Written Statement of

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Committee on Ways and Means
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Hearing on

The 2008 Tax Return Filing Season, IRS Operations, FY 2009 Budget Proposals, and The National Taxpayer Advocate's 2007 Annual Report to Congress

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Chairman Lewis, Ranking Member Ramstad, and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today to discuss the Internal Revenue Service's 2008 filing season and other issues presented in the 2007 National Taxpayer Advocate's Annual Report to Congress.[1] At the outset, I would like to say that the IRS has done an admirable job during this filing season, given all the challenges it is facing. As I noted in my Annual Report, late-year tax-law changes impact both taxpayers and the IRS, and the uncertainty surrounding such changes increases the risk that problems will arise with basic service delivery and return processing.[2] These challenges increase when the IRS must devote substantial resources during the filing season to a major new initiative, such as preparing to pay out the recently authorized economic stimulus rebates. To deliver these rebates, the IRS not only must process payments to the over 130 million taxpayers who currently file income tax returns, but it also must identify and process returns from and payments to more than 20.5 million persons who have no filing requirement.[3] All of these exigencies divert the IRS from other important work, yet the fact that the IRS has managed to turn on a dime and deliver this filing season without significant glitches is a testament to the extraordinary people who work at the IRS.

Moreover, now that the IRS has demonstrated its ability to change processes virtually overnight, I fully expect it to adopt and implement some of the recommendations I made in my Annual Report to Congress in the same time frame! I will address some of these issues below.

I. The Time Is Ripe for a Taxpayer Bill of Rights[4]

Before I address administrative challenges facing the IRS, I will briefly discuss one legislative recommendation I proposed in my recent report. On July 22nd of this year, we will be marking the tenth anniversary of the Internal Revenue Service

[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

[2] *See* National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: The Impact of Late-Year Tax-Law Changes on Taxpayers).

[3] Approximately 20.5 million persons received Social Security or Veterans benefits and are therefore likely to qualify for stimulus rebates but did not file tax returns in 2006. IRS News Release, *Special Economic Stimulus Payment Packages Go to Social Security, Veterans Recipients*, IRS-2008-37 (Mar. 10, 2008). There is also an unknown number of low income taxpayers who ordinarily would not have a filing requirement but will have to file this year to receive a rebate.

[4] *See* National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Taxpayer Bill of Rights and *De Minimis* "Apology" Payments).

Restructuring and Reform Act of 1998 (RRA 98), a landmark piece of legislation that established many significant protections for taxpayers in their dealings with the IRS. Over the last ten years, there have been many changes in the tax world – including a new batch of tax shelters, increasing identity theft, a greater ability to electronically track financial transactions, a large increase in the number of returns filed electronically, and an increased emphasis on tax law enforcement. Despite all of these changes, there has been no significant legislation in the taxpayer rights or tax procedure arena over the last ten years.

In my 2007 Annual Report to Congress, I recommend that Congress address taxpayer rights by creating a true "Taxpayer Bill of Rights" (TBOR). Modeled after the U.S. Constitution's Bill of Rights, this TBOR would serve as a clear statement of the social contract between the government and its taxpayers – that 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 file and pay their taxes. I believe it is in the best interest of taxpayers and tax administration for this unspoken agreement to be explicitly 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. I propose the following:

TAXPAYER BILL OF RIGHTS

Taxpayer Rights

1. The Right to Be Informed (including access to adequate legal and procedural guidance and information about taxpayer rights);

2. The Right to Be Assisted;

3. The Right to Be Heard;

4. The Right to Pay No More Than the Correct Amount of Tax;

5. The Right of Appeal (both administrative and judicial);

6. The Right to Certainty (including clear guidance, periods of limitations, no second exam, and closing agreements);

7. The Right to Privacy (including due process considerations, least intrusive enforcement actions, and search and seizure protections);

8. The Right to Confidentiality;

9. The Right to Representation;

10. The Right to a Fair and Just Tax System (including offers-in-compromise, appropriate abatements, access to the Taxpayer Advocate Service, and symbolic apology or other compensation for IRS errors).

Taxpayer Obligations

1. The Obligation to Be Honest;
2. The Obligation to Be Cooperative;
3. The Obligation to Provide Accurate Information and Documents on Time;
4. The Obligation to Keep Appropriate Records;
5. The Obligation to Pay Taxes on Time.

I am hopeful that legislation to enact a Taxpayer Bill of Rights can also serve as a vehicle for more comprehensive taxpayer rights and tax procedure legislation that fills some of the gaps identified since the passage of RRA 98. In recent years, the tax-writing committees have made efforts to pass such legislation. In 2003, the Ways and Means Committee reported and the full House approved the Taxpayer Protection and IRS Accountability Act,[5] and in 2004, the Finance Committee and the full Senate approved the Tax Administration Good Government Act.[6] However, no conference committee was formed, and the bills were never enacted. In 2006, the Senate Finance Committee tried again, approving a significant taxpayer rights and tax administrative package as part of the Telephone Excise Tax Repeal Act, but it was not considered by the full Senate.[7]

The passage of time has only increased the need for such legislation. Among the proposals I believe should be included are the following:

- Protect the more than 60 percent of taxpayers who rely on paid tax preparers by imposing minimum standards of competence. At present, anyone can prepare federal tax returns; there are no standards at all. Preparers should be required to pass a basic competency test and take periodic Continuing Professional Education courses. Greater accuracy in return preparation will benefit both taxpayers and the IRS.

- Increase electronic filing by allowing taxpayers to prepare and file their returns electronically without having to pay a fee to private vendors. The IRS should make an e-filing template available and develop a direct filing portal. A direct filing portal will not only attract taxpayers concerned about costs but will also reassure taxpayers who have data security concerns about routing their personal tax information through third-party vendors.

[5] H.R. 1528, 108th Cong. (2003).

[6] S. 882, 108th Cong. (2004).

[7] S. 1321, 109th Cong. (2006).

- Protect low income taxpayers by regulating refund anticipation loans (RALs), especially by prohibiting cross-collection agreements.

- Reduce the burdens on partners in partnerships by advancing the initial partnership return filing deadline from April 15 to March 15. At present, partnerships generally cannot prepare Schedules K-1 on which they report each partner's income and other tax attributes until they finish preparing the full partnership return, and hundreds of thousands of partners receive their K-1s on or after April 15, requiring them to file for extensions.

- Protect low income senior citizens by exempting Social Security payments from levies or by requiring the IRS to develop and utilize an effective screen so that levies are not automatically imposed on taxpayers who are likely to suffer economic hardship.

- Simplify the "kiddie tax" computation rules.

This is not a comprehensive list of proposals that I believe should be adopted, but it represents a good start in combination with proposals included in prior legislation approved by the Ways and Means and Finance committees. I urge the Ways and Means Committee to take up the Taxpayer Bill of Rights this year.

II. Identity Theft Is an Increasing Area of Concern to Taxpayers and to Tax Administration, and the IRS Must Do More to Assist Taxpayers Who Are Victims of Identity Theft[8]

Identity theft is the number one consumer complaint in the United States, far outpacing all others.[9] Identity theft impacts tax administration when an individual intentionally uses the Social Security number (SSN) of another person to file a false tax return or fraudulently obtain employment. Misuse of another person's SSN or identity generally occurs in tax administration in two contexts: (1) the filing of a false return to obtain a fraudulent refund ("refund fraud") or (2) the theft and use of another person's SSN to obtain employment ("employment-related fraud").

In refund fraud, the perpetrator files early in the filing season using the personal information of the innocent taxpayer and before the lawful owner of the SSN has an opportunity to file. Typically, a perpetrator will use false Forms W-2 reflecting phantom wages and withholding credits, thus forming the basis of a fraudulent claim for a refund. To secure the fraudulent refund, the perpetrator typically will direct the IRS to transmit the refund electronically to a bank account under his or her control.

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[8] *See* National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: Identity Theft Procedures).

[9] In 2007, the Federal Trade Commission (FTC) received 258,427 complaints of identity theft. The next closest complaint was shop-at-home catalog sales with 62,811 complaints. *See* FTC website, http://www.ftc.gov/opa/2008/02/fraud.pdf.

When the identity theft victim later attempts to file his or her tax return, the IRS flags it as a "duplicate" return and freezes the refund. Although the IRS is required to notify a taxpayer when a refund claim is denied, the IRS does not systemically notify a taxpayer when a refund claim is frozen in identity theft cases, despite the fact that a refund freeze can have the same economic effect as a refund denial. In my 2007 Annual Report to Congress, I recommended that the IRS consider issuing a "soft notice" to the second filer informing the taxpayer that the refund has been frozen as a result of a duplicate filing.[10] This puts the second filer on notice that a potential identity theft has occurred and allows the taxpayer to take steps to protect himself or herself. In addition, the IRS should consider whether to send a notice to the first filer, as in some cases it is not clear which filer is the victim and which filer is the perpetrator.

In employment-related fraud, persons without the necessary legal status to obtain employment in the United States unlawfully use another person's SSN to appear work eligible. The employer of the undocumented worker will file a Form W-2 reflecting the worker's wages, which IRS data systems will attribute to the rightful SSN owner. The IRS will assess a balance due unless the lawful owner of the SSN acts to halt the erroneous assessment.

Regardless of the motive, identity theft results in serious consequences for the innocent taxpayer. Such consequences may include (1) the delay or denial of refunds, (2) the assessment of tax debts resulting from income reflected on the fraudulent filer's return, and (3) the requirement for victims to prove their identity to the IRS year after year. The IRS has a duty to these taxpayers to expeditiously determine the true owner of the SSN and restore the integrity of the affected taxpayer's account.

We applaud the IRS for taking some proactive measures to assist victims of identity theft. For example, the IRS recently implemented a tracking system through which an indicator will be placed on an identity theft victim's account once he or she has provided verification of identity theft. I am very pleased with this positive development, as my office has long advocated such a tracking system.[11]

However, the IRS needs to take a much more taxpayer-centric approach to identity theft with respect to the identity theft indicator. For example, the IRS has no central guidance about how to apply the indicator, allowing each operating division and function to create its own procedures and guidance. Thus, an identity theft victim's account may be handled differently depending on which part of the IRS he or she contacts.

I am also concerned that the IRS does not know how many taxpayers are impacted by identity theft. As noted earlier, the IRS prior to FY 2008 had no method to systemically identify taxpayers whose SSNs were compromised. Although the IRS

[10] *See* National Taxpayer Advocate 2007 Annual Report to Congress 98, 115.

[11] *See* National Taxpayer Advocate 2005 Annual Report to Congress 191.

issues temporary numbers to some identity theft victims, it cannot distinguish those taxpayers from other taxpayers to whom it issues similar temporary numbers. My personal belief is that the IRS has many more cases of identity theft on its hands than it is estimating. For example, my employees report that they are now receiving calls from seniors who filed for the economic stimulus payment after not filing for years, only to find that someone else had been using their SSN on tax returns.

In talking with my local taxpayer advocates and case advocates, I often hear that there is a lack of adequate procedures available to IRS employees to address the relatively new crime of identity theft. In some respects, the IRS tries to fit a round peg into a square hole when addressing identity theft issues by using so-called "mixed entity" procedures[12] and "scrambled SSN" procedures,[13] which were initially designed to address very different circumstances. As a result, there are significant gaps in the IRS's Internal Revenue Manual into which identity theft victims fall.

For example, we are currently working a case where an individual with no filing requirement came to TAS because current IRS procedures address multiple filing situations only. The falsified income information on the fraudulent return was transmitted to the Social Security Administration, which promptly discontinued the Social Security disability benefits of the victim because it recorded the wages reported on Form W-2 under her name and therefore believed she was now working. The IRS does not have adequate procedures to address situations where the identity theft victim does not have a filing requirement, so the taxpayer was referred to TAS.

Another example that illustrates the inadequacy of current IRS procedures is the use of IRS Numbers, or "IRSNs." Under its scrambled SSN procedures, the IRS assigns a temporary tax identification number, called an IRSN, to victims of identity theft.[14] In FY 2005, the IRS assigned IRSNs to over 77,000 taxpayers. The IRS

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[12] The IRS uses "mixed entity" procedures when it knows which of the multiple SSN users is the rightful owner. Under mixed entity procedures, the IRS assigns a temporary IRS number (IRSN) to taxpayer(s) wrongfully using the SSN, while the rightful SSN owner can continue using the SSN. The IRS then separates out the income attributable to the fraudulent filer from the innocent taxpayer's account, transferring the disputed income to the IRSN. *See* IRM 21.6.2.4.3 (Oct. 1, 2007).

[13] The IRS uses "scrambled SSN" procedures when it cannot determine the true owner of the SSN. In this situation, it assigns IRSNs to both (or all, if more than two) taxpayers who used the common SSN. The IRS instructs taxpayers who are assigned IRSNs to discontinue using their SSN. 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.

See IRM 21.6.2.4.4 (Oct. 1, 2007).

[14] 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 (Oct. 1, 2007).

sends a letter (Letter 239C) to identity theft victims instructing them to use this temporary number to file tax returns while the IRS and the Social Security Administration (SSA) seek to determine the rightful owner of the SSN in question, a process that has historically taken over two years.[15] In the meantime, identity theft victims who file a return using an IRSN (per IRS instruction) will be denied personal exemptions and credits (such as the child tax credit and the earned income tax credit) because the IRS does not consider an IRSN to be a valid tax identification number. For example, if the SSN of a five-year-old child shows up on a Form W-2 reporting wages from a full-time job, it should be fairly clear that the five-year-old child did not earn those wages and should be treated as the victim rather than the perpetrator. Because of IRS processing requirements, however, that child may be instructed to use an IRSN instead of a SSN when he is claimed as a dependent on his parents' return. Now, in addition to having to straighten out the serious problem of identity theft, the child's parents –through no fault of their own – may be ineligible for the dependency exemption, child tax credit, and earned income tax credit with respect to the child until the IRS and SSA reach a formal decision about the true holder of the SSN.

This harm is compounded under the provisions of the recently enacted Economic Stimulus Act of 2008.[16] The Act provides that any return that does not include an SSN – whether for a primary or secondary taxpayer or a dependent – will be ineligible for the economic stimulus payment.[17] Thus, taxpayers who already are victims of identity theft are further victimized by IRS processes. These taxpayers in fact have an SSN. It is simply IRS's and SSA's cumbersome processes that are causing these taxpayers to wait for and possibly lose up to two years' worth of dependency exemptions, child tax credits, and earned income tax credits – and now economic stimulus payments as well.

I have proposed that the IRS search its records to identify identity theft victims that were required by the IRS to use IRSNs on their returns, contact these taxpayers, and assist them in filing amended returns that would list both their SSNs and their IRSNs, so they will be able to receive the tax benefits to which they are entitled. Since the taxpayer will also list the IRSN, the IRS will still be able to process the return. If these taxpayers are to receive their economic stimulus payments this year, however, the IRS must act quickly. At the very least, it can instruct these taxpayers to claim the payment on their 2008 income tax returns.

Another concern is that, although the IRS's Automated Underreporter, Automated Collection System, Criminal Investigation, Examination, and Accounts Management functions all work identity theft cases, there is no coordinated effort to address an

[15] The IRS states that the average scrambled SSN case currently takes approximately ten months to resolve. This is a substantial reduction from prior periods and is attributed to recently implemented process improvements made by the IRS in collaboration with the Social Security Administration. *See* National Taxpayer Advocate 2007 Annual Report to Congress 110.

[16] Pub. L. No. 110-185, 122 Stat. 613 (2008).

[17] Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008).

identity theft victim's issues from start to finish.[18] As a result, my organization has had to devote our limited resources to resolving identity theft issues. Stolen identity cases within TAS have increased by 644 percent from FY 2004 to FY 2007.[19]

In my 2007 report to Congress, I recommended that the IRS develop a dedicated, centralized unit to handle all identity theft cases and a centralized IRM to house all identity theft procedures.[20] A centralized unit will be able to identify trends and systemic problems, and can serve as a central contact point for discussions with SSA to improve processing. I am personally seeking agreement from the IRS leadership to work with me and my staff to develop such a unit and IRM.

I also recommended that the IRS develop a form that taxpayers can file when they believe they have been victims of identity theft. The creation of such a form would have two benefits. First, it would allow the IRS to better track identity theft cases. The IRS has already begun to place an indicator on an identity theft victim's account, but this form would contain much more information about the victim's circumstances. Second, the instructions on the form should explain which steps the IRS will take and which steps the taxpayer should take to restore the integrity of the taxpayer's account (*i.e.*, obtaining an FTC affidavit).

In the meantime, we have been collaborating with the IRS Office of Privacy, Information Protection, and Data Security on a pilot program to work online refund fraud crime cases. This group is charged with developing processes to assist two types of identity theft victim groups: (1) victims of refund crimes; and (2) victims of online fraud or phishing schemes. The working group will propose a new notification process and a new account maintenance process.

[18] In fact, the IRS estimated that there are 17 entry points at which an identity theft case can come into the system. *See* IRS, *Identity Theft Program Current State* (July 20, 2007).

[19] The table below shows the increase in TAS Stolen Identity cases (primary issue code 425) from FY 2004 to FY 2007.

	FY 2004	**FY 2005**	**FY 2006**	**FY 2007**
Stolen Identity	447	922	2,486	3,327

Taxpayer Advocate Management Information System, FY 2004, FY 2005, FY 2006 and FY 2007. TAS began tracking Stolen Identity cases in March 2004; the annual total for 2004 is a 12-month estimate based on an actual nine-month count of 335 cases.

[20] *See* National Taxpayer Advocate 2007 Annual Report to Congress 115.

III. The Procedures Taxpayers Must Follow to Exclude Canceled Debts from Gross Income Are Confusing, and as a Result, Many Taxpayers May Be Paying Tax They Do Not Owe[21]

Taxpayers who default on their mortgages, taxpayers whose liabilities exceed their assets, and taxpayers whose debts are discharged in bankruptcy are in most cases exempt from the general rule that canceled debts are taxable.[22] In fact, the exemption for taxpayers who default on mortgages secured by their principal residences was enacted just this past December to protect the hundreds of thousands of taxpayers who have lost or are likely to lose their homes to foreclosure in the subprime mortgage crunch.[23]

Significantly, however, none of the exceptions applies automatically. In order to exclude the amount of a canceled debt from taxable income, a taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*. If a taxpayer fails to file Form 982, the IRS's document-matching system generally will treat the amount of the canceled debt (which is reported by the lender on Form 1099-C) as unreported by the taxpayer and will issue a notice proposing additional tax. Once this notice is issued, the taxpayer at best will have to spend time understanding and responding to the notice to avoid a tax assessment. At worst, the taxpayer will not respond or will not respond adequately, and the IRS will assess tax that the taxpayer does not owe.

Taxpayers receive about two million Forms 1099-C annually reporting cancellation of debt income.[24] At least among electronically filed returns, it appears that *fewer than one percent* of taxpayers with cancellation of debt income file Form 982 claiming entitlement to exclude the amount of the canceled debt from taxable income.[25]

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[21] *See* National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem: Tax Consequences of Cancellation of Debt Income).

[22] IRC § 108(a)(1). Canceled debts are also excluded from gross income where a debt is qualified farm indebtedness and, in the case of a taxpayer other than a C corporation, where the discharged debt is qualified real property business indebtedness.

[23] Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2 (2007). The exclusion applies to the extent that the principal balance of the loan does not exceed $2 million, the home is the taxpayer's principal residence, and the debt is canceled in 2007, 2008, or 2009.

[24] IRS Document 6961, Table 2 (showing that the IRS received 1,942,694 Forms 1099-C in 2006 and projects it will receive 2,058,600 Forms 1099-C in 2007).

[25] For Tax Year 2005, the IRS received 495,495 electronically filed returns from taxpayers who had cancellation of debt income reported on a Form 1099-C. IRS Compliance Data Warehouse, Information Returns Master File and Individual Returns Transaction File (Tax Year 2005). By comparison, the IRS received only 4,571 electronically filed Forms 982 for that time period. IRS E-File Reports (Processing Year 2006). Note that the number of electronically filed returns actually was greater than 495,495 because our data search only reflects Forms 1099-C issued to taxpayers listed with the primary taxpayer identifying number (TIN) on a tax return. It does not reflect cases where a spouse or a person whose TIN was listed as other than the primary TIN received a 1099-C.

I spent 27 years preparing tax returns and representing taxpayers before I joined the government, and I do not for a minute believe that only one percent of taxpayers with canceled debts qualify for an exclusion. Taxpayers who default on their debts are generally experiencing significant financial problems, and almost by definition, their liabilities are high relative to their assets. A taxpayer whose liabilities exceed his or her assets is insolvent and may exclude cancellation of debt income to the extent of the insolvency. If taxpayers understood the definition of insolvency and knew how to compute and report it, I am convinced that a very high percentage of taxpayers would be eligible to exclude their canceled debts from income. I am therefore deeply concerned that tens of thousands of taxpayers who qualify for the insolvency exclusion are not claiming it. And now, with the recently enacted exception for canceled home mortgage indebtedness, I am concerned that even more taxpayers entitled to claim an exclusion will fail to do it.

The confusion in this area stems largely from the complexity of the law, but the IRS has devoted surprisingly little effort to explaining the rules clearly to taxpayers. Consider the following obstacles that taxpayers face:

- The instructions to Form 1040 imply that canceled debts are always taxable by listing them under the heading of "Examples of income to report on line 21" and making no mention of exceptions or of Form 982.

- Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, is intended to be used by both business taxpayers and nonbusiness taxpayers. The form is extraordinarily complex. For business taxpayers, the IRS estimates that the time required to complete the form is 10 hours and 43 minutes. While it should take non-business taxpayers considerably less time, they still must navigate requests on the form to list such things as "qualified farm indebtedness," "qualified real property business indebtedness," "real property described in section 1221(a)(1)," "depreciable real property," "depreciable property," "net operating loss," "general business credit carryover," "minimum tax credit," "net capital loss," "nondepreciable and depreciable property," "passive activity loss and credit carryovers," and "foreign tax credit carryover to or from the year of the discharge."

- Nonrecourse debts (meaning debts on which the lender can do no more than repossess the property that secures a loan if the borrower defaults) do not give rise to taxable income at all. Yet this is not explained in IRS instructions, and Forms 1099-C issued by lenders do not specify whether a canceled debt is recourse or nonrecourse. Therefore, a taxpayer who receives a Form 1099-C may unnecessarily report a canceled nonrecourse

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Note, too, that the data excludes returns filed on paper, which represent slightly less than half of all individual income tax returns filed. We could not determine how many Forms 982 were submitted with paper-filed returns.

debt as income and, if he fails to do so, the IRS likely will seek to collect tax on the canceled nonrecourse debt because it has no way to know whether the debt is recourse or not.

- Because of the complexity of the subject, the IRS has designated the tax treatment of canceled debts as "out of scope" for purposes of answering taxpayer questions at its Taxpayer Assistance Centers.

- Although IRS Taxpayer Assistance Centers generally prepare returns for low income taxpayers who seek assistance, the IRS has designated the tax treatment of canceled debts as "out of scope" for purposes of preparing tax returns as well.

- The IRS has designated the tax treatment of canceled debts as "out of scope" for purposes of return preparation at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

- The IRS currently has no publication that comprehensively explains the taxation and reporting of canceled debts.

- One of the most common bases to exclude a canceled debt from income is insolvency of the taxpayer. However, many taxpayers do not know what the term "insolvency" means, much less how it is computed. The IRS provides very little guidance for taxpayers regarding the meaning of the term or its computation.

- The IRS has posted a series of questions and answers on its website about canceled debts that states: "Insolvency can be fairly complex to determine and the assistance of a tax professional is recommended if you believe you qualify for this exception."[26] However, a taxpayer who is insolvent – meaning that his liabilities are greater than his assets – probably cannot afford to pay a tax professional, and the IRS has essentially blocked taxpayer access to free return preparation assistance by declaring canceled debt issues to be "out of scope" at its Taxpayer Assistance Centers and at VITA and TCE sites.

- In cases involving homes, cars, boats or other property, the amount of debt cancellation varies depending on the fair market value the lender assigns to the property. Valuing a home or car is not an exact science, and there are times where a taxpayer may disagree with the value a lender assigns. Yet in contrast to other Forms 1099, the IRS does not require issuers of Form 1099-C to list a telephone number. As a result, taxpayers may not be able to contact their lenders with questions or requests for correction.

[26] *See* IRS website, Questions and Answers on Home Foreclosure and Debt Cancellation, http://www.irs.gov/newsroom/article/0,,id=174034,00.html (last visited Mar. 7, 2008).

To its credit, the IRS has been working with my office to address some of these problems. It has revised the Form 982 instructions to make them somewhat clearer for nonbusiness taxpayers, it has agreed to issue a publication on the treatment of canceled debts that a member of my staff is now drafting, and it has posted a series of questions and answers on the IRS.gov website explaining the new home mortgage exclusion. However, I believe that more needs to be done, and I remain concerned that many taxpayers who are entitled to exclude canceled debts from income are either failing to file Form 982 to properly exclude canceled debts or are receiving proposed assessments from the IRS and failing to respond because they do not understand how to approach the issue.

I recently recorded a podcast intended to educate taxpayers about cancellation of debt income and its exclusions. My office will also be issuing a plain language "consumer tax tips" brochure on this issue, and we are working with Low Income Taxpayer Clinics (LITCs) to get taxpayers the help they need if disputes arise in connection with cancellation of debt income. Moreover, I made 11 specific recommendations in my recent Annual Report to Congress to address this problem, and I hope the IRS will do more to implement them on an expedited basis.

IV. Elderly and Disabled Taxpayers Who Need In-Home Care Are Sometimes Liable for Unpaid Employment Taxes on Amounts the Government Pays to Their Caretakers[27]

State and local government agencies administer a variety of health and welfare programs that provide assistance with personal care and household chores to individuals eligible to receive in-home support services.[28] Under current law, the home care service recipients in these programs are often treated as the common law employers of those who care for them.[29] As such, they are personally responsible for reporting, filing, and paying the employment taxes on their caretaker's wages.

Because participants in these programs are elderly and disabled, it is often difficult for them to correctly determine whether they are the caretaker's common law

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[27] *See* National Taxpayer Advocate 2007 Annual Report to Congress 355-373 (Most Serious Problem: Employment Tax Treatment of Home Care Service Recipients) and 556-557 (Legislative Recommendation: Home Care Service Workers).

[28] In 2003, nearly 2.6 million individuals received home and community-based services paid for by the government. *See* Kaiser Commission on Medicaid and the Uninsured, *Medicaid 1915(c) Home and Community-Based Service Programs: Data Update* (December 2006); *see also* Office of Inspector General, Department of Health and Human Services, *States' Requirements for Medicaid-Funded Personal Care Attendants*, OEI-07-05-00250 (revised Dec. 2006).

[29] 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. *See* IRC § 3121(d)(2); *see also* Rev. Rul. 87-41, 1987-1 C.B. 296.

employer (which involves applying complex and sophisticated employment tax rules and regulations).[30] Even if they determine that they are the employer, these elderly and disabled service recipients may not be able to comply with the complicated tax payment and reporting requirements applicable to employers. As a result, government entities often contract with a variety of third parties to file, report, and pay employment taxes on the caretaker's wages.[31]

One common arrangement is for the government to hire an intermediary service organization (ISO).[32] However, these ISOs or other third parties sometimes fail to properly file, report, and pay employment taxes.[33] In such cases, the elderly and disabled home care service recipients – as the common law employers – remain liable for the tax, interest, and penalties. Such liabilities can result in severe hardship.[34]

IRS computer programming errors have exacerbated these problems, even in cases where an ISO has properly complied with all employment tax obligations. Prior to January 2007, IRS systems could not link the service recipients' Social Security numbers (SSNs) to the ISO's Employer Identification Number (EIN). As a result, the IRS erroneously initiated inappropriate collection activity against thousands of

[30] The determination of who is liable for withholding, paying, and reporting employment taxes begins with the identification of who is the common law employer. IRC § 3121(d)(2). 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. *See generally* IRC §§ 3401(d) and 3121(d)(2); Treas. Reg. §§ 31.3121(d)-1 and 31.3401(c)-1. In 1987, the IRS published a 20-factor test for use as an analytical tool in determining whether an employer-employee relationship exists based on an examination of court decisions and rulings concerning indicia of common-law employment. *See* Rev. Rul. 87-41, 1987-1 C.B. 296.

[31] *See generally* IRC § 3504; Treas. Reg. § 31.3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Notice 2003-70, 2003-2 C.B. 916 (state and local governmental agents); and Rev. Proc. 2007-38, 2007-1 C.B. 1442. *See also* National Taxpayer Advocate 2007 Annual Report to Congress 339, Table 1.22.1, Third Party Arrangements (illustrating 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 of authority associated with the use of each type of third party payers).

[32] An ISO may act as a designated agent under IRC § 3504. 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. Under IRC § 3504, all provisions of law (including penalties) applicable in respect of employers apply to the designee and remain applicable to the employer. *See* IRC § 3504; Treas. Reg. § 31.3504-1; Rev. Proc. 70-6, 1970-1 C.B. 420; and Notice 2003-70, 2003-2 C.B. 916 (state and local governmental agents).

[33] The IRS currently regulates only designated IRC § 3504 agents and reporting agents. *See* Rev. Proc. 70-6, 1970-1 C.B. 420; Notice 2003-70, 2003-2 C.B. 916 (state and local governmental agents); and Rev. Proc. 2007-38, 2007-1 C.B. 1442. Neither the Internal Revenue Code nor Treasury Regulations require such agents to be bonded.

[34] The IRS has filed notices of federal tax lien, issued levies on elderly and disabled individuals' personal bank accounts, and levied their monthly Social Security benefits even though many elderly and disabled taxpayers depend on these funds to pay rent and buy food and medicine.

elderly and disabled service recipients.[35] TAS and the IRS provided relief to many of these individuals.[36] However, IRS computer systems still cannot identify existing employer/third-party payer relationships established prior to 2007.[37] Unfortunately, home care service recipients and their designated agents may continue to experience significant burden.[38]

Placing employment tax reporting and payment obligations on elderly and disabled taxpayers who need government assistance for in-home care defies logic and does not reflect good tax administration. If we do place these obligations on the elderly and disabled, we need to take additional steps to minimize the burdens they create. Both Congress and the IRS can do more in this regard.

What Can the IRS Do to Address the Problem?

The IRS should take the following actions to help elderly and disabled home care service recipients and their agents better understand their employment tax responsibilities and minimize the impact on elderly and disabled individuals of the failure of third parties to fulfill them:

- Issue a policy statement to indefinitely suspend assessment and collection of employment tax from elderly and disabled service recipients resulting from ISO defaults, while actively pursuing collection of the unpaid employment tax liability from the ISOs that are jointly and severally liable under IRC § 3504;

- Develop tools, such as flow charts, that can be used to analyze relevant facts and circumstances attributable to the service provider-service

[35] In addition, the IRS was unable to identify the specific home care service recipients included in the aggregate returns filed by ISOs on behalf of multiple clients. SB/SE response to TAS research request (Oct. 25, 2007).

[36] In FY 2006 and FY 2007, TAS and the IRS identified over 25,000 elderly and disabled taxpayers potentially subject to collection activity. TAS worked closely with various IRS Collection and Customer Service functions (Automated Collection System, Federal Payment Levy Program, and Accounts Management) to resolve the myriad account issues. The TAS Office of Systemic Advocacy initiated three immediate interventions and an advocacy project. Local TAS offices in Pittsburgh and St. Louis resolved more than 300 individual cases.

[37] The IRS implemented a programming change to prevent taxpayers from receiving erroneous Form 941, *Employer's Quarterly Federal Tax Return*, tax delinquency notices. However, this change applies only to taxpayers and agents who filed Form 2678, *Employer's Appointment of Agent,* after January 1, 2007. Taxpayers and agents could still be subject to inappropriate collection activity for prior years.

[38] In 2006 and 2007, the IRS Collection function, TAS, and the Office of Taxpayer Burden Reduction identified and successfully adjusted accounts impacted by 29 vendors in three states representing nearly 23,000 home care service recipients. However, TAS continues to work with over 20 vendors in one state that represent more than 9,000 home care service recipients. The Small Business/Self Employed Operating Division advised TAS that it no longer has the resources to resolve the remaining cases. Many elderly and disabled service recipients are still subject to inappropriate collection actions including levies against their Social Security benefits.

recipient relationships and determine whether an employer-employee relationship exists in a given case;

- Develop additional outreach and educational materials for the home health care industry;
- Simplify IRS processes for state and local agencies managing welfare-funded home care programs for home care service recipients;
- Develop uniform and mandatory third party application and filing guidelines for use by IRS campuses across the country; and
- Implement appropriate computer programming that can currently determine whether the correct amount of tax is reported and paid by the ISO on behalf of the home care service recipients and link the accounts of the service recipients and the ISOs for relationships established prior to January 1, 2007.

What Can Congress Do to Address the Problem?

As I recommended in 2001,[39] Congress should:

- 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 ISOs, regardless of the original funding source).[40]

[39] *See* National Taxpayer Advocate 2001 Annual Report to Congress 193. In 2001, I raised concerns about the disparate tax treatment of home care service workers and the classification of service recipients as common law employers. I proposed a legislative change to shift the liability for employment taxes from the service recipients, who are generally considered common law employers under current law, to the administrators of home care service recipient funding, including (but not limited to) states, state agencies, or ISOs, regardless of the original source of funding. In 2002, Senator Jeff Bingaman introduced legislation to clarify that any home care service worker is an employee of the administrator of home-based service worker program funding. S. 2129, 107th Cong. (2002).

[40] By designating these workers as statutory employees, the proposal shifts responsibility for withholding, reporting, and paying required employment taxes for home care service workers from the service recipients to the funding administrators without making a determination that a worker is a common law employee of the administrator. Thus, the proposal is neutral as to whether the administrator must treat the home care service worker as a common law employee for the purposes of employee or retirement benefits.

V. The IRS Should Take a Stronger Oversight Role in the Electronic Filing Arena[41]

While the IRS has made impressive progress in increasing the rate of electronic filing, it is still far from reaching the congressionally mandated goal of 80 percent.[42] During the 2007 filing season, almost 57 percent of all individual returns were filed electronically.[43] Considering the significant benefits e-filing affords both the IRS and taxpayers, it is time to revisit the agency's policies surrounding this program. As the tax administrator, the IRS has the authority to determine the policies and criteria that entities must meet to participate in the e-file program. In important respects, however, it appears that the IRS has relinquished control of the electronic filing program to private industry. The IRS should urgently assess what is in the best interests of taxpayers and the agency itself, and then develop plans to meet these objectives.

To Fully Realize the Benefits of e-File, the IRS Should Enable All Taxpayers to Prepare Their Returns and File Directly with the IRS without Charge

The IRS has an incentive to increase the rate of electronic filing to the highest level possible. Electronic filing of tax returns brings benefits to both taxpayers and the IRS.[44] From a taxpayer perspective, e-filing improves accuracy by eliminating the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before returns are accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which could allow the IRS to shift resources to other areas), allows the IRS to capture return data electronically, and enables the IRS to process and review returns more quickly.[45]

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[41] *See* National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return Preparation and Filing) and 471-477 (Legislative Recommendation: Free Electronic Filing for All Taxpayers); *see also* National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (Most Serious Problem: The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential) and 547-548 (Legislative Recommendation: Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers); National Taxpayer Advocate 2006 Annual Report to Congress 197-221 (Most Serious Problem: Oversight of Unenrolled Preparers); and National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives).

[42] The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. *See* Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(2), 112 Stat. 685 (1998). The 80 percent e-filing goal was not achieved by 2007. However, we believe Congress should reiterate its commitment to requiring the IRS increase the e-filing rate as quickly as possible.

[43] IRS News Release, *IRS E-File Opens for 2008 Filing Season for Most Taxpayers,* IR-2008-5 (Jan. 10, 2008).

[44] *See* S. Rep. No. 105-174, at 39-40 (1998).

[45] *See* IRS Fact Sheet, *2008 IRS E-File,* FS-2008-4 (Jan. 2008).

During the 2007 filing season, approximately 25 percent of all individual returns processed by the IRS through June 2007 were prepared using software yet mailed in rather than submitted electronically.[46] These taxpayers could have easily e-filed their returns once they were prepared using computer software, but for some reason the taxpayers chose to file paper returns, which requires the IRS to devote additional resources to enter the tax return data manually and, in turn, creates a risk of transcription error. The IRS needs to research and address the reasons behind this type of filing behavior. If the IRS successfully converts a significant portion of these taxpayers to electronic filing, it would come close to, and perhaps surpass, the 80 percent e-filing goal.

I have strongly advocated for years that the IRS place a basic, fill-in template on its website to permit taxpayers to self-prepare their tax returns and file directly with the IRS for free.[47] There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and direct filing portal would address some taxpayers' cost and security concerns and would result in a greater number of e-filed tax returns. For those taxpayers who are comfortable preparing their returns without assistance, the government should provide the means for them to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they will remain free to purchase one.

Despite the IRS's efforts, some taxpayers still will not e-file. For those cases, the IRS should develop 2-D bar code technology, which would provide taxpayers and the IRS with many of the same benefits as electronic filing.[48] It is my understanding that the IRS has already incorporated this technology into other functions.

Recent, highly publicized phishing schemes confirm the need for the IRS to develop a free fill-in template and direct filing portal. During the 2007 filing season, for example, an Internet tax scam lured taxpayers into entering confidential tax return information on sites masquerading as Free File sites, and these taxpayers became victims of identity theft.[49] It is understandable that some potential Free File users fall victim to scams, especially when taxpayers wishing to prepare their returns pursuant to an IRS sanctioned program visit the official IRS website only to be

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[46] IRS Electronic Tax Administration, Partial Tax Year 2006 / Processing Year 2007 Database, Ad Hoc 344 Results.

[47] *See, e.g.,* National Taxpayer Advocate 2004 Annual Report to Congress 471-477.

[48] To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. Once printed, the return has a horizontal and vertical bar code containing tax return information. The IRS scans the return, captures the data, decodes it and processes the return as if it had been sent electronically.

[49] *See* IRS News Release, *Late Tax Scam Discovered; Free File Users Reminded to Use IRS.gov*, IR-2007-87 (April 13, 2007). The IRS is also aware of several phishing schemes during the 2008 filing season. *See* IRS News Release, *IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting*, IR-2008-11 (Jan. 30, 2008).

directed to one of 19 potentially unfamiliar commercial websites. All taxpayers should have the option to prepare and file their federal income tax returns on a website that is clearly sanctioned by the IRS without having to understand the dynamics between the commercial website and the federal government.[50]

The IRS Needs to Assert Control over its e-File Policies so that They Serve the Best Interests of Taxpayers and Tax Administration

Currently, the IRS relies completely on private industry to develop and update tax return preparation and filing software. Furthermore, when the industry encounters a problem or determines that a certain software programming update is not feasible or cost-effective, taxpayers and the IRS are left to deal with the downstream consequences.

An example of the IRS's reliance on the e-file industry can be illustrated by a recent issue involving the economic stimulus package. Eligibility for a 2008 economic stimulus rebate is based on information reported on an individual's 2007 filed income tax return. Therefore, low income taxpayers who are not typically required to file a return pursuant to IRC § 6012(a) will need to file a 2007 return in order to receive the stimulus rebate. However, the IRS e-file systems are not programmed to accept returns reporting zero adjusted gross income (AGI). To address this limitation, the IRS quickly developed a solution that permits eligible individuals to enter $1 in AGI, without the threat of compliance-related consequences, for the sole purpose of effectuating the electronic filing of the return.[51] Yet this solution requires a certain amount of cooperation among commercial software providers due to the requisite prompts the software would need to provide the user.

The IRS has a small degree of control over Free File participants' products, but it cannot force Free File or any other software vendors to make last-minute programming changes of this nature. As of March 10, 2008, the IRS Free File webpage indicated that only five of the 19 Free File participants had accommodated the $1 work-around solution, having reprogrammed their software to alert taxpayers to this issue and directing affected taxpayers to print out step-by-step instructions to report the $1 AGI item.[52] While the IRS Free File page will seek to guide affected taxpayers to use those products that support the $1 work-around, we are concerned about the level of confusion that inevitably will ensue when taxpayers without a sophisticated understanding of these issues seek to navigate the Free File site. We are also concerned about the confusion and frustration that taxpayers who do not use the Free File site will encounter when they unwittingly purchase software products that do not support the $1 work-around.

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[50] Free File is accessible through the official IRS website, but not all taxpayers are eligible to use the program. For the 2008 filing season, 70 percent of individual taxpayers are eligible for IRS Free File. Taxpayers must have adjusted gross income of $54,000 or less to be eligible. *See* IRS Fact Sheet, *2008 IRS E-File,* FS-2008-4 (Jan. 2008).

[51] *See* IRS Notice 2008-28, 2008-10 I.R.B. 546; Rev. Proc. 2008-21, 2008 WL 556742.

[52] *See* http://www.irs.gov/efile/lists/0,,id=179739,00.html (last visited Mar. 10, 2008).

The economic stimulus package as well as other late-year tax legislation presented potentially unprecedented challenges for all parties involved. The IRS was called upon to make mid-filing season systems programming changes on a dime and managed to resolve the issues in a timely manner. At the same time, many software companies struggled to reprogram their products to accommodate the changes required by all of the late legislation. The rationale for the government's initial decision to enter into Free File and refrain from providing e-filing products itself was largely that the private sector is more innovative, nimbler, and better able to serve taxpayer needs than the IRS. However, the IRS has demonstrated this year that it *also* has the ability to rise to the occasion and meet enormous challenges on a moment's notice.

The 2007 filing season provided an additional example of the IRS's reactive role in the e-file arena and the resulting impact on tax administration. Taxpayers using Intuit Inc. tax return preparation and filing software products (Lacerte, ProSeries, and TurboTax) during the 2007 filing season experienced filing problems at the eleventh hour. Specifically, a significant number of taxpayers attempting to file returns through Intuit were unable to do so on April 17th (the standard April 15th deadline was extended because of a weekend and holiday) because of a slowdown in the company's electronic filing server. As a result, the IRS granted these taxpayers a two-day filing extension and agreed not to impose late-filing penalties. While the IRS and Intuit worked quickly to minimize the impact on these taxpayers, many of them experienced unnecessary frustration and anxiety. It would be understandable if some of the affected taxpayers revert back to paper filing in 2008 after such a negative experience with the e-file process in 2007.[53]

Finally, it has come to my attention that a nonprofit-operated free return preparation and filing product faced initial opposition to its request for a listing as a Free File program participant or, alternatively, as an IRS e-file partner on the IRS official website. The program I-CAN! E-FILE is run by the Legal Aid Society of Orange County, California (LASOC), which also happens to operate a Low Income Taxpayer Clinic (LITC).[54] Denying a listing on the IRS website placed I-CAN! E-FILE in a difficult position and potentially harmed taxpayers who stand to benefit from the product, since the IRS has actively warned taxpayers about phishing schemes and informed them that the only real way to avoid becoming a victim of a

[53] Intuit Press Release, *Intuit Apologizes to Lacerte, ProSeries and TurboTax Customers* (Apr. 19, 2007).

[54] I-CAN! E-FILE can be used to prepare and file federal and state returns of low income taxpayers who lived and worked in one of the following states: California, Michigan, New York, Pennsylvania or Montana. The program can also add the Permanent Fund Dividend to federal returns of Alaska residents. For the 2006 tax year, the program returned more than $18,370,000 in tax refunds to 13,438 low-income taxpayers. Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to David R. Williams, Director, Electronic Tax Administration and Refundable Credits (Jan. 18, 2008) (on file with the Taxpayer Advocate Service); Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Tim Hugo, Free File Alliance (Aug. 3, 2007) (on file with the Taxpayer Advocate Service). For more information about this product, see http://www.icanefile.org.

potential scam is to access an e-file product through the official IRS website. Free File denied LASOC membership on two grounds: (1) membership is limited to commercial software companies, and (2) the Alliance developed its software using federal funds received through the Legal Services Corporation, a nonprofit corporation, and through the LITC grant program (which the organization vigorously disputes).[55] The IRS initially stated that the LASOC product cannot be listed as an IRS e-file partner if the corresponding description advertises both free preparation and free filing services.[56]

When a seemingly reputable program run by a nonprofit organization has trouble obtaining a listing on the IRS website as either a Free File participant or an e-file partner merely because it is run by a nonprofit organization and wants to advertise free preparation *and* filing services in its listing description, I am concerned that the IRS's electronic filing policies have gone astray.[57] These determinations are presumably made to further the IRS e-file program, yet they do not reflect the best interests of taxpayers and do not seem to be grounded in any legitimate tax administration purpose.

I believe that the IRS should take a more proactive role in the electronic filing arena by setting the policies and standards for participation in the IRS e-file program. Such policies and procedures should align with the needs of both taxpayers and tax administration. All high quality return preparation and filing products should have equal access to the market, reflect the latest tax law changes, and be compatible with filing season peaks in demand as well as IRS's computer and processing needs. Unless the IRS takes corrective action, the IRS remains in a reactive position at the whim of private industry and is forced to devote scarce resources to address the downstream consequences of potentially avoidable problems.

[55] E-mail from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Taxpayer Advocate Service (Feb. 29, 2008) (on file with the Taxpayer Advocate Service).

[56] Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to David R. Williams, Director, Electronic Tax Administration and Refundable Credits (Jan. 18, 2008) (on file with the Taxpayer Advocate Service); e-mail from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Taxpayer Advocate Service (Mar. 5, 2008).

[57] It should be noted that exempt organizations electronically file Form 990-N, or e-postcards, for free through the Urban Institute. *See* http://epostcard.form990.org. In addition, the Urban Institute is listed as a Form 990 e-file partner with a description clearly identifying free e-file and free preparation services at http://www.irs.gov/efile/lists/0,,id=119598,00.html.

VI. The Treasury Department and Congress Should Modify the Rules Governing the Use and Disclosure of Return Information by Preparers[58]

On January 3, 2008, Treasury and the IRS issued an advance notice of proposed rulemaking (ANPR) describing rules under consideration by the Treasury Department and the IRS to restrict the marketing of refund anticipation loans (RALs), refund anticipation checks (RACs), audit insurance, and other substantially similar products or services in connection with the preparation of a tax return. The ANPR would amend the regulations under IRC § 7216.[59]

The ANPR identified two major concerns regarding certain products and services marketed by preparers during the tax return preparation and filing process. The first concern relates to the financial incentive tax preparers have to take improper tax return positions to inappropriately inflate refund claims.[60] The second concern relates to the exploitation of unsophisticated taxpayers, which was raised by commentators in response to an earlier notice of proposed rulemaking under IRC § 7216.[61]

I share the concerns raised by Treasury and the IRS in the ANPR. In general, taxpayers should be able to control the use and disclosure of their own tax information. However, there are situations where consumer protection or tax administration concerns warrant the restriction of taxpayers' use and disclosure of that information. This restriction is particularly warranted where there is a need to protect unsophisticated taxpayers from exploitation. Restriction is further warranted to protect the public fisc by limiting opportunities for return preparers to profit from inappropriately inflating tax refunds.[62]

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[58] *See* National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (Most Serious Problem: The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential) and 547-548 (Legislative Recommendation: Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers).

[59] REG-136596-07, 2008 I.R.B. (Jan. 28, 2008) (all written and electronic comments are due by April 7, 2008). Section 7216 of the Internal Revenue Code generally prohibits tax preparers from using or disclosing tax return information they obtain from their clients for any purpose other than preparing a tax return. IRC § 7216 also authorizes the Treasury Department to issue regulations permitting certain uses or disclosures. Under the current regulations, tax return preparers use the tax preparation process to sell a variety of products to their clients.

[60] The ANPR also identified a concern that the marketing of RALs creates an incentive for preparers to comply less than fully with due diligence requirements designed to ensure the accuracy of EITC claims.

[61] Department of the Treasury, Notice of Proposed Rulemaking, Guidance Necessary to Facilitate Electronic Tax Administration – Updating of Section 7216 Regulations, 70 Fed. Reg. 72,954, REG-137243-02, RIN-1545-BA96 (Dec. 8, 2005).

[62] For a more detailed discussion of the National Taxpayer Advocate's concerns, see National Taxpayer Advocate 2007 Annual Report to Congress 83-95.

With the existing statutory framework of IRC § 7216, Treasury has the discretion to restrict the ability of preparers to obtain taxpayer consent to either use or disclose tax return information in the marketing of RALs, audit protection, and similar products. The statute contains a broad prohibition against the use and disclosure of tax return information by preparers. Because the consent-based exceptions to the general rule are a regulatory creation, Treasury and the IRS have the responsibility to look to the best interests of tax administration as well as protect taxpayers against exploitation. However, the IRS has failed to conduct meaningful research on this subject despite numerous and significant concerns expressed by members of Congress, stakeholders, and the Office of the Taxpayer Advocate.[63]

Accordingly, I believe the IRS should conduct research in conjunction with the Office of the Taxpayer Advocate to determine the impact certain commercial products have on tax compliance and taxpayer exploitation. Further, I recommend that the Treasury and the IRS, after careful review of findings from the aforementioned research and public comments, amend Treasury Regulation § 301.7216-3 as set forth in the ANPR.

Finally, my 2007 Annual Report includes an additional legislative recommendation to permit the Secretary to issue guidance specific to IRC § 6713. Internal Revenue Code § 6713 is the civil counterpart to the criminal penalty applicable to tax return preparers under IRC § 7216. Like IRC § 7216, IRC § 6713 provides a broad prohibition against the use and disclosure of tax return information. However, the current statutory framework seemingly requires that exceptions be made either to both the criminal and civil statutes, or to neither. Treasury 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 against the use or disclosure of tax return information set forth in IRC § 7216. I believe that 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.[64]

[63] For a detailed list of documents raising concerns related to these issues, see National Taxpayer Advocate 2007 Annual Report to Congress 85 n.7.

[64] National Taxpayer Advocate 2007 Annual Report to Congress 547-548.

VII. The Private Debt Collection Initiative Will Cost the Federal Government at Least $81 Million in Foregone Revenue Annually and Should Be Terminated[65]

In my Annual Reports to Congress and in prior testimony, I have expressed significant concerns about many aspects of the private debt collection (PDC) initiative, including concerns about potential taxpayer rights violations, concerns that the procedures private collection agencies (PCAs) use are less transparent to the public – and to congressional oversight – than IRS procedures, and concerns that the so-called "simple" cases on which the program was initially promoted do not exist in significant numbers.

Today, I will focus on the revenue projections. Very simply, the program will cost the government more than $81 million in foregone revenue this year, and the cost is likely to reach nearly a half billion dollars over the next six years. I explain below how I arrive at this conclusion.

The IRS projects that it will use $7.65 million in appropriated funds in FY 2008 to administer the PDC program, and it anticipates relatively steady-state costs in future years.[66] At the same time, the IRS projects that the program will generate gross revenue averaging about $23 million this year and next year,[67] and it is unlikely that gross revenue will increase in future years unless significant changes to the nature of the program are made. By these calculations, the annual net revenue the program can be expected to generate after subtracting out the direct costs of the program ($7.65 million) and commissions payable to the PCAs (about $4.60 million) comes to about $11 million. Thus, an annual IRS expenditure of $7.65 million will result in annual net revenue of about $11 million, which translates to about a 1.45:1 net return on investment (ROI).[68]

If the PDC program did not exist and the IRS instead allocated $7.65 million in appropriated funds to its Automated Collection System (ACS) function, the ROI would be vastly greater. IRS data shows that the average ROI for the ACS program is about 20:1, which would mean that an expenditure of $7.65 million would

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[65] *See* National Taxpayer Advocate 2007 Annual Report to Congress 411-431 (Status Update: Private Debt Collection); National Taxpayer Advocate 2006 Annual Report to Congress 34-61 (Most Serious Problem: True Costs and Benefits of Private Debt Collection) and 458-462 (Legislative Recommendation: Repeal Private Debt Collection Provisions); *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means,* 110th Cong. (May 23, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

[66] E-mail from Director, PDC Program Office, to TAS Attorney Advisor (Feb. 29, 2008).

[67] *Id.*

[68] In fact, the data I have cited actually overstate the likely ROI because the IRS's cost estimates are not comprehensive (*e.g.,* they do not include the time that Taxpayer Advocate Service case advocates spend assisting taxpayers who request our help with PDC cases or the time senior IRS executives must devote to studying, monitoring, and answering continual questions about the program) and the IRS's revenue estimates include funds that the IRS collects on the basis of its initial letter – before the PCAs make any contact with the taxpayers.

generate annual revenue of $153 million.[69] In testimony before the Ways and Means Committee last May, Acting IRS Commissioner Kevin Brown placed the ACS ROI somewhat lower, stating in response to a question that it is about 13:1.[70] Even accepting the lower figure for this purpose, a 13:1 ROI on an expenditure of $7.65 million would produce gross revenue of $99.45 million and net revenue (after subtracting the $7.65 million expenditure) of $91.8 million.

Thus, the IRS's expenditure of $7.65 million in appropriated funds is generating about $11 million in net revenue when applied to the PDC program but should generate at least $91.8 million if applied to its ACS collection function. In other words, the opportunity cost of spending $7.65 million of appropriated funds on the PDC program each year is $81 million, and possibly much more.

Since the purpose of the PDC program was to raise revenue, the fact that it is costing the government $81 million or more each year destroys whatever thin rationale might remain for its existence. I believe it is time to end the PDC program.

VIII. To Reduce the Tax Gap, the IRS Should Place More Emphasis on Combating Noncompliance in the Cash Economy[71]

As you know, the gross "tax gap" – the amount of tax that is not voluntarily and timely reported and paid – stood at an estimated $345 billion in 2001 and remains a serious problem.[72] Households that comply with their tax obligations effectively pay a "surtax" averaging about $2,680 per year to subsidize noncompliance by others.[73] Where taxable payments are reported to the IRS by third parties, taxpayers

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[69] We have computed the fully loaded cost of an average ACS employee at slightly less than $75,000 (assuming GS-8, step 5). The current average dollars collected by an ACS employee per year is about $1.53 million. That translates to a return-on-investment on the average ACS employee of about 20:1.

[70] *IRS Private Debt Collection: Hearing Before the H. Comm. on Ways and Means,* 110th Cong. (May 23, 2007) (testimony of Kevin M. Brown, Acting Commissioner of Internal Revenue).

[71] *See* National Taxpayer Advocate 2007 Annual Report to Congress 35-65 (Most Serious Problem: The Cash Economy), 490-502 (Legislative Recommendation: Measures to Address Noncompliance in the Cash Economy), and vol. 2, at 1-43 (Research Study: A Comprehensive Strategy for Addressing the Cash Economy).

[72] The gross tax gap is the amount of tax that is imposed by law for a given tax year, but not voluntarily and timely paid. The net tax gap is the portion of the gross tax gap that remains uncollected after taking into account late payments and IRS enforcement actions for a given tax year. The 2004 IRS National Research Program study estimated the 2001 gross tax gap at $345 billion and the net tax gap at $290 billion. IRS, *Tax Gap Map for Year 2001* (Feb. 2007), *available at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf. These figures do not include unpaid tax on income from illegal activities.

[73] If we divide the estimated 2001 net tax gap of $290 billion by the estimated 108,209,000 U.S. households in 2001, we see that each household was effectively assessed an average "surtax" of about $2,680 to subsidize noncompliance. *See* U.S. Census Bureau, Population Division (data as of Mar. 2001).

generally report well over 90 percent of their income.[74] By contrast, where taxable payments are not reported to the IRS by third parties, reporting compliance drops below 50 percent.[75] Therefore, it should come as no surprise that underreported income from the "cash economy" – taxable income from legal activities that is not subject to information reporting or withholding – is probably the single largest component of the tax gap, likely accounting for over $100 billion per year.[76]

Noncompliance in the cash economy merits special attention because the IRS's traditional enforcement tools such as document matching and audits are less effective when there is no third party reporting, and also because it is growing. According to one study, the percentage of all income subject to third party information reporting fell from 91.3 percent in 1980 to 81.6 percent in 2000.[77] The IRS's filing projections suggest that the cash economy and the amount of unreported income may continue to grow.[78]

In my 2007 Annual Report to Congress, I proposed a comprehensive strategy to address the cash economy portion of the tax gap that consisted of 15 administrative recommendations and seven legislative recommendations. As a threshold matter, I believe the IRS should establish a Cash Economy Program Office. The office would have responsibility for coordinating efforts to improve compliance in the cash economy. At present, there is no single unit or executive within the IRS with responsibility for ensuring that enforcement, research, and educational activities aimed at the cash economy are implemented in a coordinated fashion. The IRS uses a coordinated approach to address certain other issues – an example being the EITC Program Office – and I believe a program office would help the IRS address the cash economy as well. Such an office would bring accountability to the effort because it could measure its success based on the impact of IRS initiatives on compliance by cash economy participants.[79] Absent a strategic, coordinated

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[74] *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.

[75] *See id.*

[76] *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. Underreporting makes up about 83 percent of the tax gap ($285 billion of the $345 billion gap). Underreporting of business income by individuals – from sole proprietors, rents and royalties, and pass-through entities – accounted for about $109 billion. *Id.* Associated underreporting of self-employment taxes by unincorporated businesses accounts for another $39 billion. *Id.*

[77] Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference (June 2003) (citing growth in capital gains, partnership, and small business income).

[78] The IRS expects the number of individual returns from small business or self-employed taxpayers to grow by about 33 percent between 2006 and 2014, while the number of individual returns from other taxpayers is expected to decline by about two percent over the same period. IRS Office of Research, Research, Analysis and Statistics, Document 6292, Fiscal Year Return Projections for the United States, 2007-2014 (Sept. 2007), *available at* http://www.irs.gov/pub/irs-soi/d6292.pdf.

[79] The Treasury Inspector General for Tax Administration and the Government Accountability Office both generally agree that measures that promote accountability would help the IRS reduce the tax

approach, the IRS is less likely to make progress in reducing noncompliance in the cash economy.

My other recommendations fall into four broad categories: (1) making compliance easier, (2) increasing income visibility and the productivity of audits, (3) increasing the focus on preparers, and (4) identifying areas where additional research is needed to help the IRS understand how it can efficiently improve voluntary compliance.

IX. EITC Audits Present a Significant and Excessive Challenge for Taxpayers and Cause Taxpayers with Representation to Fare Better Than Unrepresented Taxpayers[80]

Earned Income Tax Credit (EITC) audits demonstrate some of the problems that can arise when an examination initiative does not take into account the particular characteristics of the subject population. The EITC audit process puts a heavy burden on taxpayers who may be ill-equipped to correctly navigate the audit process, suggesting that the IRS may frequently reach the wrong conclusion concerning EITC eligibility.[81] TAS Research conducted a study exploring two key facets of the IRS EITC audit process:

- Barriers faced by taxpayers undergoing an audit; and
- The impact the presence or absence of representation has on audit outcomes.[82]

TAS Research identified potential barriers through targeted interviews with Low Income Taxpayer Clinic (LITC) attorneys and from tax preparer feedback at focus groups conducted by TAS during the IRS Tax Forums. Subsequently, Wage & Investment Research and TAS Research jointly administered a survey to a representative sample of audited taxpayers to quantify the prevalence of these barriers.

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gap. *See, e.g.*, Government Accountability Office, GAO-06-208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005); Written Statement of Russell George, Treasury Inspector General for Tax Administration, *Hearing Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies on the Internal Revenue Service's Fiscal Year 2006 Budget Request* (Apr. 7, 2005).

[80] *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 94-117 (Research Study: IRS Earned Income Credit Audits – A Challenge to Taxpayers).

[81] Attributes of EITC filers include: less likely to speak English, less education, and lower income levels. *See* Playing by the Rules, but Losing the Game – America's Working Poor, Urban Institute (http://www.urban.org/publications/410404.html). These attributes suggest that EITC taxpayers may be less likely to understand IRS correspondence and less able to afford representation (*i.e.*, power of attorney) with the IRS.

[82] *See* National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 94-117 (Research Study: Earned Income Credit Audits – A Challenge to Taxpayers).

Survey results show that the correspondence audit process causes taxpayers to experience significant barriers in communicating with the IRS and in providing the documentation requested.

Communication with the IRS was problematic. More than 70 percent of the survey respondents stated that the IRS's audit notification letter was hard to understand, and only about half of the respondents said they thought they knew what they needed to do to answer IRS questions. Nearly three-quarters of EITC audited taxpayers personally called or visited the IRS in response to the IRS audit notification letter, mostly due to communication issues. Perhaps most notably, *more than 25 percent of the respondents did not even realize their tax return was being audited*. Overall, more than 70 percent of respondents wanted to communicate with the IRS about their audit in a manner other than correspondence.

Taxpayers also experienced problems attempting to identify and provide the documentation requested by the IRS:

- More than half of the respondents reported difficulties obtaining requested documents;
- Nearly 40 percent of respondents who indicated they sent in all the requested documentation were asked for the same documentation again;
- 19 percent were asked to provide additional information (different from the original request);
- Over 40 percent of respondents reported waiting more than 30 days for the IRS to acknowledge receiving the requested documentation, and
- An additional 10 percent reported that the IRS never acknowledged receipt of the documentation.

The barriers in the audit process likely help to explain the findings in the second part of this study, which showed that taxpayers who are represented during an EITC audit fare significantly better than their unrepresented counterparts.

To conduct the study, TAS Research analyzed results for all taxpayers whose tax year 2004 returns were audited. TAS found that taxpayers who used representatives were much more likely to be found eligible for the EITC:

- Nearly twice as many represented taxpayers were found eligible for EITC after audit as those without representation,[83] and

[83] Among taxpayers with representation, 47.6 percent retained at least some EITC compared with 27.4 percent of unrepresented taxpayers.

- Representatives with more training were better able to successfully represent their clients – 46 percent of those using CPAs retained their claimed EITC, as compared with 39 percent of those who used unenrolled preparers.

Represented taxpayers also retained more EITC and owed less additional tax than those who were not represented during the audit:

- More than 40 percent of represented taxpayers retained all the EITC they claimed;
- Less than 25 percent of unrepresented taxpayers retained all the EITC they claimed;
- 41 percent of unrepresented taxpayers ended up owing additional tax, while
- Only 23 percent of represented taxpayers were found to owe additional tax.

The barriers faced by taxpayers during EITC audits and the gap in audit outcomes between represented and unrepresented taxpayers have important ramifications for the administration of EITC compliance. At a minimum, they suggest that corrective actions are necessary for the IRS to consistently reach the right conclusion on EITC eligibility.

X. Congress Should Amend IRC § 7526 to Authorize IRS Employees to Refer Taxpayers to Low Income Taxpayer Clinics[84]

In 1998, Congress created a grant program to fund Low Income Taxpayer Clinics (LITCs) after hearing testimony about the problems that low income and English as a second language (ESL) taxpayers encounter in obtaining access to representation and in learning about their rights and responsibilities as taxpayers.[85] The TAS study (described above) showing the significant impact that representation has on the outcome of audits, particularly Earned Income Tax Credit examinations, underscores the importance of the LITC program.[86]

However, IRS employees who talk with taxpayers are limited in their ability to refer taxpayers to LITCs. The Supplemental Standards of Ethical Conduct for Employees of the Department of the Treasury prohibit IRS employees from

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[84] *See* National Taxpayer Advocate 2007 Annual Report to Congress 551-553 (Legislative Recommendation: Referrals to Low Income Taxpayer Clinics).

[85] *IRS Restructuring: Hearing Before the Senate Finance Committee*, Statement of Nina E. Olson, Director of the Community Tax Law Project, 105th Cong. (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. (Sept. 26, 1997).

[86] For additional information, *see* National Taxpayer Advocate 2007 Annual Report to Congress 222-241 (Most Serious Problem: EITC Examinations and the Impact of Taxpayer Representation) and vol. 2, at 94-117 (Research Study: IRS Earned Income Credit Audits – A Challenge to Taxpayers).

recommending or referring taxpayers to specific attorneys or accountants.[87] 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.[88]

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."[89] 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.[90] IRS employees can 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. The DEO advised that IRS employees may provide a taxpayer with the contact information for a particular LITC only if the taxpayer specifically asks.

LITCs are federally funded organizations that are subject to substantial monitoring by the Taxpayer Advocate Service and the Treasury Inspector General for Tax Administration (TIGTA).[91] LITCs include (1) clinical programs at accredited law, business, or accounting schools in which students represent taxpayers in controversies before the IRS and (2) 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, I believe that LITCs can be sufficiently 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

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[87] "Employees of the IRS shall not recommend, refer or suggest, specifically or by implication, any 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).

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

[89] GLS-0779-00 (May 16, 2000).

[90] *Id.*

[91] 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).

direct taxpayers to the LITC website[92] or Publication 4134, Low Income Taxpayer Clinic List, these are not always the most effective options for putting taxpayers in touch with those who may be able to help them.[93] In light of the vital role that representation can play in the outcome of a taxpayer's audit, I urge you to consider legislation to authorize IRS employees to refer taxpayers to LITCs without restriction.

As a separate matter, I will soon be writing a letter to the heads of state bar associations, CPA societies, and other professional associations to urge their members to volunteer with LITCs in their area. In that way, I am hopeful that we can expand the number of taxpayers the LITCs are able to serve.

XI. IRS Service Delivery at Taxpayer Assistance Centers Is Improving but Still Requires Additional Resources and Effort[94]

For several years I have highlighted problems with the IRS's delivery of face-to-face taxpayer service in the Taxpayer Assistance Centers (TACs).[95] Partially in response to those concerns, Congress in 2006 directed the IRS to prepare a Taxpayer Assistance Blueprint (TAB), which was released last April.[96] The TAB

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

[93] Internal Revenue Service, *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 to use the Internet and barriers to usage). *See also* National Taxpayer Advocate 2006 Annual Report to Congress 333-354, 355-375 (discussing issues related to limited English proficiency, English and a second language, and low income taxpayers).

[94] *See* National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: Service at Taxpayer Assistance Centers).

[95] *See* National Taxpayer Advocate 2007 Annual Report to Congress 162-182 (Most Serious Problem: Service at Taxpayer Assistance Centers), *see also* National Taxpayer Advocate 2006 Annual Report to Congress xi-xiv (Taxpayer Assistance Blueprint: The National Taxpayer Advocate's Perspective); National Taxpayer Advocate 2005 Annual Report to Congress 2-24 (Most Serious Problem: Trends in Taxpayer Service); National Taxpayer Advocate 2004 Annual Report to Congress 8-66 (Most Serious Problem: Customer Service in a Complex and Changing Tax Environment).

[96] H. Rep. No. 109-307, at 209 (2005). The Senate Committee Report provides further detail on the content of the five-year plan, directing the IRS to:

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

S. Rep. No. 109-109, at 134 (2005).

was intended to serve as a strategic plan for taxpayer service and lead to the development of taxpayer-centric, research-based models to help the IRS make decisions about taxpayer service and the delivery of face-to-face service. Because of the TAB and my own office's research, we know more than ever about taxpayer needs and preferences, and their willingness to try new methods of service delivery.[97]

The IRS has certainly recommitted to delivering quality taxpayer service and begun reversing its trend in recent years of limiting the types of services and methods of delivery. I applaud the IRS for creating a Service Committee – the counterpart to the Enforcement Committee – which enables the entire senior leadership of the IRS to consider and coordinate taxpayer service initiatives. The IRS currently is undertaking many initiatives to assist taxpayers in claiming economic stimulus payments, including keeping TACs open on more Saturdays. I am also pleased that IRS management has indicated a willingness to consider reinstating Problem Solving Days and taking a geographic approach to determining which topics to designate as "out-of-scope" (*e.g.,* the IRS should not treat farm-related questions as "out-of-scope" in TACs in areas where there is a significant amount of farming activity). The IRS has also recently relaxed its stringent and illogical rules about providing taxpayers with copies of their tax return transcript at the TACs.[98]

However, there is still much to be done in the taxpayer service area. In my 2007 Annual Report to Congress, I identified several other problems that limit the usefulness of the TACs, including the insufficient number and staffing of TACs and the significant conditions for obtaining return preparation assistance that have the effect of deterring taxpayers from seeking service.

The Location and Number of TACs May Not Be Adequate

In 2001, the IRS committed to opening *118 new TACs* in the following seven to eight years.[99] Unfortunately, none of these new TACs was opened, and the IRS even initiated an unsuccessful effort to close 68 TACs.[100] The TAB concluded that TAC offices were adequately serving only 60 percent of the United States population.[101] In order to make better decisions about the location, number, and staffing of TACs, the IRS developed a decision tool about TAC operations, but that

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[97] *See* National Taxpayer Advocate 2006 Report to Congress, vol. 2 (Research Study: Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

[98] Previously the IRS required taxpayers to obtain transcripts of their accounts through the toll-free number, which would mail a transcript within 7 to 10 days. Taxpayers could only obtain transcripts at TACs in "emergency" situations. It was TAS's experience that the TACs almost never acknowledged an emergency situation. In fact, since that policy was in place, TAS transcript cases have increased sharply. The IRS's more liberal transcript policy should result in fewer TAS cases in this area.

[99] National Taxpayer Advocate 2001 Annual Report to Congress 49.

[100] IRS News Release*, IRS to Create Efficiencies with Taxpayer Assistance Centers*, IR-2005-63 (Jun. 27, 2005).

[101] Internal Revenue Service, *Taxpayer Assistance Blueprint: Phase 2* at 116 (Apr. 17, 2007).

tool only includes the present TAC locations. It is not clear whether the IRS will use this program to consider adding TAC locations, even though TAB research demonstrates that TAC coverage across the United States is insufficient. Thus, we recommend that the IRS conduct additional research of population segments to determine the volume, scope, and type of service that taxpayers require by geographical location, and utilize its TAC decision tool to identify the most appropriate number and placement of TACs.

TAC Staffing and the Availability of Services Is Inadequate to Meet Taxpayer Needs

Only 55 percent of TACs are open for 36 to 40 hours per week, and during the last three years, the IRS reduced TAC staffing by nine percent, leaving most TAC offices with staffing shortages. Although the IRS is now hiring seasonal workers to ease the staffing crunch, I believe the IRS should make a firm commitment to providing TACs with the level of staffing necessary to meet taxpayer needs.

The IRS Should Embrace its Fundamental Tax Administration Responsibility to Offer Tax Return Preparation to Needy Taxpayers

I am concerned that the IRS imposes too many barriers and limitations on tax preparation. I am pleased that the IRS heeded our earlier criticism and has changed its position on requiring taxpayers to visit a TAC twice in order to obtain return preparation services – once to make the appointment and once to have the return prepared. However, the IRS continues to downplay its role in tax preparation.

To my mind, tax preparation is a core service for the tax administrator. It cannot look to the nonprofit sector alone to meet the needs of the tens of millions of low income taxpayers, including many elderly taxpayers, who cannot afford to pay a return preparer. Yet the IRS continues to straddle the line – it prepares enough returns to allow it to claim it is providing the service but makes it very difficult in some cases for taxpayers to obtain assistance. As noted above, for example, the IRS has declared returns involving cancellation of debt income out-of-scope both for the TACs *and* volunteer preparation sites, even though those subjects are highly likely to impact the very taxpayers who are eligible for TAC services (whether because of credit card debt forgiveness or home foreclosures). Thus, these low income taxpayers have no alternative but to pay for return preparation, something they generally cannot afford to do.

It is not just individual taxpayers who suffer from this restriction of preparation services in the TACs. Today, organizations exempt from tax under IRC § 501(c)(3) are required to file an e-postcard annually if their gross receipts are normally $25,000 or less, providing the IRS with basic contact information and informing the IRS whether the organization is still a going concern.[102] Failure to file for three

[102] IRC § 6033(i).

consecutive years will result in automatic revocation of the organization's exempt status.[103]

Approximately half of exempt organizations have all-volunteer staffs and another third have fewer than ten employees.[104] These smaller nonprofits frequently lack professional tax guidance and rely on their volunteers to deal with the IRS.[105] Thus, while the e-postcard may appear to be an innocuous filing requirement, it is entirely possible that a volunteer treasurer for an all-volunteer exempt organization may need assistance but cannot afford to pay for that assistance. The TACs have agreed to assist exempt organizations with filing the e-postcard on the condition that the IRS not publicize the availability of this assistance. Thus, the only way a small exempt organization will know whether the IRS will help it is if it happens to visit a TAC on its own initiative. This "we will provide you service but we won't tell you about it" approach falls well short of the level of service the public has a right to expect from its government.

[103] IRC § 6033(j).

[104] IRS, TE/GE FY 2005 Strategic Assessment 3 (Feb. 2, 2005).

[105] IRS, TE/GE FY 2005 Strategic Assessment 3 (Feb. 2, 2005).