, nontechnical terms the rights of the taxpayer and the obligations of the IRS during the audit, appeals, refund, and collection processes.[8] Currently, the IRS informs taxpayers of these rights by outlining them in Publication 1, Your Rights as a Taxpayer ("Pub. 1").[9]

In 1988, the Organization for Economic and Co-operation Development (OECD) sent out a questionnaire to its member countries asking about their system of taxpayer rights and obligations. OECD published the results of the survey in 1990.[10] The survey found that although most countries did not have an explicit charter or bill of rights, there were certain basic rights present in all tax systems that responded:

- The right to be informed, assisted, and heard;
- The right of appeal;
- The right to pay no more than the correct amount of tax;
- The right to certainty;
- The right to privacy; and
- The right to confidentiality and secrecy.[11]

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6 *See, e.g.*, IRC § 7605(b) (a taxpayer's books and accounts can only be inspected once each tax year); IRC § 7602(e) (IRS agents shall not use financial status or economic reality examination techniques to determine if the taxpayer has unpaid income); Circular 230, 31 C.F.R., Part 10, (A taxpayer may retain an approved tax practitioner, which includes an attorney, CPA, or enrolled agent, to represent him or her before any part of the IRS); IRC § 7521(a)(1) (the taxpayer may conduct an audio recording of an in-person interview with an IRS agent regarding determination or collection of tax); IRC §6103 (providing for confidentiality of taxpayer and tax return information); IRC § 6330 (requiring IRS, among other things, to provide notice of levy setting forth the amount of unpaid tax, and the right to request a Collection Due Process hearing); IRC § 6343(a) and (e) (addressing release of levy and notice of release); IRC § 6325(a) and (b) (addressing releases of liens and discharge of property); IRC § 6323 (addressing withdrawal of lien); IRC §§ 6343(b)and (d) (addressing returns of levied property); IRC § 6015 (providing relief from joint and several liability); IRC § 7122 (providing for the acceptance of offers in compromise of tax liabilities); IRC § 6159 (providing for installment agreements in payment of tax); IRC §§ 7803 and 7811 (providing for assistance from the Office of the Taxpayer Advocate and the issuance of Taxpayer Assistance Orders).

7 *See, e.g.*, IRC § 6001 (imposing an obligation to retain adequate books and records).

8 Pub. L. No. 100-647, Title VI, § 6227, (1988); 102 Stat. 3731; IRC § 7521(b)(1).

9 IRS Pub.1, *Your Rights as a Taxpayer* (May 2005).

10 *Taxpayers' rights and obligations – a survey of the legal situation in OECD countries*, Committee of Fiscal Affairs, OECD, 27 April 1990, at http://www.oecd.org/pdf/M00023000/M00023881.pdf.

11 *Taxpayers' Rights and Obligations – Practice Note 3*, Centre for Tax Policy and Administration, OECD, August 2003.

The OECD also identified certain "behavioral norms" that governments expect of taxpayers and that are essential to the proper functioning of tax administration. These taxpayer responsibilities include:

- The obligation to be honest;
- The obligation to be cooperative;
- The obligation to provide accurate information and documents on time;
- The obligation to keep records; and
- The obligation to pay taxes on time.[12]

In its "Practice Note" based on the findings of this survey, the OECD noted that many countries have developed charters based on these fundamental rights and obligations. It noted that several of these documents specifically state the expectations of conduct by taxpayers and government officials, some consist of "general statements of broad principles", and still others are detailed explanations of taxpayer rights for each stage of the tax assessment process.[13]

The Canada Revenue Agency (CRA) has adopted and published a Taxpayer Bill of Rights as well as a Commitment to Small Business.[14] Canada's Taxpayer Bill of Rights consists of fifteen provisions, including the right to have the law applied consistently, the right to expect CRA to be accountable, the right to be treated professionally, courteously, and fairly, and the right to expect CRA to warn you about questionable tax schemes in a timely manner.[15]

Several states, including New York,[16] Pennsylvania,[17] Indiana,[18] Kentucky,[19] Maine,[20] Montana,[21] and Nebraska[22] all have some version of a Taxpayer Bill of Rights. While these charters vary in scope – Montana's is statutory, Nebraska's provides its taxpayers with "Freedom from Red Tape" – all contain most of the fundamental components identified by the OECD and several outline taxpayer obligations in addition to taxpayer rights.

12 *Taxpayers' Rights and Obligations – Practice Note 3*, Centre for Tax Policy and Administration, OECD, August 2003.

13 *Id.* at 3-4.

14 Canada Revenue Agencies Commitment to Small Business includes the commitment to "administering the tax system in a way that minimizes the costs of compliance for small businesses" and "providing service offerings that meet the needs of small businesses." at http://www.cra-arc.gc.ca/agency/fairness/tbrbill-e.html#smb.

15 Canada Revenue Agency, Taxpayer Bill of Rights, RC4418 at http://www.cra.gc.ca/E/pub/ts/rc4418/rc4418-e.pdf.

16 N.Y. Tax Law § 3000; *see also* New York Taxpayer Bill of Rights at http://www.tax.state.ny.us/nyshome/bill_of_rights.htm.

17 72 Pa. Stat. Ann. § 3310-101 (1996); *see also* Pennsylvania Taxpayer Bill of Rights at http://www.revenue.state.pa.us/revenue/cwp/view.asp?A=299&Q=224556 (Jan. 2, 2008).

18 Indiana Taxpayer Bill of Rights at http://www.in.gov/dor/reference/rights.html.

19 Kentucky Revised Statements Annotated 131.041-131.081, Taxpayer Bill of Rights; *see also* Kentucky Taxpayer Bill of Rights at http://revenue.ky.gov/billofrights.htm.

20 Maine Taxpayer Bill of Rights at http://www.maine.gov/revenue/homepage_files/tpbor.htm.

21 Montana Codes Annotated 15-1-222; *see also* Montana Taxpayer Bill of Rights at http://mt.gov/revenue/formsandresources/taxpayebillofrights.asp.

22 Nebraska Taxpayer Bill of Rights at http://www.revenue.ne.gov/rights.htm.

Recommendation 2: *De Minimis* Apology Payments to Taxpayers

There is no present authority for making "apology" payments to taxpayers under U.S. law. However, both the United Kingdom and Australia provide for apology payments to taxpayers.

In the United Kingdom, Her Majesty's Revenue & Customs (HMRC) maintains a specific policy on "Complaints and putting things right."[23] The policy permits HMRC to refund reasonable costs caused by mistakes or unreasonable delay and further states that in certain cases of distress or worry, a payment may be made to apologize to the taxpayer.[24]

The Australian government permits claims against the Tax Office to be assessed for legal liability and/or detriment caused by defective administration.[25] If those circumstances do not cover the claim, the taxpayer can seek an act of grace payment from the Department of Finance and Administration,[26] which provides the taxpayer the opportunity to seek compensation for being unintentionally disadvantaged by the actions of the government.[27]

Taxpayers in the U.S. have several means through the judicial system by which to recover certain costs. These remedies are limited and only available under specific circumstances. These remedies include:

- ***IRC § 7430-Awarding of costs and certain fees.*** Taxpayers who prevail in administrative or court proceedings against the U.S. involving the determination, collection or refund of any tax, interest or penalty may be awarded reasonable administrative and litigation costs where the taxpayer has first exhausted all administrative remedies and has not unreasonably prolonged litigation.
- ***IRC § 7431-Civil damages for unauthorized inspection or disclosure of returns and return information.*** Taxpayers may seek damages in district court against the U.S. in cases where an officer or employee of the U.S. knowingly or negligently, and without authorization, discloses returns or return information.
- ***IRC § 7432-Civil damages for failure to release lien.*** Taxpayers may seek damages in district court against the U.S. in cases where an officer or employee of the U.S. knowingly or negligently fails to release a lien under IRC § 6325.
- ***IRC § 7433-Civil damages for certain unauthorized collection actions.*** Taxpayers who have exhausted administrative remedies may seek damages in the district court against the U.S. in cases where an officer or employee of the IRS, in connection with a collection action, recklessly, intentionally, or negligently disregards any portion or regulation of this Title 26.

23 HMRC, *Complaints and putting things right*, at http://www.hmrc.gov.uk/factsheets/complaints-factsheet.pdf.

24 *Id.*

25 Australian Tax Office, *Applying for compensation*, at http://www.ato.gov.au/corporate/content.asp?doc=/content/48904.htm.

26 Australian Tax Office, *Claiming compensation*, at http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/48878.htm.

27 *Id.*

- ***IRC § 7433A-Civil damages for certain unauthorized collection actions by persons performing services under qualified tax collection contracts.*** IRC § 7433 applies to situations where the actor is a person performing under a qualified tax collection contract as defined in IRC § 6306(b).
- ***IRC § 7435-Civil damages for unauthorized enticement of information disclosure.*** In situations where an officer or employee of the U.S. has intentionally compromised the determination or collection of tax due from an attorney, CPA, or enrolled agent representing a taxpayer in exchange for information concerning the taxpayer's liability, the taxpayer may seek damages against the U.S. in district court.
- ***IRC § 7426-Civil actions by persons other than taxpayers.*** In a wrongful levy action, any person other than the taxpayer who claims an interest in or lien on the levied property may bring a judicial action against the U.S. for an injunction, recovery of the property or money, or a judgment for the proceeds or fair market value of the property.

Taxpayers who seek assistance from the National Taxpayer Advocate may be eligible for the equitable remedy of a Taxpayer Assistance Order (TAO) under the authority granted to the National Taxpayer Advocate by IRC § 7811. Under IRC § 7811, the National Taxpayer Advocate may issue a TAO when she determines that the taxpayer is suffering or about to suffer a significant hardship due to the manner in which the Secretary or his delegates are administering the internal revenue laws.[28] A significant hardship includes: "an immediate threat of adverse action; a delay of more than 30 days in resolving taxpayer account problems; the incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted."[29] In cases where the IRS has failed to follow published administrative guidance (including the Internal Revenue Manual (IRM)), the factors taken into consideration when issuing a Taxpayer Assistance Order are to be construed in the light most favorable to the taxpayer.[30] The TAO is used to require the Secretary or his delegates to act in a case in which the National Taxpayer Advocate has determined the taxpayer is suffering or about to suffer a significant hardship, and may require the Secretary to take an action, cease an action or refrain from taking an action involving the taxpayer.[31]

28 IRC § 7811(a)(1)(A).
29 IRC § 7811(a)(2).
30 IRC § 7811(a)(3).
31 IRC § 7811(b).

Reasons For Change

Recommendation 1: Taxpayer Bill of Rights

While the Internal Revenue Code contains significant rights, protections, and expectations of taxpayers, these provisions are scattered throughout the Code and the IRM. They are not easily accessible to taxpayers, nor are they written in language that is readily understandable by many taxpayers.

IRS Publication 1, Your Rights as a Taxpayer, is the primary vehicle for the IRS to tell taxpayers about their rights. Publication 1 is two pages long, with eight sections pertaining to taxpayer rights and four sections pertaining to exam, appeals, collection, and refunds, in ten point font. Its dense language is difficult to navigate, and the rights are not set forth in a way that emphasizes the fundamental principles underlying these rights. As a clear and concise statement of what rights the federal government is bestowing on its taxpayers, and what behavior it expects from those taxpayers in return, Publication 1 falls well short of the mark.

The National Taxpayer Advocate believes that taxpayers will be reassured in the essential fairness of the tax system and more disposed to voluntarily comply with the tax laws if they can see and understand a clear declaration of their rights as taxpayers. As taxpayers understand that specific statutory protections flow from these rights, they will be able to better avail themselves of these protections. IRS employees, in turn, will better understand why these specific protections exist. Moreover, a clear linkage between taxpayer rights and responsibilities will establish expectations of taxpayer behavior that are easily understandable and fulfilled.

Establishing a statutory Taxpayer Bill of Rights will reassure taxpayers that the tax system is essentially fair and just, and inform taxpayers of the treatment they can expect from their government as well as of the behavior the government expects of them. Revising Publication 1 so that it sets forth the Taxpayer Bill of Rights in its entirety and then relates specific statutory protections and obligations to those rights will enable taxpayers to avail themselves of those rights and conform their behavior accordingly.

Recommendation 2: *De Minimis* "Apology" Payments

The National Taxpayer Advocate believes the authority to make *de minimis* apology payments to taxpayers is appropriate to acknowledge situations where the IRS seriously mistreats a taxpayer, resulting in excessive expense or undue burden to the taxpayer. Faith in the tax system is essential to voluntary tax compliance. The ability to monetarily compensate taxpayers when the tax system has not functioned in an appropriate manner will work to restore taxpayer confidence in that system and encourage future compliance on the part of taxpayers who may be downtrodden or discouraged by their experience. A monetary apology to a taxpayer who has suffered emotionally and financially due to an improper handling of his or her situation may not make the taxpayer whole, but it will show the ability of the tax system to recognize and try to correct its mistakes. A tax system that is fair and just encourages taxpayer compliance.[32]

Current provisions permitting cost recovery to taxpayers are limited and narrow. Under present law, in order for a taxpayer to recover the costs of prevailing against the IRS, he or she must first exhaust all administrative remedies available, and then, when those options are exhausted and the taxpayer still has not received the outcome he or she was seeking, take the IRS to court and prevail. As demonstrated in the example, *supra*, it can take years for a taxpayer to exhaust his or her administrative remedies, with no final conclusion reached, all for a situation where the IRS itself has caused the problem. Such remedies do not assist a taxpayer, who as a result of IRS action or inaction, is embroiled in a tax situation that takes years and significant expense to unwind. Going to court increases the taxpayer's costs further and is also expensive for the government.

The rationale for a *de minimis* apology payment to such a taxpayer is not to repay him or her for the time and expense of seeking a remedy, but instead, to serve as a symbolic gesture to show that the government recognizes its mistake and seeks to make amends. This payment would be separate from any other judicial remedy otherwise already provided by current law.

Explanation of Recommendations

Recommendation 1: Taxpayer Bill of Rights

The National Taxpayer Advocate recommends that Congress enact a Taxpayer Bill of Rights that sets forth the fundamental taxpayer rights and obligations described below. The National Taxpayer Advocate further recommends that Congress direct the IRS to publish (in print and electronically) the Taxpayer Bill of Rights and, when it contacts a taxpayer concerning the determination or collection of any tax, provide the taxpayer with a written, nontechnical explanation of the Taxpayer Bill of Rights (similar to that set forth below) and the specific protections that derive from these rights during the audit, appeals, refund, and collection processes (including those protections currently described in Publication 1).

Taxpayer Rights:

- ***Right to be Informed:*** Taxpayers have the right to know what is expected of them in terms of complying with the tax law. They are entitled to receive clear explanations of the law and IRS procedures in the form of tax forms and instructions, publications, notices, and correspondence, as well as in oral communications. Taxpayers also have

32 *See* Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, vol. 2, *infra*.

the right to have access to IRS procedures, policies, guidance, and other instructions to staff, to the extent permitted by law. This should include information about protections and procedures under the Freedom of Information Act, the Privacy Act, and IRC § 6110. It also includes clear explanations of the law and IRS procedures, in the form of tax forms and instructions, publications, notices, and correspondence, as well as oral communications. Finally, taxpayers have the right to be informed of the results of and reasons for decisions made by the IRS about their tax matters.

- ***Right to be Assisted:*** Taxpayers have the right to receive prompt, courteous and professional assistance about their tax obligations in the manner in which they are best able to understand it, and to be provided a method to lodge grievances when service is inadequate. Taxpayers have a right to expect that the tax system will attempt to keep taxpayer compliance costs at a minimum and that assistance will be available in a timely and accessible manner and without unreasonable delays.
- ***Right to be Heard:*** Taxpayers have the right to raise their objections and exculpatory evidence in connection with actions taken by the IRS, which shall consider those objections and evidence promptly and impartially. Moreover, the IRS shall provide the taxpayer with an explanation of why those objections or evidence are not sufficient, if it so concludes, and what is required to better document the taxpayer's concern, where appropriate.
- ***Right to Pay No More than the Correct Amount of Tax:*** Taxpayers have the right to expect that the IRS will apply the tax law "with integrity and fairness to all."[33] Thus, taxpayers have the right pay only the tax legally due and to have all tax credits, benefits, refunds, and other provisions properly applied.
- ***Right of Appeal:*** Taxpayers have the right to be advised of and avail themselves of a prompt administrative appeal that provides an impartial review of *all* compliance actions (unless expressly barred by statute) and an explanation of the appeals decision. Taxpayers have the right to expect that Appeals personnel will not engage in ex parte communications with IRS compliance personnel except in statutorily permitted circumstances.
- ***Right to Certainty:*** Taxpayers have the right to know the tax implications of their actions and the date and circumstances under which certain actions are final (*e.g.,* the date by which a Tax Court petition must be filed, the applicable statutory or other period of limitation, the circumstances under which there will be second examinations, and the effect of closing agreements and settlements).
- ***Right to Privacy:*** Taxpayers have the right to expect that any IRS inquiry or enforcement action will involve as little intrusion into taxpayers' lives as possible, will be limited to information relevant to the matter at hand, and will follow all due process

[33] IRS Mission Statement at http://www.irs.gov/newsroom/article/0,,id=98186,00.html.

considerations, including search and seizure protections and the provision of a collection due process hearing, where required.

- ***Right to Confidentiality:*** Taxpayers have the right to expect that any information provided to the IRS will not be disclosed by the IRS unless authorized by the taxpayer or other provision of law. Taxpayers also have the right to expect that the IRS will conduct appropriate oversight over those who assist in tax administration (tax preparers, tax software providers, electronic return originators) to ensure that taxpayer and tax return information is protected from unauthorized use or disclosure.
- ***Right to Representation:*** Taxpayers have the right to be represented in contacts, transactions, and controversies with the IRS by an authorized representative of their choice. Taxpayers have the right to expect that the IRS will conduct appropriate oversight over these representatives and inform taxpayers about improper conduct or practices by such representatives. Moreover, taxpayers who do not have the means to afford representation have the right to expect that the IRS will inform them of the availability of Low Income Taxpayer Clinics (LITCs) and Student Tax Clinics that provide such representation for free or for a nominal charge.
- ***Right to a Fair and Just Tax System:*** Taxpayers have the right to expect that the tax system will take into consideration the specific facts and circumstances that might affect their underlying liability, ability to pay, or ability to provide information timely (*e.g.*, by abatement of tax, penalty or interest; offers in compromise, or installment agreements; or extensions of time to file or submit information, unless statutorily prohibited). Taxpayers have the right to receive assistance from the Office of the Taxpayer Advocate in resolving problems with the IRS. Taxpayers have the right to "apology" or other compensation where the IRS has excessively erred, delayed, or taken unreasonable positions or where otherwise authorized by statute.

Taxpayer Obligations include:

- ***Obligation to be honest:*** Taxpayers have the obligation to accurately report their income, deductions, and credits according to the law; to answer all questions completely, accurately, and honestly; and to explain all relevant facts and circumstances when seeking guidance from the IRS.
- ***Obligation to be cooperative:*** Taxpayers have the obligation to treat IRS personnel with courtesy, professionalism, and respect.
- ***Obligation to provide accurate information and documents on time:*** Taxpayers have the obligation to take reasonable care in preparing all required returns and other required information, to file all required returns timely and at the appropriate location, and to provide all required information within the requested time period.
- ***Obligation to keep records:*** Taxpayers have the obligation to maintain adequate books and records that enable them to fulfill their tax requirements, to preserve them for the period during which they may be subject to inspection by the IRS, and to provide the

IRS access to those books and records for the purpose of examining their tax obligations, to the extent required by law.

- ***Obligation to pay taxes on time:*** Taxpayers have the obligation to pay the full amount of taxes they owe by the required due dates, to pay in full any additional assessments, and to comply with all terms of any installment agreements or offers in compromise mutually agreed to when a taxpayer does not have ability to pay the liability in full.

The National Taxpayer Advocate believes that if taxpayers are informed about their rights and responsibilities under the tax law, they will be better able to comply. A Taxpayer Bill of Rights serves as the foundation for all other rights of taxpayers and the behavior expected of taxpayers. By becoming part of the fabric of tax administration, it is perhaps the most effective document for advising taxpayers of the existence of these rights and responsibilities and ensuring that the tax administrator expects them.

Recommendation 2: *De Minimis* Apology Payments

The authority to make *de minimis* apology payments to taxpayers is a mechanism that would help restore taxpayer faith in the tax system when a taxpayer has been seriously mistreated by the IRS. This authority, vested solely in the National Taxpayer Advocate, would be nondelegable. The National Taxpayer Advocate, at her discretion, would be authorized to make a *de minimis* payment to a taxpayer where the taxpayer has incurred excessive expense or experienced undue burden as a result of an IRS mistake, action, or failure to act. The National Taxpayer Advocate's decision with respect to an award under this authority would not be appealable or reviewable. To be eligible for such a payment, the taxpayer would have to meet established criteria. Payments would only be awarded in cases that meet the definition of significant hardship in IRC § 7811, and additional criteria could be described in regulations or other guidance.

A payment under this authority would not exceed $1,000 and would be paid from the IRS general appropriations fund. The Secretary of the Treasury would allocate no more than $1 million per year for this purpose, unless otherwise provided by specific appropriation and would issue regulations in accordance with this authority. The IRC should be amended to specifically exclude these payments from gross income.

The National Taxpayer Advocate believes that the ability to make a *de minimis* apology payment to taxpayers in situations where the taxpayer experiences excessive costs or undue burden due to gross mistreatment by the IRS is an important aspect of taxpayer service. Such payment is a symbolic acknowledgement of the government's error and the taxpayer's resulting burden, and enhances taxpayers' perception of the tax system as just and fair. The National Taxpayer Advocate could also include a general description of apology payments authorized during the preceding year in her annual reports to Congress, which would keep Congress apprised of both the nature of significant IRS errors and areas that might warrant congressional attention.

KLR #2 Measures to Address Noncompliance in the Cash Economy

Income from the "cash economy" – income that is not reported to the IRS by third parties – is the type of income most likely to go unreported.[1] Where taxable payments are reported to the IRS by third parties, taxpayers generally report well over 90 percent of their income.[2] By contrast, where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent.[3] Although the IRS does not estimate the portion of the tax gap attributable to the so called "cash economy," unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over $100 billion per year.[4] The cash economy may also contribute to noncompliance with filing and payment requirements.

Over the last few years, the National Taxpayer Advocate has proposed a number of legislative and administrative steps to address the portion of the tax gap attributable to the cash economy.[5] Her comprehensive strategy is discussed in volume II of this report.[6] The goal of the strategy is to propose solutions that will improve voluntary compliance by making it easier for cash economy taxpayers to understand and meet their tax obligations, and to improve the tools available to the IRS for enforcing the tax laws when necessary. The strategy is based on three assumptions:

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1 Our definition of the "cash economy" is limited to income from legal activities. For additional discussion of noncompliance in the cash economy and our administrative recommendations, see Most Serious Problem: The Cash Economy, *supra*. Volume II of this report also provides detailed administrative and legislative recommendations.

2 *See* IRS News Release, IRS Updates Tax Gap Estimates, IR-2006-28 (Feb. 14, 2006) (accompanying charts), *available at* http://www.irs.gov/newsroom/article/0,,id=154496,00.html.

3 *See Id.*

4 *See Id.* Underreporting makes up about 83 percent of the tax gap ($285 billion of the $345 billion gap). Underreporting of income tax by individuals accounted for about 69 percent of this underreporting gap ($197 billion out of the $285 billion underreporting gap). Underreporting of business income by individuals – from sole proprietors, rents and royalties, and passthrough entities – accounted for about 55 percent of the tax gap attributable to underreporting by individuals ($109 billion out of the $197 billion individual underreporting gap). Associated underreporting of employment taxes by unincorporated businesses accounts for about another $39 billion (self-employment taxes) to $54 billion (all employment taxes).

5 *See, e.g.*, National Taxpayer Advocate 2003 Annual Report to Congress 257 (Key Legislative Recommendation: Tax Withholding on Nonwage Workers); National Taxpayer Advocate 2004 Annual Report to Congress 478 (Key Legislative Recommendation: Tax Gap Provisions); National Taxpayer Advocate 2005 Annual Report to Congress 381 (Key Legislative Recommendation: Measures to Reduce Noncompliance in The Cash Economy); Testimony of Nina E. Olson, National Taxpayer Advocate, Before the Senate Committee on Finance, The Tax Gap and Tax Shelters (July 21, 2004), *available at* http://www.irs.gov/advocate/article/0,,id=125634,00.html; Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on the Budget United States Senate, The Causes of and Solutions to the Federal Tax Gap (Feb. 15, 2006), *available at* http://www.irs-tas.com/UserFiles/File/NTA_Senbudget_taxgap_021506_v2.doc; Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security Committee on Homeland Security and Governmental Affairs United States Senate Hearing, The Tax Gap (Sept. 26, 2006), *available at* http://www.irs-tas.com/UserFiles/File/NTA_Testimony_Senate_HSGAC_092606.doc; Written Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on the Budget United States Senate, The Causes of and Solutions to the Federal Tax Gap (Feb. 15, 2006), *available at* http://www.irs.gov/pub/irs-utl/nta_senbudget_taxgap_021506.pdf.

6 A Comprehensive Strategy for Addressing the Cash Economy, Vol. II, *infra*. For a summary of the National Taxpayer Advocate's administrative recommendations, see Most Serious Problem, The Cash Economy, *supra.*

- Taxpayers deserve an effective tax system that allows them to determine with confidence that they arrived at the correct tax through the use of clear instructions and simple processes;
- Taxpayers deserve a system that ensures all taxpayers are paying their share, and provides the IRS with the necessary tools to address intentional noncompliance when necessary; and
- When ensuring that all taxpayers pay their share, the IRS must use tools that narrowly target the noncompliance (and its causes) in ways that are minimally intrusive, impose the least possible burden, and protect taxpayer rights.

Because taxpayers are noncompliant for different reasons, a one-size-fits all solution should be avoided because it will not be least burdensome or least intrusive for all taxpayers.[7] For example, we should not use the same approach to address noncompliance by those who are trying to comply as we use to address intentional noncompliance. While the parts of this strategy that can be achieved administratively by the IRS without additional legislation are summarized elsewhere in this report,[8] the National Taxpayer Advocate's legislative recommendations are to:

1. Increase the use of the IRS's electronic payment system to for estimated tax payments;
2. Authorize voluntary withholding agreements;
3. Eliminate the corporate exception to information reporting for small corporations, if the National Research Program shows significant noncompliance;
4. Accelerate the taxpayer identification number validation process;
5. Provide for withholding on payments to noncompliant contractors;
6. Require information reporting by financial institutions on credit and other "payment card" receipts; and
7. Require financial institutions to report all accounts to the IRS by eliminating the $10 minimum on interest reporting.

These legislative recommendations are summarized below.

7 For a discussion of the different types of noncompliance, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

8 *See* Most Serious Problem, The Cash Economy, *supra*.

1. Increase the Use of the IRS's Electronic Payment System for Estimated Tax Payments[9]

Problem

Taxpayers sometimes inadvertently fall behind on their estimated tax payments, which are due on four oddly-spaced dates: April 15, June 15, September 15 and January 15.[10] Taxpayers who intend to make timely estimated tax payments sometimes fail because the process of estimating income, remembering odd payment dates, and saving enough for each payment is cumbersome, especially for self-employed taxpayers who are juggling many different duties.

According to IRS research, taxpayers who owe a balance upon filing a return are more likely to understate their tax liability than other taxpayers.[11] Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.[12] Thus, if the IRS could reduce estimated tax payment shortfalls it could increase both reporting and payment compliance.

The IRS has an electronic payment system that could make it easier for many taxpayers to make timely estimated tax payments, but the system is not fully utilized. The IRS's Electronic Federal Tax Payment System (EFTPS) allows taxpayers to have tax payments electronically debited from their bank account. Taxpayers may schedule one-time or recurring payments on the EFTPS website (www.eftps.gov) up to 365 days in advance. In addition, when taxpayers *e-file* their returns, they can pre-authorize up to four Electronic Funds Withdrawal (EFW) payments from a checking or savings account to make estimated tax payments for the following year.[13]

Current law requires the IRS to use EFTPS to collect at least 94 percent of depository taxes (*i.e.*, withheld income taxes and employment taxes).[14] Regulations require certain taxpayers to make depository tax payments electronically.[15] However, the IRS encouraged other taxpayers who pay depository taxes, but who are not required to do so electronically, to enroll in EFTPS by waiving one prior failure to deposit penalty for new enrollees.[16] In FY 2007, the IRS received over 96 percent of all depository tax dollars through EFTPS.[17] By contrast, the IRS received only about one percent of all estimated taxes through EFTPS

9 The National Taxpayer Advocate made a similar proposal in 2005. *See* National Taxpayer Advocate 2005 Annual Report to Congress 381, 389 (Key Legislative Recommendation: Measures to Reduce Noncompliance in the Cash Economy).

10 IRC § 6654(c)(2); Pub. 505, *Tax Withholding and Estimated Tax Payments*, 22 (Feb. 2007).

11 Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

12 *Id*. at 1.

13 *See, e.g.*, http://www.irs.gov/efile/article/0,,id=101317,00.html. The IRS should allow taxpayers to preauthorize 12 payments instead of just four.

14 *See* IRC § 6302(h). By "employment taxes" we mean Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes.

15 *See* Treas. Reg. § 31.6302-1.

16 IRS Pub. 4048, *EFTPS: Special IRS Penalty Refund Offer* (Nov. 2006).

17 W&I, Client Account Services, Response to TAS information request (Oct. 10, 2007).

in fiscal year 2007.[18] The IRS has no statutory mandate to collect estimated tax payments through EFTPS.

Example

A sole proprietor sometimes is not able to save enough money to make timely estimated tax payments on the following oddly spaced due dates: April 15, June 15, September 15 and January 15. This taxpayer already signed up to have certain payments, including automobile and student loans, electronically withdrawn from his checking account on a monthly basis. If he knew about EFTPS, at the beginning of each year he could schedule monthly or biweekly payments so that he would not inadvertently miss the filing deadline or spend his tax deposits on other items.

Recommendation

Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated taxes electronically by fiscal year 2014. Such a goal might motivate the IRS to do more to actively promote EFTPS, provide incentives for using it, and make the system easier to use. Congress should use its oversight to ensure the IRS (and the Financial Management Service) makes EFTPS more user-friendly and promotes it aggressively for estimated tax payments, and also provide adequate funding (and authorization) for any necessary enhancements and advertising.

2. Authorize Voluntary Withholding Agreements[19]

Problem

Even though withholding is not required on payments to independent contractors (payees), some contractors may wish to have customers (payors) withhold taxes for them, just like they do for employees. Such withholding would help contractors avoid the burdens of making timely quarterly estimated tax payments. Some payors may be willing to do this as a convenience to the contractors they pay, particularly if they already withhold and remit

18 W&I, Client Account Services, Response to TAS information request (Oct. 10, 2007). It received another 0.28 percent of estimated tax payments (and 0.14 percent of estimated tax dollars) through EFW. *Id.*

19 The National Taxpayer Advocate made a very similar legislative proposal in 2005 and had previously identified voluntary withholding agreements as a way to reduce the tax gap in 2004. *See* National Taxpayer Advocate 2004 Annual Report to Congress 478, 484; National Taxpayer Advocate 2005 Annual Report to Congress 381, 391. The Treasury Department recently proposed to require payors to initiate withholding at a payee's request or if the payee does not provide a certified TIN. *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals* 67 (Feb. 2007), *available at* http://www.ustreas.gov/offices/tax-policy/library/bluebk07.pdf. (proposing to require businesses to withhold on payments to contractors who do not provide a certified TIN; and also to authorize payees to require payors to withhold at a flat rate (15, 25, 30 or 35 percent) selected by the payee).

employment taxes for employees. It is unclear, however, whether statutory authority currently exists to enter into such agreements.[20]

Example

Taxpayer A is a hair stylist operating as an independent contractor who rents a booth in B's salon. A's customers pay the salon directly and then B pays A after subtracting a percentage for chair rental, general overhead expenses, and a "name use" commission. A also receives tips directly from his customers. A approaches B and explains that he is having difficulty maintaining accurate tax records and making timely estimated tax payments. A asks B if she would be willing to withhold a certain percentage of each payment to A and send it to the IRS. B responds that she is not sure if such voluntary withholding arrangements are authorized, and that she is unsure how to set up such an arrangement even if it were permitted.

Recommendation

Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)).[21] Allowing service-recipients to help independent contractors satisfy their estimated tax payment obligations is expected to reduce compliance burdens for independent contractors while increasing tax compliance.

3. Eliminate the Corporate Exception to Information Reporting for Small Corporations, if the National Research Program Shows Significant Noncompliance[22]

Problem

If a service-recipient pays $600 or more to an unincorporated independent contractor for services in the course of his or her trade or business during the year, then the service-recipient is generally required to report those payments to the IRS and to the contractor on an information return (generally on Form 1099-MISC).[23] Payments to corporations, however,

20 IRC § 3402(p)(1) provides for voluntary withholding on certain federal payments (such as Social Security benefits). IRC § 3402(p)(2) provides for voluntary withholding on unemployment compensation payments. IRC § 3402(p)(3) provides for "other voluntary withholding" agreements and authorizes the Secretary, by regulation, to provide for withholding from (1) payments from employer to employee that do not constitute wages, and (2) "any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of [IRC chapter 24, Collection of Income Tax at Source]." No such regulations have been issued and the Secretary's authority to issue regulations that would permit such voluntary withholding agreements has been questioned. *See* National Taxpayer Advocate 2005 Annual Report to Congress 381, 393 (discussing IRS Chief Counsel's concerns with issuing regulations without additional statutory authorization).

21 The legislation should also make clear that the agreement would not be taken into account in determining whether the service provider is an employee (rather than an independent contractor) for tax purposes.

22 The National Taxpayer Advocate identified eliminating the corporate exception to information reporting as an option in 2004 and made a similar (but slightly different) proposal to limit it in 2005. *See* National Taxpayer Advocate 2004 Annual Report to Congress 478, 483; National Taxpayer Advocate 2005 Annual Report to Congress 381, 394. The Treasury Department has recently proposed to eliminate the corporate exception to information reporting. *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals*, 63 (Feb. 2007).

23 IRC § 6041A.

generally are not subject to this information reporting requirement.[24] A service-recipient is not required to report payments to independent contractors on Form 1099-MISC if the contractor includes in its business name an indication that it is doing business as a corporation (*e.g.*, "Incorporated," "Inc.," Corp.," or "P.C.," (but not "Company" or "Co.")) or identifies itself as a corporation on Form W-9, Request for Taxpayer Identification Number and Certification, the form used to provide the payor with the contractor's taxpayer identification number.[25]

One possible justification for the corporate exception to the information reporting requirements is that large corporations are less likely to underreport income than sole proprietors because they must account to unrelated shareholders for business earnings and expenses. The same reports and accounting systems used to account to shareholders can be audited by the IRS, reducing the temptation to understate income. However, these safeguards may not be present in many closely-held corporations.

For Form 1099-MISC information-reporting purposes, there is no good reason to distinguish between unincorporated businesses and corporations owned by a single person. As noted above, taxpayers are much more likely to report income on a tax return if it is subject to information reporting than if it is not.

Example

Taxpayers A and B are each the sole owner of a window washing business. A conducts business as a sole proprietor, while B conducts business as a corporation and is the sole shareholder. A and B are competitors and frequently wash windows for mutual clients. When A washes windows for a client, the client generally must report payments to A on Form 1099-MISC. When B washes windows for a client, however, the client is not required to report payments to B on Form 1099-MISC because B conducts business as a corporation.

Recommendation

If the IRS's National Research Program (NRP) shows significant levels of noncompliance among small corporations, reiterate and clarify the IRS's authority to require third-party information reporting for applicable payments (aggregating to $600 or more) to independent contractors who are operating as corporations.[26] Congress should direct the IRS to waive

24 Treas. Reg. §§ 1.6041-3(p)(1) and 1.6049-4(c)(1)(ii)(A). However, payments made by federal executive agencies to contractors organized as corporations are not exempt from Form 1099-MISC reporting, unless certain exceptions apply. *See* IRC § 6041A(d)(3). IRC § 6041A(f) requires persons receiving reportable payments under IRC § 6041A(a) to provide to the payor, the payee's name, address and TIN. Payees generally use IRS Form W-9 to provide this information. Form W-9 also requires payees to declare whether they conduct business as an individual/sole proprietor, corporation, partnership, or other business entity.

25 However, a service-recipient may not treat a payee as a corporation if the service-recipient has actual knowledge that the payee is not a corporation. Treas. Reg. § 1.6049-4(c)(1)(ii)(A).

26 Although the corporate exception could be changed by regulation, because it has been in place for many years during which Congress has made changes to the information reporting rules, the Treasury Department believes the corporate exception should be eliminated through legislation. *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals*, 63 (Feb. 2007).

the requirement for those corporations willing to certify they have had a large number of shareholders (*e.g.*, 50 or more shareholders), at any time in the prior calendar year (or prior 12-month period). IRS Form W-9 could be revised to include a check box for the corporation to indicate if it had the requisite number shareholders at any time in the prior calendar year (or prior 12-month period).[27]

4. Accelerate the Taxpayer Identification Number Validation Process

Problem

When payments are subject to third-party information reporting, the payor is required to report those payments to the IRS and to the payee on an information return (generally on Form 1099-MISC).[28] The IRS needs to be able to associate the information return with the payee using the payee's tax identification number (TIN).[29] The payee generally must provide the payor with a TIN on Form W-9, which the payor uses in completing the information return.

Because TINs are long sequences of numbers, it is easy for payors and payees to transcribe them incorrectly. If a payee provides an incorrect TIN to the payor such that the payor is unable to file correct and complete information returns or payee statements, the IRS may assert a small penalty (generally $50) against the payor.[30] A payee may be subject to backup withholding if:

1. The payee fails to provide a TIN;
2. The payee has provided the payor with two incorrect TINs in a three-year period; or
3. The IRS has notified the payor that the payee's TIN is incorrect and the payee does not provide the correct TIN within 30 days.[31]

However, both TIN validation and backup withholding are often delayed.[32] Although a payor can check an IRS database to determine if the payee's name and TIN match, a payor is not permitted to begin withholding until the IRS notifies him or her of a name/

27 The qualified payment card agent (QPCA) program significantly reduces the burden of existing information reporting requirements on businesses that use payment cards. Under the IRS's QPCA program, when a payor uses a payment card (*e.g.*, a credit or debit card) the QPCA may automatically solicit, collect, and validate merchants' names, TINs and corporate status, fulfilling both payee and payor obligations. *See, e.g.*, T.D. 9136, 69 Fed. Reg. 41938 (July 13, 2004); Rev. Proc. 2004-42, 2004-2 C.B. 121. QPCAs could serve to reduce the burden associated with this proposal.

28 IRC § 6041A.

29 A TIN is a unique number used by the IRS to identify taxpayers. Perhaps the most common TINs are Social Security numbers.

30 IRC § 6721 ($50 penalty for failure to file a complete and correct information return); IRC § 6722 ($50 penalty for failure to furnish a complete and correct information statement (payee statement) to a payee).

31 IRC § 3406(a)(1); IRC § 3406(h)(2). Backup withholding is also imposed on payments of interest or dividends if the IRS determines that the payee has been underreporting income. *See id.*

32 For additional detail see, National Taxpayer Advocate 2005 Annual Report to Congress 238 (Most Serious Problem: Limited Scope of Backup Withholding Rules).

TIN mismatch.[33] The IRS cannot identify mismatches and send these notices promptly because payors are not required to file information returns that the IRS can use to identify mismatches until February of the year following the payment,[34] and the IRS does not send backup withholding notices until September or October of the following year (or in some cases until March of the second following year).[35]

Even after the IRS notifies the payor that the payee has supplied an invalid TIN, withholding may be further delayed.[36] If within 30 days after the payor sends the payee a notice indicating the TIN is incorrect, the payee provides the payor with a Form W-9 reporting a new TIN, withholding is not required until after the IRS receives the W-9 and verifies that the TIN is still incorrect and sends another notice to the payor.

Example

A general contractor hires a subcontractor in January 2006. The subcontractor provides the general contractor with an incorrect TIN on Form W-9, and begins to receive payments on a weekly basis. In January 2007, the general contractor provides the subcontractor and the IRS annual information returns showing the amount paid to the subcontractor during the year.[37] It is October 2008 before the IRS sends the general contractor a notice that the TIN is incorrect (potentially triggering backup withholding). The general contractor may be subject to penalties for failure to file correct information returns and payee statements.

Recommendation

Congress should accelerate the lengthy TIN validation and backup withholding processes by requiring payors who make payments that are already subject to information reporting to validate the payee's TIN with the IRS before making the payments. If the payee's TIN cannot be validated, the payor should initiate backup withholding on the first payment.[38]

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33 The IRS's TIN matching program allows a payor to verify whether the name/TIN combination furnished by the payee matches a name/TIN combination maintained in the IRS database. *See* Treas. Reg. § 31.3406(j)-1; Rev. Proc. 2003-9, 2003-8 I.R.B. 516. However, participation is not mandatory. The regulations provide that "the IRS will not use either a payor's decision not to participate in an available TIN matching program or the results received by a payor from participation in a TIN matching program … as a basis to assert that the payor lacks reasonable cause under section 6724(a) for the failure to file an information return under section 6721 or to furnish a correct payee statement under section 6722." Treas. Reg. § 31.3406(j)-1(d).

34 Rev. Proc. 2007-51, 2007-30 I.R.B. 143 § 8.

35 IRM 2.7.7.15(6) (Jan. 1, 2006).

36 *See* Rev. Proc. 93-37, 1993-2 C.B. 477 (describing notices that payors are required to provide to payees who have furnished an incorrect TIN before instituting backup withholding). When the IRS notifies the payor that the TIN furnished by the payee is incorrect, the payor must request that the payee provide the correct TIN on a new Form W-9. *See* IRC § 3406(a)(1)(B); Treas. Reg. § 31.3406(d)-5. The payor must begin backup withholding on reportable payments to the payee if the Form W-9 is not returned within 30 business days after the payor received the IRS notice. *Id.*

37 Treas. Reg. § 1.6041-6.

38 As noted above, the Treasury Department recently proposed to require payors to verify a contractor's TIN with the IRS and to initiate withholding at a flat rate if the TIN-name combination provided by the contractor does not match the IRS's records. *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals*, 67 (Feb., 2007).

This proposal should not be implemented until the IRS has expanded its TIN validation process so that payors can validate TINs using a touch tone phone as well as the Internet.[39]

5. Provide for Withholding on Payments to Noncompliant Contractors

Problem

Many independent contractors who work in the cash economy have low profit margins and cannot afford to pay their taxes timely. Especially in situations where an independent contractor offers to provide a discount for "under the table" cash payments, there may be little motivation for the service-recipient (payor) to comply with current information reporting requirements. While the payor may be liable for any backup withholding that should have been collected, backup withholding is only required if the contractor provided an incorrect TIN and may not be required for over a year after the contractor is hired.[40] Moreover, the penalty for missing or incorrect information reporting forms, such as Form 1099-MISC or W-9, is generally $50 per form.[41]

Example

A general contractor hires the subcontractor providing the lowest bid on a job. The subcontractor has not paid his income taxes for the last several years, so he does not factor tax expenses into his pricing structure. Since the winning subcontractor's bid is so low, the general contractor does not know or care whether the subcontractor pays his taxes. Although the general contractor would prefer to avoid the hassle of backup withholding on payments to the subcontractor, both he and the subcontractor know that any such withholding would not be required for more than a year, and even then, only if the subcontractor provided him with an incorrect TIN.

39 The qualified payment card agent (QPCA) program could significantly reduce the burden associated with this proposal. As noted above, when a payor uses a payment card (*e.g.*, a credit or debit card) the QPCA may automatically solicit, collect, and validate merchants' names, TINs and corporate status, fulfilling both payee and payor obligations. *See, e.g.*, T.D. 9136, 69 Fed. Reg. 41938 (July 13, 2004); Rev. Proc. 2004-42, 2004-2 C.B. 121. The proposal would continue to allow QPCAs to validate a payee's TIN for the payor.

40 IRC § 3406(h)(10).

41 *See* IRC § 6721($50 penalty for failure to file an information return up to a maximum of $250,000 per year); IRC § 6722 ($50 penalty for failure to furnish a payee statement up to a maximum of $100,000 per year, with greater penalties if the failure is intentional); IRC § 6723 ($50 penalty for failure to comply with a specified information reporting requirement up to a maximum of $100,000 per year). The Treasury Department has proposed to increase the penalty for failure to file a timely and accurate information return to $100 (with a $1,500,000 maximum). *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals*, 70 (Feb., 2007).

Recommendations[42]

1. Require payors to institute backup withholding on payments subject to information reporting (*i.e.*, non-employee compensation in excess of $600 paid in the course of a trade or business) to independent contractors that are specifically identified by the IRS as "substantially noncompliant;"[43] and
2. Require payors to stop backup withholding under #1, above, when the IRS deems a contractor "substantially compliant."

Only those substantially noncompliant contractors specifically identified by the IRS would be subject to withholding on payments subject to information reporting. Only contractors who had recently failed to pay income tax or self-employment tax liabilities on more than one occasion would be deemed substantially noncompliant. Even if a contractor has outstanding tax liabilities attributable to several years, the IRS would retain the discretion to treat the contractor as substantially compliant if, for example, the contractor made arrangements to satisfy past obligations and scheduled a year's worth of estimated tax payments through EFTPS or entered into a voluntary withholding agreement (as proposed, above). The process of determining a contractor's status as "substantially compliant" or "substantially noncompliant" should eventually be automated, perhaps utilizing the IRS's existing "e-Services" or TIN matching systems.[44]

If implemented, these recommendations would provide the IRS with a proactive way to help prevent noncompliance by contractors who cannot afford to pay their taxes and chose not to enter into voluntary withholding agreements (as proposed, above). Although the IRS can theoretically levy on payments to noncompliant contractors with unpaid tax debts under current law, the IRS can only issue a levy after a taxpayer has incurred a delinquency. The IRS may also have difficulty identifying payments that could be subject to levy in a timely manner. These recommendations would also provide payors with an additional incentive to hire compliant contractors (and keep them compliant) – there would

42 The National Taxpayer Advocate made a similar proposal in 2005, which included additional components that are not included this year. National Taxpayer Advocate 2005 Annual Report to Congress 381, 386-388 (Key Legislative Recommendation: Measures to Reduce Noncompliance in the Cash Economy). This prior recommendation was based on a prior version of the United Kingdom's "Construction Industry Scheme," recently revised as the "New Construction Industry Scheme" (NCIS). Under NCIS, contractors must withhold 30 percent of all payments for services to unregistered subcontractors, 20 percent to registered contractors, and nothing on subcontractors who qualify to be paid "in gross." For additional information, see http://www.hmrc.gov.uk/new-cis/. A subcontractor must satisfy various requirements, including tax compliance checks, to qualify to be paid in gross. Contractors must check with the tax administrator to determine the status of any subcontractor before making a payment. As in the U.K., the National Taxpayer Advocate's prior proposal would have required payors to initiate withholding on payments (in certain industries designated as "at risk" by the IRS) unless the payee (contractor) presented a "compliance certificate." The IRS would issue a compliance certificate after verifying that the contractor was "substantially compliant." If the other recommendations presented in this report are enacted, this part of the prior proposal may not be necessary.

43 The terms "substantially compliant" and "substantially noncompliant" would be defined by regulations. Because the existing backup withholding rates applicable to interest and dividends would be too high for contractors with slim profit margins, the IRS could determine an industry-specific withholding rate, which might be in the range of about 3.5 percent for contractors with inventory and about 5 percent for those without inventory, subject to adjustment by the IRS to account for typical industry profit margins. *See* National Taxpayer Advocate 2003 Annual Report to Congress 257. The IRS could be given discretion to set a lower rate for contractors with profit margins significantly below the average for their industry.

44 "e-Services" is a suite of web-based products that allow tax professionals and payers to conduct business with the IRS electronically.

be little likelihood they would have to institute withholding on payments to them.[45] Thus, this backup withholding proposal could substantially improve compliance by those who have had difficulty paying their taxes, without imposing unnecessary burdens on compliant contractors.

6. Require Information Reporting by Financial Institutions on Credit and Other "Payment Card" Receipts

Problem

Historically, only large established merchants accepted payment cards (*e.g.*, credit, debit, gift, and prepaid cards). Today, many small businesses take them. Cash and checks accounted for only 45 percent of payments in 2005, down from 57 percent in 2001.[46] Payment cards handled purchases of $2.6 trillion in 2005, with the total expected to rise to over $4.7 trillion in 2010.[47] Credit and debit cards also account for 80 percent of internet payments, with an additional 9 percent from related services such as PayPal.[48] Internet business activity, which is one of the fastest growing modes of commerce, is typically conducted using payment cards.

Some small businesses that accept payment cards have difficulty keeping books and records. Some businesses only report as taxable income those receipts shown on a Form 1099-MISC or similar end-of-year statement. Only some customers are required to send information returns, and not all customers or financial institutions provide useful end-of-year statements. [49]

Although gift cards and cash back transactions might make it difficult for the IRS to reliably match payment card data against amounts reported on returns, the IRS could use payment card information to identify returns with a greater risk of noncompliance.[50] In

45 If imposing backup withholding on payments to independent contractors would be burdensome for payors, as opponents of prior backup withholding proposals have argued, the possibility of having to institute backup withholding on payments to noncompliant contractors should be a powerful incentive for them to seek out compliant contractors or entering into voluntary withholding agreements. If, on the other hand, the possibility of having to institute backup withholding on payments to independent contractors provides a weak incentive to hire compliant independent contractors, then this proposal poses little risk of imposing unreasonable burdens.

46 American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the 2005/2006 Study of Consumer Payment Preferences (Oct. 2005) (results based on 3,008 survey respondents).

47 *The Nilson Report, Issue 865*, 7 (Sept. 2006).

48 American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the 2005/2006 Study of Consumer Payment Preferences (Oct. 2005).

49 A taxpayer who pays $600 or more in a calendar year to a person (other than a corporation and certain exempt entities) for services or determinable gains in the course of a trade or business is generally required to request the payee's TIN (usually on Form W-9) and send an information return to the IRS and the payee reporting the amount, as well as the name, address, and TIN of the payee (generally on Form 1099). *See* IRC § 6041A.

50 The Treasury Department and the IRS should explore the feasibility of identifying and segregating (or otherwise accounting for) nontaxable payments, and payments that are taxable in a different year or to a different person (*e.g.*, sales tax collections, tip payments, merchandise returns, and gift card purchases) so that payment card data becomes more useful.

addition, research suggests that the knowledge that the IRS receives payment information significantly improves reporting compliance even for taxpayers who are not audited.[51]

Example

When business X performs services worth more than $600 for a business customer, the customer generally must request X's TIN on Form W-9 and report payments to X and the IRS on Form 1099-MISC. When business X performs the same services for non-business clients, the clients are not required to report payments on an information return. Moreover, when business X sells products either directly or over the Internet, generally neither the purchaser nor any Internet auction website, is required to report payments on an information return.[52] Since business X does not have a reliable accounting system or a separate business bank account, X does not know how much it earned from customers who did not send a year-end statement, such as Form 1099-MISC. As a result, business X only reports receipts on its tax return if the receipts are reported to it and the IRS on an information return.

Recommendation

Provide the Treasury Department and the IRS with authority to promulgate regulations requiring organizations that process card payments to report the gross payments made to the merchant in a calendar year to the IRS.[53] The regulations should provide for a sufficiently prospective effective date to allow financial institutions to modify their reporting systems.[54]

7. Require Financial Institutions to Report All Accounts to the IRS by Eliminating the $10 Minimum on Interest Reporting

Problem

Although tracking cash flows through a taxpayer's financial institutions is a common method of identifying underreporting, not all accounts are subject to information reporting.[55] Financial institutions must report interest payments of $10 or more annually to the IRS, but are not always required to report the existence of other accounts.[56] While it is possible to avoid using a bank account when operating on a purely cash basis, this option is not practical for many businesses. Taxpayers may be less likely to underreport income if they

51 *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts) (showing that where taxable payments are reported to the IRS by third parties, taxpayers generally report well over 90 percent of their income, but that reporting compliance drops below 50 percent when payments are not subject to information reporting).

52 For a discussion of why internet sales are not generally subject to information reporting, see Richard Malamud, *How the IRS Can Close the Online Auction Tax Gap*, 106 Tax Notes 110 (Jan. 3, 2005).

53 The Treasury Department recently made a similar recommendation. *See* Department of the Treasury, *General Explanations of the Administration's Fiscal year 2008 Revenue Proposals*, 66 (Feb., 2007).

54 Financial institutions that participate in the qualified payment card agent (QPCA) program, which allows them to satisfy information reporting obligations for both the payee and payor, should have much less difficulty modifying their systems than other financial institutions. *See, e.g.*, T.D. 9136, 69 Fed. Reg. 41938 (July 13, 2004); Rev. Proc. 2004-42, 2004-2 C.B. 121.

55 IRM 4.10.3.7 (Mar. 1, 2003); IRM 4.10.4.3.3.6 (Sept. 11, 2007).

56 IRC § 6049.

know the financial institution in which the income is deposited must provide information about their accounts to the IRS. Moreover, IRS auditors would be more likely to uncover underreporting if they could request account statements using specific names of financial institutions and account numbers.

Example

Taxpayer Z, who operates a cash business, deposits cash earnings into both business and personal accounts. Z's business account bears interest, but one of his personal checking accounts does not. In an effort to avoid bouncing personal checks, Z sometimes deposits cash earnings directly into his non-interest-bearing personal account without taking the time to document the income on the business's books. Because Z knows the IRS will be aware of his business account, which is subject to information reporting, he is careful to report all of the income deposited into that account on his return. Z is not so careful in reporting cash income deposited into his personal non-interest-bearing account.

Recommendation

Require financial institutions to report the existence of accounts to the IRS that do not bear $10 or more in interest per year.

KLR #3

Home Office Business Deduction

Problem

The tax laws regarding the home office deduction are considered by many to be too complex and the recordkeeping responsibilities associated with the deduction to be too time-consuming. It is questionable whether most taxpayers who are eligible to take the deduction actually do so. In addition, the process of reporting the deduction differs depending on whether the taxpayer is an employee or self-employed. Further, among self-employed taxpayers, the reporting system lacks parity between farming and nonfarming businesses.

Congress, small business trade organizations, and the IRS Office of Taxpayer Burden Reduction (OTBR) have all supported simplification of the home office deduction. In most proposed solutions, simplification takes the form of an optional standard home office deduction. However, issues exist regarding the types of expenses included in the amount of the standard rate as well as the impact on revenue.

Example

A taxpayer started her farming business, a sole proprietorship, in tax year 2007. She uses a 160 square foot room in her 2,400 square foot house exclusively to conduct all of the administrative and managerial activities of the business. Because the taxpayer has a business degree, she feels confident in preparing her own 2007 Form 1040, including Schedule F, Profit or Loss From Farming. The taxpayer is generally aware of the existence of a home office deduction but is unsure if it is available to farmers. While completing Schedule F, it is not readily apparent that the home office deduction is available to the taxpayer, because it is not specifically listed as a farm expense on the tax form. After conducting a little research, the taxpayer notes that the instructions to Schedule F, Line 34, "Other Expenses" have a paragraph describing "Business use of your home." The instructions direct the taxpayer to IRS Publication 587, Business Use of Your Home, to determine eligibility and to use a 41-line worksheet in the publication to calculate the available deduction. Due to the complexity of these calculations, the taxpayer seriously considers foregoing the deduction because of the time it would take to compute, given that the calculation would also require her to compute depreciation on her home.

Recommendation

Amend IRC § 280A to create an optional standard home office deduction. The legislative provision should provide the following:

- Direct the Secretary of the Treasury to draft regulations detailing a method to calculate an optional standard home office deduction;
- Require that such regulations calculate the deduction by multiplying an applicable standard rate, as determined and published by the Commissioner of the IRS on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in § 280A(c); and
- Encourage the IRS to simplify the reporting of the optional standard deduction on Schedule A, Itemized Deductions; Schedule C, Profit or Loss From Business; and Schedule F, Profit or Loss From Farming.

Present Law

Internal Revenue Code (IRC) § 280A allows a deduction of expenses associated with the business use of the taxpayer's residence. To qualify for the deduction, the taxpayer must use that portion of the home regularly and exclusively as one of the following:

1. A principal place of business for any trade or business of the taxpayer;
2. A place to meet or deal with patients, clients, or customers in the normal course of the taxpayer's trade or business; or
3. In the case of a separate structure which is not attached to the taxpayer's home, in connection with the taxpayer's trade or business.[1]

The deduction is available to self-employed taxpayers and employees, who must use the home office for the convenience of their employers.[2] The deduction also applies to expenses attributable to space within the home used on a regular basis to store inventory or product samples, as long as the home is the sole fixed location of the business.[3]

If the taxpayer uses the space on a regular basis for providing daycare services, he or she can deduct business expenses for the portion of the home used for such services even if the same space is used for nonbusiness purposes. Thus, daycare providers have an exception to the exclusive use requirement. However, the expenses attributed to the daycare space are deductible only for the period the space is used for business purposes.[4]

The amount of the home office deduction is limited if the gross income from the business is less than total business expenses. Specifically, the deduction of otherwise nondeductible expenses that are allocable to the business (such as home insurance, utilities, and depreciation on the dwelling unit) cannot generate or increase a net loss in the business.[5]

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1 IRC § 280A(c).

2 *Id.*

3 IRC § 280A(c)(2).

4 IRC § 280A(c)(5).

5 *Id.* For details on calculating the deduction limit and carryover, see IRS Pub. 587, *Business Use of Your Home* 7.

Expenses eligible for the home office deduction include the business portion of real estate taxes, mortgage interest, rent, utilities, insurance, painting and repairs, and casualty losses, as well as depreciation of the business portion of the dwelling unit. Generally, the amount of deductible expenses is based on the portion of the item attributed to the business use of the home. [6]

Once the residence is sold, the exclusion of gain from the sale of the principal residence in IRC § 121 does not apply to the extent of the amount of straight-line depreciation allowed or allowable after May 6, 1997. The taxpayer will have to recognize gain on that amount, at a special maximum capital gains rate of 25 percent. This taxation of gain to the extent of prior depreciation applies even if the taxpayer did not deduct the full amount of depreciation allowable, unless the taxpayer can establish by adequate records or other evidence that the amount actually allowed was less than the amount allowable.[7]

Reasons For Change

Reporting the Deduction is Complicated

The home office business deduction is reported on several different schedules, depending on whether the taxpayer is an employee (Schedule A), a self-employed individual with nonfarm business income (Schedule C), or a self-employed individual with farm income (Schedule F). Employees who itemize deductions on Schedule A report the deduction on Line 21, "Unreimbursed employee expenses." The taxpayer must also attach Form 2106, Employee Business Expenses.

For self-employed taxpayers, reporting the home office deduction depends on the type of business conducted. [8] In general, self-employed taxpayers with nonfarm business income report the deduction on line 30, "Expenses for business use of your home," of Form 1040, Schedule C, which directs the taxpayer to attach Form 8829, Expenses for Business Use of Your Home. Self-employed taxpayers with farm income report the deduction on Line 34, "Other expenses," of Form 1040, Schedule F. Schedule F does not direct the taxpayer to attach Form 8829 because it is not available for farmers. However, the instructions for Line 34 of Schedule F include a one-paragraph description of deductible expenses and direct the taxpayer to a worksheet in IRS Publication 587, Business Use of Your Home.

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6 On an annual basis, the taxpayer must reduce the adjusted basis of the home by the amount of the allowable depreciation. IRC § 167(e)(3).

7 Upon the sale of the home, the taxpayer must determine the amount of gain on the sale, which is the amount realized on the sale minus the adjusted basis of the real estate. The taxpayer then reduces the amount of gain by the home sale exclusion pursuant to IRC § 121. However, the IRC § 121 home exclusion does not apply to the extent of the amount of depreciation allowable or allowed after May 6, 1997. Thus, the taxpayer must typically recognize gain to the extent of depreciation allowed or allowable after May 6, 1997. IRC § 121(d)(6). Furthermore, in some cases, where depreciation allowed or allowable exceeded the amount allowable on the straight-line method, the excess must be recaptured and a corresponding portion of the gain recognized as ordinary income. IRC §§ 121, 280A, 1250(a)(1)(A) and (b)(3); IRS Pub. 587, *Business Use of Your Home* 9-11, 14.

8 IRS Pub. 587, *Business Use of Your Home* 18.

Thus, Schedules C and F lack consistency with respect to the home office business deduction, because Schedule F does not include clear language to remind farmers about the existence of the deduction. Unless the taxpayer or return preparer diligently reads the instructions for Line 34 on Schedule F and the related publication, the absence of a specific line for the deduction may lead taxpayers and preparers to believe the deduction is not available to farmers.[9] In fact, the IRS recently issued a fact sheet on farm income and expenses but it made no mention of home office business deductions.

Home Office Deduction is Not Fully Utilized

Small business owners are increasingly utilizing their homes as a primary place to conduct business.[10] According to U.S. Census data, between 1999 and 2005 the number of home offices used exclusively for business increased approximately 20 percent.[11] In addition, it is estimated that slightly over half of small businesses are home-based,[12] yet many of the business owners do not take the home office deduction. Of the nearly 20 million Schedule C filers in tax year 2003, approximately 2.7 million claimed the deduction.[13] At the same time, 8.4 million respondents to the federal government's American Housing Survey for the United States in 2003 indicated they had one or more rooms used only for business.[14] Although the figures are derived from different sources and cannot be accurately compared, the data does raise questions about whether eligible taxpayers are taking the deduction. The discrepancy of over five million is likely not solely attributable to Schedules F and A filers.

Private industry has claimed that Form 8829 is too complicated and the rules regarding the home office deduction are too complex.[15] The National Association for Self-Employed (NASE) stated in 2005 testimony before the House Committee on Small Business that "[m] any home-based business owners do not make use of the home office deduction due to the

9 IRS, *Reporting Farm Income and Expenses, FS-2007* (June 2007).

10 National Association of Self-Employed, Home Office Deduction Simplification, *available at* http://advocacy.nase.org/issue_briefs/2007/HomeOfficeDeduction.asp; NASE Press Release, NASE Members Speak Out on the Home Office Deduction in May's Member Poll (June 7, 2005).

11 Approximately 9.4 million respondents to a 2005 American Housing Survey conducted by the U.S. Census Bureau, indicated that they have one or more rooms in their home solely dedicated to business use, which is an approximate 20 percent increase from 7.8 million in 1999. U.S. Department of Housing and Urban Development and U.S. Census Bureau, *American Housing Survey for the United States: 1999*, Table 2.3 (March 2003); U.S. Department of Housing and Urban Development and U.S. Census Bureau, *American Housing Survey for the United States: 2005*, Table 2.3 (Aug. 2006).

12 According to the Small Business Administration, approximately 52 percent of all firms are home-based. Small Business Administration, Office of Advocacy, *Frequently Asked Questions* 1 (updated Aug. 2007); *see also* Henry B.R. Beale, Microeconomic Applications, Inc., Home-Based Business and Government Regulation, at ES-1(Feb. 2004) (Research contracted by the Small Business Administration Office of Advocacy, reporting that over two-thirds of all sole-proprietorships, partnerships and S corporations are home-based).

13 IRS Compliance Data Warehouse, *Individual Return Transaction File for Tax Year 2003*. Note that 2,995,003 Schedule C filers claimed the home office expense out of a total number of 20,596,287 Schedule C filers in tax year 2005. IRS Compliance Data Warehouse, *Individual Return Transaction File for Tax Year 2005*. The number of farmers and employees claiming the deduction is not available for Schedules F and A filers.

14 U.S. Department of Housing and Urban Development and U.S. Census Bureau, *American Housing Survey for the United States: 2003* at 46 (Sept. 2004).

15 *Paperwork Reduction Efforts of the Internal Revenue Service: Hearing Before the Subcomm. on Regulatory Affairs of the H. Comm. On Government Reform*, 109th Cong., 1st Sess. (May 25, 2005) (statement of the National Association for the Self-Employed). Further, Form 8829 was identified by tax practitioners at a 2002 Tax Forum focus group as "one of the most burdensome federal tax forms or schedules that must be completed by small business taxpayers." IRS Office of Taxpayer Burden Reduction, *Office in the Home Project (OIH) Briefing Paper* (July 12, 2007).

complexity of the deduction and stringent criteria they must meet."[16] In addition, a 2006 survey conducted by the National Federation of Independent Business (NFIB) Research Foundation found approximately 33 percent of small-employer taxpayers try to understand the tax rules governing home office business deductions, but only about half of those respondents believe that they actually have a good understanding of the rules.[17] Further, in a member survey conducted by the National Association for the Self-Employed in March 2006, 72 percent of respondents favored the simplification of the home office deduction.[18]

Office of Taxpayer Burden Reduction Project

In July 2005, the IRS Office of Taxpayer Burden Reduction (OTBR) established a team with members from several IRS functions to address simplification of the home office deduction as a Burden Reduction Project. The project team recommended that the IRS issue guidance announcing an optional standard rate per square foot as an alternative for Schedule C, F, and A filers, and that the IRS develop a worksheet in the instructional booklet so that taxpayers no longer need to complete a separate form. The proposed standard rate would include factors for mortgage interest and real estate taxes (or a rent equivalent), utilities, repairs, maintenance, and home insurance. OTBR was flexible about whether or not the rate should include either a mandatory or optional factor for depreciation.[19] If the rate does include depreciation, the associated worksheet would have a separate line indicating the depreciation portion of the deduction to assist the taxpayer in tracking depreciation for recapture purposes.[20]

OTBR has acknowledged that this proposal will significantly impact revenue. Simplifying the deduction may not only encourage eligible taxpayers to take the deduction but might also increase noncompliance. However, OTBR believed the proposal would correct an inequity and save enforcement resources. The IRS would still need to examine compliance with IRC § 280A requirements, such as the "exclusive use test," and the duplication of expenses, but it would be relieved of examining time-consuming and complex Forms 8829.[21]

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16 *Reforming the Tax Code to Assist Small Businesses: Hearing Before the H. Comm. on Small Business*, 109th Cong. 1st Sess (Sept. 21, 2005) (statement of Kristie L. Darien, Executive Director, National Association for the Self-Employed). An informal poll conducted by NASE found that over 60 percent of micro-business owners working from home do not take the home office tax deduction. Thirty-nine percent of respondents who did not take the deduction said the paperwork required is too burdensome and time-consuming. NASE Press Release, *Home Office Tax Deduction Too Difficult to Take, Say Micro-Business Owners* (July 26, 2006).

17 NFIB Research Foundation, *National Small Business Poll: Tax Complexity and the IRS* (2006).

18 National Association of Self-Employed, *Tax Time: NASE Member Surveys* (March 2006).

19 OTBR and IRS Research estimate the depreciation factor to be approximately $0.67 per square foot out of an approximate $5.96 per square foot rate, based on data from the U.S. Census's American Housing Survey for the United States in 2003. Memorandum From Beth Tucker, Acting Director of OTBR, *Proposal to Issue a Revenue Procedure Establishing a Standard Rate for the Office in the Home (OIH) Deduction:* Related Tax Policy Issue (May 16, 2006).

20 Office of Taxpayer Burden Reduction, Office in Home Project (OIH) Briefing Paper (July 12, 2007). IRS SB/SE Research estimated the amount of the standard rate based on data from the U.S. Census's American Housing Survey for the United States: 2003. The total rate of $5.96 included the following component parts: $3.02 for mortgage interest, $0.75 for real estate taxes, $0.30 for home insurance, $0.16 for repairs and maintenance, $1.06 for utilities and $0.67 for depreciation. Memorandum From Beth Tucker, Acting Director of OTBR, *Proposal to Issue a Revenue Procedure Establishing a Standard Rate for the Office in the Home (OIH) Deduction:* Related Tax Policy Issue (May 16, 2006)

21 Memorandum From Beth Tucker, Acting Director of OTBR, *Proposal to Issue a Revenue Procedure Establishing a Standard Rate for the Office in the Home (OIH) Deduction: Related Tax Policy Issue* (May 16, 2006).

Support for Optional Standard Deduction

Simplification of the home office deduction through standardization has received congressional attention as well as support from private industry. Small business trade associations support an optional standard home office deduction to improve tax compliance and reduce tax administrative costs for small business owners.[22] In addition, several bills have included provisions to standardize the deduction.[23] For example, the Home Office Tax Simplification Act of 2002, which was proposed in H.R. 5220 of the 107th Congress, provided for a minimum deduction of $2,500 under IRC § 280A(c).[24] In the 109th Congress, H.R. 3080 and S. 1305 both proposed the Parents' Tax Relief Act of 2005, which included a similar minimum deduction of $2,500 but further limited the deduction to the amount of the gross income of the business at issue.[25] In the 110th Congress, the standard deduction capped by the amount of gross income of the business was included in S. 816 and H.R. 1421 as part of the Parents' Tax Relief Act of 2007.[26]

The standardization of home office expenses would not be the first time either Congress or the Department of Treasury has standardized deductions to reduce the burden on taxpayers. For example, Congress created a standard deduction for individual taxpayers who choose not to itemize. IRC § 63 sets specific amounts for the standard deduction and allows for inflationary adjustments. In addition, pursuant to authority granted in IRC § 274, Treasury created by regulation an optional standard mileage rate for the business use of a vehicle to alleviate the burden of substantiating actual expenses.[27] Specifically, Treas. Reg. § 1.274-5(j)(2) grants the IRS Commissioner authority to establish a method under which the taxpayer can use a standard mileage rate to determine the expenses associated with using a vehicle for business purposes.[28]

Explanation of Recommendation

To alleviate taxpayer burden associated with complexities in reporting the home office deduction, the National Taxpayer Advocate recommends that Congress amend IRC § 280A to provide an optional standard home office deduction. All taxpayers eligible to take the

22 *See, e.g., Closing the Tax Gap: Hearing Before H. Comm. On Small Business (April 26, 2007)* (statement of the National Association of Home Builders); National Federation of Independent Businesses, *Home Businesses Need Simplified Recordkeeping, Standard Deduction*, available at http://www.nfib.com/page/homeofficededuct.html (last visited on Nov. 19, 2007).

23 See also, House Committee on Small Business, *Small Business Committee Notes* (Feb. 17, 2006).

24 § 2, H.R. 5220, 107th Cong. (July 25, 2002).

25 § 5, H.R. 3080, 109th Cong. (June 27, 2005). See also, § 5, S. 1305, 109th Cong. (June 23, 2005).

26 § 5, H.R. 1421, 110 Cong. (March 8, 2007); § 5, S. 816, 110 Cong. (Mar. 8, 2007).

27 IRC § 274(d) provides " The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations."

28 Treas. Reg. § 1.274-5(j)(2) provides "The Commissioner may establish a method under which a taxpayer may use mileage rates to determine the amount of the ordinary and necessary expenses of using a vehicle ...in lieu of substantiating the actual costs. The method may include appropriate limitations and conditions in order to reflect more accurately vehicle expenses over the entire period of usage. The taxpayer will not be relieved of the requirement to substantiate the amount of each business use ... or the time and purpose of each use." For an example of a revenue procedure setting the business standard mileage rate, see Rev. Proc. 2007-70, 2007-50 I.R.B. 1162 (Dec. 10, 2007).

home office deduction pursuant to the requirements set forth in IRC § 280A(c) would have the option to use a standard rate in determining the deduction to include on either Schedule A, C, or F of Form 1040. The applicable standard rate would be multiplied by the allowable square footage of the home office. The rate would be determined and published on a periodic basis by the IRS and would factor in values for mortgage interest, real estate taxes, utilities, repairs, maintenance, home insurance, and depreciation.[29] Schedules A, C, and F would have a dedicated line for the optional standard deduction with worksheets included in the instructions to the schedules.

Statutory Creation of a Standard Deduction

The proposed legislation would amend IRC § 280A to give the Secretary authority to draft regulations providing an optional method to calculate the home office deduction. The legislative provision would direct the Secretary to establish a method for taxpayers to use an applicable standard rate to determine the amount of the ordinary and necessary expenses of using a home office in lieu of substantiating actual costs. The legislation would also generally describe the way taxpayers would multiply the applicable standard rate by the allowable square footage, both of which would be determined and published periodically by the Commissioner. The amendment should also make clear that the eligibility rules in IRC § 280A(c), such as exclusive and regular use, apply to the optional standard home office deduction.

Calculation of the Standard Rates and Square Footage Limits

The IRS should periodically release the amount of the standard rates in a tiered structure for each type of business use, with the rates based on research of national averages for each type of business use. For example, research may show that average home office expenses associated with a daycare service are higher than expenses applicable to general business use, so the IRS would set the applicable standard rates accordingly. In addition, in calculating the amount of the standard rates, the IRS should consider data from the National Research Program (NRP) on inaccuracies associated with the home office business deduction.[30]

The IRS should also consider setting a maximum amount of allowable square footage for the optional standard deduction. The amounts should vary based on the type of business use of the space, and should be based on research to determine the needs for each particular type of business. For example, the cap on allowable square footage may be less for storage space than for daycare services.

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29 Taxpayers taking the standard deduction would need to be clearly informed that they should not duplicate expenses on Schedule A. Thus, if the taxpayer takes the optional standard home office deduction, the taxpayer would need to reduce real estate taxes and mortgage interest amounts accordingly. This is currently the case with taxpayers who take the home office deduction, and can be incorporated into the relevant worksheets and instructions.

30 In fact, in response to the National Research Program (NRP) tax gap estimates for tax year 2001, the IRS released a set of fact sheets to educate taxpayers and reduce inadvertent return errors. One such fact sheet covered the topic of the home office deduction. IRS, *Home Office Deduction Reminders, FS-2006-25* (Sept. 2006).

Component Expenses of the Standard Rate

In calculating the standard rate, the IRS would need to break down the rate into component parts. The recommended deduction worksheet would also need to separately state the amounts allocated to several types of expenses in order to reduce the burden on the taxpayer. The components that must be clearly identified are real estate taxes, mortgage interest, and depreciation.

If the business owner takes the optional standard deduction and itemizes deductions on Schedule A, he or she must be careful not to duplicate deductions for real estate taxes and mortgage interest. Thus, it is important that the instructions clearly state that the taxpayer should adjust the amounts taken as personal itemized deductions by the amounts reflected in the standard rate. This should not add complexity to the return, because taxpayers are already expected to reduce personal itemized deductions by the portion deducted as business expenses.

It is important to clearly identify the depreciation portion of the standard rate. Upon the sale of the residence, the taxpayer must recapture any allowed or allowable additional depreciation.[31] However, for simplification purposes, the depreciation component of the standard rate should be calculated based on the straight-line method of depreciation, which would make the recapture calculation unnecessary. Nonetheless, the taxpayer would still need to track depreciation, because on the sale of the residence, the amount of the home sale exclusion in IRC § 121 must be reduced by any depreciation allowed or allowable after May 6, 1997. Thus, clearly identifying the depreciation portion would simplify the process by allowing the taxpayer to easily track depreciation.

Prohibition on Switching Between Methods

In the interest of simplification, a taxpayer should not be allowed to switch back to the actual expense method once he or she elects the optional standard home office deduction.[32] However, if a taxpayer who has elected the standard deduction incurs disaster-related expenses in a particular year, the taxpayer should be allowed to include those expenses as part of the home office deduction. Because the standard deduction would not compensate for disaster-related expenses, the associated publications and instructions should instruct taxpayers to claim disaster-related expenses in addition to the standard home deduction expenses on Form 8829 or the related worksheet (for Schedule F filers), as applicable. In future years, the taxpayer would continue to take the simplified standard deduction, but would not be required to fill out the more complicated form or worksheet.

31 IRC § 1250.

32 This is in contrast to the rules related to the standard mileage rate. Once a taxpayer elects the optional standard mileage rate, it is generally not permissible to switch back to deducting actual costs unless the taxpayer depreciates using the straight-line method of depreciation for the car's estimated useful life subject to any applicable limitations under IRC § 280F. Rev. Proc. 2007-70, 2007-50 I.R.B. 1162 (Dec. 10, 2007).

Response to Revenue Concerns

The National Taxpayer Advocate recognizes that the creation of a standard home office deduction may have a significant impact on revenue. However, the IRS should encourage taxpayers to take tax deductions for which they are eligible and remove barriers that prevent them from making use of these deductions. Complexity should not be a tool to protect the budget. It makes sense to reduce IRS and taxpayer burden in administering this congressionally authorized deduction when data clearly establishes both the underutilization of the deduction and an increasing trend in the use of home offices. In addition, simplification of the deduction is designed to minimize opportunities for inadvertent noncompliance, which will likely save compliance resources. Finally, in calculating the amount of the rate for the standard deduction, the IRS should take into consideration data from the NRP with respect to this deduction, which should lead to a downward adjustment in the rate.

The National Taxpayer Advocate is further aware that the standard rate would not fully address complexities associated with home value differentials as well as the differences associated with renting versus owning the residence. However, if a taxpayer incurs eligible home office expenses significantly above the national average, the taxpayer can choose between the simplicity of the lower standard deduction or a higher yet more complicated deduction based on actual expenses.

KLR #4

Eliminate Tax Strategy Patents

Problem

Tax strategy patents grant private citizens monopolies on the application of our public tax laws.[1] These government-granted monopolies may:

- Mislead taxpayers into believing the government has approved a patented tax strategy;
- Undermine congressionally-created tax incentives;
- Create conflicts of interest between tax advisors and their clients; and
- Increase the cost of tax compliance and tax advice, even if it is not covered by a tax strategy patent.

By increasing compliance costs, tax strategy patents have the potential to reduce tax compliance. They also provide additional incentives for tax advisors to "invent" tax minimization strategies, which are exclusively reserved for those who can obtain a license from the patent holder. Allowing private parties to place a toll charge on tax compliance may reduce both respect for the tax system and voluntary compliance.

Moreover, tax strategy patents do not further the purpose of patent law, which is to promote the "progress of science and the useful arts" for public benefit.[2] If the patent law works as intended, society will spend more resources to "invent" tax minimization strategies. Additional spending on tax planning, however, cannot fairly be characterized as a public benefit. Economists often characterize tax planning expenses as a "deadweight loss" to society.[3]

1 For purposes of this discussion, a "tax strategy patent" means a patent that includes any claim to a "tax planning invention," as defined in S. 2369, or any tax law or specific application of tax law. S. 2369 defines a "tax planning invention" as a "a plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, avoid, or defer, or has, when implemented, the effect of reducing, minimizing, avoiding, or deferring, a taxpayer's tax liability or is designed to facilitate compliance with tax laws, but does not include tax preparation software and other tools or systems used solely to prepare tax or information returns."

2 U.S. Constitution, Art. I, Sec. 8, Cl. 8.

3 *See, e.g.*, Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 25 (Sept. 2004), *available at* http://www.community-wealth.org/_pdfs/articles-publications/state-local-new/paper-slemrod.pdf (explaining "whether voluntarily incurred or not, [tax planning] represents a cost to the nation. What is done voluntarily will generally be a good investment *ex ante* from the company's, or the shareholders', perspective, but from the country's point of view it represents a deadweight loss."). The Joint Committee on Taxation has also observed that "many would argue that no social gains from novel tax planning strategies exist as any gain to the user of the strategy is offset by losses to the Treasury, and therefore the resources devoted to producing and using such strategies represent a net loss to society." *See* Joint Committee on Taxation, JCX-31-06, *Background and Issues Relating to the Patenting of Tax Advice*, 25 (July 12, 2006), *available at* http://www.house.gov/jct/x-31-06.pdf. For an overview of the issues raised by tax strategy patents, see John R. Thomas, Congressional Research Service, CRS Report for Congress, *Patents on Tax Strategies: Issues in Intellectual Property and Innovation* (Oct. 25, 2007).

Examples

Example 1: Tax strategy patents may reduce compliance by increasing compliance costs.[4] A business hires a tax practitioner to prepare its returns and provide routine tax planning advice. The practitioner wants to advise the business to deduct interest on certain "convertible debt." He would also like to recommend that the business engage in a tax-favored exchange of property for "like-kind" property, as permitted under § 1031 of the Internal Revenue Code (IRC). A cursory search of the U.S. Patent and Trademark Office (PTO) website, however, reveals that some processes involving convertible debt and like-kind exchanges are covered by patents.[5]

The practitioner consults a patent attorney. Without providing a written opinion, which would cost $10,000, the attorney says the recommendations are probably not covered by patents.[6] He advises that even if they are covered, it would be difficult for a patent holder to identify the client-business as a possible infringer. If the business is identified, however, both the business and the practitioner could be sued for infringement.[7] Because of the small possibility that the tax practitioner's advice could subject him to liability, he consults with an ethics attorney to determine if he needs to obtain a waiver of this conflict of interest before discussing his recommendations with the client.

After receiving a bill for the time the practitioner spent researching both tax and patent-related issues, will the business decide not to seek further professional tax advice necessary to comply with the tax laws? Given the limited risk of being audited by the IRS and the significant cost to determine whether routine tax planning and compliance could subject it to patent litigation, will the business obtain the tax savings to which it believes it is entitled -- without incurring additional fees -- by simply underreporting its income? For some businesses, the answer to these questions will be "yes," and tax compliance will suffer.

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4 Example 1 illustrates concerns raised by various commentators. *See, e.g.*, Kimberly S. Blanchard, New York State Bar Association, *NYSBA Says Applying Patent Law to Tax Advice Could Cause Problems*, 2006 TNT 160-18 (Aug. 18, 2006) ("The tax laws... are perhaps unique in that they impose universal affirmative obligations of compliance on U.S. citizens and residents. The entrepreneur that wishes to set up a new business requiring some patented technology to operate always has the choice to pay the royalty or not to engage in the business in question, and will weigh the costs against the expected profits. But when the same entrepreneur enters into even the simplest transaction – for example, incorporating his sole proprietorship -- he has no choice but to seek tax advice, if for no other reason than to report the transaction correctly on his tax return. The patenting of tax strategies would invariably increase the cost to taxpayers of complying with their tax obligations, a result we think is indefensible as a policy matter.").

5 *See, e.g.*, Patent No. 7,219,079 (May 15, 2007) (convertible debt); Patent No. 6,292,788 (Sept. 18, 2001) (like-kind exchange).

6 *See* American Intellectual Property Law Association, *Report of the Economic Survey 2005*, 18 (Sept. 2005) (indicating that the average cost of an infringement/non-infringement opinion is $10,000).

7 Some have suggested that even reporting a transaction on a tax return could constitute infringement if the underlying transaction infringes a tax strategy patent. *See* Kimberly S. Blanchard, New York State Bar Association, *NYSBA Says Applying Patent Law to Tax Advice Could Cause Problems*, 2006 TNT 160-18 (Aug. 18, 2006); Joint Committee on Taxation, JCX-31-06, *Background and Issues Relating to the Patenting of Tax Advice*, 28 (July 12, 2006), *available at* http://www.house.gov/jct/x-31-06.pdf.

Example 2: Tax strategy patents could be used to deceive taxpayers and promote tax shelters.[8] Before learning that tax strategies could be patented, a tax shelter promoter protected his tax schemes by disclosing them only to those who agreed to keep them confidential. Current Treasury Regulations classify transactions offered under "conditions of confidentiality" as "reportable transactions," meaning participants are required to flag the transactions for the IRS by attaching a disclosure statement to their returns and by sending a copy to the IRS Office of Tax Shelter Analysis.[9] As an alternative to offering tax schemes under "conditions of confidentiality," the promoter decides to protect them by applying for tax strategy patents.

Because his strategies are protected by patents, the promoter does not impose "conditions of confidentiality." Since they are not otherwise classified as "reportable transactions," they do not have to be flagged for the IRS.[10] Since many taxpayers would not invest in a scheme that had to be reported to the IRS Office of Tax Shelter Analysis, the promoter is more successful in marketing patented shelters than those subject to "conditions of confidentiality."

As an added marketing benefit, the promoter can say that he has a "patent pending" or in some cases that a strategy is "patented," with the implication that it has been approved by the U.S. government. Since many unsophisticated investors might assume the government would not be so inefficient as to issue a patent on a tax strategy that the IRS would later have to challenge on a case-by-case basis, they might be persuaded to pay for a patented strategy that does not "work."

Example 3: Tax strategy patents could undermine tax law. At least one bar association and several commentators have concerns that a business could patent the only method of obtaining a proposed tax benefit before Congress or a court determines that

8 Example 2 illustrates initial concerns of the Joint Committee on Taxation. *See* Joint Committee on Taxation, JCX-31-06, *Background and Issues Relating to the Patenting of Tax Advice*, 22 (July 12, 2006). Some commentators have noted that a few patented strategies are somewhat aggressive. *See, e.g.*, Jasper L. Cummings, *Tax Strategy Patents*, 115 Tax Notes 263 (Apr. 16, 2007) (suggesting that Patent 7,096,195 (Aug. 22, 2006) does not "work" from a tax perspective). On July 13, 2006, however, after describing IRS's analysis of existing tax strategy patents, former IRS Commissioner Everson stated "thus far …[the IRS has] not seen the use of the patents in developing or marketing aggressive or abusive tax strategies." Statement of Commissioner Everson Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (July 13, 2006), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5104. Another possibility, however, is that patented strategies could be designed to attract taxpayers who have a particular tax problem. Once the promoter identifies these taxpayers he could provide them with more aggressive tax schemes designed to address the same problem. The promoter might not feel the need to impose conditions of confidentiality before disclosing the scheme to this smaller group of taxpayers, especially since many of these taxpayers would likely have independent reasons for keeping the scheme confidential (*e.g.*, to retain a competitive advantage or to avoid an audit or adverse publicity).

9 Treas. Reg. §§ 1.6011-4(a); 1.6011-4(b)(3); 1.6011-4(d).

10 The Treasury Department previously requested comments on using the "reportable transaction" disclosure regime to address tax patents. *See* Prop. Treas. Reg. § 1.6011-4 preamble, 71 Fed. Reg. 64,488, 64,490 (Nov. 2, 2006). Currently proposed regulations would include patented transactions as a category of "reportable transactions." *See* Prop. Treas. Reg. § 1.6011-4(b)(7), 72 Fed. Reg. 54,615 - 54,618 (Sept. 26, 2007).

the tax benefit is legally available.[11] If the business does not plan to apply for a patent outside the United States, the patent application might not be available to the public while Congress or a court is considering the issue.[12] Once the benefit becomes legally available, the business would be entitled to collect a licensing fee from its competitors and other taxpayers for using its method (perhaps the only method) to obtain the benefit. Thus, the business could undermine the legislative purpose of the benefit by placing a private toll on its use. While it may be difficult for some to imagine the USPTO granting or a court upholding such a patent, Congress should eliminate any uncertainty in this regard.

Recommendation

The National Taxpayer Advocate recommends that Congress bar tax strategy patents and prevent patent holders from enforcing them.[13] If Congress does not prohibit them, it should require the PTO to provide the IRS with copies of all tax strategy patent applications so that the IRS can determine whether the strategy should be "listed" as one that has to be flagged for the IRS. The legislation should also provide for the IRS to assist the PTO in identifying claims that are not unique.

Present Law

Patents encourage innovation by granting monopolies to inventors.

Patent laws encourage technological progress and invention by granting an inventor a legal monopoly on his or her invention.[14] In exchange, the inventor must disclose the invention to the public by describing it in sufficient detail to allow others to use it.[15] Monopoly power encourages invention by allowing inventors to recover their research and development costs by charging monopolistic prices. A patent confers monopoly power by allowing

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11 *See, e.g.*, Kimberly S. Blanchard, New York State Bar Association, *NYSBA Says Applying Patent Law to Tax Advice Could Cause Problems*, 2006 TNT 160-18 (Aug. 18, 2006) (suggesting that a practitioner could have patented the strategy of amortizing FCC licenses at a time when the IRS took the position that such amortization was not permissible, thereby enabling the patent holder to charge others to obtain the amortization deduction after the courts determined that FCC licenses were amortizable); Charles F. Weiland and Richard S. Marshall, *Tax Strategy Patents – Policy and Practical Considerations*, 47 Tax Management Memorandum 499, 510 (Dec. 11, 2006) (suggesting that private parties might patent proposed tax legislation). *See also* Joint Committee on Taxation, JCX-31-06, *Background and Issues Relating to the Patenting of Tax Advice*, 25 (July 12, 2006) (noting the risk that "patent-holders could effectively claim ownership of certain routine planning tools, or even of a method which constitutes the most efficient (or, in the extreme, the only) manner of complying with the requirements of the Internal Revenue Code"). The IRS Chief Counsel reportedly expressed similar concerns. Dustin Stamper, *Korb Laments Penalty Pileup, Vows More Practitioner-Driven Guidance*, 117 Tax Notes 421 (Oct. 29, 2007) (reporting that IRS Chief Counsel Don Korb "questioned how some people could think it is 'perfectly acceptable human behavior to file a piece of paper with the government that gives you the right, you alone, to interpret [a statute] which we're all bound by in a certain way – and if anybody else wants to interpret those words in that way they've got to pay you money.'").

12 Patent applications must be published 18 months after submission, but only if they are the subject of an international filing. *See* 35 U.S.C. § 122(b).

13 Some have expressed arguments for why tax strategy patents should be invalid under current law. *See, e.g.*, Andrew A. Schwartz, *The Patent Office Meets The Poison Pill: Why Legal Methods Cannot Be Patented*, 20 Harv. J.L. & Tech. 333 (Spring 2007); Robert King, *Only in America: Tax Patents and the New Sale of Indulgences*, 60 Tax Lawyer 761 (Spring 2007). H.R. 1908, H.R. 2136, S. 681 and S. 2369 would make tax strategies unpatentable. H.R. 2365 would limit the enforceability of tax strategy patents.

14 U.S. Constitution, Art. I, Sec. 8, Cl. 8; 35 U.S.C. § 101 *et seq.*

15 *See* 35 U.S.C. § 111; 35 U.S.C. § 112.

the holder to prevent others from making, using, offering to sell, selling, and importing any patented invention for a period of 20 years from the date his or her patent application is filed.[16]

Because monopolies harm consumers and businesses by stifling competition, raising prices, and fostering costly litigation, they are only granted for certain inventions. An inventor may only obtain a patent on any "process, machine, manufacture, or composition of matter" that is "novel," "useful," and "non-obvious."[17]

Why are tax strategies patentable?

Patents that purport to cover tax strategies are based on the notion that the strategies are patentable business "processes" or "methods" rather than abstract ideas.[18] Perhaps because applications for business method patents often consisted of abstract ideas or processes that were obvious, however, prior to the landmark *State Street* decision in 1998, courts would sometimes describe "business methods" as unpatentable.[19]

The *State Street* case involved a patent on a data processing system for calculating the shares of various mutual funds in certain partnerships – an investment structure called "hub and spoke" pooling vehicles.[20] The system allowed investment and tax results to be allocated to investors on a daily basis. This daily allocation was required so that aggregate year-end income, expenses, and capital gain or loss could be accurately determined for both tax and accounting purposes.[21] Although the *State Street* case was remanded and did not hold that the patent in question was valid, it clarified that patents could not be denied solely on a basis of the so-called business method exception.[22] Moreover, since the PTO generally presumes that an invention described in an application is novel and useful,[23] the most significant hurdle an applicant is likely to face is convincing a patent examiner that a tax strategy is not obvious.

16 *See* 35 U.S.C. § 271; 35 U.S.C. § 154(a)(2).

17 35 U.S.C. § 101 (imposing subject matter and usefulness requirements), § 102 (novelty requirement), § 103 (non-obviousness requirement).

18 A "process" is defined as a "process, art or method." 35 U.S.C. § 100.

19 *See State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368, 1375-1377 (Fed. Cir. 1998), *cert. denied* 525 U.S. 1093 (1999).

20 *Id.* The mutual funds (the "spokes") would pool their assets in an investment portfolio (the "hub") organized as a partnership.

21 Because Treasury Regulations required a daily allocation, the patent appeared to cover the only way for such entities to comply with the tax law. For a line by line comparison of the patent claims and Treasury Regulations, see Richard H. Stern, *Scope-of-Protection Problems with Patents and Copyrights on Methods of Doing Business*, 10 Fordham Intell. Prop. Media & Ent. L.J. 105, 121-124, Appendix A (1999).

22 One academic has noted that the tax advantages of the "hub and spoke" pooling vehicles were obvious and that such vehicles had been used by mutual funds since the 1980s. *See, e.g.*, William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 Fl. L. Rev. 229, n.68 (2007).

23 An invention is presumed to be novel unless the PTO determines that it is not novel based on its analysis of "prior art." 35 U.S.C §§ 102(a), (b). The PTO will accept an applicant's assertion that an invention has "utility" unless the assertion is not specific, substantial, and credible to a person of ordinary skill in the art. Utility Examination Guidelines, 66 Fed. Reg. 1,092, 1,098 (Jan 5, 2001). According to the PTO, it has issued patents on inventions that may have been illegal or immoral, such as: a method of producing alcoholic liquids during Prohibition; a radar detector, the use of which is unlawful in some jurisdictions; a device for use in cockfights; a gambling device; a method of euthanizing a mammal; and a method of preparing ricin toxin useful for toxicological warfare. *See* James Toupin, General Counsel, U.S. Patent and Trademark Office, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (July 13, 2006).

Taxpayers and tax advisors need to be concerned about patents that they do not know about.

Even if a person has no knowledge of a patent, he or she can be liable for infringement or actively inducing others to infringe without permission.[24] Thus, to avoid infringement, taxpayers and their advisors need to monitor tax strategy patents.

The consequences of infringing or being accused of infringing a patent can be substantial. Once the PTO issues a patent, a court will presume it is valid unless the accused infringer proves otherwise – a costly undertaking.[25] The patent holder may seek injunctive relief or money damages against an infringer and those who actively induce others to infringe.[26] Money damages must be no less than a reasonable royalty for the use made by the infringer.[27] In cases of "willful" infringement, the infringer may have to pay triple damages and the patent holder's attorney fees.[28]

Even if taxpayers and tax advisors are using the same tax strategies they used in prior years, they still need to monitor tax strategy patents.

Pursuant to the American Inventors Protection Act of 1999,[29] a person who can prove that he or she "actually reduced the subject matter to practice at least 1 year before the effective filing date of such patent," will not be liable for infringement of a patent on a "method of doing or conducting business."[30] Thus, certain "prior users" need not worry about infringing business method patents when conducting business as usual.

However, the defense may not always be available. Although the PTO classifies tax strategy patents as a type of business method, some may not be a "method of doing or conducting business" for purposes of the defense. The defense may not protect tax advisors who are infringers as a result of "inducing" others to infringe.[31] Moreover, it will not be available to

24 For certain types of infringement, a patent holder is not able to obtain a remedy for infringement that occurred before the infringer received notice (or constructive notice) of the patent. *See* 35 U.S.C. § 287.

25 35 U.S.C. § 282.

26 35 U.S.C. § 283-284 (2007). The definition of an infringer includes those who actively induce others to infringe. *Id.* An inducer may be jointly and severally liable along with the direct infringer. *See Crystal Semiconductor Corp. v. TriTech Microelectronics Intern., Inc.*, 246 F.3d 1336 (Fed. Cir. 2001). If a practitioner may induce infringement by providing a tax opinion on a proposed transaction that is covered by a patent, it is theoretically possible that the IRS could be inducing infringement when it provides a private letter ruling which is very similar to a tax opinion. Unlike general IRS guidance, only the taxpayer to whom a letter ruling is issued can rely on it. While the federal government may not be enjoined for infringement, it could have to pay "reasonable and entire compensation" for the unlicensed use of a patent. 28 U.S.C. § 1498(a) (waiving sovereign immunity).

27 35 U.S.C. § 284.

28 35 U.S.C. § 284 (authorizing triple damages); 35 U.S.C. § 285 (authorizing attorney fees). Courts have established that a finding of willful infringement is a sufficient basis for awarding triple damages and attorney fees. *See, e.g., Johns Hopkins Univ. v. CellPro, Inc.*, 152 F.3d 1342, 1364 (Fed. Cir. 1998) (triple damages); *Modine Mfg. Co. v. Allen Group, Inc.*, 917 F.2d 538, 543 (Fed. Cir. 1990) (attorney fees).

29 American Inventors Protection Act, Pub. L. No. 106-113, Div. B, § 1000(a)(9), 113 Stat. 1501, 1501A-555-557 (1999), *codified at* 35 U.S.C. § 273(b).

30 35 U.S.C. § 273(b)(1), § 273(a)(3). But, a person asserting this defense faces the possibility of having to pay the patent holder's attorney fees if the defense fails and the court finds there was no reasonable basis for the defense. *See* 35 U.S.C. § 273(b)(4) and § 273(b)(8).

31 *See generally*, Ellen P. Aprill, *Responding to Tax Strategy Patents*, Proceedings of the Fifth-Ninth Tax Institute, Gould School of Law, USC, 18, n.60 (2007), *available at* http://ssrn.com/abstract=980347. Some have predicted that even if the prior user defense applies to tax strategies, it will rarely be available. *See generally*, William A. Drennan, *The Patented Loophole: How Should Congress Respond to this Judicial Invention?*, 59 Fl. L. Rev. 229, 292 (2007).

a client-taxpayer unless he or she used the strategy at least one year before the filing date, regardless of the tax advisor's prior use. It will also be unavailable if the inventor files a patent application within one year of a change in the law upon which the tax strategy is based because during the first year after enactment, nobody will have had the opportunity to "use" such a strategy for a year or more. According to the PTO, the prior user defense is rarely if ever used.[32] Thus, taxpayers and practitioners could be infringing a tax strategy patent even if they are simply using strategies they used in prior years.

Reasons For Change

Tax strategy patents have increased dramatically in recent years

Following the *State Street* decision in 1998, business method patent applications (class 705), a category that includes tax strategy patent applications (705/36T), increased from 973 in 1997 to 10,015 in 2006, a 929 percent increase.[33] The number of examiners working on class 705 patent applications rose from 12 in late 1997 to 132 in 2006.[34] In 1997 the PTO had issued only 2 patents under its tax strategy classification, but as of November 13, 2007, the PTO's website reflected 60 patents and another 101 published applications.[35]

Tax strategy patent holders have started to enforce tax strategy patents, initiating costly litigation and stifling the free exchange of ideas

Tax strategy patents are beginning to generate litigation.

In 2003, a tax advisor obtained a patent on the tax strategy (called "SOGRAT") of funding a "grantor retained annuity trust" (GRAT) with stock options (SO).[36] A GRAT is a commonly used estate and gift tax planning device which allows a person (called a "grantor") to transfer assets to an irrevocable trust while retaining the right to receive annuity payments from the trust for a specified term, with the remainder going to a beneficiary at the end of the term. Although the transfer may be subject to gift tax, the amount subject to tax is reduced by the value of the annuity retained by the grantor.[37] The SOGRAT patent holder recently

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32 As of June 14, 2007, Wynn Coggins, director of the business methods technology center at the PTO, was unaware of any successful use of this defense. *See Congress Increasingly Interested In Patent Reform, Former W&M Tax Counsel Says*, 2007 TNT 116-9 (June 14, 2007).

33 Class 705 application filing, available at http://www.uspto.gov/web/menu/pbmethod/applicationfiling.htm. Tax related patents may also be found under categories "705/36R" and "705/31."

34 *See* USPTO White Paper, *Automated Financial or Management Data Processing Methods (Business Methods)*, 9 (2000) *available at* http://www.uspto.gov/web/menu/busmethp/index.html; James Toupin, General Counsel, U.S. Patent and Trademark Office, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (July 13, 2006).

35 *See* Dustin Stamper, *Tax Strategy Patents: A Problem Without Solutions?* 115 Tax Notes 300 (Apr. 23, 2007), *available at* http://www.taxanalysts.com/www/website.nsf/Web/TaxStrategyPatents?OpenDocument. For the current statistics, we searched the PTO website at http://patft.uspto.gov/netahtml/PTO/search-adv.htm and http://appft1.uspto.gov/netahtml/PTO/search-adv.html using the term "ccl/705/36T." This search may understate the number of tax strategy patent applications that have been filed. Applications must be published by the PTO 18 months after submission only if they are the subject of an international filing. 35 U.S.C. § 122(b). In addition, some tax strategy patents are not properly classified as such. For example, the tax preparation and submission category could easily include some tax strategy patents. On the other hand, according to press accounts, at least four approved patents and seven pending patents in the "tax strategy" category do not appear to have any tax implications and others look like benign software programs designed to perform tax calculations. Dustin Stamper, *Tax Strategy Patents: A Problem Without Solutions?* 115 Tax Notes 300 (Apr. 23, 2007).

36 Patent No. 6,567,790 (May 20, 2003).

37 *See generally*, IRC § 2702; Treas. Reg. § 25.2702-2(a).

sued the CEO of a public company for alleged infringement and has hired a firm to review publicly-available SEC filings to detect other potential infringers.[38] On April 12, 2007, a district court approved a confidential settlement of the case.[39]

Tax strategy patents may be stifling the free exchange of ideas

As another recent example of tax strategy patent enforcement, one patent holder reportedly obtained a list of attendees at a meeting in the area of tax law related to his patent and sent all the attendees a letter suggesting that they might be infringing.[40] Any subsequent infringement by these tax advisors or their clients is more likely to be subject to triple damages because the patent holder can more easily make the case that such infringement is willful.

Although one of the supposed benefits of the patent system is to promote public disclosure of technological innovation, few tax advisors are likely to respond to such developments by applying for patents on their tax strategies.[41] Instead, most tax advisors are likely to respond by guarding their strategies more closely to avoid being identified as potential infringers.

The prospect of costly patent litigation is increasing compliance costs for all taxpayers

According to one recent survey, typical patent infringement litigation costs each litigant about $650,000, even when less than $1 million is at risk.[42] Although tax advisors have complained that the SOGRAT is not novel or non-obvious, as is required for it to be a valid patent under current law, at least 14 firms are reported to have licensed the strategy.[43] To avoid potential patent infringement litigation, others have begun to advise clients not to use GRATs, even though GRATs were created and expressly approved by Congress.[44]

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38 *See Wealth Transfer Group LLC v. John W. Rowe*, No. 3:06-cv-00024-AWT (D. Conn., filed Jan. 6, 2006). *See* Deborah L. Jacobs, *Patent Pending: As Estate Planning Heats Up, It May Not Be Enough to Invent a Brilliant Tax-Saving Technique for Your Clients. You May Need to Patent It, Too.*, Bloomberg Wealth Manager (May 2005), *available at* http://www.marketsandpatents.com/may_ft_patent%20bloomberg%20may%2005.pdf.

39 *See Wealth Transfer Group, LLC v. John W. Rowe*, Case No. 3:06-cv-00024-AWT (Apr. 12, 2007).

40 *See, e.g.*, Ellen Aprill, Associate Dean of Academic Programs, Professor of Law, and John E. Anderson Chair in Tax Law, Loyola Law School, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (July 13, 2006), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5106#_ftn11.

41 Ethical rules make it difficult for tax lawyers to patent strategies they recommend to clients. *See, e.g.*, Colorado State Bar Association, Letter to Senators Obama, Levin and Coleman, *Patentability of Tax Advice and Senate Bill 681* (Mar. 5, 2007) *available at* http://tax.aicpa.org/Resources/Tax+Patents/ (discussing the ethical rules which might prevent a tax lawyer from patenting tax advice); Crystal Tandon, *Increased Awareness of Tax Patent Risks Needed, Say Practitioners*, 115 Tax Notes 304 (Apr. 23, 2007) (concluding "there may be insurmountable ethical issues regarding whether lawyers can patent a strategy they recommend to a client").

42 American Intellectual Property Law Association, *Report of the Economic Survey 2005*, 22 (Sept. 2005).

43 *See, e.g.*, Dennis I. Belcher, *Patenting of Transfer Tax Reduction Plans Should be Prohibited, McGuireWoods Partner Testifies at W&M Panel Hearing*, 2006 TNT 135-39 (July 14, 2006).

44 *See, e.g.*, Crystal Tandon, *Increased Awareness of Tax Patent Risks Needed, Say Practitioners*, 115 Tax Notes 304 (Apr. 23, 2007); Harry F. Lee, *Zero-Out GRATS and GRUTS -- Can Still More Be Done?* 1115 Tax Notes 637 (May 14, 2007); George G. Jones and Mark A. Luscombe, *Patenting Tax Strategies: A Troubling Storm Develops*, Web CPA (Sept. 9, 2006), *available at* http://www.webcpa.com/article.cfm?articleid=21538&pg=acctoday. *See also*, Dennis I. Belcher, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (July 13, 2006); Steve Seidenberg, *Crisis Pending, Can a patent on a legal strategy prevent a client from taking your advice? The courts may soon decide*, ABA Journal (May 2007).

Even just doing patent searches in connection with tax planning will increase costs, not to mention the cost of "designing around" an increasing number of patents. According to a recent survey, it typically costs $10,000 for a taxpayer to obtain an infringement/non-infringement opinion.[45]

Patents can create conflicts of interest which may further increase compliance costs. As clients recognize that they face little likelihood of being detected if they infringe a tax strategy patent, some will seek to limit the time their advisors spend on patent-related issues. Some clients may also want to avoid knowing about tax strategy patents because "knowing" infringement could subject both them and their advisors to triple damages. However, pursuant to ethical rules, some tax advisors must exercise due diligence in advising clients.[46] To fulfill this ethical requirement and avoid a malpractice claim, a diligent tax advisor may now feel the need to conduct a patent search, consult a patent attorney, identify any patents relevant to advice, and discuss with the client the possibility of licensing any existing patents and the consequences of infringement.[47] Discussing and resolving these issues will increase costs.

Even tax advisors willing to minimize fees for clients by ignoring tax strategy patents will have to increase their fees in response to insurance premium increases. Insurance carriers are aware of tax strategy patent issues.[48] As insurers begin to raise rates to account for the increasing risk of liability that tax strategy patents present, all tax advisors will face increasing costs, which they will pass along to clients.

In short, the costs of searching for patents, licensing them, avoiding them, litigating about them, and insuring against the threat of litigation (both patent and malpractice litigation) will directly or indirectly affect every taxpayer who needs to consult a tax advisor. As the cost of the tax advice needed to comply with the law increases, fewer taxpayers will be willing to make the effort and spend the resources to consult an advisor and take the necessary steps to comply with their tax obligations.

Tax strategy patents could undermine Congress' ability to use the tax code to influence behavior

As illustrated by the reaction of tax advisors to the SOGRAT patent, tax strategy patents may deter taxpayers and tax advisors from utilizing patented strategies and other related strategies even if those strategies do not infringe the patent. Such deterrence is understandable given the cost to litigate against infringement claims, even if the defense is ultimately successful. Thus, tax strategy patents may blunt Congress' ability to influence

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45 *See* American Intellectual Property Law Association, *Report of the Economic Survey 2005*, 18 (Sept. 2005).

46 *See, e.g.*, American Bar Association Model Rules of Professional Conduct, Rule 1.3, *available at* http://www.abanet.org/cpr/mrpc/rule_1_3.html; 31 C.F.R. § 10.22 (June 20, 2005).

47 Some have speculated that the ethics rules may sometimes require attorneys to conduct patent searches before providing tax advice. Jeremiah Coder, *Practitioners Discuss Intersection of Tax Patents, Ethics*, 117 Tax Notes 114 (Oct. 8, 2007).

48 *See* Ellen P. Aprill, *Responding to Tax Strategy Patents*, Proceedings of the Fifth-Ninth Tax Institute, Gould School of Law, USC, 17 (2007).

behavior through the tax code, such as by providing an incentive for certain types of investments.

Moreover, commentators have expressed concern that tax strategy patents have the potential to undermine Congress' authority even more directly.[49] These commentators observe that because there is no "prior art" with respect to a tax provision before it is enacted or reinterpreted by a court, someone could patent a tax strategy using the provision even if the strategy would be obvious after the legislation is enacted or the decision is rendered. The possibility of this occurring is suggested by experience with patents on technical specifications adopted by various standard setting bodies.[50] Participants in industry-wide standard setting bodies sometimes obtain patents on the standard itself, or an essential component of the standard, that the standard-setting body later adopts.[51]

Tax strategy patents could reduce voluntary tax compliance by reducing respect for the government and the tax system

Even if tax strategy patents are ultimately unenforceable, the perception that the government has allowed public tax benefits to be captured by a few patent holders could erode compliance. The option, or perceived option, of either paying a higher tax to the government or a slightly lower amount to the patent-holder for the privilege of being able to claim a patented tax benefit will be seen as unfair. Perceptions of unequal treatment may reduce respect for the tax system as well as voluntary tax compliance.[52]

A tax strategy patent may erode voluntary compliance regardless of whether or not it "works" from a tax perspective. However, patents that do not "work" may also help unscrupulous patent holders defraud taxpayers.

49 *See, e.g.*, Charles F. Weiland and Richard S. Marshall, *Tax Strategy Patents – Policy and Practical Considerations*, 47 Tax Management Memorandum 499, 510 (Dec. 11, 2006) (suggesting that private parties might patent proposed tax legislation).

50 *See, e.g.*, Janice M. Mueller, *Patent Misuse Through the Capture of Industry Standards*, 17 Berkeley Tech. L. J. 623 (2002) (Describing how Unocal obtained a patent on certain "clean fuels" that "read on" California's state standards, such that any unlicensed refiner selling gasoline in compliance with the state-mandated standards would infringe Unocal's patent. Unocal did so by filing an unpublished patent application and then working with the state on its fuel regulations).

51 If the patent holder fails to disclose its patent to the standard setting body, it may have difficulty enforcing its patents, however. *See, e.g.*, Michael G. Cowie and Joseph P. Lavelle, *Patents Covering Industry Standards: The Risks To Enforceability Due To Conduct Before Standard-Setting Organizations*, 30 AIPLA Q.J. 95, 135 (Winter 2002).

52 *See, e.g.*, Organization for Economic Co-Operation and Development (OECD), Guidance Note, *Compliance Risk Management: Managing and Improving Tax Compliance* 70 (Oct. 2004), *available at* http://www.oecd.org/dataoecd/44/19/33818656.df (noting the importance of perceived fairness in promoting tax compliance). According to one noted academic:

> The tax law belongs to all of us, just as we are all subject to it and obligated to comply with it. Tax law, like all law, perhaps more than most, requires interpretation. Interpretation comes through Treasury regulations and IRS rulings, but interpretation also comes to taxpayers primarily from their professional advisers — lawyers, accountants, and return preparers. The notion strikes me as absurd that anyone should have a legal monopoly on an interpretation of the law that an adviser develops and recommends to his clients, whether it rises to a "tax strategy" or not. Cornering a market of commodities or securities is bad enough, but cornering an interpretation of the law and a use to which it may be put has to be unlawful. Bernard Wolfman, *Tax Strategy Patents: An Idea Whose Time Should Never Come*, 115 Tax Notes 505 (Apr. 30, 2007).

PTO examiners are not tax lawyers and have little background in tax law.[53] The IRS does not review patent applications.[54] As a result, the PTO could issue a patent on a tax strategy that does not produce the tax result described in the patent.[55] Such a patent could confuse taxpayers into believing the strategy has been approved by the government. This confusion could enable tax shelter promoters to obtain payments from taxpayers to license a tax strategy that the IRS later challenges. The government's indirect complicity in tax fraud could reduce respect for the government and reduce tax compliance and tax revenues.

The potential for "bad" patents exacerbates the problems presented by tax strategy patents

The PTO may have difficulty identifying obvious tax strategies

While no valid patent should be issued for a tax strategy that is "obvious" based on "prior art," such as the tax code, regulations, case law, printed publications, and IRS rulings, some have expressed concern that it is difficult for a PTO examiner to determine which tax strategies are "obvious."[56] These commentators observe that if even tax law specialists who only have to focus on one area of law must struggle to keep up with current developments, PTO examiners who often have no tax law expertise will have difficulty determining what would be obvious to tax specialists.[57]

Moreover, PTO examiners do not have access to confidential tax return information or other privileged information, which may be relevant to determining whether a strategy is obvious.[58] Interested parties have some opportunity to assist the PTO by providing "prior art" during limited time frames.[59] However, patent examiners cannot seek help from those outside the PTO who have expertise with respect to a given application unless expressly au-

53 *See* USPTO White Paper, *Automated Financial or Management Data Processing Methods (Business Methods)*, 9-10 (2000).

54 Statement of Commissioner Everson Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (July 13, 2006).

55 The PTO has recently argued that an invention solely dependent on man-made law (rather than laws of nature) for utility may not be a patentable subject matter, in part, because the PTO has no "institutional competence" to determine if it "works" under man-made law. *See* Supplemental Letter Brief § 4, *In re Comiskey*, No. 2006-1286 (Fed. Cir. Mar. 6, 2007), *available at* http://tax.aicpa.org/Resources/Tax+Patents/Comiskey+PTO+Supplemental+Brief.htm.

56 *See, e.g.*, Kimberly S. Blanchard, *New York State Bar Association, NYSBA Says Applying Patent Law to Tax Advice Could Cause Problems*, 2006 TNT 160-18 (Aug. 18, 2006).

57 The PTO is aware of the problem and is working with the IRS and the American Bar Association's Section of Taxation to pursue training and information exchange opportunities. *See* James Toupin, General Counsel, U.S. Patent and Trademark Office, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* (July 13, 2006).

58 *See, e.g.*, IRC §§ 6103; 6713; 7216; 7525.

59 Third parties may not know about some patent applications. Applications must be published by the PTO only if they are the subject of an international filing and then not until 18 months after submission. 35 U.S.C. § 122(b). However, publishing an application offers the advantage of triggering liability for patent infringement as of the date of such application, rather than the date the patent issues. *See* 35 U.S.C. § 154(d). If an application is published, a member of the public can submit publications relevant to a pending published patent application within two months of its publication date. 37 C.F.R. § 1.99. The public may also file a protest against a pending application based on prior art, or cite prior art to the PTO during any period of enforcement. *See* 37 C.F.R. § 1.291; 37 C.F.R. § 1.502.

thorized by statute.[60] PTO examiners are also under severe time constraints.[61] As a result, commentators claim the PTO is more likely to issue patents on obvious tax strategies, such as the SOGRAT patent, discussed above.[62]

The patent reexamination process is not necessarily effective

While a third party may, upon submission of a fee, request the PTO to reexamine a patent based on "prior art,"[63] tax practitioners have argued that this process will often be ineffective for the same reasons that it is difficult for the PTO to identify an "obvious" tax strategy.[64] Further, unidentified infringers have little incentive to spend resources to initiate reexamination proceedings, especially when any such challenge may help the patent holder identify them, potentially subjecting them to costly litigation.

Explanation of Recommendations

Bar tax strategy patents

The National Taxpayer Advocate recommends that Congress bar tax strategy patents.[65] This proposal would not affect the patentability of software programs designed to assist taxpayers in reporting tax liabilities.[66]

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60 *See* 35 U.S.C. § 122 (confidentiality); 35 U.S.C. § 164 (allowing the PTO to obtain assistance from the Department of Agriculture when evaluating plant patents).

61 *See* Ellen Aprill, Associate Dean of Academic Programs, Professor of Law, and John E. Anderson Chair in Tax Law, Loyola Law School, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means* n.5 (July 13, 2006) (noting that PTO examiners on average spend only 32 hours to examining a business method patent application).

62 *See, e.g.*, William A. Drennan, *The Patented Loophole: How Should Congress Respond To this Judicial Invention?*, 59 Fl. L. Rev. 229, n.68 (2007).

63 *See* 35 U.S.C. §§ 301-302.

64 *See, e.g.*, Kimberly S. Blanchard, *New York State Bar Association, NYSBA Says Applying Patent Law to Tax Advice Could Cause Problems*, 2006 TNT 160-18 (Aug. 18, 2006).

65 S. 2369, introduced in the Senate on November 15, 2007, would prevent a patent from issuing on a "plan, strategy, technique, scheme, process, or system that is designed to reduce, minimize, avoid, or defer, or has, when implemented, the effect of reducing, minimizing, avoiding, or deferring, a taxpayer's tax liability or is designed to facilitate compliance with tax laws," but would continue to allow patents on "tax preparation software and other tools or systems used solely to prepare tax or information returns." H.R. 1908, which passed in the House on September 7, 2007, included a similar provision. H.R. 2136 and S. 681 would also disallow a patent on any invention "designed to minimize, avoid, defer, or otherwise affect the liability for Federal, State, local, or foreign tax." A similar provision applies to bar patents for use of nuclear material or atomic energy in an atomic weapon. *See* 42 U.S.C. § 2181(a) ("No patent shall hereafter be granted for any invention or discovery which is useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon.").

66 Even if a court were to interpret the proposal as reducing the availability of patent protection for certain software, the programs could still be protected under copyright and trade secret law. *See, e.g.*, Jean F. Rydstrom, *Patentability of Computer Programs*, 6 A.L.R. Fed. 156 (1971) (discussing how software programs could not be patented in the 1960s because they were considered algorithms or mental processes, but noting that they were still eligible for copyright and trade secret protection).

Limit liability for tax strategy patent infringement.

If Congress does not eliminate all tax strategy patents, the National Taxpayer Advocate recommends that Congress limit liability for infringing them.[67] As with the previous proposal, this would not affect the enforceability of patents on software programs designed to report tax liabilities.

Require the PTO to provide the IRS with tax strategy patent applications.

If Congress does not bar tax strategy patents, the National Taxpayer Advocate recommends that Congress require the PTO to promptly provide the IRS with a copy of any tax strategy patent application that it receives.[68] This would allow the IRS to monitor tax strategy patent applications to determine if it needs to "list" them so that participants are flagged for the IRS. The legislation should also authorize the PTO to obtain assistance from the Department of the Treasury when evaluating tax strategy patents to reduce the likelihood that it will grant patents for obvious tax strategies[69] or those that do not work.

67 H.R. 2365 would amend 35 U.S.C. § 287 by limiting liability of the taxpayer, tax practitioner, or any related professional organization for "use" of a "tax planning method that constitutes an infringement." It defines a "tax planning method" as a "plan, strategy, technique, or structure that is designed to reduce, minimize, or defer, or has, when implemented, the effect of reducing, minimizing or deferring, a taxpayer's tax liability." The Section of Taxation of the State Bar of Texas has proposed similar legislation. *See* Section of Taxation of the State Bar of Texas, *Proposed Legislation on Patented Tax Strategies* (Jan. 2, 2007). The proposal would mirror the Physicians Immunity Statute, which bars patent holders from obtaining damages or injunctions against medical practitioners for infringing patents on certain medical procedures. *See* Pub. L. No. 104-208, 110 Stat. 3009, 616 (codified as amended at 35 U.S.C. § 287(c)).

68 This requirement would be similar to the requirement that the PTO notify the Energy Research and Development Administration regarding applications for patents on inventions "useful in the production or utilization of special nuclear material or atomic energy." *See* 42 U.S.C § 2181(d).

69 The provision would be similar to the law which allows the PTO to obtain assistance from the Department of Agriculture when evaluating plant patents. *See* 35 U.S.C. § 164.

KLR #5

Extend Exempt Organizations' Advance Ruling Periods in Cases of Extreme Application Processing Delays

Problem

Upon IRS approval of its application for recognition of exemption, an organization seeking to be treated as publicly supported will be issued either a definitive or advance ruling letter.[1] An advance ruling provides that an organization will be treated as a publicly supported organization for its first five taxable years.[2] Delays in processing Forms 1023[3] (Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code) result in some organizations receiving advance ruling letters only months before the advance ruling period ends. If such organizations cannot demonstrate broad public support at the end of their advance ruling periods, they are reclassified as private foundations.[4] Many organizations have difficulty garnering financial support while a decision on their exempt status is pending.[5] Organizations unable to obtain a favorable determination letter until shortly before the expiration of the advance ruling period are thus likely to be unable to demonstrate the requisite amount of public support and, consequently, to be reclassified as a private foundation. Private foundations are subject to various operating restrictions and excise taxes for failure to comply with such restrictions, making private foundation status less favorable than public charity status.[6]

Example

Philanthropy Inc., a nonprofit corporation, was formed under state law in the summer of 2003. It applied for exempt status under IRC § 501(c)(3) two months after its incorporation and timely responded to several requests for additional information from the IRS. In spring 2006, over two and one half years after submitting its application, Philanthropy Inc. received a proposed adverse determination letter denying its application for exempt status. After Philanthropy Inc. appealed, the IRS in June 2007, recognized it as an organization described in IRC § 501(c)(3) and classified it as a public charity for the five-year period beginning on Philanthropy Inc.'s incorporation in summer 2003 and ending on December 31, 2007.

1 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(4); IRS, *Instructions for Form 1023* 2 (2006). An organization that has not completed a tax year of at least 8 full months must request an advance ruling. Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(1); IRM 7.20.3.3.1(1) (Nov. 1, 2004); IRS, Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* 11 (2006).

2 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(4).

3 *See* Most Serious Problem, *Determination Letter Process, supra.*

4 *See* Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

5 *See* Staff of Joint Committee on Taxation, 98TH Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 705 (Comm. Print 1984).

6 *See* Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* 307 (8th ed. 2003).

Recommendation

Amend the IRC to provide for the extension of the advance ruling period by one year when, as a result of a delay of 270 days or more in the processing of an exemption application, an advance ruling letter is issued not more than eight months prior to the end of the advance ruling period.

Present Law

IRC § 509 classifies every IRC § 501(c)(3) organization as either a private foundation or an organization other than private foundation. Under IRC § 509(a), an IRC § 501(c)(3) organization is presumed to be a private foundation unless it meets one of four exceptions and is thus considered a public charity. The types of organizations excepted from private foundation status are:

1. Organizations conducting certain favored types of activities (*e.g.*, churches, schools, hospitals, medical research organizations);[7]
2. Organizations receiving a substantial amount of their support from the general public or from governmental entities ("publicly supported" organizations);[8]
3. Certain supporting organizations;[9] and
4. Organizations organized and operated exclusively to test for public safety.[10]

Public charity status is considered more advantageous than private foundation status because donations to public charities are subject to more favorable deduction limits and private foundations are subject to various operating restrictions and excise taxes that do not apply to public charities.[11] Individual donors to public charities are generally entitled to a deduction for the fair market value of the donated property, subject to a 50 percent adjusted gross income limitation,[12] whereas deductions for donations to private foundations are generally limited to 30 percent of the individual donor's adjusted gross income.[13] Private foundations (and, in some cases, their managers and disqualified persons) are subject to two-tier excise taxes for violation of:

1. The prohibition on self-dealing between private foundations and their substantial contributors or other disqualified persons;[14]

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7 IRC §§ 509(a)(1), 170(b)(1)(A)(i)-(v).

8 IRC §§ 509(a)(1), 170(b)(1)(A)(vi), 509(a)(2).

9 IRC § 509(a)(3).

10 IRC § 509(a)(4).

11 *See* Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* 307 (8th ed. 2003).

12 IRC §170(b)(1)(A).

13 IRC §170(b)(1)(B)(i).

14 IRC § 4941.

2. The requirement that private foundations annually distribute a fixed percentage of income for charitable purposes;[15]
3. The limits on private business holdings;[16]
4. Restrictions on investments that may jeopardize the carrying out of exempt purposes;[17] and
5. Provisions to help ensure that expenditures further exempt purposes.[18]

Private foundations must also pay a two percent excise tax on their net investment income.[19]

To be classified as a public charity based on public support (the second category of organizations excepted from private foundation status discussed above), an organization must meet the requirements of a detailed support test. Generally, an organization is considered publicly supported if (1) it normally receives at least 33 1/3 percent of its total support from a governmental unit or contributions from the general public (the "mechanical test");[20] or (2) it normally receives more than one-third of its support from gifts, grants, contributions, or gross receipts from activities related to its exempt purposes, and not more than one-third of its support from gross investment income (the "service provider test").[21] For purposes of both the mechanical test and the facts and circumstances test, contributions from an individual, trust, or corporation will be treated as support from the general public only to the extent that the total amount of contributions by any one such individual, trust, or corporation during the advance ruling period does not exceed two percent of the organization's total support for such period.[22] For the service provider test, gross receipts from related activities received from any person, bureau, or similar governmental agency are includible as support in any taxable year only to the extent that such receipts do not exceed the greater of $5,000 or one percent of the organization's support for the taxable year.[23]

An organization applying for exemption that has not been in existence long enough to be able to demonstrate that it is "normally" publicly supported may request a ruling or determination letter that it will be treated as a publicly supported organization for its first

15 IRC § 4942.

16 IRC § 4943.

17 IRC § 4944.

18 IRC § 4945.

19 IRC § 4940.

20 IRC § 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(2). An organization that does not meet the 33 1/3 percent test may, nonetheless, be considered publicly supported if it normally receives 10 percent or more of its support from governmental units, the general public, or a combination of these sources and it meets other factors tending to show that it is organized and operated to attract public and governmental support on a continuing basis (the "facts and circumstances test"). Treas. Reg. § 1.170A-9(e)(3).

21 IRC § 509(a)(2); Treas. Reg. § 1.509(a)-3(a)(2), (3).

22 Treas. Reg. § 1.170A-9(e)(6)(i).

23 IRC § 509(a)(2)(A)(ii); Treas. Reg. § 1.509(a)-3(b)(1).

five taxable years.[24] Such a ruling is referred to as an advance ruling.[25] The advance ruling period extends from the date of the organization's inception and ends 90 days after the advance ruling period expires.[26] The IRS will issue an advance ruling letter if the organization can reasonably be expected to meet the requirements of one of the public support tests during the five-year advance ruling period.[27] At the end of that period, the organization must submit information to the IRS to establish that it met one of the public support tests for the period.[28] If the organization fails to provide such information or meet one of the tests, it will be reclassified as a private foundation going forward.[29] The IRS will, however, retroactively treat the reclassified organization as a private foundation from its inception solely for purposes of IRC §§ 507(d) (calculation of tax due upon termination of private foundation status) and 4940 (excise tax on net investment income).[30] Thus, if an organization is reclassified as a private foundation at the end of its advance ruling period, the tax on any net investment income earned during the advance ruling period comes due, plus interest.[31]

The length of the advance ruling issued to new organizations by the IRS was set at five years based on Congress' directive in the Conference Report filed with the Deficit Reduction Act of 1984.[32] After nearly a quarter of a century, however, regulations corresponding with the establishment of a five-year advance ruling period have not been issued.[33] The regulations continue to reflect the advance ruling periods superseded by the congressional directive in the 1984 conference report. Specifically, Treas. Reg. § 1.170A-9(e)(5)(i) provides that an organization that requests an advance ruling on Form 1023 is given an advance ruling period of two years or, if the organization's first tax year consists of less than eight months, a three-year period. Treas. Reg. § 1.170-9(e)(5)(iv) further provides that the advance ruling period may be extended by three taxable years.

24 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(4); IRS, *Instructions for Form 1023* 2 (2006).

25 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(4).

26 If an organization submits the information necessary to determine whether it met the requirements of one of the support tests, the advance ruling period will also be extended until a final determination of the organization's public charity status is made by the IRS, even if the organization did not meet such requirements. Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

27 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(4).

28 Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2). IRS Form 8734 (*Support Schedule for Advance Ruling Period*) is used for this purpose.

29 Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

30 Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

31 The IRS, however, will not impose penalties under IRC § 6651. Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

32 H.R. Rep. No. 98-861, at 1090 (1984) (Conf. Rep.) ("The Conference agreement follows the House directions to Treasury to extend the advance ruling period, and to amend its regulations to permit greater reliance on IRS classifications concerning new organizations in the first five years of their existence and in any other circumstances in which Treasury concludes that greater reliance is appropriate.").

33 As part of the redesign of Form 990, *Return of Organization Exempt From Income Tax*, the IRS announced in the summer of 2007 that it was considering the eventual elimination of the advance ruling process. In December 2007, the IRS indicated that it expects to issue regulations to implement such a change. The IRS's expectations do not, however, reflect the current state of the law. *See* IRS, *Draft Form 990 Redesign – Schedule A* (June 14, 2007), available at http://www.irs.gov/pub/irs-tege/draftform990redesign_scha_instr.pdf; IRS, *Form 990 Redesign for Tax Year 2008 Schedule A, Public Charity Status and Public Support – Highlights* (Dec. 20, 2007), available at http://www.irs.gov/pub/irs-tege/highlights_schedule_a.pdf.

Under the regulations, an organization's extended advance ruling period is thus five taxable years if its first taxable year consists of at least eight months, or is six years if its first taxable year is less than eight months. Despite the lack of corresponding regulations, Form 1023 and the instructions thereto were revised in 1986 to indicate that the advance ruling, if granted, will be for a five-year period.[34] The Internal Revenue Manual (IRM) reflects that both the two or three year advance ruling period and the extended advance ruling period have been superseded by the five-year advance ruling period, and an organization's first tax year, regardless of length, is treated as the first year in the five-year period.[35]

Reasons For Change

Significant Application Processing Delays Persist

While the size of the exemption application backlog and average cycle days (the number of days from submission to final action on an application) have declined from the heights of 2005,[36] considerable application processing delays persist. In the ten-month period from October 2006 through July 2007, more than 9,700 or roughly 24 percent of the nearly 41,000 IRC § 501(c)(3) applicants did not receive a determination letter until more than 180 days after submitting their applications.[37] As of September 2007, the oldest open application, one involving a proposed adverse determination that is with the Office of Appeals, dated back to May 2003, and the next oldest open application was submitted in December 2004, and assigned to an agent in June 2005.[38] A "significant percentage" of organizations with complex applications have to wait more than 270 days for determination letters.[39] Specifically, of the applications open in August 2007, 1,452 had surpassed the 270 day mark.[40]

Negative Impact of Delays on Organizations Seeking Advance Rulings of Public Charity Status

As Congress has acknowledged, newly formed organizations may receive little financial support from the general public during their first years of existence.[41] Private foundations are especially reluctant to make grants to new organizations that have not established a broad base of public support.[42] These fundraising difficulties are exacerbated when organizations' applications for tax-exempt status are not timely processed, particularly

34 IRM 7.26.3.7(4) (Nov. 19, 1999).

35 IRM 7.26.3.7(4) (Nov. 19, 1999); IRM 7.26.3.7(5)(b) (Nov. 19, 1999).

36 *See* Most Serious Problem, *Determination Letter Process, supra.*

37 TE/GE response to TAS research request, Attachment F (Sept. 14, 2007).

38 TE/GE response to TAS research request (Oct. 15, 2007).

39 Manager, EO Determinations Quality Assurance, *Memorandum for Manager, EO Determinations and Area Managers, EO Determinations, TEQMS Report for FY 2007, Quarter 1* (Apr. 5, 2007).

40 TE/GE response to TAS research request (Sept. 28, 2007).

41 *See* Staff of Joint Committee on Taxation, 98TH Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 705 (Comm. Print 1984).

42 *See Id.*

when the delays persist into what would be the final year of the advance ruling period. If, because of IRS processing delays, an organization receives an advance ruling determination letter only months before the advance ruling period ends, the organization is unlikely to have established support sufficient to meet one of the public support tests and thus faces reclassification as a private foundation. Due to the many operating restrictions and lower deduction limits discussed above, public charity status is preferred over private foundation status.[43] Organizations that have already suffered through an overly long determinations process should not be made to suffer further by being forced into the more restrictive private foundation regime when they could qualify as publicly supported public charities if given adequate time. To allow such a result would unfairly penalize organizations for the IRS's inability to issue determination letters within a reasonable time period.

Termination of Private Foundation Status under IRC § 507(b)(1)(B) Is Not a Satisfactory Remedy

An organization that fails to satisfy one of the public support tests at the end of its five-year advance ruling period and is reclassified as a private foundation may attempt to regain its public charity status under the procedure set forth in IRC § 507(b)(1)(B).[44] Under IRC § 507(b)(1)(B), a private foundation may start another five-year period upon notification of the IRS. If, at the end of that period, the organization demonstrates to the IRS that it operated as a public charity and met the requirements of IRC § 509(a)(1), (2), or (3) for the entire five-year period, it will be reclassified as a public charity from the beginning of that period.[45]

The earliest the five-year period can begin is the first day of the taxable year after the organization requests IRC § 507 termination.[46] Thus, if an organization waits to notify the IRS of its intent to terminate its private foundation status until it submits Form 8734 in the 90 days after its advance ruling period ends or receives formal notice from the IRS that it has been reclassified as a private foundation, the new five-year period will not start until the beginning of the organization's next fiscal year.[47] The organization would therefore have a "stub year" in which it was a private foundation. While an organization could avoid this timing issue by submitting to the IRS before the end of its advance ruling period a notice agreeing to be treated as a private foundation as of the first day of its next fiscal year and asking to start the five-year termination period at that time, having to make that type of "protective" filing adds unwanted complexity and presents a trap for unrepresented organizations.

43 *See* Staff of Joint Committee on Taxation, 93d Cong., *General Explanation of the Tax Reform Act of 1976* (Comm. Print 1976) ("if [an organization] is classified as a private foundation … its status as a charitable contribution donee is in some respects significantly less favorable than if it is not so classified …. ").

44 *See, e.g.*, I.R.M. 7.20.3.3.8(3) (Nov. 1, 2004) ("An organization that fails to meet a public support test at the end of its advance ruling period and is classified as a private foundation may request IRC § 507 termination.").

45 Treas. Reg. § 1.507-2(b)(1).

46 IRC § 507(b)(1)(B); I.R.M. 7.20.3.3.8(3) (Nov. 1, 2004).

47 IRM 7.20.3.3.8(3) (Nov. 1, 2004); 7.20.3.3.8(10) (Nov. 1, 2004).

Apart from this timing issue, an IRC § 507(b)(1)(B) termination is lacking as a remedy for organizations whose delayed determination letters arrive within months of the end of their advance ruling periods because it requires such organizations to wait an additional five years for a definitive ruling on their public charity status. Such organizations would, in essence, undergo a ten-year advance ruling period and have to combat the fundraising difficulty an advance ruling entails for the first decade of their existence. Asking those who have already waited too long to wait even longer is hardly a remedy.

In addition, an IRC § 507(b)(1)(B) termination is less preferable than a simple extension of the advance ruling period because the consequences of failing to demonstrate at the end of the period that a public support test has been met differ in an important way. If an organization fails to meet a public support test at the end of its five-year advance ruling period, it is still treated as a public charity for those five years.[48] It is not retroactively reclassified as a private foundation except for purposes of the tax on investment income and calculating the tax due if private foundation status is later involuntarily terminated.[49] In contrast, if an organization fails to satisfy a public support test for any year in a five-year private foundation termination period, it is retroactively treated as a private foundation for that year for purposes of all of the private foundation rules and is thus subject to excise taxes if it did not comply with any of those rules.[50]

Explanation of Recommendation

The National Taxpayer Advocate recommends creating an automatic one-year extension of the advance ruling period that would apply in cases where the processing of an exemption application took 270 days or more and, as a result, an advance ruling letter was issued not more than eight months before the end of the advance ruling period. Because a prospective IRC § 501(c)(3) organization must file its application within 27 months from the end of the month in which it was created for exemption to relate back to the organization's formation,[51] the situations addressed by the proposed extension would not be ones in which organizations waited until their fifth year of existence to file applications.

The National Taxpayer Advocate's recommendation of a one-year extension tracks the previously-applicable Treas. Reg. § 1.170A-9(e)(5)(i) and (iv), which provided for an advance ruling period totaling six years where an organization's first taxable year was less than eight months. The recommendation that the extension apply where an advance ruling letter is not issued more than eight months before the advance ruling end date is also consistent with the distinction made in Treas. Reg. § 1.170A-9(e)(5)(i) between organizations that have been in existence for more than eight months and those that have not. It is clear from the now-superseded Treas. Reg. § 1.170A-9(e)(5)(i) as well as the Regulations' current

48 Treas. Reg. § 1.170A-9(e)(5)(iii)(B); Treas. Reg. § 1.509(a)-3(e)(2).

49 *Id.*

50 Treas Reg. § 1.507-2(f)(2)(ii).

51 *See* Treas. Reg. § 1.508-1(a)(2)(i); T.D. 8680, 1996-33 I.R.B. 5, 1996-2 C.B. 194 (June 27, 1996).

requirement that an organization that has not completed a tax year of at least eight full months request an advance rather than a definitive ruling[52] that the Treasury Department believes an organization cannot establish a stable pattern of public support in less than eight months. By enacting this recommendation, Congress will hold the IRS accountable for its processing delays, encourage the IRS to eliminate such delays, and minimize the harmful effect of such delays on IRC § 501(c)(3) organizations.

52 Treas. Reg. § 1.170A-9(e)(5)(i); Treas. Reg. § 1.509(a)-3(d)(1).

Introduction: Legislative Recommendations to Reduce the Compliance Burden on Small Exempt Organizations

More than 73 percent of public charities reported annual expenses of less than $500,000 in 2004.[1] Approximately half of all exempt organizations (EOs) have all-volunteer staffs and another third have fewer than ten employees.[2] Smaller EOs frequently lack professional tax guidance and rely on their volunteers to deal with the IRS.[3] Yet the compliance burden imposed on small EOs is significant.

In her 2006 Annual Report to Congress, the National Taxpayer Advocate recommended that Internal Revenue Code (IRC) § 6033(a)(3)(A)(ii) be amended to increase the EO information return filing threshold from $25,000[4] to $50,000 and to adjust the filing threshold for inflation going forward.[5] The IRS announced in December 2007 that it will raise the information return filing threshold to $50,000 beginning with the 2010 tax year.[6] At that time, organizations other than private foundations with gross receipts of less than $50,000 will no longer be required to file the full information return (IRS Forms 990 or 990-EZ) and will instead be required to file the new IRS Form 990-N (the e-postcard).[7] The National Taxpayer Advocate commends the IRS for adopting this small organization-friendly approach to the EO annual filing requirements.

Congress should further lessen the burden on small EOs, as follows:

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1 Independent Sector, *Facts and Figures about Charitable Organizations* 3 (last updated Jan. 4, 2007).

2 IRS, *TE/GE FY 2005 Strategic Assessment* 3 (Feb. 2, 2005).

3 *Id.*

4 The $25,000 threshold was set administratively in 1982. *See* Announcement 82-88, 1982-25 IRB 23. The statutory threshold remains at $5,000. IRC § 6033(a)(3)(A)(ii).

5 *See* National Taxpayer Advocate 2006 Annual Report to Congress 483-495 (Key Legislative Recommendation: Increase the Exempt Organization Information Return Filing Threshold).

6 IRS News Release IR-2007-204, IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transition Relief (Dec. 20, 2007).

7 *Id.*

KLR #6

Creation of a Short-Form Application for Recognition of Exemption Under IRC § 501(c)(3)

Problem

With some exceptions,[8] organizations generally must apply to the IRS to be treated as exempt from federal income tax under IRC § 501(c)(3).[9] The application form, Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,* is 28 pages long (including a two-page checklist and eight different schedules).[10] The instructions to Form 1023 are 38 pages long,[11] and Publication 557, Tax-Exempt Status for Your Organization, which also explains how to complete the application, is 63 pages long.[12] In addition to answering the questions on the form and its schedules, applicants must obtain an employer identification number (EIN) by filing Form SS-4, Application for Employer Identification Number, and submit organizing documents (*e.g.*, articles of incorporation), bylaws, financial statements, and a description of proposed activities.[13] Applicants may also be required to submit a variety of supporting documents, including supplemental financial data[14] and explanations of certain activities[15] or transactions.[16] The IRS estimates that an organization will need to devote approximately 105 hours — or approximately 13 eight-hour work days — to complete the 12 core pages of Form 1023.[17] The time needed to complete the various schedules of Form 1023 ranges from seven hours to approximately 16 hours.[18]

Under IRC § 508(c)(1)(B), organizations that are not private foundations and whose gross receipts in each taxable year are normally not more than $5,000 are excused from the

8 Organizations that are excepted from the filing requirement are churches, charities with gross receipts of not more than $5,000 in each taxable year, subordinate organizations covered by a group exemption letter, and certain trusts. Treas. Reg. § 1.508-1(a)(3)(i).

9 IRC § 508(a).

10 IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006).

11 IRS, *Instructions for Form 1023* (June 2006).

12 IRS Pub. 557, *Tax-Exempt Status for Your Organization* (Mar. 2005).

13 *See* IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006); IRS, *Instructions for Form 1023* (June 2006).

14 For example, if an organization has gross receipts from admissions or from sales of merchandise or services, the organization must attach an itemized list showing such receipts. Generally, any revenues or expenses not otherwise classified in the *Financial Data* section of Form 1023, which provides lines for the most common types of revenues and expenses, must be explained in an attachment. *See* IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006).

15 For example, organizations that lobby or make grants to other organizations need to attach an explanation of their lobbying or grant-making activities, as relevant. *See* IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006).

16 For example, if an organization purchases goods, services or assets from any of its listed officers, directors, trustees, highest compensated employees, or highest compensated independent contractors, the organization must attach copies of any written contracts or other agreements relating to such purchases. *See* IRS, Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code* (June 2006).

17 This estimate includes time spent recordkeeping, learning about the law or the form, preparing the form, and copying, assembling, and sending the form to the IRS. IRS, *Instructions for Form 1023*, 24 (2006).

18 IRS, *Instructions for Form 1023*, 24 (June 2006).

application requirement.[19] The $5,000 threshold has not been adjusted for inflation since IRC § 508 was enacted in 1969.[20] Gross receipts of $5,000 in 1969 would be equal to $28,634 in today's dollars.[21]

Example

Small Town Charity Inc., a local charitable organization, was incorporated under state law in September 2007 to provide relief to the poor and underprivileged. Its gross receipts are expected to be composed entirely of contributions from individuals in Small Town and to total approximately $12,000 per year. The organization will be run entirely by volunteers and will not receive professional legal or accounting advice, but Small Town Charity Inc. is required to file Form 1023.

Recommendation

Retain the application filing exemption of IRC § 508(c)(1)(B) but amend the Code to provide that non-private foundations with gross receipts not normally more than $25,000 may submit a short-form application for recognition of IRC § 501(c)(3) status (*i.e.*, a Form 1023-EZ).

Additional Legislative Recommendation

Require the IRS to Retain Form 990-EZ

Problem

Under IRC § 6033, EOs are generally, with certain exceptions, required to file annual information returns, Form 990, Return of Organization Exempt from Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt from Income Tax. An organization can use Form 990-EZ if (1) its gross receipts during the year were less than $100,000, and (2) its total assets at the end of the year were less than $250,000.

Form 990-EZ is three pages long while Form 990 is nine pages in length. The IRS estimate of the total amount of time an organization will spend preparing and completing Form 990 is over 95 hours greater than the time estimated to complete Form 990-EZ.[22]

When the IRS released a discussion draft of a redesigned Form 990 for public comment on June 14, 2007, it specifically solicited comments as to "whether certain portions of the

19 IRC § 508(c)(1).

20 Tax Reform Act of 1969, Pub. L. No. 91-172, Title I, § 101(a), Dec. 30, 1969, 83 Stat. 494.

21 Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Inflation Calculator*, at www.bls.gov/cpi (calculation run Dec. 27, 2007).

22 The estimates include time devoted to recordkeeping, learning about the law or the form, preparing the form, and copying, assembling, and sending the form to the IRS. IRS, 2007 *Instructions for Form 990 and Form 990-EZ*, 55.

discussion draft Form 990 can be used as a substitute for the current Form 990-EZ."[23] The National Taxpayer Advocate submitted comments on the draft redesigned Form 990 that, among other things, urged the IRS to retain Form 990-EZ.[24] Nonetheless, the IRS stated during fall 2007 that it planned to eliminate Form 990-EZ at some point in the future and instead require small EOs to complete certain designated parts of the redesigned Form 990.[25] Then, in December 2007, the IRS announced that it was retaining Form 990-EZ "[a]t this time" and increased the Form 990-EZ filing thresholds to allow a greater number of small EOs to file it instead of Form 990 beginning in tax year 2008.[26]

Example

Dog Rescue Inc. is an organization recognized by the IRS as exempt under IRC § 501(c)(3). It has an all-volunteer staff, with no prior accounting or tax experience, upon which it relies to handle such matters. The organization's gross receipts for its fiscal year (ended June 30, 2007) were $75,000, and its total assets at the end of the year were $110,000. Dog Rescue Inc. filed Form 990-EZ in November 2007. If the IRS eliminated Form 990-EZ, Dog Rescue Inc. would be required to file Form 990.

Recommendation

Require the IRS to continue to offer a separate short-form ("EZ") version of Form 990 that may be filed by small exempt organizations in lieu of the long-form Form 990 or parts thereof.

23 IRS, *Background Paper Redesigned Draft Form 990* 5 (June 14, 2007).

24 Memorandum from Nina E. Olson, *Form 990 Redesign* 2 (Sept. 14, 2007) (available at http://www.irs.gov/pub/irs-tege/ntacomments.pdf). The National Taxpayer Advocate was not alone in her recommendation regarding the continued use of Form 990-EZ. *See, e.g.*, Letter from American Bar Association Section of Taxation and Health Law Section, *Comments Concerning Discussion Draft of Redesigned Form 990 for Tax-Exempt Organizations* 3 (Oct. 4, 2007) (available at http://www.irs.gov/pub/irs-tege/aba990rcomments.pdf) ("We suggest that an increase in the filing threshold, and perhaps a new Form 990-EZ, be considered to ease the burden on small organizations which are least able to bear the costs of increased reporting burdens."); Letter from American Association of Museums, *Redesigned Form 990* 7 (Sept. 12, 2007) (available at http://www.aam-us.org/getinvolved/advocate/issues/upload/2007_AAM_Comments_on_Form_990_to_IRS.pdf) ("AAM has many smaller museum members that would find the complexity of the redesigned form daunting. We recommend retaining Form 990-EZ and increasing the filing threshold for the Form 990-EZ substantially.")

25 *See* Steven T. Miller, Commissioner, Tax-Exempt and Government Entities Division, Remarks before Independent Sector, Los Angeles, CA (Oct. 22, 2007) ("[S]hould we allow a broader band of organizations to file the Form 990EZ for a period before requiring them to file the new Form 990?"); Diane Freda, *Exempt Organizations: Revised Draft Form 990 Draws Comments On Information Requested, General Focus*, 195 DTR G-7 (Oct. 10, 2007) (regarding comments of Ron Schultz, senior technical adviser with IRS Tax-Exempt and Government Entities Division, to the American Health Lawyers Association).

26 IRS, *Form 990-EZ Changes for Tax Year 2008*, available at http://www.irs.gov/pub/irs-tege/highlights_form_990_ez.pdf (Dec. 20, 2007).

Key Legislative Recommendation

Require the IRS to Establish a Voluntary Compliance Program for Exempt Organizations

Problem

The IRS has no formal mechanism for exempt organizations that discover they have fallen out of compliance with the tax law to voluntarily correct that problem. The absence of a self-correction program:

> [H]as led to the evolution of a dual-class system for exempt organizations: the represented and the unrepresented. Larger organizations with counsel familiar with the tax laws, or accountants accustomed to negotiating the intricacies of IRS regulation, are able to resolve their problems relatively quickly, often in the organization's favor, whether or not the result in one instance is consistent with the result in other instances with similar fact patterns.[27]

The Advisory Committee on Tax-Exempt and Government Entities (ACT) recommended in its sixth report released in June 2007 that the IRS create an EO voluntary compliance program, and laid out a detailed framework for such a program.[28] While the IRS recently indicated it will develop an EO voluntary compliance program along the lines recommended by the ACT in FY 2008,[29] congressional action would reinforce the urgency in the establishment of an EO voluntary compliance program.

Example

Local Theater Inc. is an organization recognized by the IRS as exempt under IRC § 501(c)(3). It is run by volunteers who did not understand the filing requirements applicable to exempt organizations. While Local Theater Inc. had gross receipts in excess of the $25,000 filing threshold in each of its first three tax years, it failed to file Form 990. A new treasurer familiar with the filing requirements takes office and discovers the Forms 990 have not been filed. The organization would like to become compliant but is hesitant to file the past and future returns because it lacks sufficient funds to pay late-filing penalties.

Recommendation

Require the IRS to create a broad-based, formal, and ongoing voluntary compliance program for exempt organizations similar to those offered in the areas of employee plans, tax-exempt bonds, and Indian tribal governments by September 30, 2008.

27 Advisory Committee on Tax Exempt and Government Entities, *Proposal for an Exempt Organizations Voluntary Compliance Program* 5 (June 13, 2007).

28 Advisory Committee on Tax Exempt and Government Entities, *Proposal for an Exempt Organizations Voluntary Compliance Program* (June 13, 2007).

29 IRS, *FY 2008 Exempt Organizations Implementing Guidelines* 9 (Dec. 13, 2007).

KLR #7

Taxpayer Protection from Third Party Payer Failures

Problem

Third party payers provide a valuable service to employers, especially small businesses, by helping them comply with a myriad of federal, state, and local employment tax requirements. They also play a significant role in tax administration by facilitating payroll tax processing and collection, which can be costly and burdensome to the employer.[1] The payroll industry has created various types of third party arrangements for reporting, filing, and paying employment taxes.[2]

In recent years, a number of third party payers have gone out of business or embezzled their customers' funds.[3] Because employers remain liable for payroll taxes, however, those who fall victim to these situations (especially self-employed and small business taxpayers) can experience significant burden. This burden includes not only being forced to pay the amount twice – once to the third party payer that absconded with or dissipated the funds and a second time to the IRS – but also being liable for interest and penalties. Some small businesses may not be able to recover from these financial setbacks and will be forced to cease operations. These situations also impact effective tax administration. Because the Internal Revenue Code (IRC) does not protect taxpayers from third party payer failures, the IRS faces difficult decisions about how to handle these cases.[4] This issue demonstrates the vital need for taxpayer protection in the payroll service industry, particularly for small business taxpayers that use the services of smaller third party payers.[5]

Example

A taxpayer hires EasyTax Corp., a third party payer, to administer its payroll, collect payroll taxes, and file applicable IRS forms. EasyTax collects payroll tax deposits from the taxpayer but does not turn these funds over to the IRS. EasyTax also changes the taxpayer's

1 In fiscal year 2007, nearly 20 percent of employers nationwide utilized third party payers to transmit approximately one third of all electronic federal tax deposits received by the Treasury. *See* IRS, *EFTPS Deposits Received and Processed, Volumes and Dollars Collected FY 2007 Year End* (Sept. 28, 2007). *See also* Brady Bennett, Director, Filing and Payment Compliance, Wage and Investment Division, *Talking Points, Important Contributions of Reporting Agents, SB/SE Focus and Updates*, National Reporting Agents Forum (Feb. 21, 2007), available online at http://sbse.web.irs.gov/cl2/cl/speeches/default.asp?page=3&sort=dateTime%20DESC&whereClause.

2 *See* Table __, Most Serious Problem, *Third Party Payers, supra*. The table illustrates the range of responsibilities, required forms and authorizations, potential tax liability of the third party payer and the client employer, and the current regulatory authority or absence thereof associated with the use of each type of third party payers.

3 *See* SB/SE Fraud Digest, August 2007, available online at http://sbse.web.irs.gov/compliance/TechDigest/FraudEdition/2007/2007-08/Payroll.htm.

4 The IRS generally requires the party responsible for the tax (the employer) to pay the tax.

5 The National Taxpayer Advocate has proposed a number of legislative and administrative steps to alleviate the problem of third party payer failures. *See* Most Serious Problem, *Third Party Payers, supra*. *See also* 2004 National Taxpayer Advocate Annual Report to Congress 394, Key Legislative Recommendation: *Protection from Payroll Service Provider Misappropriation.*

mailing address on file with the IRS to EasyTax's business address without the taxpayer's knowledge. Thus, when the IRS sends delinquent payroll tax notices to the taxpayer, EasyTax receives them and withholds them from the taxpayer. EasyTax's owner takes the funds deposited by the taxpayer and EasyTax's other clients and disappears to an offshore jurisdiction. Lacking sufficient assets to function as a going concern, EasyTax declares bankruptcy. The taxpayer then discovers that EasyTax never deposited with the IRS any of the payroll taxes it collected, and the taxpayer is now liable for delinquent payroll taxes, interest, and penalties.

Recommendations

The National Taxpayer Advocate recommends that Congress:

- Amend the Code to define "third party payer" as any person who provides services of filing, reporting, withholding, and payment of employment taxes on behalf of client taxpayers if such person has the authority, control, receipt, custody, or disposal of client taxpayers' funds intended by the taxpayers to be used for the purpose of making federal payroll tax deposits;
- Amend the Code to make a third party payer jointly and severally liable for the amount of tax collected from client employers, but not paid over to the Treasury, plus applicable interest and penalties;
- Amend the Code to authorize the Secretary of the Treasury to require third party payers that have the authority, control, receipt, custody or disposal of client funds intended for the purpose of making federal payroll tax deposits to: (1) register with the IRS; (2) be sufficiently bonded; and (3) provide mandatory disclosure on the form prescribed by the IRS to client taxpayers that the employer may be potentially responsible for unpaid payroll taxes and that the employer can and should periodically verify, through IRS, that their employment tax liability is satisfied in full;
- Amend IRC § 6671(b) to include "third party payers" within the definition of a "person" subject to the trust fund recovery penalty imposed by IRC § 6672(a); and
- Amend the U.S. Bankruptcy Code[6] to clarify that IRC § 6672 penalties survive bankruptcy, even when the debtor is not an individual.

Present Law

Employers are required by law to withhold and deposit employment and income taxes from wages paid to their employees.[7] Employers who fail to collect and deposit these taxes

6 Title 11, U.S. Code.

7 *See generally* IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); IRC §§ 3501-3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); and IRC § 6302(g) (deposits of Social Security taxes).

timely and in the manner prescribed are subject to penalties ranging from two percent to 15 percent of the amount of the underpayment.[8] When these monies are not paid as required, the law also provides for the assessment of a trust fund recovery penalty (TFRP) against individuals who are deemed to be the "responsible persons."[9] The penalty is equal to the amount of income and FICA taxes withheld from employees.[10] Such taxes are referred to as "trust fund" taxes because employers hold the employee's money in trust until it is paid over to the government.

Under present law, the determination of who is liable for withholding, paying, and reporting federal employment taxes begins with the identification of the common law employer.[11] Generally, this determination is based on all facts and circumstances, taking into consideration whether the employer has the right to direct and control the method and means by which an employee performs the services.[12] In 1987, the IRS published a 20-factor test for use as an analytical tool in determining whether an employer-employee relationship exists.[13] This guidance was based on an examination of court decisions and rulings concerning indicia of common law employment. Eventually, the complexity of applying the 20-factor test and changes in certain business practices led to a new analytical approach to be used to determine employer classification.[14] In 2004, the IRS provided materials that set forth an approach that can be used to analyze facts in a given case and determine whether an employer-employee relationship exists which is based upon grouping relevant facts into three general categories – behavioral control, financial control, and relationship of the parties.[15]

Present law does not define the term "third party payer," nor does it specifically authorize the IRS to promulgate regulations to that effect. Generally, IRC § 3504 allows employers to designate agents to act on their behalf to perform duties such as payment of employee wages and company payroll taxes.[16] Under IRC § 3504, all provisions of law (including penalties) applicable in respect of employers apply to the designee and remain applicable

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8 IRC §§ 6656(a).

9 IRC § 6672(a). "Responsible person" is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes, but willfully fails to do so. IRC §§ 6671(b) and 6672(a). *See also* Most Serious Problem, *Assessment and Processing of the Trust Fund Recovery Penalty (TFRP), supra.*

10 *See* IRM 5.7.3.3.1 (Apr. 13, 2006) for factors determining personal responsibility and IRM 7.7.3.3.2 (Apr. 13, 2006) for factors determining willfulness.

11 IRC § 3401(d) generally defines "employer" as "the person for whom an individual performs or performed any services, of whatever nature, as the employee of such person, except that if the person for whom the individual performs or performed the services does not have control of the payment of wages for such services, the term "employer" means the person having control of the payment of such wages." The common law rules apply for determining whether an employer-employee relationship exists. IRC § 3121(d)(2); *see* Rev. Rul. 87-41.

12 Treas. Reg. §§ 31.3121(d)-1 and 31.3401(c)-1.

13 *See* Rev. Rul. 87-41.

14 *See* IRS Information Letter 2004-0087 (June 30, 2004).

15 *See* IRS, Independent Contractor or Employee? Training Materials, Training 3320-102 (10-96) TPDS 84238I; IRS Pub. 15-A, *Employer's Supplemental Tax Guide* (last revised January 2007); *see also* Present Law and Background Relating to Worker Classification for Federal Tax Purposes, Joint Committee on Taxation Report, JCX-26-07 (May 7, 2007).

16 See 26 U.S.C. § 3504; 26 C.F.R. § 31.3504.

to the employer.[17] The IRS currently regulates only designated Form 2678 agents and reporting agents.[18] Neither the Code nor the Treasury Regulations require such agents to be bonded.

The Bankruptcy Code § 523(a)(1) provides that bankruptcy "does not discharge an individual debtor" from taxes given priority under 11 U.S.C. § 507(a)(8), but does not address situations where a business entity owes a tax debt.[19] 11 U.S.C. § 507(a)(8)(C) provides that "a tax required to be collected or withheld and for which the debtor is liable in whatever capacity" is given eighth priority in bankruptcy. The legislative history of 11 U.S.C. § 507 explains that IRC § 6672 penalties are considered to be taxes given priority in bankruptcy.[20] The U.S. Supreme Court held that debts incurred under IRC § 6672 are not dischargeable and treated as priority taxes in bankruptcy.[21]

Reasons for Change

In the more than 60 years that have passed since the enactment of IRC Subtitle C, *Employment Taxes,* the payroll industry has created various third party arrangements for reporting, filing, and payment of employment taxes.[22] However, Congress never amended the relevant Code provisions to reflect the evolution of the industry, nor to authorize the IRS to better regulate the growing use of third party payers.

Unfortunately, in recent years, an increasing number of third party payers have gone out of business, creating a growing amount of uncollected tax liability. For example, in 2006, four third party payers failed to remit millions of dollars in payroll taxes or file quarterly employment tax returns for thousands of taxpayers across the country.[23] These payers

17 See 26 U.S.C. § 3504; 26 C.F.R. § 31.3504.

18 *See* Rev. Proc. 70-6; Notice 2003-70 (state and local governmental agents); Rev. Proc. 2007-38. Reporting agents only report and deposit employment taxes, but are not in position of control and do not pay wages to the employees. The courts have narrowly interpreted Treas. Reg. § 31.3504-1(a) distinguishing agents on the basis of their control and authority to remit salary payments to the employees, not on their control over the funds used for the payment of employment taxes. It has been held that an agent is jointly and severally liable for the company's payroll taxes only if the agent actually had "control, receipt, custody, or disposal of, or pays the wages of an employee or group of employees." *See Pediatric Affiliates, P.A. v. U.S.*, 2006 WL 454374, 2006-1 USTC ¶50,201 (unreported D.N.J. 2006); *see also Morin v. Frontier Bus. Tech.*, 288 B.R. 663, 671-72 (W.D.N.Y. 2003) (holding that agent was not liable for payroll taxes because it never had actual control over the funds used to pay employee wages). In *Pediatric Affiliates*, the court defined a payroll service provider as a third-party agent.

19 *See generally* 11 U.S.C. §§ 523(a); 507(a)(8).

20 S. 2266, 95th Cong., 2d Sess., as reported by the Senate Judiciary Committee and the Senate Finance Committee (1978).

21 *United States v. Sotelo*, 436 U.S. 268, 275 (1978).

22 *See* Most Serious Problem: *Third Party Payers*, Table 1.22.1, *Third Party Arrangements, supra.* Table 1.22.1 illustrates the range of responsibilities, required forms and authorizations, potential tax liability of the third party payer and the client employer, and the current regulatory authority or absence thereof associated with the use of each type of third party payers.

23 Memorandum from Director, Collection Policy, to Collection Area Directors, *Penalty Relief* (Sept. 21, 2006); ALERT: *One Time Penalty Abatement Procedures for Clients of Payroll Service Provider*, Ref. No. BMF 07464 (Oct. 26, 2007).

commingled and improperly used funds that were held in trust for their clients' payroll tax deposits, thus rendering over 800 of their clients' accounts unpaid.[24]

When third party payers fail or commit fraud and abscond with their customers' funds, leaving millions of dollars in employment taxes unpaid, their clients (especially self-employed and small business taxpayers) face significant economic difficulties. Usually, defunct payers do not have sufficient assets to collect against upon default. The IRS then has no recourse other than to initiate collection of unpaid employment taxes from the employers. Not only have the employers paid an amount equal to their employment tax liability twice (once to the failed third party payer and again to the IRS), but they may also be liable for interest and penalties. Moreover, in attempting to resolve the tax liability, many employers will also invest significant amounts of time and incur additional expense for representation before the IRS. Some small businesses may not be able to recover from these financial setbacks and will be forced to cease operations.

The tax system has an interest in taking the steps necessary to protect taxpayers from finding themselves in this situation for at least two reasons. First, this problem primarily affects small businesses, few of which have the cash flow sufficient to pay their employment taxes twice in addition to interest and penalties. For a small business, the tax compliance burden imposed by this problem may even be substantial enough to jeopardize its status as a going concern. Significantly, this is a taxpayer that has done its best to comply with its tax obligations and should not be treated the same way as a willfully noncompliant taxpayer. Second, like return preparers, third party payers have a fiduciary duty not only to their clients, but to the tax system itself. These payers are in fact profiting from obligations imposed on taxpayers by the tax system. Thus, the government has a legitimate interest in ensuring that third party payers faithfully discharge this fiduciary duty.

Explanation of Recommendations

The National Taxpayer Advocate's recommendations would take several steps toward serving both the government's and taxpayers' interests in protecting the small businesses that use third party payers, and preventing the payers from profiting by abusing the tax system.

Essentially, the term "third party payer" should be defined as any person that provides services of filing, reporting, withholding, and payment of employment taxes on behalf of client taxpayers if such person has the authority, control, receipt, custody or disposal of client taxpayers' funds intended by the taxpayers to be used for the purpose of making federal payroll tax deposits. Such third party payers should be jointly and severally liable for all taxes collected from client employers, but not paid over to the treasury. Currently, the IRS and the courts determine who is liable for withholding, paying, and reporting of

24 Memorandum from Director, Collection Policy, to Collection Area Directors, *Penalty Relief* (Sept. 21, 2006); *see also* Carrie Mason-Draffen, *Payroll Firm Fails to Pay Taxes*, Newsday, July 27, 2006, at A46; Carrie Mason-Draffen, *Payroll Firm's Founder Charged*, Newsday, Oct. 12, 2007, at A44; and Saeed Ahmed, *Canton Man Gets Jail for Defrauding Clients*, Atlanta Journal-Constitution, June 28, 2007, at D8.

federal employment taxes generally on the basis of the identification of the common law employer.[25] Typically, third party payers do not pay wages to the employees and lack the sufficient level of direction and control to be the common law employer, and thus are not legally liable for reporting, filing, and paying employment taxes. In most cases, they are also not secondarily liable for employment taxes and the trust fund recovery penalty as fiduciaries or agents under IRC §§ 3504, 3505, or 6672.[26] Therefore, defining a third party payer and imposing joint and several liability on the third party will make a payer liable for all of its clients' employment taxes if the payer has received payment for the client's taxes and fails to pay these taxes over to the IRS.

The National Taxpayer Advocate recommends that Congress authorize the Secretary to impose monetary penalties on third party payers for failure to register or obtain requisite bonding, absent reasonable cause.[27] Registration will assist taxpayers in verifying that their third party payer has met minimal soundness requirements, and bonding will give taxpayers the assurance that a surety company has performed the due diligence required to issue a bond. Payers should also be required to disclose to client taxpayers on a form prescribed by the IRS that the employer may be potentially responsible for unpaid payroll taxes and that the employer can and should periodically verify, through the IRS, that their employment tax liability is satisfied in full. This measure will serve notice to taxpayers of the risks associated with using a third party payer.

Including third party payers within the definition of a "person" subject to the TFRP imposed by IRC § 6672(a) would increase the number of responsible persons jointly and severally liable for the penalty, and also increase the pool of assets available from which the IRS could collect the penalty. The liability would only arise where the third party payer had collected taxes from client employers but did not pay this amount over to the Treasury. This proposal would help protect taxpayers that have fallen victim to third party payer misappropriation by reducing the likelihood that the IRS would need to reach their assets to collect the penalty.

Finally, specifically providing that IRC § 6672 penalties survive bankruptcy would essentially codify the Bankruptcy Code's legislative history and current case law. It would also clarify that IRC § 6672 penalties are not discharged in bankruptcy with respect to responsible persons that are entities as well as those who are individuals. The Bankruptcy Code

25 The courts are reluctant to hold the third party payers jointly and severally liable for embezzled payroll taxes because it is "not a corporate officer or in a position of authority" and does "not have final control over [the employer's] taxpaying duties." *Pediatric Affiliates, P.A. v. U.S.*, 2006 WL 454374, 2006-1 USTC ¶ 50, 201 (unreported D.N.J. 2006).

26 The courts have narrowly interpreted Treas. Reg. § 31.3504-1(a) distinguishing payroll agents on the basis of their control and authority to remit salary payments to the employees, not on their control over the funds used for the payment of employment taxes. It has been held that an IRC § 3504 agent is jointly and severally liable for company's payroll taxes only if the agent actually had "control, receipt, custody, or disposal of, or pays the wages of an employee or group of employees." *See Pediatric Affiliates, P.A. v. U.S.*, 2006 WL 454374, 2006-1 USTC ¶50,201 (unreported D.N.J. 2006); *see also Morin v. Frontier Bus. Tech.*, 288 B.R. 663, 671-72 (W.D.N.Y. 2003) (holding that agent was not liable for payroll taxes because it never had actual control over the funds used to pay employee wages).

27 The Secretary may also be authorized to waive the bonding requirement for payroll agents that meet certain high fiduciary standards.

provides that bankruptcy does not discharge an individual debtor from taxes given priority under 11 U.S.C. § 507(a)(8), but we want to bring an entity under IRC § 6672, so we propose that 11 U.S.C. § 523(a) be amended to include "entities." This clarification would further protect taxpayers that use third party payers that fail to pay over taxes to the IRS and then declare bankruptcy.

ALR # 1

Expand Definition of Taxpayer Identification Number (TIN) to Include Internal Revenue Service Numbers (IRSN)

Problem

Current regulations require a taxpayer to provide a valid taxpayer identifying number (TIN) to claim an exemption or the earned income tax credit (EITC).[1] Treasury Regulations provide that TINs include Social Security numbers (SSN), individual taxpayer identification numbers (ITIN), adoption taxpayer identification numbers (ATIN), and employer identification numbers (EIN).[2]

In certain situations, the IRS assigns a temporary TIN to a victim of identity theft.[3] The IRS instructs the identity theft victim to file his or her tax return using this temporary number, called an Internal Revenue Service Number (IRSN), while the IRS attempts to determine who is the true owner of the SSN in dispute.[4] However, because IRSNs are not among the four types of numbers included in the definition of a TIN, an identity theft victim who files a tax return using an IRSN (per IRS instructions) is not allowed to claim an exemption or the EITC.[5]

If a taxpayer attempts to claim an exemption or the EITC while filing a tax return using an IRSN, the IRS follows its math error procedures to deny the claim.[6] Internal Revenue Code (IRC) § 6213(b) authorizes the IRS to assess an addition to tax, without issuing a notice of deficiency, where the adjustment is the result of a mathematical or clerical error on the tax return. A taxpayer receiving a math error assessment may go to Tax Court if he or she contests the assessment within 60 days after the assessment has been made.[7] If the taxpayer convinces the Tax Court that he or she is the legal owner of the common TIN, the Tax Court will reflect this conclusion in its final order and decision.

The IRS's policy of denying tax benefits, such as an exemption or the EITC, to a taxpayer using an IRSN is inequitable and perpetuates the harm suffered by an identity theft

1 *See* IRC § 151(e) (requiring a valid TIN for the dependency exemption) and IRC §§ 32(c)(1)(F) and 32(c)(3)(D) (requiring a valid TIN for the EITC).

2 *See* Treas. Reg. 301.6109-1(a)(1)(i).

3 However, identity theft victims are not the sole recipients of IRSNs. For example, in mixed entity cases, perpetrators of identity theft are assigned IRSNs. *See* IRM 21.6.2.4.3.1.

4 Letter 239C advises taxpayers:

> You should use the Internal Revenue Service Number (IRSN) for federal income tax purposes until we can verify your social security number (SSN). Your IRSN is only a temporary number. We cannot allow you credits such as the Earned Income Tax Credit, etc., unless you have a valid taxpayer identification number. However, you should file your return on time and claim any credits.

5 Treas. Reg. § 301.6109-1(a)(1)(i) provides that taxpayer identifying numbers include SSNs, individual taxpayer identification numbers, adoption taxpayer identification numbers, and employer identification numbers.

6 *See* IRM 21.5.4.2 (Oct. 1, 2007).

7 IRC § 6213(b)(2).

victim.[8] The denial of these tax benefits can turn a refund into a balance due account. Moreover, the IRS does not freeze collection actions in identity theft cases, which may exacerbate the identity theft victim's situation.

Example

Jane Doe has learned that someone else used her SSN to file a fraudulent tax return early in the 2006 filing season. After she reported this incident to the IRS, Jane received a letter from the IRS instructing her to file future tax returns using the IRSN assigned to her. In April 2007, Jane complies with the instructions and files her tax return using the assigned IRSN. Because Jane used an IRSN to claim a personal exemption for herself and the EITC, with her young daughter as a qualifying child, the IRS disallowed her claims for these tax benefits. With $14,000 in earned income during 2006, Jane lost out on a deduction of the exemption amount and an EITC of $2,747 as a result.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC §§ 151(e), 32(c)(1)(F), and 32(c)(3)(D) to require a taxpayer to provide a valid TIN or IRSN in order to claim an exemption and the EITC.[9] This recommendation would enable an identity theft victim who files a tax return using an IRSN to claim an exemption or the EITC.

8 TAS asked Accounts Management what the rationale was for the IRS to use IRSNs in scrambled SSN situations, given that it results in the denial of the personal exemption. Accounts Management responded that IRSNs are used to separate tax data on scrambled cases until the owner of the common number is identified, and that the personal exemption must be denied until the Social Security Administration can determine who is the true owner of the SSN. Accounts Management further stated, "Consider that the same taxpayer may have filed all of the returns posted under the common number. Until sufficient information is received to resolve the case, the taxpayer should not be given the benefit of claiming the exemption again." Email from Accounts Management to TAS, dated Jan. 17, 2007. TAS has been unsuccessful in its attempts to persuade the IRS to modify its procedures.

9 The National Taxpayer Advocate will be exploring the possibility of amending the IRC § 6109 regulations.

ALR #2

Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers

Problem

Internal Revenue Code (IRC) § 6713 has historically been identified as the civil counterpart to the criminal penalty imposed on tax return preparers under IRC § 7216. Like IRC § 7216, IRC § 6713 provides a broad prohibition against the use and disclosure of tax return information. Exceptions to the broad prohibition are provided in IRC § 6713(b), which states that the rules of IRC § 7216(b) apply. IRC § 7216(b) authorizes the Secretary to create regulatory exceptions to the criminal penalty statute. Thus, the current statutory framework seemingly requires that exceptions be made either to both the criminal and civil statutes or to neither.

The penalty regime under IRC § 7216 is significantly harsher than under IRC § 6713. Most importantly, IRC § 7216 is a criminal statute, and a violation constitutes a misdemeanor carrying a fine of up to $1,000 and/or imprisonment for up to one year along with liability for the costs of prosecution. By contrast, IRC § 6713 imposes a civil penalty of $250 for each unauthorized use or disclosure of tax return information, not to exceed a total of $10,000 per calendar year.

While the intent of treating the improper use or disclosure of tax return information as a criminal offense was presumably to provide maximum protection for taxpayers, the paradoxical effect may be to limit taxpayer protection. The Treasury Department is understandably reluctant to subject preparers to criminal sanctions except for egregious conduct, so it has used its regulatory authority to carve out broad exceptions from the general prohibition on the use or disclosure of tax return information set forth in IRC § 7216. Because the exceptions under IRC § 7216 (criminal statute) are deemed to apply to IRC § 6713 (civil statute), there is no room for Treasury and the IRS to designate the use or disclosure of tax return information for certain questionable business practices or the sale of certain products with high-abuse potential as civil violations without also making them criminal violations. Therefore, we believe taxpayer protections would be stronger if Treasury is given the flexibility to promulgate regulations applicable only to the civil penalty without concern that the criminal penalty would also apply.[1]

1 It is debatable whether IRC § 7805(a) provides Treasury with the flexibility to issue regulations exclusively addressing the civil penalty imposed under IRC § 6713. Therefore. it is the intent of this recommendation to provide Treasury with the unquestionable authority to issue regulations specific to IRC § 6713.

Example

A tax preparer who serves the low income taxpayer community uses tax return information to determine whether taxpayers qualify for a balance due loan product provided by a third party financial institution. The preparer receives a financial incentive from the institution to market the product to taxpayers who meet certain criteria. Advocates for low income taxpayers and state attorneys general have reported that taxpayers have negative experiences with this particular product and cannot separate the act of purchasing the product from the act of return preparation. In the interest of tax administration, Treasury would like to restrict the preparer's ability to use and disclose tax return information to market this particular type of balance due loan. Under the current provisions, Treasury believes it is not authorized to draft regulations which would address the imposition of only civil penalties under IRC § 6713 on preparers engaged in this activity without also subjecting them to criminal liability under IRC § 7216.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 6713 to authorize the Secretary to prescribe regulations under IRC § 6713. Specifically, Congress should amend IRC § 6713 as follows:

- Amend subsection (b) to read:

  "(b) **Exceptions.** — Except as otherwise provided in regulations prescribed by the Secretary under subsection (d), the rules of section 7216(b) apply for purposes of this section."

- Create subsection (d) to read:

  "(b) **Regulations.**—The Secretary may prescribe such regulations and other guidance as may be necessary or appropriate to carry out this section."

ALR #3

Allow Taxpayers to Raise Relief Under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions

Problem

Spouses filing joint tax returns are jointly and severally liable for any deficiency or tax due.[1] Internal Revenue Code (IRC) § 6015 provides rules regarding relief from joint and several liability. Spouses living in community property states and filing separate returns are generally required to report one-half of the community income on the spouse's separate return. Under IRC § 66, a spouse may be relieved from the operation of the community property laws. These rules are sometimes collectively referred to as the "innocent spouse" rules. Generally, the innocent spouse rules either reallocate income between spouses (IRC § 66) or relieve one spouse of joint and several liability for tax attributable to the other spouse (IRC § 6015).

In last year's Annual Report to Congress, the National Taxpayer Advocate proposed several changes to IRC § 6015 to make the provision consistent and fair.[2] Specifically, the National Taxpayer Advocate recommended that Congress:

- Require the IRS to include the last date to file a petition with the U.S. Tax Court in any final determination letter the IRS issues in connection with an election or request for innocent spouse relief and provide that a taxpayer may file a petition with the Tax Court within 90 days of the date of determination or by the date specified in the final determination letter, whichever is later;
- Suspend the period for filing a Tax Court petition during the stay triggered by a bankruptcy filing and for 60 days thereafter;
- Provide the Tax Court with jurisdiction to review community property relief determinations under IRC § 66(c);
- Provide that a taxpayer may request equitable relief from liabilities under IRC § 6015(f) or IRC § 66(c) at any time the IRS could collect such liabilities; and
- Expand the availability of refunds to taxpayers granted innocent spouse relief.

As discussed in the Most Litigated Issue section of this report, the National Taxpayer Advocate has identified another innocent spouse issue this year.[3] While taxpayers may raise relief from joint and several liability in a Collection Due Process (CDP) proceeding,[4]

1 IRC § 6013(d)(3).

2 *See* National Taxpayer Advocate 2006 Annual Report to Congress 534-543 (Additional Legislative Recommendation: "Innocent Spouse" Relief Fixes).

3 *See* Most Litigated Issue: *Relief from Joint and Several Liability under IRC § 6015, infra.*

4 IRC §§ 6320(c); 6330(c)(2)(A)(i).

a deficiency proceeding,[5] a bankruptcy proceeding,[6] or a refund suit,[7] a number of recent United States district court opinions have held that relief from joint and several liability cannot be raised as a defense in a collection suit in district court. In *United States v. Feda*,[8] an action to reduce to judgment federal tax assessments against a husband and wife for underpayments of tax reflected on several joint income tax returns, the court held that only the IRS, not the district court, may grant such relief. Relying on *Feda*, the court ruled in *United States v. Boynton*,[9] a suit under IRC § 7402 to reduce the taxpayer's joint income tax liability to judgment, that the district court only has jurisdiction to consider a IRC § 6015 claim in the context of a refund suit and exclusive jurisdiction lies with the Tax Court in all other circumstances. Similarly, in *United States v. Cawog*,[10] a suit to foreclose tax liens on real property under IRC § 7403, the court concluded that exclusive jurisdiction to review an IRC § 6015 determination lies with the Tax Court and refused to allow the taxpayer to raise the defense.[11] In *United States v. Bucy*,[12] the court likewise held that a taxpayer was not entitled to innocent spouse relief in a suit to reduce joint income tax liability to judgment because the taxpayer had not requested such relief from the IRS or petitioned the Tax Court for it. These decisions conflict with the position of the Tax Court, which held in *Thurner v. Commissioner*[13] that a taxpayer was barred from raising IRC § 6015 as a defense in a Tax Court proceeding because the taxpayer could have raised the defense in a prior collection suit.

Example

The United States filed a collection suit in district court under IRC § 7402 seeking to reduce W's joint income tax liability to judgment. W raised her entitlement to relief under IRC § 6015 as her only defense. The district court ruled in favor of the United States on the grounds that the district court lacked jurisdiction to consider W's IRC § 6015 claim.[14]

Recommendation

Amend IRC §§ 6015 and 66 to clarify that taxpayers may raise relief under IRC §§ 6015 or 66 as a defense in a proceeding brought under any provision of Title 26 (including §§ 6213, 6320, 6330, 7402, and 7403) or any case under title 11 of the United States Code.

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5 IRC § 6213; *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

6 11 U.S.C.A. § 505(a)(1).

7 IRC § 7422.

8 97 A.F.T.R.2d (RIA) 1985 (N.D. Ill. 2006).

9 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007).

10 97 A.F.T.R.2d (RIA) 3069 (W.D. Pa. 2006), *appeal dismissed* (3d Cir. July 5, 2007).

11 The court did, however, state that if it had jurisdiction, it would have denied the taxpayer's request for IRC § 6015 relief.

12 2007 U.S. Dist. LEXIS 82548 (S.D. W. Va. 2007).

13 121 T.C. 43 (2003).

14 *See United States v. Boynton*, 99 A.F.T.R.2d (RIA) 920 (S.D. Cal. 2007).

ALR #4

Referral to Low Income Taxpayer Clinics

Problem

Elsewhere in this report, the National Taxpayer Advocate discusses the impact that representation has on the outcome of a taxpayer's case, particularly in Earned Income Tax Credit (EITC) examinations.[1] One opportunity for taxpayers to obtain representation before the IRS is through the Low Income Taxpayer Clinics (LITCs).[2] Congress authorized the LITC program under Internal Revenue Code (IRC) § 7526 in 1998 after hearing testimony about the problems that low income and English as a second language (ESL) taxpayers have in obtaining access to representation, and in learning about their rights and responsibilities as taxpayers.[3]

However, the Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury prohibit IRS employees from recommending or referring taxpayers to specific attorneys or accountants.[4] Further, the Office of Government Ethics (OGE) Standards of Ethical Conduct for Employees of the Executive Branch prohibit employees, including IRS employees, from endorsing any product, service or enterprise.[5]

Based on both the OGE Standards and the Treasury Standards, the IRS's Deputy Ethics Official (DEO) has advised that although the Treasury Standards appear to apply only to recommendations or referrals of attorneys or law firms, tax clinics are "similar enough to law firms, such that they fall within the prohibitions of the OGE Standards and the Treasury Standards."[6] According to the DEO, tax clinics are similar to law firms in that they have a fiduciary duty to taxpayers, provide legal advice, and represent taxpayers in court.[7] The DEO further advised that IRS employees may provide a taxpayer with the contact information for a particular LITC if the taxpayer asks. IRS employees can also read the names and phone numbers of the clinics located in a taxpayer's geographic area but cannot refer a taxpayer to a specific LITC.

1 For additional information, *see* Most Serious Problem, *EITC Examinations and the Impact of Taxpayer Representations, supra*; and *infra* Vol. 2.

2 The LITC program is a grant program under IRC § 7526 in which qualified organizations receive matching federal grants to represent low income taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers.

3 *IRS Restructuring: Hearing Before the Senate Finance Committee*, Statement of Nina E. Olson, Director of the Community Tax Law Project, 105th Cong., 2nd Sess. (Feb. 5 1998); *Taxpayer Rights Proposals: Hearing Before the House Ways and Means Committee*, Statement of Nina E. Olson, Director of the Community Tax Law Project, 105th Cong., 1st session (Sept. 26, 1997).

4 "Employees of the IRS shall not recommend, refer or suggest, specifically or by implication, ay attorney, accountant, or firm of attorneys or accountants to any person in connection with any official business which involves or may involve the IRS. 5 C.F.R. § 3101.106(a).

5 *See* 5 C.F.R. § 2635.702(c)(1) and 5 C.F.R. § 2635.101(b)(8).

6 GLS-0779-00 (May 16, 2000).

7 GLS-0779-00 (May 16, 2000).

LITCs are federally-funded organizations that undergo substantial monitoring from TAS and the Treasury Inspector General for Tax Administration (TIGTA).[8] LITCs include clinical programs at accredited law, business, or accounting schools in which students represent taxpayers in controversies before the IRS, and IRC § 501(c) organizations exempt from tax under IRC § 501(a) that either directly represent taxpayers or refer taxpayers to qualified representatives. By virtue of their congressional authorization, the type of work they engage in, and the population they are designed to serve, LITCs can be distinguished from law and accounting firms to entitle them to different treatment on the issue of taxpayer referrals.

Without the ability to refer low income taxpayers to specific clinics, the IRS cannot help these taxpayers find the assistance they need. Although IRS employees can direct taxpayers to the LITC website[9] or Publication 4134, Low Income Taxpayer Clinic List, these are not necessarily the easiest options for putting taxpayers in touch with those who may be able to help them.[10] Given the vital role that representation can play in the outcome of a taxpayer's audit, the IRS should be able to do whatever it can to put an eligible taxpayer in touch with a clinic in his or her area to ensure that the right result is reached in the taxpayer's case.

Example

John receives a notice from the IRS regarding an examination of his tax return. John calls the toll-free phone number on the notice because he does not understand what he needs to do. John speaks English as a second language, and consequently has some difficulty communicating with the IRS employee. The employee believes John may be eligible for assistance from an LITC and refers him to the IRS website for a list of clinics in his state. John does not have Internet access, is unfamiliar with the clinic program, and asks the employee to give him the name of the clinic closest to him. However, IRS guidance prevents the employee from providing John with the name and phone number. The employee can only provide John with a list of all of the clinics in his geographic area.

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8 Treasury Inspector General for Tax Administration, Ref. No. 2006-10-093, *Confirmation of Tax Compliance Issues Among Low Income Taxpayer Clinics* (Sept. 18, 2006); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-129, *Progress Has Been Made but Further Improvements Are Needed in the Administration of the Low Income Taxpayer Clinic Grant Program* (Sept. 21, 2005); Treasury Inspector General for Tax Administration, Ref. No. 2003-40-125, *Improvements Are Needed in the Oversight and Administration of the Low-Income Taxpayer Clinic Program* (May 29, 2003); Treasury Inspector General for Tax Administration, Ref. No. 2002-10-085, *Increased Monitoring of the Low-Income Taxpayer Clinics Is Needed to Ensure Compliance with the Grant Terms and Conditions* (May 10, 2002).

9 http://www.irs.gov/advocate/article/0,,id=106991,00.html.

10 IRS, *The 2007 Taxpayer Assistance Blueprint Phase 2* at 37-39 (Apr. 2007) (discussing barriers to website use); National Taxpayer Advocate 2006 Annual Report to Congress vol. 2 at 10-13 (discussing taxpayer unwillingness and barriers to Internet usage). *See also* National Taxpayer Advocate 2006 Annual Report to Congress at 333-354, 355-375 (discussing issues related to limited English proficiency, English and a second language, and low income taxpayers).

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 7526(c) to add a special rule stating that notwithstanding any other provision of law, IRS employees may refer taxpayers to Low Income Taxpayer Clinics receiving funding under this section. [11]

This change will allow IRS employees to refer a taxpayer to a specific clinic for assistance. In making such referrals, the IRS should maintain its current disclaimer language to prevent any misconception that taxpayers may be either advantaged or disadvantaged in their cases based on their decision of whether to use a clinic.[12]

11 There have been numerous similar proposals introduced in Congress over the last five years. *See* Taxpayer Protection and Assistance Act of 2007, S.1219, 110th Cong., § 2 (2007) (introduced in the Senate); Taxpayer Protection and Assistance Act of 2005, S.832, 109th Cong., § 2 (2005) (introduced in the Senate); Taxpayer Protection and IRS Accountability Act of 2003, H.R.1528 108th Cong., § 601 (2003)(reported in House); Tax Administration Reform Act of 2002, H.R. 5728, 107th Cong., § 106 (2002) (engrossed as agreed to or passed by House); Taxpayer Protection and IRS Accountability Act of 2002, H.R.3991 107th Cong., § 601 (2002) (reported in House) Tax Relief Guarantee Act of 2002, H.R. 586, 107th Cong., § 271 (2002) (engrossed amendment as agreed to by the House); Fairness in Tax Collection Act of 2002, H.R. 5548, 107th Cong. § 7 (2002) (introduced in the House).

12 The current disclaimer language states:

> The partial funding by the IRS does not imply that the clinic(s) have a preferential relationship with the IRS. The IRS and the United States Government do not endorse or warrant the use of these clinics and organizations. The decision of whether to use these clinic(s)/organizations is your own and their use will not affect your rights before the IRS.

GLS-0779-00 (May 16, 2000).

ALR #5

Consent-Based Disclosures of Tax Return Information Under Internal Revenue Code Section 6103(c)

Problem

When closing on a mortgage or other loan, borrowers often must consent to disclose certain tax information in order to verify their income. This consent usually involves signing a *blank* copy of Form 4506-T, *Request for Transcript of Tax Return,* which gives the lender access to four years of tax information for 60 days from the date on the form. However, the information disclosed is not subject to the same protection and limits on use as other taxpayer information, which raises numerous privacy concerns. As the IRS makes it easier for the private sector to access this information, the lack of taxpayer protection can lead to misuse or even the sale of confidential tax information.[1]

Consent-based disclosures of confidential tax return information raise significant privacy concerns. Under Internal Revenue Code (IRC) § 6103(c), the use of tax information obtained by consent is not limited to the original purpose for which it was obtained.[2] Thus, a lender or other investor could use the information obtained by a § 6103(c) consent for purposes other than verifying the borrower's financial information. Current law provides no protection and requires no due diligence concerning whether lenders are actually filling in the forms with regard to the date signed, to whom the information is provided, and the tax years requested, or are leaving forms blank.

Example

Joe applied and was approved for a mortgage to purchase a home. At the closing of the mortgage, Joe is given a stack of papers to sign. Included with the papers is a blank Form 4506-T, *Request for Transcript of Tax Return*. Joe was told to sign the form and not to worry about the rest of the information on the form. Years later, Joe's mortgage is sold to another lender and the lender is given a copy of Joe's signed Form 4506-T. Unknown to Joe, the new lender completes the rest of the form and submits it to the IRS, obtaining access to Joe's tax return information.

1 This discussion is limited to legislative changes that can be made to protect taxpayer information. For a discussion of recommended administrative changes the IRS can make, *see* Most Serious Problem, *Mortgage Verification, supra.*

2 IRC § 6103 provides that, in general, tax returns and return information cannot be disclosed unless expressly authorized. Section 6103(c) authorizes the Secretary to disclose, pursuant to regulations, tax information to any person designated by a taxpayer. Under the regulations, the taxpayer designates the party to whom his or her information should be disclosed by completing a request for or consent to disclosure, usually on Form 4506, *Request for Copy of Tax Return*, Form 4506-T, *Request for Transcript of Tax Return* or Form 8821, *Tax Information Authorization*. Treas. Reg. 301.6103(c)-1. For a detailed discussion and analysis of § 6103, see National Taxpayer Advocate 2003 Annual Report to Congress at 232 – 255 (Key Legislative Recommendation: Confidentiality and Disclosure of Returns and Return Information).

Recommendation

The National Taxpayer Advocate recommends that IRC § 6103(c) be amended to limit the disclosure of tax returns and tax return information requested through taxpayer consent solely to the extent necessary to achieve the purpose for which consent was requested. Elsewhere in this report, the National Taxpayer Advocate makes an administrative recommendation to amend Form 4506 and related forms to allow taxpayers to specify the reasons for which they are granting consent.[3] Limiting the use of tax return information to the express purpose of the taxpayer consent prevents misuse of taxpayer information.

Additionally, IRC § 6103(p)(3)(C) should be amended to require the Secretary of the Treasury to include in the Treasury's annual disclosure report to the Joint Committee on Taxation detailed information about the number and types of disclosures pursuant to taxpayer consent.[4] Requiring the IRS to track disclosures made through IRC § 6103(c) consent will enable the IRS to monitor how § 6103(c) consents are being used and whether increased taxpayer education or oversight are necessary to protect taxpayer information.

To provide a deterrent to misusing taxpayer return information obtained pursuant to a § 6103(c) consent, IRC §§ 7213A and 7431 should be amended to apply criminal and civil sanctions.[5] Implementing criminal and civil sanctions of up to $1,000 per violation will dissuade lenders from using tax return information for reasons outside the scope of the taxpayer's consent.

Finally, to ensure that lenders no longer ask individuals to sign blank or incomplete forms, IRC § 7431 should be amended to impose a civil penalty of $500 for each attempt to obtain a signed blank or incomplete Form 4506, 4506-T, and 2858, subject to a reasonable cause exception. Although the IRS can and should request the cooperation of mortgage and other lenders in ensuring that borrowers do not sign blank or incomplete forms, properly applied penalties will further demonstrate the importance of safeguarding taxpayer information and encourage the users of such data to conduct the necessary due diligence.

3 For a discussion of administrative recommendations, *see* Most Serious Problem, Mortgage Verification, infra.

4 Under IRC § 6103(p)(3)(C), within 90 days after the close of each calendar year, the Secretary of the Treasury must submit to the Joint Committee on Taxation a report on the number of certain types of disclosures of tax returns and return information during the year. Section 6103(c) is specifically exempted from the reporting requirements of § 6103(p)(3), and therefore the IRS is not required to track disclosures pursuant to § 6103(c). IRC § 6103(p)(3)(A).

5 IRC § 7213A imposes a criminal penalty of up to $1,000 against federal employees and other persons. IRC § 7431 imposes a civil penalty of up to $1,000 against an employee of the U.S. or any other person.

ALR #6

Home Care Service Workers

Problem

Home Care Service Workers (HCSWs) help disabled or elderly persons with personal care or household chores. Generally, state and local government health and welfare programs determine that a Home Care Service Recipient (HCSR) is eligible to receive in-home support services, and the HCSR receives services from an HCSW in accordance with the terms of the program. Notwithstanding the governments' supplying of funds for and often-extensive involvement in the programs, HCSWs generally are considered domestic employees of HCSRs.[1]

Because HCSRs in these programs are elderly and disabled, and thus likely are not able to fulfill the complicated payment and reporting requirements imposed on employers, a variety of third party payroll reporting and payment arrangements have arisen.[2] These arrangements may cause problems for the HCSRs, who are among the least able taxpayers to successfully navigate IRS account resolution and collection processes.[3]

Example

State A administers a wide variety of home care service programs for thousands of its elderly and disabled residents. State policy affords HCSRs as much discretion as possible over the services and program operation, allowing them to choose the HCSWs and direct the services to be performed. However, State A retains control of welfare funds, controls the bank account from which the HCSWs are paid, and can exercise discretion on the HCSR's behalf if the HCSR is not capable of communicating for him or herself.

State A has contracted out the administration of the program to EasyTax, an intermediary service organization that includes administering payroll functions. State A deposits funds intended to pay HCSWs' employment taxes to EasyTax's operating bank account on a monthly basis. EasyTax accumulates payroll tax deposits from the state for a number of months, but does not turn these funds over to the IRS. Instead, EasyTax's owner takes the

1 The determination of who is liable for withholding, paying, and reporting of employment taxes begins with the identification of who is the common law employer. A worker is a common law employee of the entity that has the right to direct and control the method and means by which he or she performs the services. *See generally* IRC §§ 3401(d); 3121(d)(2); Treas. Reg. §§ 31.3121(d)-1 and 31.3401(c)-1; *see also* Rev. Rul. 87-41.

2 *See generally* IRC § 3504; Treas, Reg, § 31.3504; Rev. Proc. 70-6; Notice 2003-70 (state and local governmental agents); Rev. Proc. 2007-38. *See also* Most Serious Problem, *Third Party Payers, Table 1.22.1, Third Party Arrangements, supra*. The table illustrates the range of responsibilities, required forms and authorizations, potential tax liability of the third party payer and the client employer, and the current regulatory authority or absence thereof associated with the use of each type of third party payers.

3 *See* Most Serious Problem, *Employment Tax Treatment of Home Care Service Recipients, supra.*

funds deposited by the state and other clients and disappears to an offshore jurisdiction. Lacking sufficient assets to function as a going concern, EasyTax declares bankruptcy.

Eventually, the IRS discovers arrearages on HCSRs' accounts and initiates collection from elderly and disabled HCSRs (who are considered to be common law employers of the HCSWs). These elderly and disabled taxpayers are now liable for delinquent payroll taxes, interest, and penalties.

Recommendation

The National Taxpayer Advocate reiterates her 2001 recommendation[4] and recommends that Congress:

- Amend IRC § 3121(d)(3) to provide that a Home Care Service Worker is the statutory employee of the administrator of the Home Care Service Worker funding (defined as states, localities, their agencies, or intermediate service organizations, regardless of the original funding source).[5]

4 *See* National Taxpayer Advocate 2001 Annual Report to Congress 193; Key Legislative Recommendation: *Home-Based Service Workers.*

5 By designating these workers as statutory employees, the proposal shifts responsibility for withholding, reporting, and paying required employment taxes for HCSWs from HCSRs to the funding administrators without making a determination that the worker is a common law employee of the administrator. Thus, this is neutral as to whether the administrator must treat the HCSW as a common law employee for the purposes of employee or retirement benefits.