

**WRITTEN STATEMENT OF**

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**BEFORE THE**

**SUBCOMMITTEE ON OVERSIGHT**

**COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON**

**TAX COMPLIANCE CHALLENGES FACING FINANCIALLY STRUGGLING**

**TAXPAYERS**

**FEBRUARY 26, 2009**

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

Thank you for inviting me to testify today about the challenges facing financially struggling taxpayers.<sup>1</sup> The IRS itself faces a difficult challenge in balancing its mission of collecting the tax revenue that our government requires to function with the fair and compassionate treatment of taxpayers who, for whatever reason, are unable to pay their tax bills. The nature of the challenge is no different in a recession, but the number of affected taxpayers is obviously much greater. The IRS has tools it can use to help these taxpayers, and it is now more important than ever that it use these tools appropriately and compassionately.

I applaud Commissioner Shulman and Deputy Commissioner Stiff for the sensitivity the IRS has shown toward the challenges financially distressed taxpayers are experiencing and for announcing plans to show flexibility in certain collection matters.<sup>2</sup> In my testimony today, I will identify a number of obstacles that place burdens on financially struggling taxpayers, and I will propose administrative and legislative solutions.

**A. Issues Affecting Financially Struggling Taxpayers**

**1. Early intervention in collection cases is efficient and benefits taxpayers, but IRS case assignment practices do not promote early intervention.**

IRS methods for establishing the priority of collection cases have traditionally placed primary emphasis on the aggregate dollar amounts of the delinquencies.<sup>3</sup> For example, a taxpayer owing \$100,000 will typically receive higher priority than one owing \$10,000, while the latter taxpayer will generally be considered a much higher priority than one owing \$1,000. While the type of tax at issue may affect the priority of a case – for example, a case involving employment taxes may receive more priority consideration than one involving income taxes – we believe that the age of the account often does not receive appropriate weight in determining its priority, which in turn plays a critical role in deciding which cases receive personal contacts from IRS collection personnel. As a result, many collection accounts do not receive adequate

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<sup>1</sup> 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.

<sup>2</sup> IRS News Release, IRS Begins Tax Season 2009 with Steps to Help Financially Distressed Taxpayers; Promotes Credits, e-File Options, IR-2009-2 (Jan. 6, 2009).

<sup>3</sup> IRS Small Business/Self-Employed Division, *Risk Based Collection* (Mar. 2006).

attention because the taxpayer does not owe “enough” delinquent taxes – at least not yet.

It is widely accepted in the business community that accounts receivable become much more difficult to collect the longer they remain delinquent. According to a study by Dun & Bradstreet, the probability of collecting a payment 90 days past due declines by 12 percent for each additional 30-day period.<sup>4</sup> A survey of members of the Commercial Collection Agency Section of the Commercial Law League of America, completed in June 2001, indicates that generally, if an account is 90 days delinquent, only 73 percent of the debt will be collected; at six months only 50 percent will be collected; at 12 months the figure falls to 25 percent; and at 24 months, only 10.5 percent will be collected.<sup>5</sup> In fact, the IRS has also recognized and validated this “collectibility curve” in a number of studies.<sup>6</sup> These studies acknowledge that on tax debts that are 24 months past due, the IRS typically collects approximately 13 cents on the dollar, and tax debts become practically uncollectible after three years.

In addition to the problem of accounts becoming stale and less likely to be collected in full, the amount of tax owed tends to “pyramid” due to the accumulation of interest and penalties the longer it is outstanding. Interest generally accrues on delinquent tax accounts at the federal short-term rate plus three percentage points, is *compounded daily*, and applies to penalties and interest as well as the outstanding tax balance itself. Failure-to-pay penalties accrue at 0.5 percent per month up to 25 percent of the delinquent balance.<sup>7</sup> When balance due accounts are not addressed and resolved timely, it is not uncommon for penalties and interest to equal or exceed the original delinquencies. Such additional liabilities can make it very difficult for taxpayers to pay both their delinquent taxes and their current liabilities. This situation occurs against a backdrop of unavailability of collection alternatives, as described below.

The IRS generally uses an “assembly line” approach to collection cases, starting with a preset number of automatically generated written notices, followed by assignment to the Automated Collection System, followed by placement in a queue for assignment to field personnel. However, this approach has produced less than desirable results. Consider the following:

Of all taxpayer delinquent accounts the IRS reported in “active” inventory at the end of FY 2008, 49 percent of the individual taxpayer accounts involved two or more delinquent tax years, and 39 percent of the business taxpayer accounts involved three

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<sup>4</sup> See David Shor & Martin Shor, *How to Collect Debts and Still Keep Your Customers* at 51 (1999).

<sup>5</sup> *Collection Trends*, available at [www.proconsv.com/colltrends.htm](http://www.proconsv.com/colltrends.htm).

<sup>6</sup> IRS/Booz-Allen & Hamilton, *SB/SE Collections Quick Hits Approach and Preliminary Findings* 30 (Mar. 27, 2001); IRS, Automated Collection System Operating Model Team, *Collectibility Curve* (Aug. 5, 2002).

<sup>7</sup> IRC § 6651(a)(2).

or more delinquent tax periods.<sup>8</sup> Additionally, 80 percent of delinquent modules involved tax periods in the years 2005 and prior.<sup>9</sup> In light of the IRS's "collectibility curve," it is not surprising that the IRS reported nearly \$20 billion as not collectible in FY 2008 – significantly more delinquent tax dollars than were collected on taxpayer delinquent accounts, installment agreements, and offers-in-compromise combined.<sup>10</sup> The traditional IRS inventory delivery methods for collection accounts are not delivering optimal results in the collection of delinquent revenue or in providing timely service to taxpayers with collection problems.

I recommend that the IRS allocate its resources to provide earlier intervention, in the form of personal or other meaningful contact by IRS employees, in collecting delinquent taxpayer accounts.

**2. IRS procedures discourage the use of collection alternatives like offers-in-compromise and partial-payment installment agreements, even in cases where taxpayers cannot pay the full amount of their tax liabilities.**

The general premise under which the IRS operates is that taxpayers should pay the full amount of the tax liabilities they owe. In my view, this general premise is correct. But there are times when taxpayers experience financial difficulties and cannot reasonably pay their tax liabilities in full – or sometimes even at all. This may happen if a taxpayer has lost a job, becomes disabled, or experiences some other major financial setback. When this happens, the IRS's goal should be to collect as much of the tax as possible without imposing an undue financial burden on the taxpayer or the taxpayer's family.

Congress has given the IRS two important collection alternatives to use in working with financially struggling taxpayers. One is the "offer-in-compromise" in which the IRS agrees to settle a tax liability for less than the full amount owed.<sup>11</sup> Offers based on collectibility concerns are a good deal for taxpayers because, while they require taxpayers to pay their tax obligations to the extent they are able, they give taxpayers the opportunity to make a fresh start, removing the threat of enforced IRS collection actions that otherwise would be hanging over their heads for the next decade. Offers can also be a good deal for the government because they bring in as much revenue as

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<sup>8</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-2/242, Taxpayer Delinquent Account Cumulative Report* (Sept. 28, 2008).

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

<sup>10</sup> *Id.* (\$19,992,535,770 was reported as "currently not collectible" in FY 2008); *Collection Activity Report NO-5000-6, Installment Agreement Cumulative Report* (Sept. 28, 2008); *Collection Activity Report NO-5000-108, Report of Offer in Compromise Activity* (Sept. 29, 2008); *Collection Activity Report NO-5000-149, Recap of Accounts Currently Not Collectible Report* (Sept. 27, 2008).

<sup>11</sup> IRC § 7122. The IRS accepts offers based on three grounds – doubt as to collectibility, doubt as to liability, and effective tax administration (including equity, public policy, and economic hardship concerns).

is feasible and, very importantly, they contain a contractual term that requires the taxpayer to remain in full compliance with the tax laws for the following five-year period.<sup>12</sup> If the taxpayer does not comply with the contract terms, the IRS may place the offer into default, which will cause the original tax liability (minus any payments made) to be reinstated in full.<sup>13</sup> One study showed that about 80 percent of individual taxpayers with accepted offers remained substantially compliant for the five-year period.<sup>14</sup> Importantly, the offer-in-compromise program also gives taxpayers confidence that the government will deal with them fairly and compassionately. It reassures the public that the government will not put them out on the street or require them to live without the ability to meet basic living expenses.

A second collection alternative is the partial-payment installment agreement.<sup>15</sup> Partial-payment installment agreements may be used when a taxpayer cannot fully pay a tax debt during the 10-year collection statute of limitations but has the ability to pay a portion of the debt in installments. The IRS is required to review partial-payment installment agreements every two years and may require the taxpayer to make larger monthly payments if it determines that the financial condition of the taxpayer has significantly improved.<sup>16</sup> Absent such a significant improvement, however, the taxpayer will continue to make payments under the agreement until the collection period expires.

Congress has made its support for collection alternatives explicit. In 1998, the conference committee report accompanying the IRS Restructuring and Reform Act made the following statement about offers-in-compromise:

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<sup>12</sup> See IRS Form 656, *Offer in Compromise*, § V(d) (Feb. 2007).

<sup>13</sup> IRM 5.19.7.3.20 (Jan. 16, 2009); IRM 8.23.3.13(2) (Oct. 16, 2007).

<sup>14</sup> Internal Revenue Service, *Analysis of Various Aspects of the OIC Program* (Sept. 2004). As noted, offers can also be beneficial from a revenue standpoint. In FY 2007, accepted offers generated 17 cents for every dollar owed. Internal Revenue Service, *Offer in Compromise Program, Executive Summary* (Aug. 13, 2007). By contrast, IRS research indicates the IRS has historically collected only 13 cents for every \$1 owed on debts that are two years old and virtually nothing on debts that have been outstanding for three years or more. Internal Revenue Service, *Automated Collection System Operating Model Team, Collectibility Curve* (Aug. 5, 2002). An IRS study of rejected offers that subsequently were deemed “currently not collectible” (CNC) found that 27 percent of the cases involving individuals and 49 percent of the cases involving businesses were already in CNC status at the time the offers were rejected. Internal Revenue Service, *Analysis of Various Aspects of the OIC Program* (Sept. 2004). In other words, the IRS rejected the taxpayer’s offer to pay something, and often ended up with nothing.

<sup>15</sup> IRC § 6159. Prior to 1998, the IRS administratively entered into partial-payment installment agreements. In 1998, the IRS Office of Chief Counsel issued a memorandum concluding that partial-payment installment agreements were not permissible under the law. Thus, from that time until October 22, 2004, installment agreements were available only if taxpayers paid their tax liabilities in full. In the American Jobs Creation Act, Congress authorized partial-payment installment agreements. See Pub. L. No. 108-357, § 843(a)(1), 118 Stat. 1418, 1600 (2004); H.R. Rep. No. 108-755 at 649 (2004) (Conf. Rep.).

<sup>16</sup> IRC § 6159(d).

The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.<sup>17</sup>

Similarly, the House report relating to the American Jobs Creation Act made the following statement about partial-payment installment agreements:

The Committee believes that clarifying that the IRS is authorized to enter into installment agreements with taxpayers that do not provide for full payment of the taxpayer's liability over the life of the agreement will improve effective tax administration.

The Committee recognizes that some taxpayers are unable or unwilling to enter into a realistic offer-in-compromise. The Committee believes that these taxpayers should be encouraged to make partial payments toward resolving their tax liability, and that providing for partial payment installment agreements will help facilitate this.<sup>18</sup>

Yet despite this clear direction from Congress, the IRS Collection function possesses what I would characterize as an institutional aversion to any collection method that results in collection of less than 100 percent of the tax the IRS believes is owed. Consider the following:

- At the end of FY 2008, there were 2,600,437 taxpayers with delinquent accounts or accounts reported not collectible because the taxpayer had no current means to pay the tax liability (excluding cases received during the second half of the year).<sup>19</sup>
- In FY 2008, the IRS accepted 10,677 offers in compromise.<sup>20</sup>

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<sup>17</sup> H.R. Rep. No. 105-599, at 289 (1998) (Conf. Rep.).

<sup>18</sup> H.R. Rep. No. 108-548, pt. 1, at 307 (2004).

<sup>19</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-2, Taxpayer Delinquent Account Cumulative Report* (FY 2007 and FY 2008). To arrive at this total, we started with the number of taxpayers with Taxpayer Delinquent Accounts at the beginning of the year, added additional cases received during the first six months of the year, and subtracted all taxpayer account dispositions except currently not collectible (CNC) hardship dispositions. For purposes of this calculation, we excluded accounts that became delinquent during the second half of FY 2008, as the IRS would not necessarily have had an opportunity to work those cases. Overall, the inventory of delinquent accounts at the end of FY 2008 stood at 4,001,260.

<sup>20</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-108, Monthly Report of Offer in Compromise Activity FY 2008 Cumulative Through September – National Total*.

- In FY 2008, the IRS entered into 22,555 partial-payment installment agreements.<sup>21</sup>

In other words, one out of every 244 taxpayers with a delinquent account received an offer-in-compromise, and one out of every 115 taxpayers with a delinquent account received a partial-payment installment agreement. Combined, one out of every 78 taxpayers with a delinquent account was granted one of these collection alternatives.<sup>22</sup>

It is clearly the case that some taxpayers are unresponsive to IRS notices out of fear, preoccupation with other problems, or in certain circumstances a willful desire to flout the law. But it clearly is not the case that 77 out of every 78 taxpayers with delinquent accounts are unwilling to deal with the IRS. Rather, the IRS has made collection alternatives too inaccessible for taxpayers to obtain.

Consider the offer-in-compromise program. In 2001, the IRS centralized the evaluation of offers-in-compromise, shifting responsibility from Collection field personnel to IRS campuses. The IRS also instituted more rigorous requirements for the processing and consideration of offers out of concern that it was receiving too many frivolous offers.<sup>23</sup> If the IRS's assumption that it was receiving excessive frivolous offers was correct and the procedures it instituted to reduce the number of frivolous offers were effective, one would expect that the number of offers received would have declined and the number of accepted offers would have remained relatively constant.

Yet the data tell a very different story. The number of offers the IRS receives has, indeed, declined – from 125,390 in FY 2001 to 43,989 in FY 2008, a drop of 65 percent. But the number of accepted offers, far from remaining constant, has declined even more – from 38,643 in FY 2001 to 10,677 in FY 2008, a drop of 72 percent. In FY 2001, the IRS accepted 34 percent of offers, while in FY 2008, it accepted only 24 percent of offers.<sup>24</sup> These data suggest that the IRS has erected so many barriers

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<sup>21</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-6, Installment Agreement Cumulative Report (FY 2008)*.

<sup>22</sup> The IRS makes installment agreements easily available to taxpayers who can pay their liabilities in full. In FY 2008, the IRS granted 2.6 million installment agreements. IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-6, Installment Agreement Cumulative Report*. Thus, partial-payment installment agreements constituted less than one percent of all installment agreements granted.

<sup>23</sup> The IRS Form 656, *Offer in Compromise*, package is now nearly four times as long as it was before the program was centralized, increasing from 12 pages in 1997 to 44 pages today. Combined with information about the program on the IRS website, the current application and accompanying instructions measure nearly a half inch thick.

<sup>24</sup> The percentage of accepted offers is computed by dividing the number of offers accepted by the number of offer dispositions. See accompanying chart on page 8.



that it has actually deterred valid offers at a higher rate than it has deterred frivolous offers.<sup>25</sup>

Legislation enacted in 2006 has further discouraged taxpayers from submitting offers.<sup>26</sup> Under IRC § 7122(c)(1), taxpayers requesting offers in compromise must now generally provide significant down payments at the time they submit their offers. In the case of a lump-sum offer, the taxpayer must make a down payment of 20 percent of the offered amount. In the case of a periodic payment offer, the taxpayer must make an initial installment payment with the offer and must continue to make the proposed installment payments during the pendency of the offer. Taxpayers whose incomes do not exceed 250 percent of the poverty level are eligible for a waiver from the down payment requirement.<sup>27</sup>

In 2007, the Taxpayer Advocate Service conducted a research study to assess the impact of the down payment requirement.<sup>28</sup> The study analyzed a representative sample of more than 400 offers that the IRS accepted in the months just before the 20 percent requirement took effect. Among the principal findings were that 56 percent of taxpayers whose offers were accepted and who made lump-sum payments obtained the funds from family members and friends. While family and friends may be willing to help a taxpayer get straight with the IRS, they are probably much less willing to provide funds for taxpayers to make down payments on offers that are unlikely to be accepted – and fewer than one in four offers is, in fact, accepted. Thus, not surprisingly, the number of offers received by the IRS fell by 21 percent from FY 2006 to FY 2007 as the down payment requirement took effect. The following table illustrates the sharp decline in the number of offers received and accepted.

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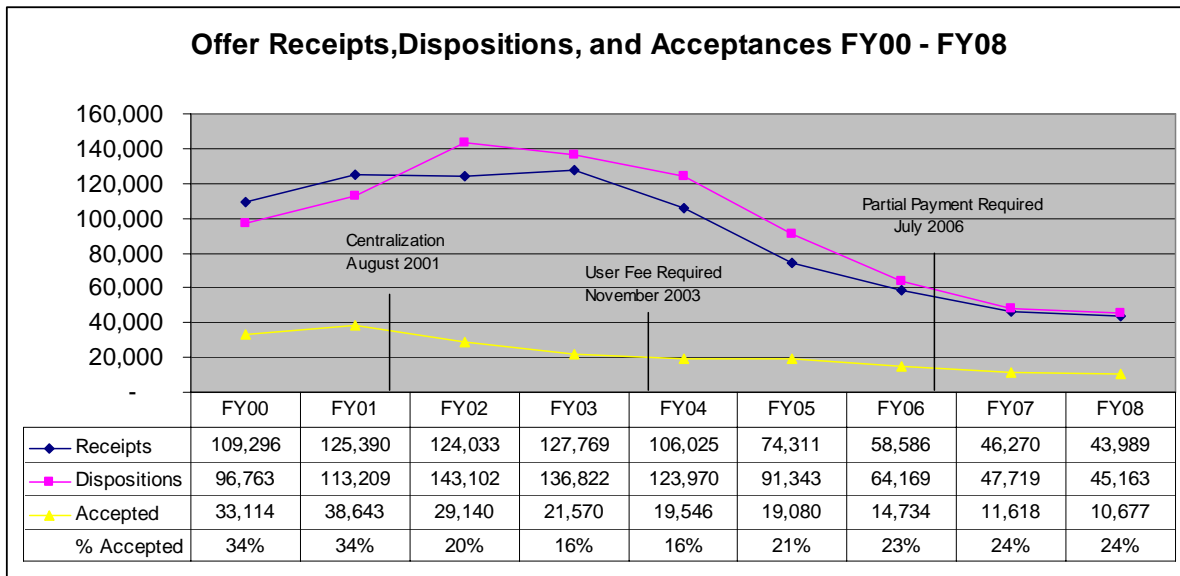
<sup>25</sup> In most cases, the IRS did not make a final decision to accept or reject the offer – 29 percent of offers were returned, 10 percent were determined to be not processable, and 10 percent were withdrawn or terminated. Thus, the barriers are so high that not only is it difficult to get an offer accepted, but most taxpayers who submit offers do not even receive a decision based on the merits of the case. Compare IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-108, Monthly Report of Offer in Compromise Activity Cumulative through September 2001* with IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-108, Monthly Report of Offer in Compromise Activity Cumulative through September 2008*.

<sup>26</sup> Tax Increase and Prevention Reconciliation Act of 2005, Pub. L. No. 109-222, § 509, 120 Stat. 345, 362 (2006).

<sup>27</sup> See IRS Fact Sheet, 2007-16, *Revisions to Form 656, Offer in Compromise*, available at <http://www.irs.gov/newsroom/article/0,,id=168404,00.html> (last visited Feb. 23, 2009). For this purpose, the poverty guidelines issued annually by the Department of Health and Human Services are used.

<sup>28</sup> National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Report: *Effect of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program*).

**IRS OFFER-IN-COMPROMISE PROGRAM, FY 2000 - FY 2008<sup>29</sup>**



As a result of the administrative and legislative obstacles that have been erected, I hear regularly from tax practitioners who say they have given up on the offer-in-compromise program as essentially a dead letter. Moreover, tax professionals tell me that given the low possibility of the IRS accepting an offer, they are advising their clients to file for bankruptcy. When that happens, the IRS generally will collect less than through the offer-in-compromise.

While the history of the partial-payment installment agreement program is much briefer, the aggregate data indicate that it, too, is not widely utilized. Indeed, most taxpayers and many practitioners are not even aware it exists.

What has the IRS done instead with respect to taxpayers with delinquent accounts? In FY 2008, it placed one million taxpayers into “currently not collectible” status – meaning that the IRS is collecting nothing at all<sup>30</sup> – and it took traditional enforcement actions about 3.4 million times, imposing 2,631,038 levies, placing 768,168 liens, and conducting 610 property seizures.<sup>31</sup>

IRS data show that greater use of traditional enforcement tools like liens and levies does not have a significant impact on overall collection. For example, the number of levies the IRS has imposed plummeted from 3,659,000 in FY 1997 just before the IRS Restructuring and Reform Act of 1998 (RRA '98), to 220,000 in FY 2000, and then

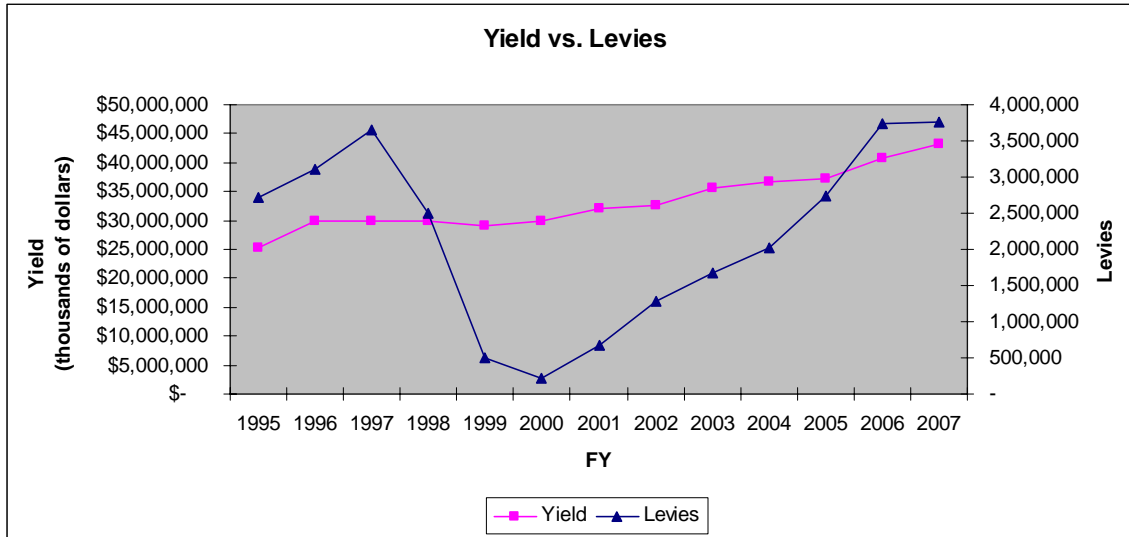
<sup>29</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-108* (FY 2000-FY 2008).

<sup>30</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-149* (Sept. 2008).

<sup>31</sup> IRS Small Business/Self-Employed Division, *Collection Activity Report NO-5000-23* (Sept. 2008).

climbed back up to 3.76 million in FY 2007.<sup>32</sup> Yet the IRS collection yield has risen on a slow, relatively consistent and gradual path over that period of time with no discernable revenue loss resulting from the post-RRA '98 reduction in levies, as shown by the following chart.

### TOTAL COLLECTION YIELD AND LEVIES ISSUED, FY 1995 – FY 2007



Simply stated, this chart shows no correlation between the number of levies issued and the collection yield. It also is not clear from this information whether the IRS is using its levy authority in the most appropriate instances. For example, I discuss the Federal Payment Levy Program below and address its impact on low income taxpayers. Separately, however, it is worth noting that the Treasury Inspector General for Tax Administration recently found that in order to place these levies, the IRS is paying fees to the Treasury Department’s Financial Management Service (FMS) that come to 51 percent of the levy proceeds the IRS receives in certain low-dollar cases.<sup>33</sup>

There is no doubt that collection alternatives are a good option for financially struggling taxpayers, and some of the data I have cited suggests that collection alternatives may also be a good deal from a revenue collection standpoint. In 2001, it may have been fair to ask the question: “How can we reduce the number of frivolous offers?” But in light of what has happened with the offer program, it is now time to ask the question: “How can we increase the number of appropriate offers?”

<sup>32</sup> See IRS Small Business/Self-Employed Division Research, *Liens, Levies, Seizures, and Total Yield: 10 Year Filing Trend* (Aug. 19, 2005); IRS Statistics of Income Data Books, Table 16 – Delinquent Collection Activities.

<sup>33</sup> Treasury Inspector General for Tax Administration, Ref. No. 2008-40-031, *The Federal Payment Levy Program Needs to Reduce Taxpayer Burden and Maximize Revenue* (Feb. 20, 2009).

I am pleased to report that the IRS has committed to working with my office to conduct a comprehensive review of the offer process, to revise its procedures to encourage qualified taxpayers to submit offers, and to refine its acceptance standards to accept more valid offers.

I recommend (1) that the IRS take steps to make collection alternatives more accessible to appropriate taxpayers and (2) that Congress consider suspending the 20 percent down payment requirement so that we can assess whether revamped IRS procedures can block frivolous offers while soliciting more valid offers.

**3. Taxpayers are subject to levy on their Social Security benefits with no filter in place to determine whether such levies will cause economic hardship.**

The Federal Payment Levy Program, which I will refer to as the FPLP, was established by Congress in 1997.<sup>34</sup> It enables the IRS to continuously levy up to 15 percent of certain federal payments made to delinquent taxpayers. These levies most commonly attach to Social Security Administration payments. In fact, of the more than two million FPLP levy payments the IRS received from taxpayers in 2008, more than 83 percent were from Social Security benefits.<sup>35</sup>

FPLP levies on Social Security benefits are not one-time attachments. FPLP levies may continue until the entire amount of the federal tax debt is repaid, other payment arrangements are made, or the debt becomes unenforceable by law.

Until 2005, the IRS used a filter to prevent low income taxpayers from being subjected to FPLP levies on their Social Security payments. However, a report published by the Government Accountability Office (GAO) in 2003 questioned the effectiveness of the low income filter,<sup>36</sup> which relied on the taxpayer's Total Positive Income from the last filed return as its sole measure of a taxpayer's financial situation.<sup>37</sup> The GAO observed that most taxpayers had not filed a recent return and that the income

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<sup>34</sup> Taxpayer Relief Act, Pub. L. No. 105-34, § 1024, 111 Stat. 788, 923 (1997); IRC § 6331(h).

<sup>35</sup> See IRS, Wage and Investment Division spreadsheet, *FPLP Monthly Counts*, FY 2008 [1,797,530 (total number of FPLP Social Security Administration levy payments received in fiscal year 2008) / 2,161,974 (total number of all FPLP levy payments received in FY 2008) = 83 percent].

<sup>36</sup> General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Payment Program Measures, Performance and Equity Can Be Improved* (2003). The name of the "General Accounting Office" has since been changed to the "Government Accountability Office."

<sup>37</sup> Total Positive Income is calculated by adding the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distributions from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero. For a more detailed discussion of this filter, see National Taxpayer Advocate 2005 Annual Report to Congress 123-135, National Taxpayer Advocate 2004 Annual Report to Congress 246-263, National Taxpayer Advocate 2003 Annual Report to Congress 206-212, and National Taxpayer Advocate 2001 Annual Report to Congress 202-209.

information was therefore not reliable. The GAO report also noted that the filter failed to recognize that taxpayers might have other assets that could satisfy the tax liability. As a result, the IRS stopped using the filter even though the report did not explore the effect of the FPLP levies on taxpayers who are unable to afford the levy. Since the removal of the low income filter, TAS's FPLP cases have increased by more than 500 percent.<sup>38</sup>

The report published in Volume Two of my 2008 Annual Report to Congress documents TAS Research's design, development, and preliminary testing of an improved screening model that could determine whether the FPLP levy will cause a taxpayer economic hardship. The new TAS model uses taxpayers' income information from filed individual income tax returns and payor documents filed with the IRS, such as Forms W-2 and Forms 1099 for pension, capital gains, dividend and interest income, to estimate the taxpayer's income.

Next, the TAS model uses other tax return data to estimate expenses routinely allowed by the IRS when determining a taxpayer's ability to pay. The TAS model then compares these two amounts to determine whether the FPLP levy on the taxpayer's Social Security benefits will cause the taxpayer to suffer economic hardship. In additional testing of the model, TAS Research looked at how results differ when the 2008 allowable living expense guidelines are used compared to results using the 2006 guidelines as well as differences that emerge when the 2008 poverty level is used as a filter in lieu of using the 2008 allowable living expense guidelines.

The TAS study also examined the availability of other assets to satisfy the tax liability. In addition to looking for the presence of real property, as suggested by the GAO, TAS Research reviewed cases for the presence of more liquid assets by estimating underlying principal amounts from reported interest, dividends, and capital gains.

TAS Research's findings show that the use of data already in the possession of the IRS appears sufficient to accurately determine whether FPLP levies will cause economic hardship to Social Security recipients. The following are some of the most significant conclusions from the report:

- Over one-third of all FPLP cases subject to an ongoing FPLP levy would likely be classified as unable to pay based on current IRS allowable living expense guidelines.
- TAS estimates that more than one-quarter of FPLP taxpayers who paid their tax liabilities, entered into installment agreements with the IRS, or were subject to an ongoing FPLP levy had incomes at or below the poverty level.

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<sup>38</sup> TAS FPLP cases increased from 525 in FY 2004 to 3,222 in FY 2008. Taxpayer Advocate Service, *Business Performance Management System* (Sept. 2008).

- Most taxpayers with small liabilities endured the FPLP Social Security levy even though their incomes showed an inability to pay, suggesting that they may have foregone some basic living expenses.
- Although the 2008 allowable living expense standards are typically more generous than the 2006 standards and classified more taxpayers who paid or established installment agreements as being unable to pay, our financial analysis suggests that most of these taxpayers still had incomes at or below the poverty level.
- An analysis of taxpayer assets located by a third-party data source shows that the IRS has sufficient tax data to determine if many of these taxpayers have assets that may be used to satisfy a tax delinquency.

In partnership with my office, the IRS is now in discussions with its programmers about the feasibility of implementing an allowable expense or alternative filter. Prior to implementation, I recommend that the IRS conduct a field test of the allowable expense filter we developed to determine its effectiveness in protecting low income Social Security recipients who are experiencing economic hardship from an FPLP levy while not unfairly filtering out taxpayers who have the wherewithal to pay their tax liabilities. During the test, financial information would be collected from taxpayers selected to participate. The results of this analysis could then be compared to results of the simulated financial analysis performed by the filter to determine its accuracy. If the field test verifies the accuracy of the allowable expense filter, the IRS should proceed to implement this filter to protect taxpayers from FPLP levies which would cause economic hardship.<sup>39</sup>

**4. Taxpayers who cannot pay their debts in full may have taxable “cancellation-of-debt” income, meaning that they may obtain relief from their creditors only to find themselves faced with additional tax and a minefield of reporting obligations.**

Under section 61(a)(12) of the Code, a taxpayer who is relieved of an obligation to pay all or a portion of a debt generally must include the amount of debt forgiveness in gross income. This “cancellation-of-debt” rule is subject to certain exclusions, such as where a taxpayer’s debts are discharged in a bankruptcy proceeding or where (and to the extent that) a taxpayer is “insolvent,” meaning that the taxpayer’s total liabilities exceed the fair market value of the taxpayer’s assets. In 2007, Congress added a new exclusion in the Mortgage Forgiveness Debt Relief Act. The new exclusion relieves homeowners who used mortgage proceeds to purchase, substantially improve, or

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<sup>39</sup> The Treasury Inspector General for Tax Administration also recently recommended that the IRS reinstitute a filter to identify and exclude taxpayers for whom a levy would impose hardship. See Inspector General for Tax Administration, Ref. No. 2008-40-031, *The Federal Payment Levy Program Needs to Reduce Taxpayer Burden and Maximize Revenue* (Feb. 20, 2009).

refinance their principal residence from additional tax liability if all or a portion of their mortgage debt is canceled pursuant to a foreclosure or loan modification.<sup>40</sup> Taken together, the bankruptcy, insolvency, and mortgage exclusions are designed to provide relief from the cancellation-of-debt rules for financially struggling taxpayers.

However, two major sources of confusion prevent taxpayers from taking advantage of these relief provisions.<sup>41</sup> First, the terms of the exclusion are complex. Few taxpayers know what the word “insolvent” means. It is particularly difficult for taxpayers to figure out how to compute their total liabilities and the fair market value of their assets so they can determine whether they are insolvent and, if so, in what amount. Similarly, available data suggest that a majority of homeowners who have subprime mortgages used a portion of the loan proceeds for purposes other than acquiring, substantially improving, or refinancing their principal residence (e.g., to pay off car loans, student loans, medical bills, credit card bills, or other consumer debt).<sup>42</sup> To the extent of the amount borrowed for these non-qualifying purposes, mortgage debt cancellation is not excludable from income.

Second, taxpayers who determine that they qualify to exclude an amount of debt cancellation from income must make certain basis and other tax attribute adjustments.<sup>43</sup> To do so, taxpayers must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, with their returns. Form 982 is technically challenging, asking taxpayers to adjust, among other things, net operating losses, general business credit carryovers, minimum tax credits, net capital losses, nondepreciable and depreciable property, passive activity loss and credit carryovers, and foreign tax credit carryovers (although many non-business taxpayers do not have these tax attributes).

Unfortunately, very few taxpayers have heard of Form 982, and it is difficult to obtain assistance in filling it out. Many practitioners have never worked with the form, some tax software packages do not support it, and the subject of canceled debts is considered “out of scope” at Volunteer Income Tax Assistance (VITA) programs,

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<sup>40</sup> Pub. L. No. 110-142, 121 Stat. 1803 (2007).

<sup>41</sup> The Taxpayer Advocate Service has undertaken several initiatives to reduce this confusion and educate taxpayers and their representatives about the rules pertaining to cancellation-of-indebtedness income. First, TAS sponsored a program on this issue during the 2008 IRS Tax Forums. The program attracted so much interest that the IRS scheduled two sessions to accommodate interested practitioners. In both 2008 and 2009, the National Taxpayer Advocate recorded a series of podcasts – or “TAScasts” – on cancellation of indebtedness income. The 2008 materials are available on the electronic Tax Literacy Toolkit at <http://www.taxtoolkit.irs.gov>.

<sup>42</sup> According to a federal government report issued in 2000: “The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms of a mortgage.” Department of Housing and Urban Development and Department of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 26 (2000). We have not located more recent government data on this point.

<sup>43</sup> See IRC § 1017 and the regulations issued thereunder.

except with respect to the exclusion for qualified mortgage indebtedness. In tax year 2006, the IRS received at least 401,981 electronically filed returns from taxpayers with canceled debts reported on a Form 1099-C, yet only 4,571 of the returns were filed with Form 982 – just one percent.<sup>44</sup>

The consequences of failing to file Form 982 can be significant. When a lender cancels all or part of a debt, the lender generally is required to report the amount to the IRS on Form 1099-C, *Cancellation of Debt*. If the IRS receives a Form 1099-C and the taxpayer does not account for the amount on a tax return, the IRS's document-matching program will generally flag the disparity. If the IRS sends out notices and the taxpayer does not respond, the IRS may propose and assess tax.

To reduce the burden these rules impose on financially struggling taxpayers, I recommend that Congress (1) consider adding an exclusion in section 108(a) of the Code which provides that taxpayers are not required to include canceled debts in gross income if the aggregate amount of their canceled debts from all sources during the taxable year falls below a specified threshold and (2) make clear that taxpayers with canceled debt below the threshold amount are not required to make attribute adjustments (so that they do not have to file Form 982). I believe that many if not most taxpayers who default on consumer debts qualify under one of the existing exclusions, and even among taxpayers who do not fall within an exclusion, it is unlikely that the IRS collects much revenue from taxpayers who have just defaulted on other debts. Therefore, I believe the simplification benefits of this proposal are considerable, and I believe the revenue loss should be quite small.

**5. Many taxpayers who are entitled to refunds and need them quickly do not receive them for weeks, driving them to purchase refund anticipation loans.**

Federal tax refunds are a significant source of funds for many individual taxpayers, particularly low income taxpayers. For example, among taxpayers who received earned income tax credit (EITC) benefits and tax refunds in tax year 2006, the average refund amount was \$3,184, and the average adjusted gross income was \$15,763.<sup>45</sup> Thus, the average refund amounted to *20 percent* of each taxpayer's adjusted gross income. Yet if a taxpayer does not have a bank account into which a refund may be electronically deposited, the taxpayer may have to wait weeks to receive the refund. Because low income taxpayers often want or need their refunds quickly, this delay

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<sup>44</sup> IRS Compliance Data Warehouse, Information Returns Master File and Individual Returns Transaction File (Tax Year 2006); IRS E-File Report 1558 (Processing Year 2007). Note that the number of electronically filed returns actually was greater than 401,981 because the data 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 Form 1099-C. 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.

<sup>45</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).



drives many of them to pay significant transaction fees to obtain refund anticipation loans (RALs). With a RAL, the taxpayer typically receives a loan (secured by a tax refund) within one day after the preparer files the tax return with the IRS.

If the IRS could deliver refunds more quickly, most taxpayers would probably forego RALs. According to a TIGTA survey, most taxpayers who obtained RALs would have been willing to wait seven or more days to receive their tax refunds from the IRS.<sup>46</sup>

For taxpayers who do not have bank accounts, I believe the IRS should issue stored value cards. The Financial Management Service (FMS) already uses stored value cards to distribute Social Security benefits, so the federal government has considerable experience working with the cards efficiently and with an eye toward preventing fraud. In addition, most states currently use debit cards to distribute unemployment benefits.<sup>47</sup> While using stored value cards to deliver tax refunds may require the IRS to work through additional issues, I am confident this can be done and can be done quickly. In fact, because stored value cards have routing and account numbers just like traditional checking and savings accounts, taxpayers who already have these cards for purposes of receiving their wages and salaries should be able to use them to receive tax refunds.

In addition, some taxpayers who have bank accounts do not know about the direct deposit option and also wait long periods to receive their refunds. The IRS has the capability to direct deposit refunds for problem-free returns processed through its Customer Account Data Engine system in five to seven days from the day the returns are submitted.<sup>48</sup> It appears that by processing returns more quickly, the IRS could steer taxpayers away from more expensive refund delivery options.<sup>49</sup>

I recommend that the Department of the Treasury and the IRS take the following steps:

- Evaluate the entire refund process to determine opportunities to shorten the turnaround time;
- Develop a pilot program to determine the impact on tax administration of modifying return processing procedures to release a Revenue Protection Indicator in the acknowledgement file and evaluate the feasibility of

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<sup>46</sup> Treasury Inspector General for Tax Administration, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Refund Anticipation Loans Could Benefit from Free Tax Preparation Services* (Aug. 29, 2008).

<sup>47</sup> See Associated Press, *States Issuing Jobless Benefits Debit Cards* (Feb. 20, 2009).

<sup>48</sup> IRS, Debt Indicator Report to Congress 26 (Oct. 31, 2006), as requested by H.R. Rep. No. 109-307 (2005) (Conf. Rep.).

<sup>49</sup> National Taxpayer Advocate 2008 Annual Report to Congress 430. Returns processed on IRS's older systems can be processed in 9-15 days. *Id.* at 427.

including such information in the current “Where’s My Refund” online application;<sup>50</sup>

- Evaluate existing stored value card programs to distribute government benefits, with particular emphasis on the experience of FMS’s Direct Express Program to distribute Social Security benefits;
- Promote and publicize the ability of taxpayers who already have stored value cards to designate those cards for receipt of refunds; and
- Develop a stored value card program to distribute refunds to individual taxpayers before the 2010 tax filing season.

I also recommend that Congress authorize the IRS to conduct an annual public awareness campaign to provide accurate information to taxpayers regarding available refund delivery alternatives, associated turnaround times, and any other pertinent information.

**6. Taxpayers who are forced to tap into a retirement account because of financial hardship before age 59-1/2 face a bewildering array of rules that govern whether a hardship distribution from a particular type of retirement account is permissible and, if so, whether it is subject to the 10 percent additional tax on early withdrawals.**

As more taxpayers are losing their jobs or otherwise facing financial emergencies, they are increasingly looking to tap into their retirement savings to provide for current needs. In 2006, approximately 5.1 million tax returns reported tax on such “early distributions” taken from retirement accounts.<sup>51</sup>

Some retirement plans allow participants to receive an early distribution in cases of financial hardship, such as a medical emergency. However, there is no uniform definition of “hardship” among the various retirement plans to enable a participant to easily determine when an early withdrawal is allowable.<sup>52</sup> Further, even if a plan allows for a hardship withdrawal, participants must deal with inconsistent rules for triggering the 10 percent additional tax for early withdrawal.<sup>53</sup>

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<sup>50</sup> For a detailed discussion of the proposed Revenue Protection Indicator, see National Taxpayer Advocate 2008 Annual Report to Congress 427-441.

<sup>51</sup> Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

<sup>52</sup> For example, a hardship distribution in the section 401(k) context is defined in terms of the heavy financial need of the employee. See Treas. Reg. § 1.401(k)-1(d)(3). Compare that with a hardship distribution in the section 457 context, which is defined as a general financial hardship of the participant or beneficiary resulting from illness, accident, loss of property due to casualty, or other extraordinary and unforeseeable emergency. See Treas. Reg. § 1.457-6(c)(2).

<sup>53</sup> See IRC § 72(t)(1).

Assume that a 50-year-old retirement-plan participant suffers a medical emergency that will require him to miss six months of work. Assume further that he incurs \$15,000 in medical expenses and estimates that his living expenses for the six months while he recovers from surgery will be \$20,000. Whether he will be able to receive a hardship distribution and whether the distribution will be subject to the 10 percent additional tax on early withdrawals will depend on the type of retirement plan in which he is a participant.

If the worker was a participant in his employer's section 401(k) plan, the plan may allow a hardship withdrawal for his medical expenses, but not for his living expenses during the period when he is unable to work.<sup>54</sup> Hardship distributions from a section 401(k) plan generally are subject to the 10 percent additional tax for early withdrawal.<sup>55</sup> However, if the medical expenses satisfied certain requirements under section 213 and Treas. Reg. § 1.213-1(a)(1), the amount distributed for medical expenses would not be subject to the 10 percent additional tax.<sup>56</sup>

If, instead, the worker was a participant in a section 457(b) plan (which generally covers employees of state and local governments), he could make a hardship withdrawal for "unforeseeable emergencies." Severe financial hardship resulting from an illness or accident is considered to be an instance of unforeseeable emergency.<sup>57</sup> In contrast to section 401(k) plans, the 10 percent additional tax does not apply to a hardship withdrawal from a section 457(b) plan unless the amount distributed is attributable to a transfer from another plan.<sup>58</sup>

In further contrast, traditional individual retirement accounts (IRAs) can be distributed for any reason including due to hardship. A distribution taken from an IRA for medical expenses may be exempt from the 10 percent additional tax if the distribution is for medical expenses that satisfy the requirements of section 213. However, if the worker in our example withdraws funds from his IRA to pay for his living expenses while recovering from his illness, the 10 percent additional tax will apply to the amount withdrawn.

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<sup>54</sup> An early distribution may be made to a section 401(k) plan participant "upon hardship of the employee." See IRC § 401(k)(2)(B)(i)(IV). Applicable Treasury regulations provide that a distribution is made on account of hardship only if (1) the distribution is made due to an immediate and heavy financial need of the employee and (2) the distribution is necessary to satisfy the heavy need. See Treas. Reg. § 1.401(k)-1(d)(3)(i). An "immediate and heavy need" is determined using a facts and circumstances test under Treas. Reg. § 1.401(k)-1(d)(3)(iii). Expenses for medical care incurred by the employee, spouse, or certain dependents are included in the safe harbor definition of an immediate and heavy financial need. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(1).

<sup>55</sup> See IRC § 72(t)(1).

<sup>56</sup> IRC § 72(t)(2)(B).

<sup>57</sup> Treas. Reg. § 1.457-6(c)(2).

<sup>58</sup> The 10 percent additional tax imposed by IRC § 72(t) does not apply to section 457(b) plans because a section 457(b) plan is not a "qualified retirement plan" as defined in IRC § 4974(c).

As this example illustrates, there is very little uniformity among the rules governing early withdrawals from retirement plans. This wide array of outcomes can seem impenetrable to taxpayers and grossly unfair. I recommend that Congress establish uniform rules regarding hardship withdrawals from retirement plans and exempt such distributions from the 10 percent additional tax.

**7. Taxpayers are increasingly turning to Low Income Taxpayer Clinics for help, and increased funding for the program is needed.**

Section 7526 of the Code authorizes the Secretary to make federal matching grants of up to \$6 million (except if otherwise provided by specific appropriation) for the development, expansion, or continuation of qualified low income taxpayer clinics (LITCs).<sup>59</sup> This matching grant program was created as part of the IRS Restructuring and Reform Act of 1998 and provides a means for low income taxpayers (defined as taxpayers whose incomes do not exceed 250 percent of the poverty guidelines) to receive assistance in controversies with the IRS.<sup>60</sup> The program also funds LITCs to conduct tax education and outreach to taxpayers who speak English as a second language (ESL taxpayers).

The LITC Program fills a significant gap in tax administration. Through the Volunteer Income Tax Assistance (VITA) program, Tax Counseling for the Elderly (TCE), and the IRS's Taxpayer Assistance Centers, low income taxpayers have long been able to obtain free assistance in preparing their tax returns. However, these taxpayers often had nowhere to turn for help if the IRS questioned or challenged their returns.<sup>61</sup> The LITC Program is now in its 11<sup>th</sup> year and funds 163 clinics, with at least one in every state, the District of Columbia, and Puerto Rico.<sup>62</sup> The program is cost effective and provides extensive benefits to taxpayers because many of the clinics have created partnerships with local law and accounting firms that take referred cases on a *pro bono* basis. Thus, the clinics use the funding they receive not only to represent taxpayers themselves but also to expand the scope of coverage by enlisting the help of professionals in their communities who are willing to volunteer their time.

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<sup>59</sup> IRC § 7526 provides for matching grants of up to \$100,000 per year for qualifying organizations that represent low income taxpayers involved in controversies with the IRS and that provide tax education and outreach to taxpayers who speak English as a second language. IRC § 7526 requires clinics to provide services for free or for no more than a nominal fee.

<sup>60</sup> The Department of Health and Human Services issues poverty guidelines each year that are used to determine financial eligibility for certain federal programs, including the LITC program. The 2009 Poverty Guidelines were recently published in the Federal Register. See 74 F.R. 4199 (Jan. 23, 2009).

<sup>61</sup> IRS Restructuring: Hearing Before the S. Comm. on Finance, 105<sup>th</sup> Cong. (Feb. 5, 1998) (statement of Nina E. Olson, Executive Director, Community Tax Law Project); Recommendations of the National Committee on Restructuring the IRS on Taxpayer Protections and Rights: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 105<sup>th</sup> Cong. (Sept. 26, 1997) (statement of Nina E. Olson, Executive Director, Community Tax Law Project).

<sup>62</sup> Of the 163 clinics funded for 2009, 46 provide only controversy representation, 20 provide only ESL outreach and education, and 97 provide both types of assistance. Seventy-four LITCs are located at nonprofit community-based organizations, 53 are legal aid societies, 28 are at law schools, and eight are at business or accounting schools.

A recent Taxpayer Advocate Service study demonstrates the importance of representation for low income taxpayers to enable them to obtain the correct result in an audit. A review of all EITC audits conducted by the IRS in 2004 found that taxpayers who were represented during the audit fared substantially better than unrepresented taxpayers, with nearly twice as many represented taxpayers found eligible for the EITC as compared with unrepresented taxpayers. Similarly, represented taxpayers retained, on average, 45 percent of the EITC as compared to 25 percent for taxpayers without representation – nearly twice as much.<sup>63</sup> This study demonstrates that representation during audits has concrete, positive results for low income taxpayers and ensures they are not denied tax benefits simply because they cannot navigate the audit process by themselves.

The current economic environment presents significant challenges because the number of taxpayers who cannot pay their liabilities is rising while available assistance from tax professionals is declining.<sup>64</sup> The decline in the availability of legal services is attributable to several factors. First, the decline in equity values has reduced the amount of funds that foundations and other endowments have available to distribute. Second, declining incomes and the rising need for social services have placed strains on state and local government budgets that ordinarily provide assistance for legal service programs. Third, the emphasis that law firms and lawyers traditionally place on performing *pro bono* services has declined; billable hours and surviving the next round of layoffs are the order of the day.<sup>65</sup>

The LITC program operates under the stewardship of the Office of the Taxpayer Advocate. TAS has established several goals for this program that it may not be able to achieve under current funding levels, including funding clinics in areas where there are significant unmet needs and establishing clinics in each state, the District of Columbia, Puerto Rico, and Guam that provide both *pro bono* controversy representation and ESL outreach. When the LITC Program was first created, Congress believed that annual funding of \$6 million was sufficient to ensure that low income taxpayers had access to representation. Since the creation of the LITC Program, however, Congress has provided specific appropriations in excess of \$6 million.<sup>66</sup>

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<sup>63</sup> See National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2 (Research Report: *IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

<sup>64</sup> See Bill Myers, *Economic Collapse Will Affect Legal Aid to Poor*, The Washington DC Examiner, Feb. 17, 2009, at 4, available at <http://www.dcxaminer.com/local/Economic-collapse-will-affect-legal-aid-to-poor-0217-39690412.html> (stating that the deteriorating economy has created an “overwhelming demand for low-income legal assistance” while the challenges facing law firms are “eating away at the legal aid community’s capacity to provide the services”).

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

<sup>66</sup> See, e.g., Appropriations Act of 2006, Pub. L. No. 109-115, 119 Stat. 2396 (2005) (providing funding of \$8 million); Consolidated Appropriations Act of 2008, Pub. L. No. 110-161, 121 Stat. 1844 (2007) (providing funding of \$9 million).

To meet the increasing needs we are seeing, I recommend that Congress (1) increase the annual authorization amount specified in section 7526(c)(1) from \$6 million to \$12 million and (2) amend section 7526(c) to add a new provision stating that, notwithstanding any other provision of law, IRS employees may refer taxpayers to LITCs receiving funding under this section.<sup>67</sup>

## **B. Other Issues**

There are four additional issues that do not relate exclusively to financially struggling taxpayers but that I believe deserve priority attention.

### **1. The Alternative Minimum Tax for individuals continues to baffle and frustrate taxpayers, and it is not good for taxpayers or the IRS to continue to provide one-year “patches.”**

I recognize that the enormous revenue consequences of repealing the AMT make its repeal outside the context of major tax reform unlikely. However, I believe strongly that the AMT is bad for the tax system, and I would be remiss if I did not raise the issue, at least in passing.<sup>68</sup>

The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year,<sup>69</sup> now effectively requires taxpayers to compute their taxes twice – once under the regular rules and again under the AMT regime. The taxpayer is then generally required to pay the higher of the two amounts.<sup>70</sup>

While the AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed. For tax year 2006, it is estimated that 77 percent of the

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<sup>67</sup> The second change is needed to provide clarification in light of rules that prohibit IRS employees from referring taxpayers to specific attorneys or accountants and that prohibit all federal employees from endorsing any product, service, or enterprise. For a more complete discussion of this issue, see National Taxpayer Advocate 2007 Annual Report to Congress 551-553 (Legislative Recommendation: *Referral to Low Income Taxpayer Clinics*).

<sup>68</sup> For additional information, see National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*) and prior reports cited therein.

<sup>69</sup> See The 1969 Economic Report of the President: Hearings Before the Joint Economic Comm., 91<sup>st</sup> Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The forerunner of the AMT was an “add-on” minimum tax enacted in 1969.

<sup>70</sup> The AMT rules are contained in IRC §§ 55-59.

additional income subject to tax under the AMT was attributable not to any such loopholes, but simply to family size or residing in a high-tax state.<sup>71</sup>

Those factors give rise to AMT tax liability because the regular tax rules allow taxpayers to claim a deduction for each dependent (recognizing the costs of maintaining a household and raising a family) and a deduction for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. Common sense suggests that Congress could not have viewed the act of having children or living in a high-tax state as a tax-avoidance technique. Yet to the chagrin of most observers, that is exactly how it has evolved.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has evolved into something that was never intended. The AMT hits taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it penalizes taxpayers for such nontax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it takes large numbers of taxpayers by surprise – and subjects them to penalties to boot; it is very challenging to compute; it alters the distribution of the tax burden that exists under the regular tax system; it changes the tax incentives built into that system; it neutralizes the effects of changes to tax rates imposed under the regular tax rules; and it requires the IRS to divert resources from other priority work to re-program its computers each year to reflect changing exemption amounts that, as discussed immediately below, often are not set until very late in the year.

I urge Congress to repeal the Alternative Minimum Tax for individuals in the context of fundamental tax reform.

**2. Late-year changes in the tax code present significant challenges for taxpayers and the IRS, particularly for low income and financially struggling taxpayers.**

When Congress makes changes to the Internal Revenue Code late in the year, the IRS must scramble to reprogram its computers and take other necessary steps to implement the changes. These last-minute changes can delay the start of the filing season for a significant number of taxpayers. In general, the IRS begins to process tax returns on or about January 15. In 2006, however, the Tax Relief and Health Care Act was not signed into law until December 20, 2006.<sup>72</sup> This legislation affected tax benefits for more than 11 million taxpayers.<sup>73</sup> The IRS was not able to process returns

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<sup>71</sup> See Tax Policy Center, Tax Facts: AMT Preference Items 2002, 2004-2006 (citing unpublished tabulations from the Office of Tax Analysis, Department of the Treasury), *available at* [http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt\\_preference.pdf](http://www.taxpolicycenter.org/taxfacts/Content/PDF/amt_preference.pdf).

<sup>72</sup> Pub. L. No. 109-432, 120 Stat. 2922 (2006).

<sup>73</sup> For tax year 2006, IRS data show that more than 11 million taxpayers claimed the deduction for state and local sales taxes, more than 4 million taxpayers claimed the deduction for post-secondary tuition and fees, and more than 3.2 million taxpayers claimed the deduction for educator expenses. IRS

claiming those benefits until February 3, 2007, which amounted to approximately a three-week delay.<sup>74</sup> In 2007, the Tax Increase Prevention Act, which was not signed into law until December 26, 2007, raised the AMT exemption amounts for 2007 and extended an ordering rule that applies to personal tax credits.<sup>75</sup> The IRS was unable to process about 13.5 million returns claiming certain of those benefits until February 11, 2008, which amounted to approximately a four-week delay.<sup>76</sup>

Overall, more than 80 percent of individual taxpayers receive refunds when they file their returns,<sup>77</sup> and tax refunds are particularly important to low income taxpayers. Among taxpayers who received EITC benefits and tax refunds in tax year 2006, the average refund amounted to 20 percent of the taxpayer's yearly income.<sup>78</sup> A taxpayer for whom the refund is so significant often makes financial plans based on when he or she anticipates receiving the refund and may view the refund as a lifeline. For some taxpayers, a delay of two to four weeks in receiving the refund could mean eviction or inability to pay the high heating bills that arise during winter. Congress should be aware that delays in the start of the filing season can cause financial hardship for taxpayers who depend on receiving timely refunds, and for some taxpayers, the magnitude of the hardship can be significant.

In my 2007 Annual Report to Congress, I wrote at length about other problems associated with late-year tax-law changes.<sup>79</sup> In particular, I discussed data suggesting that taxpayers may miss deductions for which they qualify simply because they do not know about them. By the time the 2006 and 2007 changes discussed above were made, for example, the Form 1040 and accompanying instructions and shrink-wrapped software for the year at issue had already been finalized, and some taxpayers therefore did not find out about the changes.

The major challenges resulting from late-year tax-law changes in recent years have primarily involved the extension of expiring tax provisions. To ensure that Members of Congress understand the filing-season impact of deferring action on these so-called

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Statistics of Income, Individual Income Tax Returns (unpublished analysis as of December 2006). These deductions were authorized for Tax Year 2006 by the Tax Relief and Health Care Act, Pub. L. No. 109-432 (2006).

<sup>74</sup> See IRS News Release IR-2007-26, *IRS Begins Processing Returns Claiming Extender Deductions; Urges Taxpayers to File Electronically, Check on Phone Tax Refund* (Feb. 6, 2007).

<sup>75</sup> Tax Increase Prevention Act, Pub. L. No. 110-166, 121 Stat. 2461 (2007).

<sup>76</sup> See IRS News Release IR-2008-19, *IRS Successfully Processing Tax Forms Affected by AMT Legislation* (Feb. 14, 2008).

<sup>77</sup> In tax year 2006, the IRS received 138,893,908 Form 1040-series returns and issued 114,475,957 refunds. See IRS Data Book, 2007, Tables 3 and 7. Put differently, 80 percent of taxpayers had more tax withheld or paid more estimated tax than was required to satisfy their tax liabilities, and fewer than 20 percent of taxpayers owed a balance to the IRS at the time they filed their returns.

<sup>78</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

<sup>79</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*).



“extenders” until late in the year, I recommend that the Treasury Department and the tax-writing committees create a formal process through which the IRS’s estimates of the filing-season impact of significant tax legislation are transmitted to the tax-writing committees at several points during the year, perhaps on April 30, June 30, August 31, and monthly thereafter.

**3. Current budgeting rules chronically under-fund the IRS, depriving the agency of the resources it needs to close the tax gap.**

In my 2006 Annual Report to Congress, I discussed in detail why I believe existing congressional budget procedures cause the IRS to be chronically underfunded.<sup>80</sup> In essence, existing budget procedures treat expenditures for IRS operations as they treat most other federal expenditures, without regard to the additional revenue that spending on the IRS generates. On a budget of about \$11.2 billion, the IRS in FY 2008 collected about \$2.74 trillion.<sup>81</sup> That translates to an average return on investment of about 245 to 1. While additional expenditures will not generate a 245:1 return on investment, there is widespread consensus that the IRS can make productive use of additional resources that would generate a return considerably in excess of 1:1.

In essence, the IRS is the Accounts Receivable Department of the federal government. If the federal government were a private company, its management clearly would fund the Accounts Receivable Department at a level that it believed would maximize the company’s bottom line. Because the government is not a private company, maximizing the bottom line is not – in and of itself – an appropriate goal. But the public sector analogue should be to fund the IRS at a level that will maximize tax compliance, especially voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden. As the IRS has come under increasing pressure to close the “tax gap,” it should be recognized that the IRS suffers from a “resources gap,” and the IRS’s lack of resources is a significant impediment to its ability to close the tax gap and thereby to reduce the federal budget deficit.

In the course of preparing my 2006 report and in subsequent discussions with congressional staff on the tax-writing, appropriations, and budget committees, it became clear there is broad agreement that the existing budget rules do not fund the IRS in a manner that enables the IRS to maximize tax compliance. However, there was also a sense that changing the budget-scoring rules vis-à-vis the IRS presents significant challenges that will require considerable work and collaboration to overcome. For example, either the IRS would have to be taken “off budget” or economists would have to devise a way to score the likely revenue impact of additional funding for the IRS. Neither is easily done. A decision to take the IRS off budget or

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<sup>80</sup> See National Taxpayer Advocate 2006 Annual Report to Congress 442-457 (Key Legislative Recommendation: *Revising Congressional Budget Procedures to Improve IRS Funding Decisions*).

<sup>81</sup> Government Accountability Office, GAO-09-119, *Financial Audit: IRS’s Fiscal Years 2008 and 2007 Financial Statements* at 21 (Nov. 2008).

come up with an alternative approach (my report suggested one) would require significant high-level attention and commitment from congressional leaders and the Office of Management and Budget, while scoring the likely revenue impact of additional funding for the IRS cannot be done with precision due to a lack of adequate data regarding the return on investment of various categories of IRS work.

These challenges are real. But if there continues to be agreement that additional funding for the IRS would enable the IRS to collect considerably more revenue, I believe we must find a way to address them. I recognize that this issue is not solely within the jurisdiction of the Ways and Means Committee, but I encourage you, as the Members of Congress who mostly closely monitor the IRS, to give the issue a closer look and to take the lead in finding a solution.

**4. The IRS's ability to perform its core mission may be compromised when it is asked to take on non-core tasks; notably, the IRS's level of service on the telephone lines continues to suffer due to the Economic Stimulus Payment program.**

The IRS is occasionally asked to administer programs that fall outside its core tax-collection mission. Most recently, the IRS was asked last year to administer the Economic Stimulus Payment (ESP) program. Even with the additional funding Congress provided to administer the ESP program, however, the IRS was deluged with telephone calls from taxpayers inquiring about the status of their ESPs.

The IRS has a measure, known as toll-free assistor level of service (LOS), that measures the percentage of taxpayers who speak with a telephone assistor among all callers seeking to do so. The LOS has declined sharply. In FY 2007, the LOS stood at 82 percent. In FY 2008, the LOS dropped to 53 percent.<sup>82</sup>

While much of the decline was attributable to ESP-related calls, we are continuing to see inadequate levels of service. For the week ending February 7, 2009 (the most recent week for which complete data was available), the LOS on IRS phone lines overall was 55 percent, as compared with 79 percent last year for the comparable week.<sup>83</sup> On the main "1040" line that serves individual income taxpayers, the LOS was 50 percent this year, as compared with 80 percent last year.<sup>84</sup> And of particular concern to me, the LOS on the line that serves taxpayers seeking to reach the Taxpayer Advocate Service has fallen to 69 percent from 83 percent last year.<sup>85</sup>

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<sup>82</sup> See Internal Revenue Service Fiscal Year 2008 Enforcement Results 7, available at [http://www.irs.gov/pub/irs-news/2008\\_enforcement.pdf](http://www.irs.gov/pub/irs-news/2008_enforcement.pdf).

<sup>83</sup> Internal Revenue Service, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Feb. 7, 2009).

<sup>84</sup> Internal Revenue Service, Joint Operations Center, *Snapshot Reports: Product Line Detail: Individual Income Tax Services 800-829-1040* (week ending Feb. 7, 2009).

<sup>85</sup> Internal Revenue Service, Joint Operations Center, *Snapshot Reports: Product Line Detail: NTA 877-777-4778* (week ending Feb. 7, 2009).

I believe the service mission of the IRS compels us to do better, particularly during economically challenging times when more taxpayers are having trouble meeting their tax obligations and may be seeking assistance. I recommend either that the IRS reassign personnel to handle the telephone lines, which may cause other work to suffer, or that Congress provide additional funding for the IRS to do the job without sacrificing in other areas.