

As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is Increased Risk It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections

Introduction to Revenue Protection Issues: As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is Increased Risk It Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections

OVERVIEW

Historically, when a taxpayer filed a return and signed it under penalties of perjury, the IRS assumed it was correct.¹ Except in the case of clear mathematical errors (and inconsistencies evident on the face of the return), the IRS generally did not disturb the taxpayer's self-assessed liability unless it examined the return and identified a problem.² Perhaps assuming the IRS would assess most deficiencies only after an examination, Congress granted taxpayers procedural rights in connection with that process. Thus, when conducting an examination, the IRS was required to follow legally-mandated procedures (described below) designed to minimize burden, inform taxpayers of their rights, and ensure the determination was correct. It provided taxpayers an opportunity to appeal the determination to the IRS Office of Appeals and the United States Tax Court before paying the disputed assessment. These procedures promoted accuracy and established important taxpayer rights.

Today, when a taxpayer's return is inconsistent with information the IRS receives from third parties, the IRS often assumes the return is wrong and the third-party data are correct — without conducting an actual examination. In fiscal year (FY) 2010, the IRS made over 15 million contacts that taxpayers might regard as examinations, but treated only about ten percent (1.6 million) as “real” examinations, subject to real examination procedures and taxpayer protections³ — and it conducted about 78 percent of the “real” examinations by correspondence in a highly-automated campus setting where it is more challenging for the taxpayer to communicate with the examiner.⁴

It is easy to understand why the IRS has embraced an automated approach. Without automation, it would be more difficult to prevent improper payments while also timely

¹ For an interesting analysis of the tax assessment process and the recent rise of automation, see Bryan T. Camp, *Theory and Practice in Tax Administration*, 29 Va. Tax Rev. 227 (Fall 2009). For a broader discussion of automation, see *From Tax Collector to Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*, vol 2, *infra*.

² The IRS was able to identify returns that did not match third-party information reporting (e.g., Forms W-2 and 1099) in the 1960s and 1970s. Bryan T. Camp, *Theory and Practice in Tax Administration*, 29 Va. Tax Rev. 227 (Fall 2009). It was not until 1990, however, when the IRS's Automated Underreporter (AUR) system went online, that IRS computers could identify each mismatch and attempt to fix it by automatically generating letters to taxpayers. *Id.*

³ The IRS conducted 1,581,394 examinations of individuals, closed 4,336,000 AUR contact cases, sent 8,445,374 million math error notices, and made 1,175,000 Automated Substitute for Return (ASFR) contacts in FY 2010. IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program (FY 2010)* (math error, AUR, and ASFR data); IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage (2010)* (examination data).

⁴ IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage (2010)* (reflecting 1,581,394 examinations of individuals in FY 2010, including 1,238,632 by correspondence from an IRS campus and 342,762 in the field or from a field office). For further discussion of this problem, see *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, vol. 2 *infra*.

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delivering tax benefits.⁵ The recent increase in spending programs run through the tax code,⁶ combined with a reduction in IRS funding, makes the IRS’s job even more challenging, as described in the most serious problem (MSP) entitled “*The IRS Is Not Adequately Funded To Serve Taxpayers and Collect Taxes.*” Reports of identity thieves and others making improper claims for refunds also increase the pressure upon the IRS to use automation to address the problem.⁷ In addition, when enacting new tax benefits, Congress sometimes expands the IRS’s “math error” authority to make automated assessments with respect to the new benefits, as it did with the Making Work Pay (MWP) credit and the First-Time Homebuyer Credit (FTHBC).⁸

Automating certain compliance checks makes sense.⁹ However, automated adjustments are often less accurate than face-to-face examinations, particularly when the third-party data is unreliable or either the IRS or the taxpayer has difficulty communicating.¹⁰ In addition, automated procedures may sidestep taxpayer protections applicable to “real” examinations. Without sufficient safeguards, automated procedures are more likely to eliminate or delay tax benefits properly due and desperately needed by some. Thus, as the IRS increases its reliance on automation to “protect revenue,” it should appropriately balance these efforts by simultaneously increasing its efforts to protect taxpayers who are sincerely trying to

⁵ The National Taxpayer Advocate has recommended that the IRS expressly recognize its dual mission. See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency’s Increasing Responsibilities for Administering Social Benefits Programs*).

⁶ For a more in-depth discussion, see National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, at 101-119 (Research Study: *Evaluate the Administration of Tax Expenditures*) and National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, at 75-104 (Research Study: *Running Social Programs Through the Tax System*).

⁷ See, e.g., Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-30-141, *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions* (Sept. 2009); TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Mar. 31, 2009); TIGTA, Ref. No. 2010-41-011, *Evaluation of the Internal Revenue Service’s Capability to Ensure Proper Use of Recovery Act Funds* (Nov. 27, 2009); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009); Government Accountability Office (GAO), GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011). For additional discussion, see Most Serious Problem: *The IRS’s Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing and Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS, infra*.

⁸ See, e.g., IRC § 6213(g)(2)(N) (MWP); IRC § 6213(g)(2)(O) and (P) (FTHBC). For additional discussion of math error, see Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights, infra*.

⁹ For example, it might make sense to extend math error authority to address improper claims for the American Opportunity Tax Credit (IRC § 25A(i)). See *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What’s Due, Hearing Before the Senate Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011). Because the credit is available only for the first four years of a student’s post-secondary education, and because the number of years claimed for each student is apparent on the face of the return, additional math error authority would enable the IRS to stop the improper payment of capped claims with minimal resources. *Id.*

¹⁰ According to the IRS, when it conducts Earned Income Tax Credit (EITC) examinations face-to-face, as it does in connection with the National Research Program (NRP), it achieves an 85 percent response rate (for FY 2007), but this figure falls to 30 percent (for FY 2010) for regular EITC examinations conducted by correspondence. Most Serious Problem: *The IRS Needs to Reevaluate Earned Income Tax Credit Measures and Take Steps to Improve Both Service and Compliance, infra* (IRS comments). Moreover, the IRS assumes for purposes of the NRP that many who do not respond are, in fact, entitled to the EITC they claimed. *Id.*

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comply as well as protecting longstanding taxpayer rights. As described in the MSPs that follow, the IRS's approach will be balanced only if:

- The IRS's automated systems use only the most reliable data;
- The IRS's letters reach taxpayers and clearly explain the discrepancy at issue along with any applicable procedures and taxpayer rights; and
- The IRS's mitigation procedures make it easy for taxpayers to communicate with the IRS to explain apparent discrepancies and resolve problems.

DISCUSSION

The IRS could use automation to help taxpayers and increase compliance.

Although automation has the potential to harm taxpayers who are trying to comply, it can be helpful. The IRS has long-term plans to make third-party data electronically available to taxpayers before they file.¹¹ By making it available for download or as part of a simple pre-populated return, the IRS could increase compliance and reduce the stress associated with tax preparation. Such assistance could be particularly helpful to low income taxpayers who file a return just to claim benefits, such as the earned income tax credit (EITC).¹² To date, however, the IRS has focused instead on using third-party data for post-filing enforcement, particularly with respect to refundable credits.

The IRS is charged with administering an increasing number of refundable tax credits.

The IRS administers a wide range of refundable tax credits.¹³ In addition to credits such as the EITC, the Additional Child Tax Credit, and the fuel tax credit,¹⁴ which have long been refundable, Congress recently made some other longstanding credits refundable, including the Hope Scholarship Credit for educational expenses, and the Adoption Tax Credit.¹⁵ It has also recently added new refundable credits such as the First-Time Homebuyer Credit

¹¹ See IR-2011-38, *Prepared Remarks of IRS Commissioner Doug Shulman at the National Press Club* (Apr. 6, 2011); IR-2011-114, *IRS to Host Public Meeting Dec. 8 on Real-Time Tax System* (Nov. 30, 2011). The National Taxpayer Advocate is pleased that the IRS has embraced her vision in this regard. For a discussion of the National Taxpayer Advocate's vision, see National Taxpayer Advocate 2009 Annual Report to Congress 338 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refund First, Verify Eligibility Later" Approach to Tax Return Processing*).

¹² For further discussion of this issue, see Most Serious Problem, *Accelerated Third-Party Information Reporting and Pre-Populated Returns Would Reduce Taxpayer Burden and Benefit Tax Administration*, *infra*.

¹³ For additional discussion of these credits, see, e.g., Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *infra*; and Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

¹⁴ IRC § 32 (EITC); IRC § 24(d) (Additional Child Tax Credit); IRC § 34 (fuel tax credit). The Additional Child Care Tax Credit (ACTC) became refundable in 2001. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 201(c), 115 Stat. 38, 46 (2001). The Patient Protection and Affordable Care Act of 2010 (PPACA) increased the ACTC, effective for tax years beginning after December 31, 2009. Pub. L. No. 111-148, § 10909(b), 124 Stat. 119, 1022 (2010).

¹⁵ The PPACA replaced the adoption credit under former IRC § 23 with a refundable adoption credit under IRC § 36C, effective for tax years beginning after December 31, 2009. Pub. L. No. 111-148, § 10909(b), 124 Stat. 119, 1023 (2010). The American Recovery and Reinvestment Act of 2009 created the American Opportunity Tax Credit (AOTC), an expansion of the Hope Scholarship Credit, making it partially refundable, effective for 2009 and 2010. Pub. L. No. 111-5, § 1004, 123 Stat. 115, 313 (2009) (codified at IRC § 25A(i)). The AOTC was further extended to the 2011 and 2012 tax years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Pub. L. No. 111-312, § 103(a)(1), 124 Stat. 3296, 3299 (2010).

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for the purchase of a home, the Making Work Pay credit, and the credit for qualified health insurance premiums.¹⁶

Reports of identity theft and improper claims for credits increase pressure on the IRS to use automation to “protect revenue.”

When administering refundable credits, the IRS becomes a target for identity thieves, organized crime, and others seeking improper payments. Organizations charged with overseeing the IRS have urged the IRS to use automation to prevent or recover payments on improper claims.¹⁷ The IRS Accounts Management Taxpayer Assurance Program (AMTAP) recently established the Automated Questionable Refund (AQR) pilot to expand its use of automation to prevent improper refunds.

The IRS continues to expand its use of automation in lieu of face-to-face examinations in many areas.

As described in the MSPs that follow, the IRS has significantly increased its use of automated procedures for second-guessing returns (or the taxpayer’s decision not to file) in a wide range of areas.

- The Electronic Fraud Detection System (EFDS) selected 1,054,704 returns in calendar year (CY) 2011 — an increase of 72 percent over the prior year;¹⁸
- The math error program processed 10.6 million math errors and issued 8.4 million math error notices in FY 2010 — 170 percent more than in FY 2003;¹⁹
- The Automated Underreporter (AUR) matching program closed 4,336,000 cases in FY 2010 — 277 percent more than in FY 2003;²⁰

¹⁶ The Housing and Economic Recovery Act of 2008 established the FTHBC under IRC § 36, which was initially applicable to residences purchased on or after Apr. 9, 2008, and before July 1, 2009. Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2888 (2008). Subsequent amendments to IRC § 36 further extended the credit to residences purchased before May 1, 2010. The American Recovery and Reinvestment Act of 2009 created the MWP credit under IRC § 36A, which is generally applicable for 2009 and 2010. Pub. L. No. 111-5, § 1001, 123 Stat. 115, 309 (2009). Pursuant to the PPACA a refundable credit under IRC § 36B for qualified health insurance premiums provides assistance to low income taxpayers. Pub. L. No. 111-148, § 1401, 124 Stat. 119, 213 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1001(a)(1)(A)-(B), 124 Stat. 1029, 1030 (2010) (effective for taxable years ending after 2013). The PPACA also added the Small Business Health Care Tax Credit, a credit for small business employee health insurance expenses, which may be partially refunded to certain tax-exempt entities. Pub. L. No. 111-148, § 1421, 124 Stat. 119, 237 (2010) (codified at IRC § 45R).

¹⁷ See, e.g., TIGTA, Ref. No. 2009-30-141, *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions* (Sept. 2009); TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Mar. 31, 2009); TIGTA, Ref. No. 2010-41-011, *Evaluation of the Internal Revenue Service’s Capability to Ensure Proper Use of Recovery Act Funds* (Nov. 27, 2009); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009); GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011); *Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means* (May 25, 2011).

¹⁸ The number of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011, a 72 percent increase. W&I response to TAS information request (July 27, 2011, as updated Nov. 4, 2011).

¹⁹ IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program* (FY 2010) (10,554,735 math errors and 8,445,374 math error notices issued in FY 2010); IRS Pub. 55B, Data Book, *Table 26, Taxpayer Contact Information, by Type of Math Error and Selected program* (2003) (4,967,703 math error notices issued in 2003).

²⁰ IRS Pub. 55B, Data Book, *Table 14, Information Reporting Program* (FY 2010) (4,336,000 AUR contact closures in FY 2010); IRS Pub. 55B, Data Book, *Table 26, Taxpayer Contact Information, by Type of Math Error and Selected program* (2003) (1,561,068 AUR contact closures in FY 2003).

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- The Automated Substitute for Return (ASFR) program made 1,150,573 assessments in 2011 — 896 percent more than in FY 2003;²¹ and
- The Correspondence Examination program, which uses automation more than the IRS's other audit programs, closed 1,238,632 examinations of individual returns in FY 2010 — 13 percent more than the prior year and 93 percent more than in FY 2003.²²

Growth in these automated procedures dwarfs relatively small increases in traditional examination work. By comparison, examiners working outside of centralized processing centers closed only 342,762 examinations of individual returns in FY 2010 — five percent more than the prior year and 66 percent more than in FY 2003.²³

Moreover, the IRS is likely to expand its reliance on automation as it receives, and attempts to process and use, more and more third-party data. For example, credit card issuers will soon be required to report the charges they process for businesses,²⁴ and brokerage firms generally will be required to report the cost basis (as well as gross proceeds) of stock, bond, and mutual fund sales.²⁵

If the IRS does not receive a response to computer-generated form letters, it assumes third-party data is correct and tax returns are not.

When automated IRS systems identify mismatches between a return and third-party data, they generate letters, but the IRS rarely calls or visits the taxpayer or conducts any further investigation.²⁶ If the IRS does not receive and process a timely and satisfactory response, it may simply withhold the refund or assess additional tax, without ever being certain that the taxpayer's return (or decision not to file) was incorrect. The IRS assumes that if the return was correct, the taxpayer would have responded with additional documentation and an explanation.

²¹ See Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*, *infra* (reflecting 1,150,573 ASFR assessments in FY 2011 and 128,319 in FY 2003).

²² IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage* (2010) (reflecting 1,581,394 examinations of individuals in FY 2010, 1,272,952 by correspondence from an IRS campus, and 342,762 in the field or from a field office); IRS Pub. 55B, Data Book, *Table 9a, Examination Coverage* (2009)), <http://www.irs.gov/pub/irs-soi/09databk.pdf> (reflecting 1,425,888 examinations of individual returns, 1,099,639 by correspondence from an IRS campus, and 326,249 in the field or from a field office); IRS Pub. 55B, Data Book, *Table 10, Examination Coverage* (2003), <http://www.irs.gov/pub/irs-soi/03databk.pdf> (reflecting 849,296 examinations of individual returns, 642,839 by correspondence from a compliance center, and 206,457 in the field or from a field office).

²³ *Id.* While 66 percent may seem significant, each of the increases in the automated programs cited above exceeded 66 percent.

²⁴ IRC § 6050W.

²⁵ IRC § 6045(g).

²⁶ For a discussion of this problem in the context of the ASFR program, see Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*, *infra*.

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Accurate returns may appear to be inconsistent with third-party data, which can be unreliable or inconclusive.

Longstanding IRS matching programs illustrate how third-party data are often unreliable when used as the sole basis to conclude that the taxpayer's return is wrong. For example, AUR assessments reflect mismatches between a tax return and data from third-party information returns, such as Forms W-2 and 1099. As we previously reported, 59 percent of the statutory notices of deficiency issued by the AUR program went unanswered in FY 2006, resulting in default assessments.²⁷ When taxpayers did respond, however, the IRS granted 88 percent of all AUR abatement requests.²⁸ Thus, even the most reliable third-party data — data from information returns — may be a weak basis on which to conclude that a taxpayer's return is wrong.²⁹ The data may be unreliable or the IRS may have failed to identify another reasonable explanation for the mismatch.

As another example, TAS studied a statistically valid sample of tax year 2009 accounts in which the IRS reversed its dependent Taxpayer Identification Number (TIN) math error corrections.³⁰ For these types of math errors, the IRS reversed itself 55 percent of the time. Moreover, TAS found that it could have resolved 56 percent of these errors using readily available internal data, rather than charging a math error and asking the taxpayer to explain the apparent discrepancy. Taking this action would have prevented math error notices and delays in releasing over 100,000 refunds.

As a final example, in the 1990s the IRS developed the Electronic Fraud Detection System to select questionable returns for “verification” prior to releasing refund claims as part of the IRS Criminal Investigation (CI) Division's Questionable Refund Program (QRP). Following a sharp increase in the number of taxpayers seeking assistance from the Taxpayer Advocate Service (TAS) because their refunds were delayed (or “frozen”) by the QRP, a 2005 TAS study suggested the QRP was not very good at identifying only questionable returns.

The TAS study found that in 66 percent of TAS's cases, the taxpayer received a full refund (or more) and in 80 percent of the cases the taxpayer received at least a partial refund.³¹ These freezes were particularly appalling because the taxpayers in question really needed

²⁷ National Taxpayer Advocate 2007 Annual Report to Congress 259, 261 (Most Serious Problem: *Automated Underreporter*).

²⁸ *Id.* (citing data for FY 2006). The IRS granted 83.3 percent of all AUR abatement requests in FY 2011. IRS, Enforcement Revenue Information System Summary Database (Dec. 2011).

²⁹ According to TIGTA, more than two billion information returns were submitted to the IRS in TY 2007, of which almost 31.7 million had invalid payee data (1.5 percent). TIGTA, Ref. No. 2011-30-019, *Targeted Compliance Efforts May Reduce the Number of Inaccurate Information Returns Submitted by Government Entities* 3-4 (Feb. 15, 2011). Because third-party information returns can be unreliable and difficult for a taxpayer to disprove, the IRS is not always entitled to rely on its general presumption of correctness in court when its determination is based on them. See, e.g., *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991); IRC § 6201(d). For further discussion of this issue, see *An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*, vol. 2 *infra*.

³⁰ *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued for Claimed Dependents*, vol. 2, *infra*.

³¹ National Taxpayer Advocate 2005 Annual Report to Congress vol. 2, 1, 2 (*Criminal Investigation Refund Freeze Study*).

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them quickly — their median income was \$13,330 and their median refund was \$3,519.³² Yet, the IRS presumed these low income taxpayers had submitted fraudulent refund claims, delayed their refunds by a median of 8.5 months, and refused to provide any explanation to them.³³

The AMTAP, which is the successor to CI's QRP, presents similar concerns. TAS analyzed the results of approximately 20,000 cases closed in FY 2011 involving taxpayers who sought TAS assistance with refund delays related to AMTAP. The IRS agreed to grant full or partial relief to taxpayers in 79.8 percent of these cases.³⁴

Taxpayers whose returns are correct may not respond to IRS letters because of communication difficulties.

IRS letters do not always reach taxpayers.

About ten percent of the IRS's mail is returned.³⁵ As a result, a significant number of taxpayers do not respond to IRS letters because they do not receive them.

IRS letters are often difficult to understand.

Even if a taxpayer receives the IRS's letter, computer-generated form letters are often difficult to understand.³⁶ A 2004 TAS Research study found that in EITC "no response" audit cases where taxpayers later sought an audit reconsideration, 43 percent were entitled to essentially all of the EITC claimed on their original returns.³⁷ In a follow-up survey of taxpayers subject to EITC audits, more than one quarter indicated they did not understand that the IRS was auditing their return, almost 40 percent did not understand what the IRS was questioning about their EITC claim, and only about half felt that they knew what they needed to do in response to the audit letter.³⁸

³² National Taxpayer Advocate 2005 Annual Report to Congress 25, 26 (Most Serious Problem: *Criminal Investigation Refund Freezes*).

³³ Following publication of these findings and the resulting congressional and public outcry, the IRS agreed to dramatically alter these procedures, but similar procedures remain as part of AMTAP. See Most Serious Problem: *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, *infra*.

³⁴ See *id.*

³⁵ TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 1* (May 14, 2010). For further discussion of the problem, see National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

³⁶ For a discussion of communication problems, see for example, National Taxpayer Advocate 2008 Annual Report to Congress 227, 230 (Most Serious Problem: *Suitability of the Examination Process*) (noting that more than 50 percent of the taxpayers audited by correspondence did not respond to the IRS's letters, and that 26.5 percent of the respondents to a TAS survey were not even aware the IRS was auditing their returns) and National Taxpayer Advocate 2011 Annual Report to Congress vol. 2 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*) (discussing the potential confusion generated by various IRS letters).

³⁷ See National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, 9 (*EITC Audit Reconsideration Study*). These taxpayers were entitled to an average of 96 percent of the EITC they originally claimed. *Id.*

³⁸ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103-104 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*). Another TAS study found that taxpayers who used a representative during the audit process were nearly twice as likely to be determined EITC eligible when compared to those without representation. *Id.* at 108.

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The IRS does not always answer the phone.

Even if a taxpayer generally understands the IRS's letter, he or she will often want to call the IRS for clarification before responding.³⁹ However, taxpayers often have difficulty reaching the IRS by phone.⁴⁰ For example, as previously reported, the AUR toll-free operation only answered between 70 and 74 percent of the calls it received.⁴¹ When taxpayers did reach the IRS by phone, the person they reached was rarely able to resolve the issue.⁴²

The IRS does not always timely respond by mail.

Even if a taxpayer responds by mail, the IRS does not always timely process the response.⁴³ For example, a recent report suggested the IRS was late in responding to math error submissions about 40 percent of the time.⁴⁴

At some point, taxpayers are going to give up. As a result, the IRS's assumption — that if it does not receive a written response from the taxpayer, the return must be wrong — is often incorrect. Thus, as described in more detail in the MSPs that follow, the IRS should do more to avoid harming taxpayers who are sincerely trying to comply by making it easier for them to communicate with the IRS.

The IRS's assumptions may have a disparate impact on low income taxpayers.

Improper claims for refundable credits such as the EITC, which are aimed at low and middle income taxpayers, account for a fairly small proportion of the overall tax gap. Underreporting by unincorporated businesses cost the government \$109 billion in 2001 (the latest year for which data are available), dwarfing the \$17 billion lost to improper claims for credits by more than six to one.⁴⁵ The net misreporting percentage for nonfarm proprietor income is 57.1 percent, as compared to 26.3 percent for credits.⁴⁶ Moreover, part

³⁹ The EITC survey results (cited above) indicate that:

Even though slightly over half of the respondents indicated that they understood what was being questioned and knew what they needed to do, overall, more than 90 percent contacted the IRS. Seventy-two percent of the respondents said that they either called or visited the IRS in response to the letter. More than 75 percent of those taxpayers contacting the IRS about their audit letter did so by telephone.

Id. at 104.

⁴⁰ See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 4 (Most Serious Problem: *IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing*) (noting that even if the IRS were to reach its goals for FY 2010, nearly three in ten callers would not get through, and those that did would have to wait nearly 12 minutes on hold before reaching a person).

⁴¹ National Taxpayer Advocate 2007 Annual Report to Congress 259, 262-263 (Most Serious Problem: *Automated Underreporter*) (a sample of TAS cases indicated that most (57 percent) had previously called or written AUR without resolution and 21 percent were calling because they received no response from the IRS).

⁴² National Taxpayer Advocate 2007 Annual Report to Congress 259, 271 (Most Serious Problem: *Automated Underreporter*) (noting that when callers did get through to the AUR toll-free operation the IRS resolved just seven percent of the cases).

⁴³ See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 235 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*) (noting that over 75 percent of IRS correspondence received in two Compliance Service Collection Operations took more than 14 days to be processed and that for all Correspondence Imaging System cases closed in FY 2009, it took between 15 and 30 days to assign the correspondence).

⁴⁴ TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* 4 (July 7, 2011) (Figure 3).

⁴⁵ IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

⁴⁶ *Id.*

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of the IRS's job should be to get eligible taxpayers to claim the EITC, rather than discouraging them from claiming it by making the credit an audit trigger.

Recognizing that an excessive number of EITC audits would disproportionately burden low income taxpayers and would not be an efficient use of scarce audit resources, the IRS set an internal cap on the number of EITC audits it would undertake.⁴⁷ Pursuant to new AMTAP and math error procedures, however, the IRS plans to check more returns from low income taxpayers where the errors are “below tolerance” (*i.e.*, not considered significant enough to warrant a “real” examination) — precisely the taxpayers who are most likely to have difficulty communicating with the IRS. The National Taxpayer Advocate is concerned that these new streamlined procedures bypass key taxpayer rights that the IRS routinely provides to high income taxpayers who are subject to “real” examinations.

Summary assessment procedures may bypass taxpayer rights.

Traditional examination procedures protect taxpayer rights.

In connection with an examination, the taxpayer has the right to:⁴⁸

1. Avoid repetitive and unnecessary examinations;⁴⁹
2. Avoid an audit based on financial status;⁵⁰
3. Be informed before the IRS contacts third parties;⁵¹
4. Be informed about how the IRS selects returns for examination;⁵²
5. Be informed about the right to be represented in any interview;⁵³
6. Be examined at a reasonable time and place;⁵⁴

⁴⁷ See, e.g., TIGTA, Ref. No. 2008-40-131, *While Progress Has Been Made, Limits on the Number of Examinations Reduce the Effectiveness of the Earned Income Tax Credit Recertification Program* (July 3, 2008), which explained:

Beginning in Calendar Year (CY) 2005, the IRS Commissioner set a case limitation (or ‘cap’) on the number of EITC-related returns.... the IRS began using a dollar tolerance to limit the number of EITC related returns ... sent to the Examination function...[the IRS stated that] imposing the cap shifted resources to other areas to improve overall audit coverage. The IRS also noted that setting a tolerance allows the IRS to conduct more higher-yielding audits...

Id.

⁴⁸ See generally IRS, Pub. 1, *Your Rights as a Taxpayer* (2005); IRS, Pub. 556, *Examination of Returns, Appeal Rights and Claims for Refund* (2008); IRS, Pub. 3498-A, *The Examination Process* (2004). The National Taxpayer Advocate has recommended legislation to codify more taxpayer rights. See *Enact Previous Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights, infra*. See also National Taxpayer Advocate 2007 Annual Report to Congress 478-489.

⁴⁹ IRC § 7605(b); Policy Statement 4-3 (Dec. 21, 1984), *reprinted at* IRM 1.2.13.1.1 (Aug. 31, 2007); 26 C.F.R. § 601.105(j) (statement of procedural rules).

⁵⁰ IRC § 7602(e).

⁵¹ IRC § 7602(c).

⁵² The IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3503, 112 Stat. 685, 771 (1998).

⁵³ RRA 98 § 3502, 112 Stat. 685, 770 (1998).

⁵⁴ IRC § 7605(a) (“The time and place of examination ... shall be ... reasonable under the circumstances.”).

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7. Receive an explanation of the examination and appeals process;⁵⁵
8. Receive an explanation of the IRS’s “determination;”⁵⁶
9. Appeal the IRS’s determination to the United States Tax Court before paying;⁵⁷
10. Require the IRS to bear the burden of proving in the Tax Court that its determination is correct, provided the taxpayer cooperated with the IRS and met certain other conditions;⁵⁸ and
11. Receive compensation for administrative and litigation costs if the IRS position was largely unjustified and other conditions are satisfied.⁵⁹

Automated procedures may jeopardize taxpayer rights.

When IRS systems adjust a return based on mismatches, the adjustment is not an “examination,” according to the IRS.⁶⁰ Thus, some of the rights associated with an examination do not apply to the IRS’s automated matching procedures. For example, the right to avoid unnecessary and repetitive examinations of the same return does not apply.⁶¹ Similarly, the IRS uses streamlined assessment procedures to make “math error” adjustments.⁶² Under these procedures, the taxpayer is required to respond more quickly than if they had been examined (within 60 days, rather than 90 days or more), or risk losing the right to appeal the adjustment to the Tax Court.⁶³

The IRS does not always explain what taxpayer rights apply to its new automated procedures.

When the IRS sends a taxpayer a letter pursuant to one of its automated procedures, it does not always explain what procedures apply. Nor does it explain which of the rights

⁵⁵ RRA 98 § 3504, 112 Stat. 685, 771 (1998) (“include with any first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals an explanation of the entire process from examination through collection with respect to such proposed deficiency, including the assistance available to the taxpayer from the National Taxpayer Advocate at various points in the process.”). The IRS generally includes Publication 1 in the so-called 30-day letter.

⁵⁶ IRC § 6212; see generally 26 C.F.R. § 601.105(d) (statement of procedural rules); IRC § 6402(l) (“In the case of a disallowance of a claim for refund, the Secretary shall provide the taxpayer with an explanation for such disallowance.”).

⁵⁷ IRC § 6213(a).

⁵⁸ IRC §§ 6201(d) and 7491.

⁵⁹ IRC § 7430.

⁶⁰ See, e.g., Rev. Proc. 2005-32, § 4.03(d)(iii)(B), 2005-1 C.B. 1206 (excluding from the definition of examination, “adjustments resulting from ... a discrepancy between a filed tax return and information received from a third party or a federal or state governmental databank; or ... an information-return matching program, or other correction programs operated by Internal Revenue Service Centers or Campuses”). Similarly, at least one IRS attorney has concluded that an ASFR does not constitute an examination. CCA 200518001 (May 6, 2005).

⁶¹ Rev. Proc. 2005-32, § 4.03, 2005-1 C.B. 1206.

⁶² For a discussion of math error procedures and recommendations for improving them, see, e.g., Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*; and Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

⁶³ A taxpayer has no right to petition the Tax Court upon receipt of a math error notice. IRC § 6213(b)(1). If the taxpayer responds to the notice within 60 days after the IRS mails it by requesting an abatement, however, the IRS will (at least temporarily) abate the assessment specified in the notice. IRC § 6213(b)(2). The IRS would have to use normal procedures to (re)assess any deficiency. A taxpayer normally has at least 90 days to petition the Tax Court after the IRS mails a statutory notice of deficiency. IRC § 6213(a).

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normally associated with examinations apply in connection with its matching programs and which do not.⁶⁴ If taxpayers do not know about their rights, they cannot invoke them. Unfortunately, it is easy to find examples of this problem.

AMTAP USED LETTER 105C INAPPROPRIATELY.

As described in the MSP entitled *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, the IRS improperly attempted to use math error authority to recover the FTHBC based on third-party data. Third-party data suggested that some taxpayers may have purchased their homes before the effective date of the credit. The IRS issued Letter 105C, *Claims Disallowed*, to 36,000 taxpayers.⁶⁵ However, the IRS does not have the authority to recover the FTHBC in this manner.⁶⁶ Before the IRS can make such an adjustment, it is legally required to issue a so-called “statutory notice of deficiency,”⁶⁷ which gives the taxpayer the right to petition the Tax Court.⁶⁸

In addition, Letter 105C was confusing and misleading to taxpayers who had already received the credit. The letter stated a taxpayer could only appeal the IRS determination to Appeals if the IRS disallowed the claim because it was late.⁶⁹ These taxpayers had not filed late claims. If they had, they would not have received the FTHBC. The IRS had to send a second letter to these 36,000 taxpayers apologizing for the confusion and indicating the credit was “not disallowed.”⁷⁰

AUR’S CP 2000 DOES NOT EXPLAIN THAT THE IRS COULD EXAMINE THE RETURN AGAIN.

The CP 2000 letter, which the IRS uses to initiate the AUR process, is also somewhat ambiguous. It suggests to the taxpayer that he or she is under examination. Under the heading of “What steps should I take?” the CP 2000 provides “Review your rights in the Examination Process Booklet (enclosed).” On the first page of text in the enclosed booklet, it says: “Your return is going to be examined.” It does not warn the taxpayer that the IRS does not consider an AUR to be an examination for purposes of the right not to have the same return examined again.⁷¹ Thus, the CP 2000 is confusing because it may appear to

⁶⁴ The letter that the IRS is using in connection with its AQR program does not use the word “audit” or “examination,” but nonetheless includes Publication 1, which only describes the taxpayer rights associated with the examination, collection, or appeals process.

⁶⁵ IRS response to TAS information request (Sept. 13, 2011).

⁶⁶ The IRS was making an adjustment based on inconsistencies between the date of purchase shown on the return and the date of purchase reflected in third-party data. The IRS’s general authority to make math error adjustments under IRC § 6213(g)(2)(C) applies only when one item on a return is inconsistent with another. We understand the IRS mistakenly believed, based on an informal discussion with Counsel, that it could use math error authority to make the reversals.

⁶⁷ IRC § 6212.

⁶⁸ IRC § 6213(a).

⁶⁹ Letter 105C, *Claim Disallowed* (May 3, 2010) (“You may appeal our decision with the Appeals Office (which is independent of our office) if we disallowed your claim because our records show that you filed your claim late.”).

⁷⁰ SERP Alert 110544 (Aug. 4, 2011).

⁷¹ See, e.g., Rev. Proc. 2005-32, § 4.03, 2005-1 C.B. 1206.

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conflict with the IRS's legal position that an AUR is not an examination for purposes of the no-repetitive-examination rule.

AQR'S LETTER 4800C DOES NOT INDICATE WHICH PROCEDURES APPLY.

As discussed in the MSP entitled, *The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*, Letter 4800C, which the IRS uses to initiate the AQR process, is similarly confusing. It does not refer to the inquiry as an audit or examination. However, the IRS includes Publication 1 as an attachment to the letter. Publication 1 explains examination, collection and appeals procedures, but not AQR procedures. As with an AUR, some taxpayers might conclude they are under examination and assume the IRS will not examine them again. After all, Publication 1 explains that the IRS will generally not examine returns more than once. The letter does not warn the taxpayer that the IRS does not consider the AQR process to be an examination for purposes of the right not to have the same return examined again, or that the IRS may actually examine the same return after closing the AQR inquiry.⁷²

CONCLUSION

The IRS is increasingly relying on unexplained data mismatches to adjust a person's liability and to deny or delay refunds to those in need. Matching programs that rely primarily on third-party data are not always accurate. Some mismatches will remain unexplained for a wide variety of reasons, even if the taxpayer's return is correct. Thus, the IRS's adjustment will be inaccurate in many cases and taxpayers will be harmed. Moreover, by defining these procedures as "not an examination," without explaining what they are and what procedures apply, the IRS abridges longstanding taxpayer rights. In other words, the IRS is able to pick and choose which taxpayer rights it is willing to provide, and do so without informing taxpayers.

As described in the following MSPs, the IRS's approach will be balanced only if:

- **The IRS's automated systems use only the most reliable data.** For example, the MSPs entitled "*The IRS's Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delay Refund Processing*," "*Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*," and "*Automated 'Enforcement Assessments' Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers*," each raise concerns about the IRS's use of third-party data.⁷³

⁷² If a return involves more than one issue, AQR should refer it for a "real" examination. If AQR issues a statutory notice and the taxpayer files a petition in the Tax Court, the IRS may not be able to reopen the return in any event. See IRC § 6212(c)(1) (stating that with certain exceptions, after a taxpayer files a petition with the Tax Court, "the Secretary shall have no right to determine any additional deficiency of income tax for the same taxable year ...with respect to any act (or failure to act) to which such petition relates").

⁷³ While appearing later in the report, the Most Serious Problem entitled "*The IRS Should Reevaluate Earned Income Tax Credit Compliance Measures and Take Steps to Improve Both Service and Compliance*" raises many of the same concerns.

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- **The IRS's letters reach taxpayers and clearly explain the discrepancy along with any applicable procedures and taxpayer rights.** These MSPs identified above also raise concerns about IRS correspondence.
- **The IRS's mitigation procedures make it easy for taxpayers to communicate with the IRS to explain apparent discrepancies and resolve problems.** Each of these MSPs raises concerns about the burden that taxpayers may face in responding to automated IRS procedures. Similarly, the MSP entitled "*Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*" raises concerns about the burdens that identity theft victims may face.

MSP
#2**The IRS's Wage and Withholding Verification Procedures May
Encroach on Taxpayer Rights and Delay Refund Processing****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Jodi Patterson, Director, Return Integrity and Correspondence Services

DEFINITION OF PROBLEM

As the nation's tax collection agency, the IRS is responsible for processing over 141 million individual income tax returns annually, including nearly 120 million requests for refunds.¹ As part of this process, it must protect the public fisc from illegitimate refund requests while expeditiously processing legitimate tax returns and paying out legitimate refund claims. The dual tasks of fraud prevention and timely processing of returns present challenges even in the simplest of tax systems, and ours is far from simple. The recent increase in spending programs run through the tax code, combined with a reduction in IRS funding, has made the IRS's job much harder, and to better protect the public fisc from a surge of new refund schemes, the IRS has expanded its use of various automated screens to filter out questionable refund claims. The result is that more legitimate taxpayers are becoming ensnared in the IRS's revenue protection apparatus.

In fiscal year 2011, the Accounts Management Taxpayer Assurance Program (AMTAP) delayed nearly two million refund claims, identifying them as questionable or potentially fraudulent.² The Electronic Fraud Detection System (EFDS), which the IRS claims had an 89 percent accuracy rate in 2011, selected over one million returns for screening, a 72 percent increase from the previous year.³ In addition to these questionable refund claims selected by EFDS, AMTAP also identified 893,000 returns as part of the Operation Mass Mail (OMM) scheme in CY 2011 — and has no plans to process such OMM returns.⁴

¹ In fiscal year (FY) 2010, the IRS processed 141,617,000 individual tax returns. IRS 2010 Data Book, Table 2, *Number of Returns Filed by Type of Return, Fiscal Year 2010*. In FY 2010, the IRS processed 119,443,586 refund requests. IRS 2010 Data Book, Table 7, *Number of Refunds Issued by Type of Refund and State, Fiscal Year 2010*.

² The Electronic Fraud Detection System (EFDS) is one tool the IRS uses to select questionable returns for "verification" prior to releasing refunds. EFDS selected 1,054,704 questionable returns for screening in calendar year (CY) 2011. The IRS stopped an additional 893,267 potentially fraudulent returns as part of the Operation Mass Mail (OMM) program. See Wage and Investment (W&I) division response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

³ The volume of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011 (through Oct. 15, 2011), a 72 percent increase. See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011). By the IRS's own estimation, it was unable to "verify bad" 11 percent of these returns, leaving up to 116,000 potentially "good" taxpayers improperly caught up in the EFDS filter. Of the approximately 20,600 pre-refund cases TAS closed in FY 2011, more than 16,000 taxpayers (79.8 percent) obtained relief. So by comparing these two numbers, it is reasonable to conclude that potentially 100,000 innocent taxpayers who did not come to TAS were harmed by the EFDS filter in 2011.

⁴ AMTAP identified 893,267 OMM returns through October 15, 2011. Email from AMTAP analyst (Nov. 4, 2011).

While the number of returns screened by EFDS rose by 72 percent, AMTAP staffing grew by less than nine percent,⁵ causing inventory to soar to 690,000 cases at one point during the 2011 filing season.⁶ As inventory levels increase, so do the delays in responding to legitimate refund claims. Although the manual process of verifying the taxpayer's wages and withholding is supposed to take 13 weeks or less, in practice the delay could be much longer.

In an effort to better understand the reasons for the significant increase in pre-refund cases, we conducted a study of a statistically representative sample of TAS's pre-refund wage verification cases closed in FY 2011 (hereinafter the "TAS study").⁷ In these cases, the average refund amount was over \$5,600 (median refund was approximately \$4,100), and the average delay was 25 weeks (median delay was slightly under 19 weeks). Requiring legitimate taxpayers to wait nearly half a year to receive refunds of this magnitude often imposes significant financial hardships. TAS found that the IRS had placed a hard freeze on the taxpayer's account in at least 50 percent of the cases in this sample, with taxpayers obtaining relief in 84 percent of the time.⁸

TAS often feels the effects of systemic problems within the IRS. In FY 2011, TAS received over 21,000 pre-refund cases, a 504 percent increase over cases received in FY 2010.⁹ Such cases constituted 7.2 percent of all TAS case receipts in FY 2011.¹⁰ Notably, we found that taxpayers coming to TAS with pre-refund problems ultimately received relief 75 percent of the time.

TAS typically issues one or more Operations Assistance Requests (OARs) to IRS functions to resolve open cases. In FY 2011, TAS issued nearly 25,000 OARs to AMTAP.¹¹ The unit did not complete the requested actions within three days of the negotiated timeframe on approximately 4,600 of those OARs – over 18 percent of the OARs issued to AMTAP.¹² To get AMTAP's attention, Local Taxpayer Advocates issued 210 Taxpayer Assistance Orders

⁵ The AMTAP staff increased from 336 in FY 2010 to 366 in FY 2011, a gain of nearly nine percent. See W&I response to TAS information request (July 27, 2011).

⁶ TAS notes from IRS Decedent Schemes conference call (Apr. 25, 2011).

⁷ TAS analyzed Compliance Data Warehouse (CDW) data from the Individual Returns Transaction File of 373 closed TAS cases with primary issue code (PIC) 045 (Pre-Refund Wage Verification) and PIC 425 (Stolen Identity) with secondary issue code (SIC) 045 cases pulled on October 11, 2011 (hereinafter "TAS Study"). The 373 cases are a representative sample of the FY 2011 TAS PIC 045 and PIC 425 SIC 045 cases. The sample has a margin of error of plus or minus 5.1 percent at a confidence level of 95 percent. The TAS study is not a representative sample of all IRS AMTAP cases.

⁸ See TAS Study. Hard freezes were almost certainly applied in additional cases. In some instances, the IRS may apply a hard freeze by inputting a second TC 570. Because the master file does not capture when a second TC 570 is input, TAS included in its count of hard freezes only cases that contained RCC 3 and TC 841 codes in the 373-case sample.

⁹ TAS, Business Performance Review (4th Quarter FY 2011). The 21,286 pre-refund wage verification (PIC 045) cases actually represent a 571 percent increase over the 3,171 PIC 045 cases received in FY 2010. However, because TAS did not use PIC 045 until March 24, 2010, a more appropriate comparison would be between PIC 045 case receipts from the last two quarters of FY 2011 (18,018 cases) and the last two quarters of FY 2010 (2,981 cases), which represents a 504 percent increase. See TAS, Business Performance Review (4th Quarter FY 2010 and 4th Quarter FY 2011).

¹⁰ TAS received 295,904 cases in FY 2011. See TAS Business Performance Review (4th Quarter FY 2011).

¹¹ TAS issued 24,911 OARs to TAMIS in FY 2011. Data obtained from Taxpayer Advocate Management System (TAMIS) (Nov. 2, 2011).

¹² AMTAP did not complete the requested action within three days of the negotiated timeframe in 4,606 OARS in FY 2011. Data obtained from TAMIS (Nov. 2, 2011).

(TAOs) to AMTAP in FY 2011, approximately equal to the number issued to all other IRS functions combined, and more than TAS has issued to the IRS in any preceding year.¹³ Given that Local Taxpayer Advocates had such difficulty getting AMTAP to respond to their requests for help and directions for action, it seems likely that taxpayers who proceeded without TAS assistance faced even greater resistance.

The prevalent use of refund freezes is reminiscent of the IRS Criminal Investigation (CI) division's prior practice of freezing refund claims through its Questionable Refund Program (QRP). In her 2005 Annual Report to Congress, the National Taxpayer Advocate criticized the QRP for, among other problems, freezing the legitimate refunds of tens of thousands of taxpayers without notifying them or giving them an opportunity to respond.¹⁴ In response to the National Taxpayer Advocate's concerns, the IRS moved the refund verification process from CI to the Wage and Investment (W&I) division in 2009. Although the IRS has expanded its notification process to alert most taxpayers whose returns face verification, many of our concerns remain, including:

- The IRS should limit its use of hard refund freezes to cases that exhibit clear indicia of fraud. Hard freezes should never be used simply as an inventory management tool.
- AMTAP selects more returns than ever but relies on screens based on imperfect data, increasing the risk of taxpayer harm.
- The IRS does not notify taxpayers when it "auto-voids" certain suspicious refund claims.
- The IRS does not have sufficient staffing and systems resources to keep up with its mounting AMTAP inventory.¹⁵
- The IRS should be careful not to abridge taxpayer rights as it proposes new initiatives to address questionable refunds.

ANALYSIS OF PROBLEM

Background

At the time that the National Taxpayer Advocate identified refund freezes as a most serious problem in her 2005 Annual Report to Congress, the IRS Criminal Investigation function

¹³ Internal Revenue Code (IRC) § 7811 authorizes the National Taxpayer Advocate to issue a Taxpayer Assistance Order when a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered if relief is not granted. See IRC § 7811(a)(1); IRM 13.1.20.1 (Dec. 15, 2007). TAS issued a total of 422 TAOs in FY 2011. In FY 2010, TAS issued a total of 95 TAOs. TAS, Business Performance Review (4th quarter FY 2011).

¹⁴ See National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*); National Taxpayer Advocate 2005 Annual Report to Congress vol. 2 (*Criminal Investigation Refund Freeze Study*). See also National Taxpayer Advocate 2006 Annual Report to Congress 408 (Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*).

¹⁵ EFDS is operating at maximum capacity, meaning the system cannot accept any more new users or data without first deleting current users or data.

(CI) was operating the QRP.¹⁶ Following a 400 percent increase in TAS cases originating from CI, TAS conducted a research study that found that taxpayers in over 80 percent of the decided cases in the statistically representative case sample received at least a partial refund (66 percent had received a full refund) and that taxpayers had to wait about nine months, on average, to receive these refunds.¹⁷ As part of the study, TAS learned that well over 200,000 taxpayers with frozen refunds never received any notice of CI's actions, and CI had taken no action to resolve those disputed refund claims.¹⁸

Following the National Taxpayer Advocate's 2005 report and consequent congressional and public criticism, the IRS agreed to dramatically alter the QRP procedures, including transitioning them out of CI and into W&I.¹⁹ The Commissioner established an Executive Steering Committee consisting of representatives from CI, TAS, the Examination functions of W&I and the Small Business/Self-Employment Division (SB/SE), the Accounts Management function in W&I, and Modernization & Information Technology Services. After weeks of negotiations, a memorandum of understanding (MOU) regarding revised QRP procedures was agreed to by the National Taxpayer Advocate; Chief, CI; Commissioner, W&I; and Commissioner, SB/SE.²⁰ The 2006 MOU set forth the following process:

1. The IRS can delay processing of refund claims for up to 14 days in order to identify questionable claims. CI will then have to either post the return and release the refund or temporarily freeze the refund claim for further investigation.
2. If it chooses the temporary freeze, CI will have up to 70 days (*i.e.*, ten weeks or "processing cycles") from the date the return is posted either to release the refund or to impose a hard freeze on the claim.
3. If CI imposes a hard freeze, its employees must decide within a reasonable time whether to investigate the case as part of a fraudulent scheme, refer the case to the IRS Compliance function for further investigation, disallow the claim, or release the refund.

In October 2009, W&I fully assumed responsibility over the QRP, under the Accounts Management Taxpayer Assurance Program (AMTAP). In October 2011, the group moved

¹⁶ The National Taxpayer Advocate made the following recommendations in her 2005 Annual Report to Congress: (1) the IRS should notify all taxpayers within two weeks whenever it places a freeze on a refund claim; (2) once CI "determines" that fraud exists, it should immediately refer the case to the Examination function or it should immediately notify the taxpayer of his or her right to file a refund suit in court; (3) the IRS should give serious consideration to moving the initial screening outside the CI function; (4) the IRS should devote additional resources to improving the accuracy of its screening methods; (5) the IRS should review CI's policy of freezing refunds for a certain number of years after it "determines" fraud on a taxpayer's return; (6) CI should facilitate a study of a random sample of frozen-refund cases in which the affected taxpayers have not contacted TAS; and (7) when releasing reports of revenue protected by the QRP, the IRS should be more complete in describing the achievements and limitations of the QRP. See National Taxpayer Advocate 2005 Annual Report to Congress 52-54.

¹⁷ National Taxpayer Advocate 2005 Annual Report to Congress vol. 2, 2.

¹⁸ National Taxpayer Advocate 2006 Annual Report to Congress 411.

¹⁹ See New York Times, *Editorial: Guilty Until Proven Innocent* (Jan. 20, 2006); Tax Notes, *Players In IRS Restructuring Effort Distressed By Frozen Refunds*, 2006 TNT 9-1 (Jan. 12, 2006); Tax Notes, *Editorial: The Refund Freeze Program Warrants Outrage* (Jan. 18, 2006); Tax Notes, *Senate Democrats Ask Snow to Examine IRS Questionable Refund Program* (Jan. 23, 2006); Tax Notes Today, *Capitol Hill Hot Over Frozen Refunds*, 2006 TNT 13-1 (Jan. 19, 2006).

²⁰ See Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures (Feb. 3, 2006).

from Accounts Management to a newly created W&I organization called Return Integrity & Correspondence Services.

AMTAP's main objective as a pre-refund revenue protection program is to identify and stop fraudulent refunds primarily generated as a consequence of misreported wages and withholding. The Electronic Fraud Detection System, built in the 1990s, filters all refund returns pursuant to business rules designed to distinguish good returns from bad ones, and it flags returns with a high perceived risk of fraud.²¹

When EFDS selects a return for screening, the return is "re-sequenced" (*i.e.*, the posting of return information is delayed) for up to 14 days. If the return screening suggests the likelihood of fraud, AMTAP places a temporary refund freeze on the account for 11 weeks to allow time for wage and withholding verification. AMTAP sends a letter informing the taxpayer that income, withholding, or tax credits are being "reviewed" and that the refund is being held for a more thorough assessment.²²

One method AMTAP uses to verify return information during this review period is to compare it with the Information Returns Master File (IRMF).²³ However, IRMF information for the prior year is not available until mid-May (one month after the regular April 15 filing deadline).²⁴ If the IRMF were available in real time, or even a month earlier, it would alleviate a great deal of burden for the thousands of taxpayers whose refunds are held up for wage withholding "verification."²⁵ Notably, the IRS does obtain wage and withholding data from certain large employers in real time, which enables the IRS to conduct some real time matching.

If AMTAP cannot initially verify wage and withholding documents through systemic filters, it moves on to a manual "verification" process. AMTAP employees attempt to contact the employer to verify the amounts reported on the return via disc, fax, or phone.²⁶ If AMTAP verifies the wages and withholding as accurate, the IRS will release the refund.

²¹ Based on prior years' returns, including those involving "verified" fraud, models are built and implemented for detecting fraud. Incoming returns requesting refunds are passed through the knowledge base and scored for likelihood of fraud. Returns that are flagged are diverted into a workload for further inspection before any refund is issued. Kenneth A. Kaufman, *An Analysis of Data Mining in the Electronic Fraud Detection System* (Apr. 28, 2010).

²² Notice CP 05, *Information Regarding Your Refund*.

²³ The IMRF contains third party information including wage and withholding reported on Forms W-2 *Wage and Tax Statement*, and most Forms 1099, *U.S. Information Return*. Under present law, issuers who file these forms electronically have until March 31 to file them with the government. Issuers send Forms 1099 directly to the IRS and Forms W-2 directly to the Social Security Administration (SSA), which in turn sends information extracted from the forms to the IRS each week, starting in late March. IRC §§ 6051(a), 6049(a), 6042(a); see *IRS Instructions for Forms W-2 and W-3, Wage and Tax Statement and Transmittal of Wage and Tax Statements*; Social Security Administration, *Employer W-2 Filing Instructions & Information*, available at <http://www.ssa.gov/employer/gen.htm> (last visited Oct. 31, 2011).

²⁴ Per IRM 2.3.35.1.1 (May 3, 2010), TY 2011 data should be accessible online by May 11, 2012.

²⁵ See Most Serious Problem: *Reinstatement of a Modernized Telefile Would Reduce Taxpayer Burden and Benefit Tax Administration*, *infra*. However, we understand that the AMTAP currently does not have an automated way to utilize IRPTR information, so this matching must be conducted manually, further delaying the "verification" process.

²⁶ IRM 21.9.1.8(2) (Oct. 1, 2010).

If AMTAP cannot verify the information through internal records or by contacting the employer, the IRS sends the taxpayer a Letter 4115C with an “unable to verify” paragraph requesting documentation (e.g., pay stubs, Forms W-2), and extends the refund hold.²⁷ AMTAP will also extend the hold when information has not been verified and the temporary hold is expiring.²⁸

The IRS Should Use Hard Refund Freezes Only When There Is an Indication of Fraud, Not as an Inventory Management Tool.

Given the importance of protecting taxpayers and the tax system from refund fraud and improper payments, the National Taxpayer Advocate believes that the IRS should have a reasonable amount of time in which to determine whether the refund claim bears the “badges of fraud” or is otherwise suspect, such that it should be held for further investigation or examination. As provided in the 2006 memorandum, the IRS and the National Taxpayer Advocate agreed that releasing refunds systemically within 70 calendar days of the initial refund freeze (then known as a “P-freeze”), unless it referred the case for criminal investigation (such cases received a “Z-freeze”), struck an appropriate balance between revenue protection and taxpayer burden.²⁹ As a consequence, CI issued guidance stating that a P-freeze “must be resolved within 70 calendar days; if not, the refund will be automatically released through master file programming.”³⁰

With the Questionable Refund Program transferred from CI to W&I, the National Taxpayer Advocate is concerned that the IRS is moving away from its commitment to release refunds if it cannot determine in a reasonable time that a claim requires additional investigation. Current procedures advise IRS employees that “[i]t may be necessary to take additional actions to hold the refund after the 11 cycle freeze [77 days on top of the two-week re-sequencing] if a permanent freeze has not posted and the final return disposition still is uncertain.”³¹

The IRS does not systemically release refunds within 70 days, harming taxpayers and violating the 2006 Memorandum of Understanding with the National Taxpayer Advocate.

The current process of manually matching wage and withholding information is labor-intensive and further delays legitimate refund requests. While verifying wages and withholding is necessary to protect against improper claims, such delays can create real financial

²⁷ IRM 21.9.1.8.4(6) (Mar. 31, 2011); IRM 21.9.1.11.6 (Mar. 7, 2011). Letter 4115 requests income documentation from the taxpayer/employee (e.g., copies of checks, bank statements, pay statements, check stubs, and employer letters).

²⁸ Email from AMTAP analyst (Sept. 28, 2011).

²⁹ See Memorandum Regarding IRS Criminal Investigation Questionable Refund Program Procedures (Feb. 3, 2006); National Taxpayer Advocate 2006 Annual Report to Congress 412; IRS, *Fraud Detection Center - FDC Guidelines for Processing Year 2007 Issued by Refund Crimes and the Fraud Detection Centers* 17 (Dec. 2006).

³⁰ See IRS, *Fraud Detection Center - FDC Guidelines for Processing Year 2007 Issued by Refund Crimes and the Fraud Detection Centers* 17 (Dec. 2006).

³¹ IRM 21.9.1.2.3(1), *Stopping the Refund* (Oct. 1, 2010). IRM 21.9.1.2.5 does instruct AMTAP employees to send the 4115 letter requesting additional information, but does not specify that this letter should be sent when the hard freeze is input on the account.

hardship for taxpayers awaiting legitimate refunds. Despite the significant challenges the IRS is facing, we believe that requiring honest taxpayers to wait more than ten weeks to receive their refunds — and often substantially more than ten weeks — imposes a heavy burden. Moreover, ten weeks should be enough time for the IRS to determine whether a refund claim is so questionable as to require a “hard freeze” or a referral to Examination personnel.

In practice, the IRS routinely extends refund freezes past 11 weeks by placing hard freezes on accounts. *The IRS has informed TAS that it applied a subsequent freeze to 414,000 taxpayer accounts in FY 2011.*³² We are concerned that, instead of releasing refunds after 11 weeks when it cannot determine they warrant deeper scrutiny, AMTAP is placing hard freezes on the accounts simply because it could not verify wages and withholding within the established timeframe. In other words, AMTAP is using a hard freeze — normally designated for accounts in which potentially fraudulent activity has been “verified” — as an inventory management tool, without first having conducted sufficient analysis of relative risk.

*A TAS review of a representative sample of TAS pre-refund cases closed in FY 2011 shows that the taxpayers who received a hard refund freeze obtained relief 84 percent of the time.*³³

In a review of TAS pre-refund cases closed in FY 2011, we found that the IRS had applied a “hard freeze” in at least 50 percent of cases reviewed.³⁴ In such cases, taxpayers obtained relief 84 percent of the time — with full relief in 81 percent of these cases.³⁵ The review confirmed that even in cases where the IRS applied a hard freeze to an account, the IRS ultimately agreed that approximately five out of every six taxpayers who received a hard refund freeze and came to TAS were eligible for relief (with four out of five taxpayers receiving full relief).³⁶ While the TAS study is not a representative sample of all AMTAP cases, it demonstrates that the IRS screens suffer from significant flaws that impose heavy burdens on legitimate taxpayers.

When a case has a temporary, expiring freeze code, IRS employees have an incentive to work the case within the agreed-upon timeframe. If a permanent, hard freeze replaces the soft freeze, this incentive no longer exists. With competing priorities, the temptation is to work current cases and let cases with a hard freeze languish. This is the same situation that prompted the National Taxpayer Advocate to highlight the problems in CI procedures in 2005 and 2006. Today, these problems still exist, except that they involve IRS employees on the civil side, rather than from CI.

³² Email from AMTAP analyst (Oct. 4, 2011). AMTAP cannot determine how many of these related to known schemes or cases where it was unable to verify wages or withholding.

³³ See TAS Study.

³⁴ See *id.*

³⁵ *Id.*

³⁶ *Id.*

The IRS should not address its resource shortfall by using permanent refund freezes as an inventory management tool. Refunds should be held past the agreed-upon 11-week period only in limited circumstances (*e.g.*, where AMTAP has reason to believe the taxpayer was involved in a scheme based on a referral from CI or other law enforcement agencies). Absent exigent circumstances, the IRS should adhere to its commitment to systemically release frozen refunds if cannot determine within 70 days that the return is part of a scheme or merits more investigation. If this is not possible with the present staffing levels in AMTAP, then fairness and due process considerations require the IRS to increase the program's staffing, as well as to continually improve its filtering criteria.³⁷

AMTAP Selects More Returns than Ever, but Relies on Screens Based on Imperfect Data, Increasing the Risk of Taxpayer Harm.

The IRS appears to be facing a growing influx of sophisticated criminal schemes designed to claim improper refunds. In response, the IRS is increasingly using external databases to identify and prevent refund fraud. For example, the IRS has identified a fraudulent refund scheme involving prisoner Social Security numbers (SSNs). The Earned Income Tax Credit (EITC) excludes from the definition of earned income any amount received for services provided by an inmate.³⁸ Despite this limitation, the IRS continues to receive refund claims originating from prisons, such as false EITC claims or overstated withholding.³⁹ To combat prisoner EITC schemes, the IRS uses state prison system records to systemically deny refund claims from inmates who have been incarcerated for the entire year.

The National Taxpayer Advocate is concerned that the IRS is relying on inaccurate state information to systemically deny such refund claims. The Treasury Inspector General for Tax Administration (TIGTA) noted in a December 2010 report that 12 percent of the data in the 2009 prisoner file contained inaccurate or missing information.⁴⁰ For example, the prisoner file may contain inaccurate SSNs, dates of birth, and release dates. If a release date is incorrect, the IRS may deny a refund to an ex-prisoner who is entitled to the refund because it accrued before incarceration or after release from prison. One possible result of

³⁷ The National Taxpayer Advocate recognizes that in the current budget environment, the IRS must make a choice between increasing AMTAP staffing and using its resources elsewhere in the agency. Ultimately, we encourage Congress to fund IRS adequately to both protect revenue and assist legitimate taxpayers in receiving their refunds timely. See Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *supra*.

³⁸ IRC § 32(c)(2)(B)(iv). This includes amounts received for work performed while in a work release program or while in a halfway house.

³⁹ Not all prison schemes involve prisoners committing the fraudulent act. In some instances, the fraudulent schemes originate from prison employees who unlawfully obtain the names and SSNs of inmates to file falsified refund claims. See Department of Justice, *Plea Entered in Prison Tax Refund Ring* (June 14, 2007), available at www.justice.gov/tax/usaopress/2007/txdv0720070614_Robinson_TpaTaxPlea.pdf.

⁴⁰ See TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist with Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* 10 (Dec. 29, 2010).

the IRS's dependence on unreliable data as the basis of an adjustment is that the IRS may lose its presumption of correctness if a taxpayer challenges the assessment in court.⁴¹

In discussions with TAS, the IRS has recognized the need to validate the accuracy of such information obtained from third parties, but it has not articulated or committed to precisely how and when it will do the validation. If validation is not done before the 2012 filing season, the IRS will create unnecessary work for its already over-burdened program and inflict unnecessary harm on taxpayers.

The IRS has identified another scheme that has been dubbed "Operation Mass Mail." Tax returns identified as being part of this scheme are simply not processed (*i.e.*, they are "auto-voided," in IRS parlance). In CY 2011, AMTAP identified approximately 893,000 returns that fit OMM criteria.⁴² When an impacted taxpayer calls the IRS to inquire about his or her refund, the customer service representative will instruct the taxpayer to re-submit the return, but will not advise the taxpayer of its "auto-void" status — which means that the tax return is put aside and not processed, and the taxpayer is never notified.⁴³ Thus, rather than engaging with the taxpayer and giving him or her an opportunity to correct or explain the questionable item, the IRS creates more work for itself by telling the taxpayer to re-submit the return. Moreover, because the IRS does not use the opportunity to obtain more information from the taxpayer, the re-submitted return may again be "auto-voided."

The IRS has no systemic filters that kick out OMM returns, relying instead on its employees' discretion in flagging these returns as being suspicious based upon a manual review. The rules used to identify an OMM return are sweeping in their reach and have the potential to ensnare many legitimate taxpayers.⁴⁴ The OMM program in CY 2011 potentially impacted over 34,000 innocent taxpayers (almost eight percent of the returns originally marked "OMM") who had no idea that their returns had been "auto-voided."⁴⁵ Some of these taxpayers came to TAS for help in obtaining their legitimate refunds. In the TAS study, 23 out of 373 cases (six percent) were identified as OMM cases.⁴⁶ Of these, TAS was able to obtain relief in 17 cases, or 74 percent of the time (with full relief in 16 cases,

⁴¹ IRC § 6201(d) may require the IRS to prove that its determination is based on "reasonable and probative information" in any court proceeding regarding a deficiency based on an information return. IRC § 6201(d) was enacted following the IRS's loss in *Portillo v. Comm'r*, 932 F.2d 1128 (5th Cir. 1991) (described at IRM 4.10.4.6.1.3.2(2)), where it relied on information from a third party (Form 1099 from a customer of the taxpayer) to assert that the taxpayer underreported income. Although the IRS established that the taxpayer was a painter who engaged in painting during the period in question, the court held the IRS's statutory notice of deficiency was "arbitrary and erroneous" and not entitled to a "presumption of correctness" because the IRS failed to establish that the taxpayer received the unreported income shown on a Form 1099 after the taxpayer cooperated and raised reasonable concerns about its accuracy. For a more detailed discussion, see the introduction to the revenue protection MSPs, *supra*.

⁴² AMTAP identified 893,267 OMM returns through October 15, 2011. Email AMTAP analyst (Nov. 4, 2011).

⁴³ See IRM 21.4.1.3.1.1 (Aug. 12, 2011).

⁴⁴ The National Taxpayer Advocate is not at liberty to disclose these OMM criteria, but has expressed her concern to the highest levels of the IRS about the sweep of these rules and their underlying assumptions.

⁴⁵ In CY 2011 (through September 30), AMTAP marked 429,108 taxpayer accounts with OMM. During this period, AMTAP marked 34,053 accounts with OMM GB, nearly eight percent of the total. An OMM GB marker means that after the IRS initially nullified a return as OMM, it later determined the return was from a legitimate taxpayer reporting the correct wages and withholding, and should have been processed. Privacy, Information Protection and Data Security (PIPDS) Incident Tracking Statistics Report (Sept. 30, 2011).

⁴⁶ See TAS Study.

70 percent of the time).⁴⁷ We are concerned that the broad and vague scope of the rules, coupled with inadequate training of employees, causes legitimate returns to be branded as OMM returns, with severe consequences to the taxpayers.

The IRS Does Not Notify Taxpayers When It “Auto-Voids” Certain Suspicious Refund Claims.

Under the OMM “auto-void” procedures, the impacted taxpayer is given no notice and no opportunity to respond. This lack of communication was one of the main concerns raised in the National Taxpayer Advocate’s 2005 Annual Report to Congress, when CI was in charge of the QRP:

Because of the seriousness of fraud, the government generally affords taxpayers an extra measure of protection before making determinations. Indeed, the general rule that the taxpayer bears the burden of proof in tax liability disputes is reversed where the IRS asserts fraud; the government bears the burden of proving fraud in court. Yet despite the serious consequences of a finding of fraud, the IRS often freezes refunds without advising the taxpayer that it has made a determination of fraud, of the reasons for the determination, or of the consequences of that determination. Unless the taxpayer takes the affirmative step of contacting the IRS to inquire about his or her refund, the taxpayer may never know the IRS’s position with respect to that return.⁴⁸

Six years later, the QRP has been passed on to W&I, but the concern regarding lack of taxpayer notification remains.

As the nation’s tax administrator, the IRS has an obligation to process all tax returns that meet the requirements of a timely filed return. However, under the OMM procedures, the IRS simply refuses to process a large subset of returns on the theory that a fraudulent return is a “nullity.” While non-processing of a “nullity” may be proper in limited circumstances where the IRS has actual evidence that an identity thief has filed a fictitious return, we do not believe that the IRS has the legal authority to determine that a tax return is a “nullity” based on a cursory screening, particularly in the OMM situation, where the screening rules are so broad and vague and where the IRS acknowledges it errs in tens of thousands of cases.

The IRS Does Not Have Sufficient Staffing or Systems Resources to Keep Up with Mounting AMTAP Inventory.

While the number of returns selected for screening increased by 72 percent in 2011, AMTAP has not increased staffing accordingly.⁴⁹ AMTAP staffing in June 2011 was only

⁴⁷ See TAS Study.

⁴⁸ National Taxpayer Advocate 2005 Annual Report to Congress 27.

⁴⁹ The volume of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011, a 72 percent increase. See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

about nine percent higher than in June 2010.⁵⁰ This disparity between workload and resources caused AMTAP's inventory level to rise to 690,000 cases at one point in FY 2011.⁵¹ The hundreds of thousands of taxpayers caught up in the backlog may have to wait months for their refunds. This delay creates downstream work (such as the filing of duplicate returns and processing of additional correspondence) and forces the IRS to respond to a significant volume of additional calls from taxpayers inquiring about refunds.

With a significantly increasing volume of questionable refund claims coming in, EFDS is reviewing more returns than ever. EFDS, originally built in the 1990s, is nearing its maximum capacity. The IRS plans to replace EFDS with the Return Review Program (RRP) to alleviate this capacity concern. RRP is an integrated and unified system that will enhance the IRS's capabilities to prevent, detect, and resolve criminal and civil tax non-compliance. The IRS will begin phasing in RRP in 2013, but it may not be fully operational until 2014 or beyond.

The IRS Should Be Careful Not to Abridge Taxpayer Rights as It Proposes New Initiatives to Address Questionable Refunds.

In FY 2011, IRS convened a team called the Accelerated Revenue Assurance Program (ARAP) to develop front-end verification procedures to prevent the payment of improper refund claims. For example, one of ARAP's proposals is for AMTAP to obtain access to the IRMF information earlier in the filing season, which may allow it to more easily "verify" a significant portion of its inventory.

The National Taxpayer Advocate is concerned that some ARAP proposals may infringe upon taxpayer rights. For example, ARAP has considered expanded use of the IRS's math error authority. Math error authority can be an effective processing tool in limited circumstances,⁵² but it is only appropriate when errors are apparent on the face of a return or from information provided on a return. ARAP proposes that the IRS expand its use of math error authority to more complicated and facts-and-circumstances-based provisions. TAS has identified several proposals (*e.g.*, involving the adoption credit, education credits, and residential energy credit) whereby legitimately qualifying taxpayers could erroneously be issued a math error notice.

ARAP has also discussed using an automated process (called Automated Questionable Credits, or AQC) to deny certain below-tolerance refund claims. TAS raised several concerns about the AQC process. First, we noted the disparate treatment of low income taxpayers, who could be subject to multiple reviews or examinations of the same tax return,

⁵⁰ AMTAP staff increased from 336 in FY 2010 to 366 in FY 2011, an increase of 8.9 percent. See W&I response to TAS information request (July 27, 2011).

⁵¹ IRS Decedent Schemes Conference Call (Apr. 21, 2011). AMTAP inventory not only includes cases requiring manual verification, but also decedent scheme identity theft cases and OMM cases.

⁵² See Most Serious Problem: *Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights*, *infra*. The early legislative history of math error clearly shows that the deviation from deficiency procedures was to be limited in scope. See Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

while higher-income taxpayers and businesses would not. We also expressed concerns about the ambiguous language in the letter to taxpayers subject to the AQC process. Over the National Taxpayer Advocate's objections, for example, the letter to taxpayers in the AQC pilot did not include the word "audit" or "examination" even though there are dire consequences for not responding to this ambiguous letter and we believe the vague wording obscures those consequences.

As the IRS is exploring the use of systemic tools and processes to reduce AMTAP's workload, it is important that the IRS thoroughly analyze the legal and policy ramifications of each proposal. The IRS should first determine the specific legal basis for the changes, determine what notices are required by law (*e.g.*, Notice of Claim Disallowance or Statutory Notice of Deficiency), and examine whether taxpayers have an adequate opportunity to challenge the IRS's determination. The IRS should not let bad facts (*e.g.*, the influx of new schemes) dictate bad policy (*e.g.*, ignoring the requirements for taxpayer notice or simply refusing to process tax returns it suspects of being fraudulent).

Taxpayers Coming to TAS with Pre-Refund Wage Verification Problems Obtained Relief at Least 75 Percent of the Time.

Despite the significant increase in cases selected for review, EFDS purports to have a fairly high reliability rate. The IRS asserts that approximately 89 percent of the returns selected in 2011 (through October 15) as questionable have been "verified bad" — an upward trend from 68 percent "verified bad" in 2009 and 85 percent in 2010.⁵³ The National Taxpayer Advocate questions what the IRS means by "verified bad," because a TAS review of its AMTAP-related cases showed surprising results.

In the TAS study, 75 percent of the taxpayers who came to TAS with AMTAP-related issues obtained relief. This finding was corroborated when we analyzed data from every closed TAS case in FY 2011 with a Primary Issue Code 045 (Pre-Refund Wage Verification) or PIC 425 (Stolen Identity) with a Secondary Issue Code 045 — over 20,000 cases.⁵⁴ According to this analysis, taxpayers obtained relief from the IRS in 79.8 percent of these cases, with taxpayers receiving full relief 72.3 percent of the time.

Note that when taxpayers come to TAS for assistance, TAS generally must obtain the concurrence of the IRS function "owning" the case in order to obtain relief for the taxpayer. This is true for AMTAP cases in TAS (*i.e.*, AMTAP must agree that the taxpayers are entitled to relief). The most common reason cases closed with no relief was that the taxpayer did not respond to requests for supporting documentation that would have allowed release of the stopped refund, as shown in the table below.

⁵³ See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

⁵⁴ TAMIS/Business Objects (BOBJ) Report, FY 2011 Closures. All TAS cases are assigned a Primary Issue Code, and many TAS cases are also assigned a Secondary Issue Code.

TABLE 1.2.1, Issue Code 045 Closures by Relief Code, FY 2011⁵⁵

Cases with Relief	# of Cases Closed	# of Cases Closed
Taxpayer Assistance Orders (TAOs)	72	0.3%
Full Relief	14,917	72.3%
Partial Relief	332	1.6%
Assistance	315	1.5%
OD Function Provided Relief	823	4.0%
Cases with No Relief	# of Cases Closed	# of Cases Closed
No Relief - Law Prevents	15	0.1%
No Relief - Hardship Not Substantiated	16	0.1%
No Relief - No Response	3,620	17.6%
No Relief - TP Withdrew Request	149	0.7%
No Relief - No Internal Revenue Law Issue	15	0.1%
No Relief - Other	349	1.7%
Total Closures	20,623	
Relief Rate		79.8%

These results raise the question of why a group of taxpayers who eventually obtained full relief (*i.e.*, received their full refunds) at such a high rate was pulled into the EFDS filters, which purportedly generate “verified bad” returns 89 percent of the time.⁵⁶

We recognize that the taxpayers coming to TAS may not be representative of the general taxpayer population and we cannot extrapolate the 75 percent relief figure from the TAS study across AMTAP’s entire inventory (which includes cases related to identity theft and other schemes). However, the TAS data clearly demonstrate significant limitations inherent in the IRS verification process and its assumptions. In these cases, the IRS should be asking: what initially triggered the EFDS filters and what steps did TAS have to take to advocate and provide relief for the taxpayers? For example, did TAS case advocates follow up with taxpayers by phone multiple times? If so, would it make sense for AMTAP employees to follow up with a phone call to taxpayers who do not immediately respond to the Letter 4115 requesting documentation of wages or withholding?

EFDS selected approximately one million returns for screening in 2011.⁵⁷ By the IRS’s own estimation, it was unable to “verify bad” 11 percent of these returns, leaving up to 116,000 potentially “good” taxpayers improperly caught up in the EFDS filter.⁵⁸ Of the approximately 20,600 pre-refund cases TAS closed in FY 2011, more than 16,000 (79.8 percent) obtained relief. So by comparing these two numbers, it is reasonable to conclude

⁵⁵ This chart includes PIC 045 cases, plus PIC 425 cases with SIC 045, closed in FY 2011. TAMIS/BOBJ Report, FY 2011 Closures.

⁵⁶ See W&I response to TAS information request (July 27, 2011, and updated Nov. 4, 2011).

⁵⁷ The volume of returns selected to be screened was 1,054,704 in CY 2011 (through Oct. 15, 2011). See W&I response to TAS information request (Nov. 4, 2011).

⁵⁸ Inability to “verify bad” could result from a variety of reasons; it does not necessarily indicate that such a tax return is legitimate or submitted by the person who owns the Social Security number.

that potentially 100,000 innocent taxpayers who did not come to TAS were harmed by the EFDS filter in 2011.⁵⁹ Some probably worked directly with the IRS to obtain relief, and others were probably too intimidated, perplexed, or otherwise unable to respond, with the result that they will not receive their refunds.

The National Taxpayer Advocate raised this concern in her 2005 Annual Report to Congress: “CI’s fraud detection methods are not as effective as they should be at screening out non-fraudulent refund claims, and therefore cause undue burden for a significant number of taxpayers.”⁶⁰ In its written response, the IRS touted the “efficiency” of EFDS at stopping refunds.⁶¹ We now have evidence that there is significant collateral damage caused by AMTAP pulling in so many legitimate taxpayers. Tens if not hundreds of thousands of taxpayers entitled to refunds are getting caught up in anti-fraud procedures that, at best, require them to devote time and effort to substantiating their claims and, at worst, block them from ever receiving their legitimate refunds.

CONCLUSION

The IRS must deal with the challenging combination of increasing opportunities for refund fraud and decreasing resources to combat such activities. The National Taxpayer Advocate recognizes the need for automated screening mechanisms to alleviate the burden of manual reviews. However, systemic screens are inherently imperfect – they will be both underinclusive and overinclusive. It is therefore critical that the IRS develop a mitigation strategy to ensure it can promptly and accurately resolve the problems of legitimate taxpayers who get caught up in the filters.

It is easy to paint all taxpayers who are ensnared by systemic filters with a broad brush, but experience tells us that even where the IRS believes it has verified that a return is false or fraudulent, it is sometimes wrong. To minimize the harm to innocent taxpayers, the IRS must give taxpayers adequate notice of its findings and an adequate opportunity to respond.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Provide the AMTAP unit sufficient staff and systems resources to work its inventory timely.
2. Make Information Returns Master File data available sooner in the filing season.
3. Adhere to the policy of systemically releasing refunds after 70 days if the IRS cannot determine that the return is part of a known scheme or requires greater scrutiny.

⁵⁹ 116,017 (potentially “good” taxpayers caught up in EFDS) less 11,743 (that obtained relief after coming to TAS) leaves 104,274 “good” taxpayers who were caught up in the EFDS screen in 2011. See W&I response to TAS information request (Nov. 4, 2011). This is a conservative estimate, as we know from our study that some percentage of the taxpayers that receive a hard freeze (purportedly because they are deemed “verified bad”) ultimately prevail and receive their refunds. In the TAS study, 84 percent of such taxpayers received relief (81 percent receiving full relief).

⁶⁰ National Taxpayer Advocate 2005 Annual Report to Congress 29.

⁶¹ See *id.* at 46.

4. When considering implementation of any front-end verification procedures, concurrently develop procedures to promptly assist taxpayers who demonstrate that they have filed legitimate refund claims.
5. When considering alternative treatment streams, conduct a thorough analysis to determine the specific legal basis for the proposed action (or non-action).
6. Before "auto-voiding" any tax returns, notify the impacted taxpayers and allow them an opportunity to correct or explain the questionable items.
7. Include language in the Automated Questionable Credits notice alerting taxpayers that the tax return is being examined or that they are under audit, and make clearer that there are significant legal consequences for failing to respond to the notice by the deadline.

IRS COMMENTS

The Taxpayer Assurance Program, known as AMTAP, recently completed its second filing season. AMTAP screened and verified almost two million cases in FY 2011, stopping over \$14 billion in false refunds. In FY 2010, AMTAP screened and verified over 800,000 cases, stopping over \$5 billion in false refunds. This 2011 activity represents a 142 percent increase in cases worked and a 162 percent increase in revenue protected over 2010 results.⁶²

The IRS must continually balance the rights of taxpayers with our responsibility to protect the interests of the United States and the majority of taxpayers who accurately file and pay their federal taxes. The voluntary compliance design of America's tax system requires the IRS to take efforts to support compliant taxpayers by detecting fraud and errors of those looking to be noncompliant. It is a continuous challenge to quickly identify perpetrators and individuals who use sophisticated methods to defraud the nation's tax system. This detection can be more time-consuming when individuals are not associated with a known scheme, and cases require analysis, third party information, and actions to assure that legitimate taxpayers are protected.

Those looking to defraud the government have become more brazen and are availing themselves to a variety of resources both outside and within the system to try to force the release of false refunds. In some cases, this even includes calling Taxpayer Assistance toll-free telephone numbers or seeking support through the Taxpayer Advocate Service. A current example involves over 200 filings that IRS deemed fraudulent with associated revenue protected of more than \$800,000. Thirty of those false returns had an open TAS case; meaning that perpetrators have contacted the IRS through TAS to try to force the release of the associated refunds. As another example, Operation Mass Mail is a scheme where perpetrators contact toll-free assistors and TAS to force refund release. In dealing with these situations, the IRS follows established taxpayer support requirements which require use of

⁶² AMTAP from the EFDS.

valuable resources to ensure that the fraud determination is correct. These two examples are just a snapshot of the challenges to the IRS in maintaining a balance between revenue protection, providing valid taxpayer support and minimizing taxpayer burden.

As those attempting to commit refund fraud become more sophisticated, the IRS must take steps to respond accordingly. The IRS continues to recognize the importance of taxpayer rights, but we must ensure that processes are in place to effectively stop refund fraud. We have made recent improvements in this regard. The IRS launched two high impact initiatives in May 2011 to identify improvements to better combat fraud, identity theft, and revenue and taxpayer protection. The Accelerated Refund Assurance Program was a servicewide initiative working internally and externally with IRS partners, stakeholders, agencies and departments at the local, state, national and international level to preserve the integrity of America's tax system. The National Taxpayer Advocate participated in this initiative, and provided representatives for our ARAP teams. The IRS is deploying a number of improvements from the ARAP initiative for filing season 2012 and beyond, such as accelerating availability of wage and withholding documents by eight weeks, and launching systemic tools to perform income verification.

An additional effort is the formation of Return Integrity and Correspondence Services, creating a centralized organization for ensuring revenue protection and refund compliance. AMTAP was realigned to this new RICS office October 2011. The new RICS office has quickly moved to balance the taxpayer experience, revenue protection and resource efficiency. During filing season 2011, RICS extended AMTAP seasonal employees to better address inventory needs. For filing season 2012, RICS increased AMTAP staffing significantly, and is training all AMTAP permanent employees on account work to dedicate more higher skilled employees to successfully tackle the complex challenges of refund fraud and identity theft work. To further protect taxpayers and their refunds, the RICS organization is finalizing plans to deploy a specialized identity theft unit in FY 2012.

We respectfully disagree with the National Taxpayer Advocate's conclusions from the TAS study referenced in the report – we believe that it creates an inaccurate perception that all AMTAP cases average a delay of 25 weeks. We believe that the TAS study is not a representative sample of AMTAP cases. We also disagree with the inference that IRS employees have no incentive to work cases that have an extension of a freeze code. IRS employees take seriously their responsibility to accurately assist taxpayers – freezes on accounts do not affect their commitment to taxpayers.

With respect to the specific recommendations in the draft report, the IRS notes the following.

As discussed, the IRS has taken steps to provide the AMTAP unit staff and systems resources to work its inventory timely. We increased our AMTAP staff this filing season and will continue to monitor whether additional resources are necessary (if available). We will also assess the efficiencies gained from the accelerated availability of the Information

Returns data to determine appropriate resources utilization and allocation to best address our inventory.

With respect to the recommendation to make data available sooner in the filing season, in 2009 AMTAP recognized accessing Information Returns Master File (IRP) data earlier in the filing season would allow for faster verification; thus releasing legitimate claims sooner. An ARAP team worked with Modernization and Information Technology Services and IRP to accelerate availability of W-2 data in filing season in order to allow earlier identification of mismatches. We will continue to pursue additional opportunities to shorten that timeframe in filing season 2013.

With respect to the recommendation to release refunds after 70 days, the IRS believes that given the current environment, the IRS must maintain the right to determine when it is inappropriate to release refunds if questions as to legitimacy exist. The IRS developed revenue protection processes over many years using historical data to determine fraud indicia. The IRS refines fraud models each year based on performance and new characteristics and updates procedures for reviewing and processing revenue protection inventory accordingly to ensure indication of fraud before holding a refund. Manual screening processes also ensure that a return meets established fraud characteristics before designation for verification and refund hold. Due to the historical evidence of known fraud, the explosion in fraud and identity theft in the past two years, and the consistent amount of revenue protected by IRS fraud detection efforts developed from this analysis, IRS must maintain the right to determine when a hard refund freeze is appropriate.

Regarding changes to processes, the IRS balances taxpayer rights with the need to stop refund fraud. As we move forward, we will continue to explore opportunities for expeditious treatment and assistance for taxpayers with legitimate refund claims in all stages of design, development, testing and deploying of any new technology, process and procedures. When considering alternative treatment streams, as with our past practices, AMTAP will continue to request specific legal guidance about proposed alternatives.

The IRS will consider the views in the draft report regarding notifying impacted taxpayers before auto-voiding tax returns. The IRS is mindful of taxpayer rights and only uses this policy where we believe appropriate. The IRS developed the policy to "auto-void" returns to address schemes identified based on historical analysis of repeated fraud characteristics. For example, the Operation Mass Mail scheme is a very high volume scheme attempted annually. Part of the scheming effort is to inundate IRS with returns to force release of some of the refunds. In these cases, attempting to correspond on these fraud returns would be an ineffective use of resources and taxpayer dollars. These returns often do not include a valid address. In addition, in some cases, corresponding provides fraudsters with additional or new avenues to try to force refund release.

Finally, with respect to the recommendation to include audit or examination language in the Automated Questionable Credits notice, we have determined that under Revenue Procedure 2005-23 Automated Questionable Credits are not considered audits.

The IRS will continue to work with the National Taxpayer Advocate as we make improvements in detecting and stopping refund fraud while recognizing the rights of legitimate taxpayers.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate recognizes the difficult position the IRS is in as the gatekeeper to the public fisc and applauds its efforts to flag suspicious refund claims. The National Taxpayer Advocate supports the use of front-end screening where appropriate, but firmly believes that an *expedited* mitigation strategy must be part of any such process.

When the IRS selects a return for manual verification or otherwise delays a refund, it should notify the taxpayer and allow him or her the opportunity to respond. Knowing that a significant percentage of legitimate taxpayers will be caught up in the automated filters, it is imperative for the IRS to conclude its verification process or release refunds in a reasonable time. The National Taxpayer Advocate continues to believe 70 days (plus the 14 days used for initial selection) is reasonable, as agreed to in 2006 by CI, SB/SE, W&I, and TAS. This time limitation does not in any way impact the IRS's "right to determine when a hard refund freeze is appropriate." Instead, the time limitation ensures that the IRS makes that determination — whether to issue a hard freeze or release the refund — within a reasonable period of time. This is the least that the IRS can do as a mitigation strategy for legitimate taxpayers who will inevitably be caught up in IRS filters.

The National Taxpayer Advocate understands the difficulty of staffing AMTAP to accommodate the increasing volume of questionable refund claims. Particularly when manual verification is required, it will be challenging for AMTAP to meet the 70-day timeframe without a corresponding increase in personnel. The new RICS organization must closely monitor AMTAP's workload and adjust staffing as necessary to keep up with inventory. Ultimately, Congress will need to make funding decisions that would enable the IRS to adequately staff AMTAP.⁶³

We studied a statistically representative sample of pre-refund wage verification cases TAS closed in FY 2011 in an effort to better understand the reasons for the significant increase in these TAS cases. We found the IRS had placed a hard freeze on the taxpayer's account in at least 50 percent of the cases in this sample, with taxpayers eventually obtaining relief

⁶³ See Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*, *supra*.

84 percent of the time.⁶⁴ The average refund amount was over \$5,600 (the median was approximately \$4,100), and the average delay was 25 weeks (with a median delay of slightly under 19 weeks).⁶⁵ While these taxpayers may not be representative of the general taxpayer population, the TAS data clearly demonstrate significant limitations inherent in the IRS verification process and its assumptions. The findings of the TAS study support the need for the IRS to develop an effective mitigation strategy to assist the legitimate taxpayers who will inevitably become caught up in even the best of filters.

The IRS states that some persons who submitted fraudulent returns have come to TAS for assistance, implying a misuse of TAS resources. To support this statement, the IRS refers to a study and 30 cases. We note that the IRS has neither cited a source for this study nor shared with TAS information about those 30 cases, so we do not know the ultimate outcomes. As far as we know, this could be just another instance of the IRS “deeming” fraud but ultimately agreeing that the taxpayer is entitled to relief once it actually looks at the facts of the case.⁶⁶

To eliminate any confusion, the National Taxpayer Advocate would like to point out that TAS does not make substantive decisions in any case. For example, the 84 percent relief rate in the TAS study was a result of advocacy on the part of TAS case advocates, but ultimately it was the IRS that determined the taxpayers were entitled to relief.

In addition, for the 16 percent of taxpayers that did not obtain relief in the TAS study, there is still value in the process. One of TAS's quality measures is to educate the taxpayer. By informing taxpayers about why they were not entitled to relief, we educate them on tax law and procedure and seek to foster improved compliance in the future.

⁶⁴ See TAS Study. Hard freezes were almost certainly applied in additional cases. In some instances, the IRS may apply a hard freeze by inputting a second TC 570. Because the master file does not capture when a second TC 570 is input, TAS included in its count of hard freezes only cases that contained RCC 3 and TC 841 codes in the 373-case sample.

⁶⁵ See *id.*

⁶⁶ Historically, it is true that a very small number of taxpayers with clearly improper claims approach TAS for assistance each year. When that happens, TAS generally identifies the improper claim or the IRS identifies it when TAS consults with the IRS on the case. Both in absolute and relative terms, however, the number of taxpayers who are brazen enough to attempt to use TAS to further fraudulent activity is infinitesimal. Moreover, the extent of the problem should not be overstated for several reasons. First, it could cause taxpayers with bona fide problems to refrain from seeking TAS assistance out of concern they may be viewed as potential perpetrators of fraud. Second, it could encourage perpetrators of fraud to seek TAS assistance. Third, it could cause case advocates to treat all taxpayers with great skepticism. For the context, the TAS historically has obtained full relief approaching 70 percent of taxpayers who seek our assistance (and partial relief for another three to five percent of taxpayers). In the remaining cases, the taxpayer typically believed he or she was entitled to assistance, and the experience has enabled TAS to educate the taxpayer about the law, which should improve future compliance.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Provide the AMTAP unit sufficient personnel and systems to work its inventory timely.
2. Continue working to accelerate the availability of Information Returns Master File data to identify mismatches earlier in the filing season.
3. Adhere to the policy of systemically releasing refunds after 70 days if the IRS cannot determine that the return is part of a known scheme or requires greater scrutiny.
4. When considering implementation of any front-end verification procedures, concurrently develop procedures to promptly assist taxpayers who demonstrate they have filed legitimate refund claims.
5. When considering alternative treatment streams, conduct a thorough analysis to determine the specific legal basis for the proposed action (or non-action).
6. Before "auto-voiding" any tax returns, notify the taxpayers and allow them an opportunity to correct or explain the questionable items.
7. Include language in the Automated Questionable Credits notice making clearer to taxpayers the significant legal consequences for failing to respond to the notice by the deadline.

MSP
#3**Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS****RESPONSIBLE OFFICIALS**

Beth Tucker, Deputy Commissioner for Operations Support

Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

Tax-related identity theft is a rapidly growing crime that often imposes enormous financial, emotional, and time-consuming burdens on its victims. It may take many forms, including the following:

- An identity thief files a false return early in the filing season that claims a refund and uses a victim's Social Security number (SSN). When the victim later tries to e-file her own return, it is blocked.¹ About 83 percent of all tax returns result in refunds, with the average amount over \$3,000.² For many taxpayers, a significant delay in receiving a refund of this magnitude can impose financial hardship. Moreover, the victim may have to devote significant time and effort to proving to the IRS that she is the "real" taxpayer.
- An identity thief files a false return that claims a refund and uses the SSN of a disabled person in an assisted living facility. The false return shows fake self-employment (Schedule C and Schedule SE) income and refundable credits, resulting in a refund. The IRS reports the self-employment income to the Social Security Administration (SSA), which terminates the victim's Social Security benefits, potentially causing the facility to discharge the patient.
- An identity thief obtains data from the Social Security Death Master File via the Internet to find the names, SSNs, birth dates, and locations of recently deceased minor children and then claims them as dependents on a false tax return. When the parents subsequently try to electronically file a return claiming their child as a dependent during the year in which he or she died, they are unable to do so because the child was previously claimed by the identity thief. Instead, the grieving parents must file a paper return.

In recent years, the Taxpayer Advocate Service (TAS) has worked closely with the IRS to improve servicewide efforts to assist identity theft victims. Over the last few years, the IRS has made significant progress in this area and has adopted many of our recommendations, including the establishment of a dedicated unit to help the victims.

¹ See Internal Revenue Manual (IRM) 21.3.4.32.1 (Nov. 8, 2010).

² The average fiscal year (FY) 2010 refund amount was \$3,048. FY 2010 IRS Data Book, table 8, footnote 3. The percent of returns with refunds is 82.9 percent (119.4 million refunds out of 144.1 million total individual tax returns). FY 2010 IRS Data Book, tables 2 and 7.

However, the crime of tax-related identity theft continues to grow, and notwithstanding the IRS's efforts, its resources and ability to resolve cases are stretched thin. In fiscal year (FY) 2011, the centralized Identity Protection Specialized Unit (IPSU) received more than 226,000 cases, a 20 percent increase over FY 2010.³ Despite the establishment of the IPSU, TAS received over 34,000 identity theft cases in FY 2011, a 97-percent increase over FY 2010.⁴ In reaction to this growing workload, the IRS is taking steps that may ensnare legitimate taxpayers without creating a pathway to quick resolution of their cases.

An IRS task force found that 28 different units within the IRS are involved in helping victims and discovered over 50 gaps in IRS procedures.⁵ Among other deficiencies, the IRS does not have a mechanism to monitor how long it takes to resolve an identity theft case.⁶ The task force recommended that the IRS adopt a specialized model for identity theft victim assistance and issue a personal identification number (PIN) to victims to use when filing returns so the IRS can properly distinguish the true taxpayer from the identity thief.

Even with a more specialized approach to victim assistance, the IRS will still require a “traffic cop” to ensure that the proper function handles each case in an acceptable timeframe. The IPSU has already been serving in this capacity for three years and should remain the single point of contact for taxpayers. In our view, however, this “traffic cop” needs greater authority. Although IPSU requests are supposed to receive priority treatment from other IRS organizations, some IPSU cases are not considered “aged” until after 180 days have passed.⁷ Moreover, the IPSU has no way to ensure that the other functions adhere to the requested timeframes. Not surprisingly, identity theft cases controlled by the IPSU may languish for months.

The National Taxpayer Advocate has identified the following additional problems related to IRS handling of identity theft issues:

- The federal government facilitates tax-related identity theft by publicly releasing considerable personal information about recently deceased individuals, including a decedent's full name; SSN; date of birth; date of death; and the county, state, and zip code of the last address on record.
- When the IRS implements new filters to catch potentially fraudulent tax returns in identity theft cases, it does not always have effective strategies and sufficient resources

³ IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include 26,695 cases that meet TAS's “systemic burden” case criteria, which the IPSU tracks separately.

⁴ In FY 2010, TAS opened 17,291 stolen identity (primary issue code 425) cases. In FY 2011, the number jumped to 34,006. Taxpayer Advocate Management Information System (TAMIS), FY 2010, FY 2011 (Oct. 31, 2011).

⁵ IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 14 (Oct. 19, 2011).

⁶ TAS had an average cycle time of 107 days for identity theft cases, which sometimes involves multiple issues or multiple years, closed in FY 2011. TAS, Business Performance Management System.

⁷ IRM 21.9.2.1(6) (Oct. 1, 2011).

to adequately assist honest taxpayers whose returns and refund claims are held up by the filters in error.

- The IRS is not adequately protecting identity theft victims by quickly acting upon referrals of identity theft schemes from its Criminal Investigation (CI) division and other sources.
- The IRS has not developed consistent guidance for its employees to promptly remove fraudulent income and credits related to substantiated identity theft from the victims' accounts.
- The IRS is not fully utilizing its existing authority to share information about identity theft schemes and the impact on the victims with the heads of other federal agencies.
- Because TAS employees have the unique perspective of working identity theft cases from start to finish, the IRS should include TAS in all levels of identity theft program and procedural planning. This should include front-line teams, training development, guidance, and advisory and executive steering committees.

ANALYSIS OF PROBLEM

Background

In general, identity theft occurs in tax administration in two ways — when an individual intentionally uses the SSN of another person to (1) file a false tax return with the intention of obtaining an unauthorized refund or (2) gain employment under false pretenses. In both situations, the victim is often sent on a journey through IRS processes and procedures that may take years to complete.

The IRS Has Improved Its Processes for Assisting Identity Theft Victims.

The National Taxpayer Advocate has discussed the problem of tax-related identity theft for over seven years in her Annual Reports to Congress and congressional testimony.⁸ The IRS has accepted many of TAS's recommendations for improving identity theft procedures. At various times, we have advocated for the following improvements, each of which the IRS has adopted in some form:

- Allowing employees greater discretion to determine the true owner of an SSN in question without referring the matter to the SSA;

⁸ See National Taxpayer Advocate 2009 Annual Report to Congress 307-317; National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 180-191; National Taxpayer Advocate 2004 Annual Report to Congress 133-136; *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, a Drain on the Public Treasury*, Hearing Before the S. Comm. on Finance, Subcommittee on Fiscal Responsibility and Economic Growth, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Filing Season Update: Current IRS Issues*, Hearing Before the S. Comm. on Finance, 111th Cong. (Apr. 15, 2010) (statement of Nina E. Olson, National Taxpayer Advocate); *Identity Theft: Who's Got Your Number*, Hearing Before the S. Comm. on Finance, 110th Cong. (Apr. 10, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

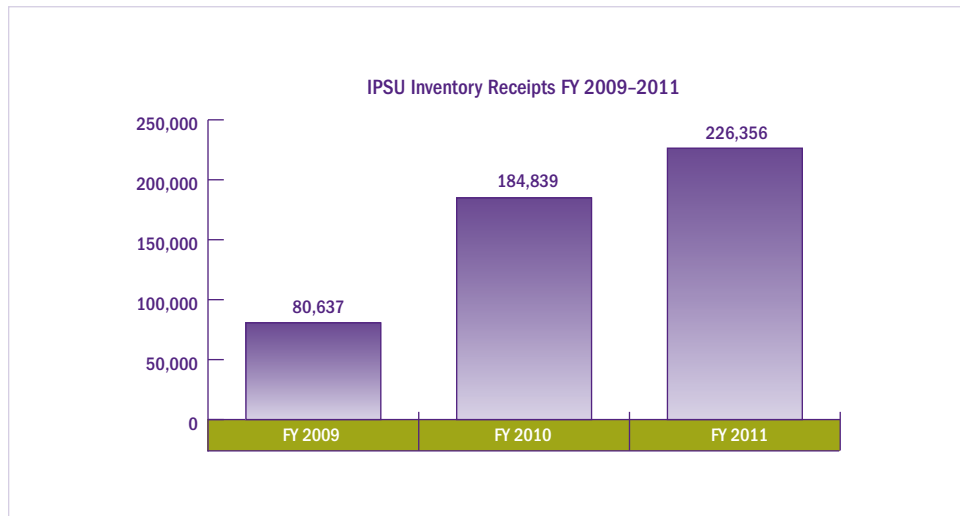
- Developing an electronic indicator to mark the tax accounts of verified victims;⁹
- Creating an IRS identity theft affidavit form;
- Adopting a standardized list of acceptable documents to substantiate identity theft;
- Establishing a centralized unit to help identity theft victims;
- Providing for a global account review prior to closing an identity theft victim's case to ensure that all related issues have been resolved; and
- Issuing a PIN to verified victims of identity theft to enable them to file returns electronically and prevent others from filing under the victims' SSNs.

Without doubt, the IRS is in a better position to help identity theft victims today than when the National Taxpayer Advocate first identified identity theft as a Most Serious Problem facing taxpayers in her 2005 Annual Report. But despite the improvements that have taken place in the last few years, the IRS continues to struggle with identity theft and cannot proactively safeguard taxpayer accounts from this crime.

Despite Major Improvements, the IRS Is Receiving Unprecedented Volumes of Identity Theft Casework.

The IRS established the IPSU in 2008 because it wanted to have a centralized unit that would accept identity theft cases and, if necessary, monitor actions taken by the various functions. This centralized unit is receiving an unprecedented volume of cases. As the chart below shows, IPSU receipts in FY 2011 increased substantially over the two previous years. This inventory does not include the tens of thousands of potential victims linked to various ongoing investigations of organized identity theft operations.

⁹ Since the IRS started using an electronic indicator in 2009 to flag an account as being potentially compromised, it has tracked over 1.8 million incidents impacting over 1.1 million taxpayers. See IRS Office of Privacy, Information Protection, and Data Security (PIPDS) Incident Tracking Statistics Reports for calendar years ending 2009 and 2010 and for the period of January 1, 2011, through September 30, 2011.

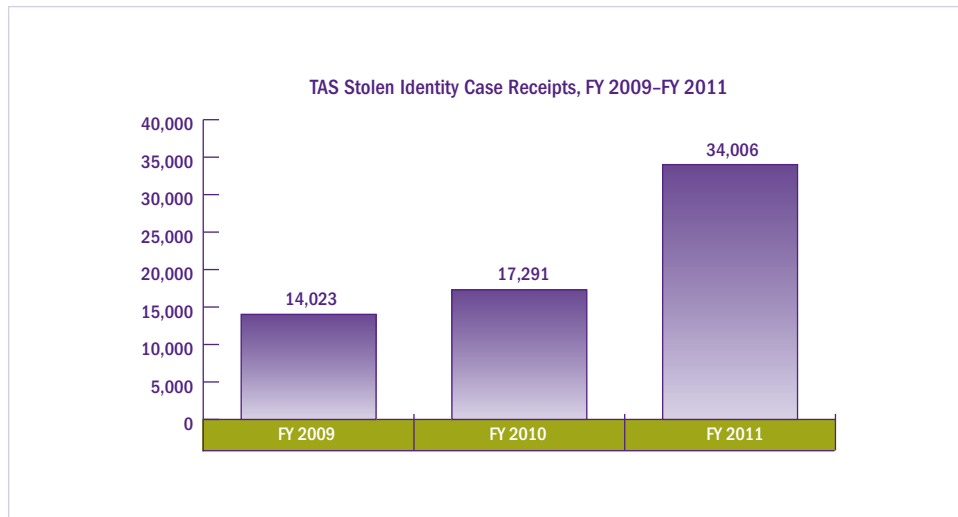
FIGURE 1.3.1, IPSU Inventory Receipts, FY 2009 to FY 2011¹⁰

TAS casework reflects the impact of the IRS's inability to promptly address identity theft victims' tax issues. TAS received 34,006 stolen identity cases in FY 2011, compared to 17,291 in FY 2010 and 14,023 in FY 2009.¹¹ This translates to a 97 percent increase in identity theft receipts in FY 2011 over FY 2010, on top of a 23 percent gain from FY 2009 to FY 2010. Moreover, this increase does not include 26,695 cases that meet TAS's "systemic burden" case criteria and were referred to the IPSU for processing under the March 2010 Memorandum of Understanding between TAS and the Wage and Investment (W&I) division.¹²

¹⁰ IRS, *IPSU Identity Theft Report* (Oct. 1, 2011); IRS, *IPSU Identity Theft Report* (Oct. 2, 2010); IRS, *IPSU Identity Theft Report* (Oct. 3, 2009). This inventory includes all identity theft cases controlled by the IPSU paper unit, including self-reported non-tax-related identity theft cases, cases the IPSU monitors, and cases undergoing global account review. It does not include cases that meet TAS's "systemic burden" case criteria, which the IPSU tracks separately.

¹¹ TAMIS, FY 2009, FY 2010, FY 2011 (Oct. 31, 2011).

¹² IRS, *IPSU Identity Theft Report* (Oct. 1, 2011). See *Memorandum of Understanding Between the National Taxpayer Advocate and the Commissioner, Wage & Investment to Transition TAS Criteria 5-7 Identity Theft Cases to Wage & Investment Identity Protection Specialized Unit (IPSU)* (Mar. 31, 2010).

FIGURE 1.3.2, TAS Stolen Identity Case Receipts, FY 2009 to FY 2011¹³**There Are Multiple Explanations for the Increase in Identity Theft Cases.*****Identity Thieves Have Become More Proficient.***

Over the years, those who commit identity theft have become more adept at devising schemes to steal identities. Increasingly, these schemes target taxpayers who are not required to file returns, such as the elderly, disabled, and children. As a result, it may take years for a victim to find out that an identity thief has stolen his or her SSN. One of the more sinister schemes involves the misuse of a deceased taxpayer's SSN to obtain fraudulent refunds. Perpetrators have gone as far as using the SSNs of deceased children, leaving their grieving parents to deal with the aftermath of the identity theft.¹⁴

Tax-Related Identity Theft Remains a Growing Problem.

The rising IRS caseload may reflect an overall increase in *tax-related* identity theft as opposed to other types. The Federal Trade Commission (FTC) reports overall identity theft complaints have actually decreased in 2009 for the first time since 2006.¹⁵ However, tax return-related identity theft has increased nearly six percentage points from 2006 to 2008.¹⁶ The overall decline in incidents reported to the FTC may be attributable in part to the IRS's

¹³ Taxpayer Advocate Management Information System (TAMIS), FY 2009, FY 2010, FY 2011.

¹⁴ See CBS 3 News Report, *Deceased Riverside Child's Identity Stolen, Falsely Claimed on Taxes* (Mar. 1, 2011), available at <http://philadelphia.cbslocal.com/2011/03/01/diseased-riverside-childs-identity-stolen-falsely-claimed-on-taxes>; *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, A Drain on the Public Treasury*, Hearing Before the S. Comm. on Finance, Subcommittee on Fiscal Responsibility and Economic Growth, 112th Cong. (May 25, 2011) (statement of Terry D. McGlun, Jr.).

¹⁵ See Federal Trade Commission, *Consumer Sentinel Data Book 5* (Feb. 2010), available at <http://www.ftc.gov/sentinel/reports/sentinel-annual-reports/sentinel-cy2009.pdf>.

¹⁶ See Federal Trade Commission, *Consumer Sentinel Data Book 3* (Feb. 2009), available at <http://www.ftc.gov/sentinel/reports/sentinel-annual-reports/sentinel-cy2008.pdf>.

creation of its own identity theft affidavit in 2009.¹⁷ Additionally, the victims are sometimes deceased individuals, who cannot report the incidents to the FTC.

One example of alleged tax-related identity theft involves what media reports describe as a sophisticated ring based in the Tampa area. The media reported the individuals allegedly were using laptops, off-the-shelf tax preparation software, wireless hotspots, and easily obtainable personal information to file false returns and obtain refund checks or debit cards. Federal investigators estimate they have seized \$100 million in questionable tax refunds from the operation, which authorities say adopted the name of the popular tax-filing software “Turbo Tax.”¹⁸

The Public Is Increasingly Aware of Identity Theft.

The increase in identity theft cases may also be due to increased public awareness. Whether because of more effective outreach or just greater media coverage, people may be checking their credit reports more frequently and becoming better at detecting identity theft. If they see suspicious entries on their credit profiles, taxpayers may contact the IRS to make sure no one has used their SSNs to file returns.

The IPSU Is Struggling to Effectively Manage Identity Theft Cases.

The establishment of the Identity Protection Specialized Unit may have created a false sense of well-being in the IRS. Commissioner Shulman, in his written response to Senate Finance Committee Chairman Max Baucus’s follow-up questions after an April 2008 hearing, described the unit as providing “a central point of contact for the resolution of tax issues caused by identity theft.” His response further stated: “This unit will provide end-to-end case resolution. Victims will be able to communicate with one customer service representative to have their questions answered and issues resolved quickly and efficiently.”¹⁹ While this description fits the model for which TAS advocated, it does not accurately reflect how the IPSU operates in practice.

The reality is that the IPSU does not work identity theft cases from beginning to end. Whether because of resource constraints or a policy decision, the IPSU is not staffed to work identity theft cases itself. Instead, it attempts to coordinate with up to 27 other functions within the IRS to obtain relief for the victim.²⁰ In some cases, the IPSU simply routes

¹⁷ See Form 14039, *Identity Theft Affidavit* (rev. Mar. 2010), available at <http://www.irs.gov/pub/irs-pdf/f14039.pdf>. Prior to 2009, identity theft victims could obtain an identity theft affidavit from the FTC and submit it to the IRS to receive assistance. See IRM 21.6.2.4.4.3(1) (Oct. 1, 2007) (superseded). The IRS still advises taxpayers, by telephone and notices, to file a complaint with the FTC. Filing a complaint to enter an incident in the FTC database is different from completing the FTC identity theft affidavit.

¹⁸ See Elaine Silvestrini & Lauren Mayk, *Police: Tampa Street Criminals Steal Millions Filing Fraudulent Returns*, Tampa Bay Tribune (Sept. 1, 2011), available at <http://www2.tbo.com/news/politics/2011/sep/01/11/police-tampa-street-criminals-steal-millions-filin-ar-254724/>.

¹⁹ *Identity Theft: Who's Got Your Number, Hearing Before the S. Comm. on Finance*, 110th Cong. (Apr. 10, 2008) (response of IRS Commissioner Douglas H. Shulman to questions from Chairman Max Baucus), available at <http://finance.senate.gov/hearings/hearing/download/?id=f989b16e-5da3-452d-9675-b75d796fe2b4>.

²⁰ IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 14 (Oct. 19, 2011).

the case to other IRS organizations and “monitors” the victim’s account every 60 days.²¹ In other cases (*e.g.*, those with a systemic burden issue), the unit uses Identity Theft Assistance Requests (ITARs) to ask other IRS functions to take specific actions.²²

While the procedures call for the receiving functions to give ITARs priority treatment, there are no “teeth” to ensure that happens.²³ Unlike TAS, which can issue a Taxpayer Assistance Order²⁴ (TAO) if an operating division (OD) does not comply with its request for assistance in a timely manner, the IPSU procedures do not specify any consequences for functions that are unresponsive to a case referral or an ITAR. Moreover, TAS has negotiated agreements with the operating divisions that clearly define when and how the ODs will respond to a TAS request for action. The National Taxpayer Advocate urges the IPSU to enter into similar Service Level Agreements (SLAs) with other IRS divisions and functions that set forth the timeframes for taking the requested action and to develop tracking procedures to report to heads of office when functions regularly fail to meet these timeframes. For example, the SLAs may set forth a reporting mechanism that would notify the executives of other functions when their employees do not meet timeliness standards. The SLAs may also require the ODs to publish their identity theft case timeliness measures in their quarterly Business Performance Review reports.

IPSU procedures are a vast improvement over IRS processes in effect as recently as three years ago. Unless the IPSU is given adequate staffing and authority to oversee cases from start to finish, however, the benefits of these improvements will be inadequate for both taxpayers and the IRS.

Even with a Specialized Approach to Assisting Identity Theft Victims, the IPSU Should Continue to Play an Important Role.

Despite its “specialized” name, the IPSU actually operates as a hub in a centralized environment. One major recommendation from the identity theft working group was that the IRS create a specialized unit *within each function* to work on identity theft cases. Under this approach, each function would retain responsibility for individual aspects of a case, but would rely on employees who receive specialized training to help the victims.

The National Taxpayer Advocate believes the IPSU should continue to play an important role in this specialized environment. The IRS needs a “traffic cop” to work with the various functions, hold them to timeframes, and ensure that they do not neglect cases. The IPSU should remain the single point of contact for victims and should coordinate with the

²¹ IRM 21.9.2.4.3(7) (Oct. 31, 2011).

²² IRM 21.9.2.10.1 (Oct. 1, 2010).

²³ IRM 21.9.2.1(4) (Oct. 1, 2011) provides:

All cases involving identity theft will receive priority treatment. This includes... Form 14027-A *Identity Theft Case Monitoring*, and Form 14027-B, *Identity Theft Case Referral*...Identity Theft Assistance Request (ITAR) referrals are also included. IRM 21.9.2.10.1(1) (Oct. 1, 2011) provides that “Cases assigned as ITAR will be treated similar to Taxpayer Advocate Service (TAS) process including time frames.”

²⁴ See IRC § 7811.

specialists in the various functions. Each function should have a liaison with the IPSU and be held accountable for meeting established deadlines for taking requested actions (as set forth in the SLA).

The IRS Does Not Accurately Track Identity Theft Cases or Cycle Time.

The IRS does not yet have a centralized system to track identity theft cases and must pull data from multiple systems to estimate case receipts. Because identity theft often involves multiple tax issues that need to be worked by different functions, a case frequently appears on multiple systems. A task force determined that the IRS has 22 distinct systems and data sources that collect identity theft data.²⁵ Without conducting manual workarounds to manipulate the data, the IRS is susceptible to double- or triple-counting identity theft receipts if it simply adds up the case counts from the 22 systems.

Equally important, the IRS does not currently track any data about the cycle time for identity theft cases, although it recognizes the benefits of such a measure. The National Taxpayer Advocate believes that cycle time is useful as an indicator, but urges the IRS to focus more on *timeliness*. Because TAS routinely deals with complicated cases that may take months to fully resolve, TAS case advocates are measured on the timeliness of their actions rather than simply on how long it takes to close a case. For example, did the case advocate phone the taxpayer within one day of the initial contact? Did the case advocate follow up with the appropriate IRS function within three days of the negotiated completion date? Focusing on timeliness (1) requires the case advocate to come up with a detailed action plan to resolve the case and (2) alleviates the artificial pressure to prematurely close the case solely to reduce cycle time. Identity theft cases are similarly complicated and should be measured on timeliness, rather than strictly on cycle time.

Without the ability to compile meaningful identity theft case tracking data, it is difficult, if not impossible, for the IRS to determine whether identity theft cases are being treated with the urgency they demand.

The Federal Government Facilitates Tax-Related Identity Theft by Publicly Releasing Significant Personal Information of Deceased Individuals.

SSNs and other personal information are more accessible than ever. What is surprising and disturbing is that the federal government is the source of much of this personal information. Under a 1980 consent judgment resulting from a Freedom of Information Act (FOIA) lawsuit, the SSA was required to provide certain personally identifiable information about deceased individuals.²⁶ In response, the SSA created a “Death Master File” (DMF) containing the full name, SSN, date of birth, date of death, and the county, state, and ZIP

²⁵ IRS, Identity Theft Assessment and Action Group, *IRS Identity Theft Program Future State Report* 8, 136 (Oct. 11, 2011).

²⁶ See *Perholtz v. Ross*, Civil Action No. 78-2385 and 78-2386, U.S. District Court for the District of Columbia (Apr. 11, 1980).

code of the last address on record.²⁷ Today, anyone who conducts a quick web search can find a number of sites (including genealogy sites) that provide this information, for free or for a nominal fee.²⁸

The National Taxpayer Advocate is appalled that the federal government is making sensitive personal information so readily available, when such information can easily be used to commit identity theft. Notably, the DMF contributes to tax-related identity theft by providing the date of birth, allowing thieves to determine which decedents are minors who can be claimed as dependents. While the Freedom of Information Act may require disclosure of this information, the IRS should work with the SSA to explore ways to minimize the potential harm associated with such information. For example, the SSA provides weekly updates to the DMF. Perhaps the DMF could be released once a year to the public, after the tax filing season. The IRS would continue to receive DMF data on a weekly basis, and thus would have time to load information onto its systems and be better positioned to scrutinize claims that include the SSNs listed in the DMF.

Alternatively, the SSA, perhaps in conjunction with the IRS, may propose to make public only the final four digits of decedents' SSNs, at least for several years after their deaths, to prevent the theft and misuse of their identities. If the federal government can show that the release of full SSNs is substantially furthering criminal conduct and that it reasonably believes the public benefits of partially redacting SSNs outweigh the public benefits of the release of full SSNs, we think a court would give such a request favorable consideration.

If neither of these approaches yield the desired result, the National Taxpayer Advocate is proposing that Congress pass legislation to restrict disclosure of certain personally identifiable information to the public.²⁹

When the IRS Implements New Filters, It Should Have an Effective and Expedited Mitigation Strategy to Help Legitimate Taxpayers Obtain Their Refunds on a Timely Basis.

In the current environment, the IRS is under tremendous pressure to protect Treasury revenue from improper refund claims. The IRS is understandably deploying front-end verification procedures to prevent suspicious refunds from going out. For the 2012 filing season, the IRS plans to implement a set of identity theft filters it developed by analyzing a population of tax returns that included "verified" false returns along with known legitimate returns. Based on analysis of the differences between these "good" and "bad" returns, the IRS has developed a series of business rules that aim to filter out the verified false returns, while allowing the good returns to pass through processing. The IRS plans to notify

²⁷ See Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public Via the Death Master File*, A-06-08-18042 (June 2008).

²⁸ See Scripps Howard News Service, *ID Thieves Cashing in on Dead Children's Information* (Nov. 3, 2011).

²⁹ See Legislative Recommendation: *Restrict Access to the Death Master File*, *infra*. See also Identify Theft and Tax Fraud Prevention Act, S. 1534, 112th Cong. § 9 (1st Sess. 2011) (proposing restrictions on access to the Death Master File).

taxpayers whose returns it has flagged that it has questions about their returns and will not be able to process them until the taxpayers provide the requested information.

The National Taxpayer Advocate appreciates the need for the IRS to develop effective screening mechanisms to combat identity theft. However, she has several concerns about the planned filters. First, filters of this nature are inherently imprecise, so it is critical that the IRS employ reliable methods to determine whether a return flagged as questionable is valid or false. Indeed, IRS personnel generally do seek to “validate” or “verify” whether a flagged refund claim should be paid. However, this process often produces inaccurate results. According to a TAS review of approximately 20,000 TAS pre-refund wage verification cases in which refunds were denied, 80 percent of the taxpayers ultimately were found eligible for refunds, with 72 percent receiving the entire amounts they had claimed on their returns.³⁰ While TAS cases may not be representative of the overall population of taxpayers, the review raises questions about the accuracy of the IRS’s processes and its claims concerning the number and percentage of “verified” false returns.

Second, the National Taxpayer Advocate is concerned that the IRS’s mitigation strategy may not be effective. According to the plan, employees of the Submission Processing organization will be able to help taxpayers erroneously caught up in the identity theft filter. These employees are to retrieve the tax return information and make sure the return is treated as processed on the original date of filing. In the current budget environment, there is a significant risk that Submission Processing will not have sufficient staffing to aid the impacted taxpayers (a number which is unknown at this time).

Third, the National Taxpayer Advocate is concerned that procedural changes adopted through Servicewide Electronic Research Program (SERP) alerts or other staff instructions often have a significant impact on taxpayer mitigation strategies yet are not reviewed by TAS or other affected functions. To protect against that, we urge the IRS to require that any proposed modifications to its mitigation strategies be approved in advance by the Identity Theft Executive Steering Committee.

Fourth, the National Taxpayer Advocate is concerned that the IRS is underestimating the impact of these identity theft filters. During the 2011 filing season, when the IRS vastly underestimated the problems involved in processing repayments of the First-Time Homebuyer Credit, it had no communication strategy to inform the public about these issues. The IRS’s silence drove taxpayers to vent their frustrations and share often inaccurate information on a Facebook page.³¹ The IRS should learn from this experience and develop a national communication strategy now. It is important for the IRS to keep taxpayers better informed, especially if it becomes apparent that the identity theft filters will impact a significant number of taxpayers. Moreover, if the IRS’s suspicions are correct and

³⁰ See Most Serious Problem: *The IRS’s Wage and Withholding Verification Procedures May Encroach on Taxpayer Rights and Delays Refund Processing*, *supra*.

³¹ See National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 28-32.

it receives an unprecedented number of returns involving identity theft in the 2012 filing season, it may have to slow down the processing of all returns to protect revenue. The IRS must have a nationwide communication plan in place if that happens.

The IRS Is Not Adequately Protecting Identity Theft Victims by Quickly Acting Upon Criminal Investigation and Other Identity Theft Referrals.

The Criminal Investigation division and other agencies sometimes investigate large-scale identity theft schemes and in the course of their investigations acquire lists of taxpayers whose identities have been or may be misused. When CI efforts or referrals from law enforcement agencies yield names and SSNs of impacted taxpayers, the IRS should not only try to protect revenue but should also help the victims. The IRS should promptly (1) place a civil freeze code on such accounts to prevent refunds from being processed without further scrutiny; (2) abate taxes, penalties, and interest from the impacted accounts, as appropriate; and (3) to the extent permitted by law, share this information with other agencies (such as the SSA) to reduce the effect of improperly inflated income.

The IRS Should Develop a Civil Freeze Code to Protect Revenue.

Historically, CI would input a TC 918 freeze code to flag accounts when it received leads from law enforcement agencies about SSN misuse. This code would protect revenue and control accounts. The downside of CI applying this code is that the civil functions of the IRS would no longer control the account and be unable to adjust the account or even discuss it with taxpayers. The IRS is considering the development of a civil freeze code that would allow Wage & Investment employees to talk with affected taxpayers and make adjustments while protecting revenue. However, the National Taxpayer Advocate is concerned that W&I employees will not have the expertise and experience to evaluate the merits of a referral from a law enforcement agency. With the mounting external pressure to protect revenue and limited resources to work cases, we are concerned that refund claims that are merely “suspicious” or “potentially fraudulent” may be permanently frozen. To address this concern, the National Taxpayer Advocate recommends that CI remain involved in the decision to implement a TC 918-equivalent freeze code. Only after CI personnel determine that a freeze code is warranted should W&I apply the TC 918-equivalent.

The IRS Has Not Developed Consistent Guidance for Its Employees to Promptly Remove Fraudulent Income and Credits Related to the Substantiated Identity Theft from the Victims’ Accounts.

In June 2011, the National Taxpayer Advocate issued a Proposed Taxpayer Advocate Directive (TAD) ordering the Commissioner of W&I to establish procedures to adjust a taxpayer’s account in instances where a tax return preparer altered the return without the taxpayer’s knowledge or consent.³² To date, the IRS has not issued this guidance to its employees. In August 2011, the National Taxpayer Advocate issued TAOs in four cases

³² See Proposed Taxpayer Advocate Directive (TAD) 2011-1 (June 13, 2011). This Proposed TAD is attached at the end of this Most Serious Problem.

ordering the Commissioner of W&I to adjust the accounts to remove all entries attributable to the purported returns. It was not until the National Taxpayer Advocate elevated the four TAOs to the Deputy Commissioner of Services and Enforcement in September 2011 (after W&I failed to respond) that the IRS took action in these particular cases. The Proposed TAD remains outstanding and unsatisfied, despite the W&I Commissioner's commitment to develop procedures.

The IRS Currently Has Sufficient Authority to Share Information Pertaining to Identity Theft with Other Federal Agencies and Should Do So Promptly to Minimize the Impact on Identity Theft Victims.

The IRS periodically receives referrals from law enforcement agencies that have uncovered an identity theft scheme. If a victim is receiving certain Social Security benefits, his or her benefits may be affected if the perpetrator reported inflated income using the victim's SSN. When the IRS receives such information, it has an obligation to notify both the victim and other agencies (such as the SSA) to minimize the impact to the victim. It should identify a liaison within the SSA and ensure that income information the SSA relies upon to process benefits is accurate.

Identity theft heightens historic concerns with security of return information. While the law generally makes return information confidential, there are various exceptions that allow the IRS to share certain information with the SSA.³³ When the IRS corrects an item of return information (by audit or otherwise), it incorporates updated data into the authorized release.³⁴ If the IRS corrects an item of return information due to identity theft, it likewise incorporates the correction into the authorized release for corresponding adjustment by the SSA.³⁵

Conversely, law enforcement agencies that need return information can obtain it through proper procedures.³⁶ Federal officials can request return information for use in criminal investigation or proceedings, such as those relating to identity theft.³⁷ Effective use of existing authority can help stem identity theft.

³³ See, e.g., IRC § 6103(l)(1), (5), (7), (12), (21).

³⁴ See IRM 11.3.29.3 (Sept. 1, 2009); *Agreement Between the Social Security Administration and the Internal Revenue Service* (Mar. 14, 2007).

³⁵ Additionally, IRC § 6103(i)(3)(A) authorizes the IRS to apprise another federal agency charged with enforcement of a non-tax crime. To the extent that the Social Security Act criminalizes elements of identity theft (under 42 USC § 1307 or other provisions), this disclosure statute may apply to the agency charged with enforcement.

³⁶ See IRC § 6103(i)(1), (i)(2); see also IRC § 6103(d) (permitting disclosure to state tax enforcement agencies).

³⁷ See IRC § 6103(i)(2). In case of tax data provided by an individual that is classified as "taxpayer return information," a federal prosecutor may obtain a court order for release in criminal investigation or proceedings. See IRC § 6103(i)(1).

The IRS Issued Identity Protection PINs that Should Protect Some Victims from Refund Delays and Protect Revenue.

For the 2012 filing season, the IRS issued identity protection personal identification numbers (IP PINs) to over 200,000 victims whose identities and addresses have been verified.³⁸ In November 2011, the IRS sent out letters informing the victims that they must use the IP PIN to file their 2011 returns electronically. In December 2011, the IRS issued a second letter that actually contained the IP PIN. If the taxpayer attempts to e-file without that number, the IRS will not accept it and the taxpayer will need to file a paper return, which will delay processing.

The National Taxpayer Advocate supports the IP PIN in concept. However, we recognize that some taxpayers will not receive the notification letter, will lose the IP PIN, or will simply forget to use it when they try to e-file. The IRS must be prepared to respond to phone inquiries from these taxpayers and must be prepared, without the need for TAS involvement, to expedite return processing for those victims who demonstrate that identity theft has caused economic hardship. Absent such a mitigation strategy, this policy decision by the IRS may dramatically increase TAS's caseload.

The IRS Should Promptly Notify Victims of Identity Theft that Their SSNs Have Been Compromised in the Tax Context.

When the IRS discovers and confirms that a taxpayer's SSN was used without authorization to file a tax return, it should immediately disclose to the SSN owner that the number has been used on another return and that he or she is an apparent victim of identity theft. In many instances, the IRS is the first agency to learn of the theft. For example, a taxpayer's SSN may have been used by someone else for employment purposes. Where the IRS is able to verify without contacting the taxpayer that misuse has occurred, it can adjust the victim's account without notifying the taxpayer that his or her SSN has been compromised.

In 2008, the IRS Office of Chief Counsel advised that the IRS could notify taxpayers that they were the victims of identity theft without violating confidentiality laws.³⁹ Based on this advice, the IRS developed a letter informing the taxpayer that his or her personal information has been compromised and providing suggestions about what the taxpayer may wish to do (*e.g.*, contact the credit reporting agencies). However, the IRS does not send such notification in all known instances of identity theft. For example, the IRS does not send such letters to victims of employment-related identity theft.⁴⁰

³⁸ IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 6 (Oct. 19, 2011).

³⁹ IRS Office of Chief Counsel Memorandum, *Identity Theft Returns and Disclosures Under Section 6103*, PMTA 2009-024 (June 8, 2008).

⁴⁰ Email correspondence from Office of Privacy, Government Liaison, and Disclosure analyst (Nov. 2, 2011). The IRS does issue victim notification letters to CI-identified taxpayers. See IRM 10.5.3.2.2.4.3 (Dec. 23, 2010).

Taxpayers Should Be Allowed to Turn Off Their Ability to File Tax Returns Electronically.

Electronic filing has many benefits, including more accurate returns and faster processing. “IRS e-file is the best option for everyone, especially for people impacted by recent tax law changes,” said Commissioner Shulman when IRS e-file approached the milestone of one billion returns processed in January 2011.⁴¹ Twenty years after the IRS introduced e-file, nearly 70 percent of U.S. taxpayers use it.⁴²

Unfortunately, the benefits of e-file also extend to perpetrators of identity theft. E-file allows the thieves to submit falsified returns early and repeatedly, in an attempt to beat the legitimate taxpayer to the IRS and claim improper refunds. The mandatory use of the IP PIN would go a long way toward alleviating recurring identity theft, but it would not help taxpayers who no longer have a filing obligation (or young children who do not need to file for many years to come). The IRS should allow taxpayers to voluntarily turn off the ability to e-file using their SSN and enable taxpayers to reacquire the e-file option later, upon proof of identity, if circumstances change. Such a feature would offer an additional level of protection to vulnerable taxpayers.

The IRS Should Include TAS Representatives in All Levels of Identity Theft Program and Procedural Planning.

As discussed, the IPSU functions as a traffic cop, coordinating with various IRS functions to address bits and pieces of an identity theft victim’s tax issues. By contrast, TAS employees are the only IRS employees who work identity theft cases from start to finish. Their global perspective, along with the experience they have gained from working the significant volume of identity theft cases that TAS receives, qualifies some TAS employees as experts in identity theft processing. To ensure the IRS receives the benefit of TAS’s broad experience in assisting identity theft victims, the IRS should include TAS in all levels of identity theft program and procedural planning, including front-line teams, training development, guidance, and advisory and executive steering committees.

CONCLUSION

In conclusion, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Implement Service Level Agreements between the Identity Protection Specialized Unit and the various functions that process case referrals and Identity Theft Assistance Requests.
2. Establish timeliness measures for identity theft case actions.
3. Before implementing identity theft filters, develop an effective and expedited mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis.

⁴¹ IRS, *IRS e-file Launches Today; Most Taxpayers Can File Immediately*, IR-2011-4 (Jan. 14, 2011).

⁴² *Id.*

4. Require any proposed modifications to its identity theft filters mitigation strategy be approved in advance by the Identity Theft Executive Steering Committee.
5. Create and implement a national communication strategy if the identity theft filters impact a significant number of legitimate taxpayers or cause excessive processing delays.
6. In conjunction with the Social Security Administration, seek a modification of the consent judgment requiring the SSA to release the SSNs of decedents, so that the SSA can begin to partially redact SSNs (*e.g.*, release only the last four digits).
7. If a civil freeze code is implemented for referrals from law enforcement agencies, require CI personnel to determine whether such a refund freeze is necessary before applying the civil freeze code.
8. Establish a point of contact in W&I so that Criminal Investigation or other IRS operations can supply lists of victims from their investigations of identity theft schemes and W&I can promptly mark the accounts accordingly.
9. Promptly notify all victims of identity theft of the misuse of their SSN and provide information about what steps the taxpayer may take to further protect himself or herself.
10. Allow taxpayers to turn off the ability to file electronically.
11. Include TAS in all levels of identity theft program and procedural planning, including front-line teams, training development, guidance, and advisory and executive steering committees.

IRS COMMENTS

The IRS takes very seriously the issue of identity theft and its impact on the tax system, including the harm that it inflicts on innocent taxpayers. Over the past few years, the IRS has seen a significant increase in refund fraud schemes involving identity theft. The IRS has prioritized this issue and is committed to taking the necessary steps to be better prepared in both fraud prevention and victim assistance. In meeting this commitment, the IRS has substantially increased the resources devoted to both fraud prevention and victim assistance. Even in a declining budget environment, the IRS is taking a variety of steps to address the growing challenge of identity theft.

On the prevention side, the IRS is implementing new processes for handling returns, new filters to detect fraud, new initiatives to partner with stakeholders and a continued commitment to investigate the criminals who perpetrate these crimes. In implementing these processes the IRS must maintain the balance between the processing of refunds in a timely manner with the controls that are needed to minimize errors and fraud in returns that are submitted for processing.

The IRS launched a new program to enhance return processing and catch fraudulent refunds when they come in the door. A cross-functional group made up of IRS divisions developed processes and policies for the 2012 filing season to protect revenue by:

- Designing new identify theft screening filters;
- Developing new procedures to handle returns that are believed to be filed by identity thieves;
- Issuing special identification numbers to taxpayers whose identity has been stolen;
- Identifying mismatches in returns earlier in the process;
- Developing mechanisms to stop the growing trend of returns submitted with deceased taxpayers' information;
- Developing procedures for handling lists of personal information discovered by law enforcement officials;
- Expanding IRS' authority to better utilize the list of prisoners to stop fraudulent returns; and
- Collaborating with software developers and other industries to prevent theft.

In addition, the Criminal Investigation division is working closely with other IRS divisions to improve processes and procedures related to identify theft refund fraud prevention.

Along with prevention, the other key component of the IRS's efforts to combat identity theft involves providing assistance to taxpayers whose personal information has been stolen and used by a perpetrator in the tax filing process. This situation is complicated by the fact that identity theft victims' data has already been compromised outside the filing process by the time we detect and stop perpetrators from using their information.

The IRS agrees that integrated processes and procedures are needed to ensure that identity theft victims receive timely assistance. We recently initiated a focused effort to improve the overall end-to-end case resolution process. A servicewide group was formed to assess the current strategic and operational state of identity theft across the IRS. This effort identified several process and workflow enhancements that will significantly improve our victim assistance services. Because identity theft can manifest within multiple IRS functions, the IRS is establishing specialized groups within each function that encounters identity theft issues. The IRS is working to speed up case resolution, provide more training for employees who assist victims of identity theft, and step up outreach to and education of taxpayers so they can prevent and resolve tax-related identity theft issues quickly. The IRS is also capturing additional data about identity theft cases and integrating this with more robust management oversight processes. In combination, these processes, structural and oversight improvements are targeted to reduce the time required to resolve taxpayer issues and deliver a higher quality of taxpayer service.

Fighting identity theft will be an ongoing battle for the IRS, and one where we cannot afford to let up. The identity theft landscape is constantly changing, as identity thieves continue to create new ways of stealing personal information and using it for their gain. We must continually review our processes and policies to ensure that we are doing everything possible to minimize the incidence of identity theft and to help those who find themselves victimized by it.

As we continue our efforts in this area, we will continue to take into account the views of the National Taxpayer Advocate. With regard to the report's preliminary recommendations, we offer the following comments.

As discussed, the IRS recently has made a number of significant improvements and we continue to work to define our processes and procedures in this area. Due to the risk that specific information about these processes and procedures could be used to facilitate fraud, we are unable to publicly disclose all of our improvements with specificity.

We have greatly improved our internal coordination throughout the operating divisions and criminal investigations in dealing with identity theft issues. We will consider whether implementing Service Level Agreements between the Identity Protection Specialized Unit and the various functions is necessary. The role of the IPSU will be reviewed and modified as the various operating units begin to stand up specialized teams. We will consider whether timelines are necessary, but recognize that given the complexity of the work required in the mitigation of identity theft issues and because multiple business operating divisions will have specialized units to address their unique issues, one standardized measure may not be applicable to all situations.

The IRS is making every effort to minimize the impact of identity theft filters on legitimate taxpayers. The growth in identity theft requires the IRS to put in place new methods to stop refund fraud. We recognize that these efforts could slow refunds for some taxpayers, but we are making every effort to minimize the impact. Our communication strategy will be implemented for the filing season as appropriate.

With respect to a mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis, the IRS plans to issue a letter to filers within days of their return being identified as having a potential issue. This new letter was shared with the National Taxpayer Advocate. IRS employees will be prepared to answer calls related to the letter and equipped with procedures to post the return and allow the refund when it is determined the return was filed by a legitimate taxpayer. The IRS is also testing the filters on returns prior to the filing season to assess their accuracy.

The IRS actively notifies victims and marks taxpayer accounts when we identify that a Social Security number has been misused. We have developed a specific indicator to note taxpayer accounts when the IRS first determines that there is a likelihood of identity theft. After these accounts are marked, taxpayers receive a notice that informs them of the SSN

misuse and that their tax accounts have been corrected and marked with the identity theft indicator. We also include information on steps that taxpayers should take to protect their identities. We have issued guidance through the IRM on how to apply the account indicator and when to send a notification letter to the victim. We have several additional initiatives underway to expand our processes to notify and assist identity theft victims.

The IRS supports efforts to prevent Social Security Administration death information from public availability as such information significantly contributes to identity theft in the tax system.

The electronic filing of tax returns creates multiple benefits for taxpayers including increased accuracy of filed returns, expedited refunds and ease of use. The IRS recognizes that these same benefits are sometimes exploited by those who choose to perpetrate fraud through identity theft. We have started to offer the Identity Protection Personal Identification Number to protect known identity theft victims and prevent subsequent fraudulent filings using their stolen identity. We are taking several additional steps in this regard.

The IRS looks forward to continued collaboration with the National Taxpayer Advocate on the servicewide tax related identity theft program.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate applauds the IRS for bringing the IP PIN into service in advance of the 2012 filing season, one of the many process improvements the IRS has made over the years to assist victims of identity theft. However, despite even the best communication efforts, some taxpayers will inevitably need to contact the IRS because they either never received the IP PIN or have misplaced it. The National Taxpayer Advocate reiterates the need for the IRS to develop and implement mitigation strategies as part of its normal planning. In other words, not every taxpayer who loses the IP PIN should be referred to TAS, even if he or she meets TAS criteria.⁴³ Instead, the IRS's mitigation strategy should anticipate the need for taxpayers who require a replacement IP PIN. It should allocate sufficient staffing, develop adequate procedures, and conduct the necessary training to help these taxpayers, with minimal impact to TAS.

While the IRS recognizes the need for a time-tracking measure for identity theft cases, it states a standardized cycle time measure may not be desired, due to the complexity and uniqueness of such cases. The National Taxpayer Advocate agrees, and suggests that the

⁴³ See IRM 13.1.7.4 (Oct. 1, 2001) (providing that "Problems that meet TAS criteria do not necessarily need to be sent to TAS when they can be immediately resolved by an operating division or function...Cases that can be resolved on the "Same Day" should not be referred to TAS unless the taxpayer makes the request.").

IRS focus on *timeliness*, rather than cycle time, in developing measures for identity theft cases. By focusing on timeliness of actions, the IRS can give its employees an incentive to keep identity theft cases moving. Whether a case involves one issue for one tax year, or six issues spanning four tax years, a timeliness measure would allow the IRS to assess whether the case truly needed a long time to resolve, or whether the case was languishing in one IRS department with no action.

The National Taxpayer Advocate is pleased to report that some genealogy websites have voluntarily agreed to curtail the availability of Death Master File information. Ancestry.com recently announced it will no longer display SSNs for anyone who has passed away within the past ten years.⁴⁴ RootsWeb.com, another genealogy site affiliated with Ancestry.com, states that it will not share information from the DMF “due to sensitivities around the information in this database.”⁴⁵ These changes appear to be in response to congressional and media pressure, and should make it more difficult for identity thieves to file false tax returns. It is our hope that other websites will follow suit, and that the SSA (or Congress, if necessary) will restrict access to the DMF to those with a legitimate need for such sensitive information. The National Taxpayer Advocate commends the IRS for its support of these efforts.

Finally, the National Taxpayer Advocate is pleased that the IRS has committed to working with and including TAS on servicewide teams to address identity theft issues and procedures. She urges the IRS to include TAS representatives at all levels of planning, given TAS’s unique and extensive experience with identity theft cases.

⁴⁴ See Ancestry.com, *Why Was the Social Security Death Index Recently Changed?* http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1 (last visited Dec. 19, 2011).

⁴⁵ See About.com, *Genealogy Sites Pressured Into Removing SSDI*, <http://genealogy.about.com/b/2011/12/16/genealogy-sites-pressured-into-removing-ssdi.htm> (last visited Dec. 19, 2011); Ancestry.com, *Why Was the Social Security Death Index Recently Changed?* http://ancestry.custhelp.com/cgi-bin/ancestry.cfg/php/enduser/sab_answer.php?p_faqid=5420&p_created=1323809913&p_sid=utw11BLk&p_accessibility=&p_redirect=&p_lva=&p_sp=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfcGFnZT0x&p_li=&p_topview=1 (last visited Dec. 19, 2011); Scripps Howard News Service, *Genealogy Sites Remove Social Security Numbers of Deceased* (Dec. 15, 2011), available at <http://www.abcactionnews.com/dpp/news/national/genealogy-sites-remove-social-security-numbers-of-deceased>.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Implement Service Level Agreements between the Identity Protection Specialized Unit and the various functions that process case referrals and Identity Theft Assistance Requests.
2. Establish timeliness measures for identity theft case actions.
3. Before implementing identity theft filters, develop an effective and expedited mitigation strategy to help legitimate taxpayers obtain their refunds on a timely basis.
4. Require any proposed modifications to its identity theft filters mitigation strategy be approved in advance by the Identity Theft Executive Steering Committee.
5. Create and implement a national communication strategy if the identity theft filters impact a significant number of legitimate taxpayers or cause excessive processing delays.
6. In conjunction with the Social Security Administration, seek a modification of the consent judgment requiring the SSA to release the SSNs of decedents, so that the SSA can begin to partially redact SSNs (*e.g.*, release only the last four digits).
7. If a civil freeze code is implemented for referrals from law enforcement agencies, require CI personnel to determine whether such a refund freeze is necessary before applying the civil freeze code.
8. Establish a point of contact in W&I so that Criminal Investigation or other IRS operations can supply lists of victims from their investigations of identity theft schemes and W&I can promptly mark the accounts accordingly.
9. Promptly notify all victims of identity theft of the misuse of their SSN and provide information about what steps the taxpayer may take to further protect himself or herself.
10. Allow taxpayers to turn off the ability to file electronically.

June 13, 2011

MEMORANDUM FOR RICHARD E. BYRD, JR., COMMISSIONER
WAGE AND INVESTMENT DIVISION

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: *Proposed Taxpayer Advocate Directive 2011-1 (Establish procedures for adjusting the taxpayer's account in instances where a tax return preparer altered the return without the taxpayer's knowledge or consent, and the preparer obtained a fraudulent refund).*

PROPOSED TAXPAYER ADVOCATE DIRECTIVE

I am issuing this proposed Taxpayer Advocate Directive (TAD) to direct the Commissioner, Wage and Investment Division to:

- 1) within ten days of the date of this proposed TAD, cease any collection actions on liabilities assessed against taxpayers in connection with a refund or portion of a refund that the taxpayer never received due to return preparer fraud;
- 2) within 45 days of the date of this proposed TAD, in consultation with the National Taxpayer Advocate, issue interim guidance to establish procedures to abate assessments and correct refund amounts where the IRS is holding a taxpayer liable for repayment of a refund or portion of a refund that the taxpayer never received due to return preparer fraud; and
- 3) within 90 days of the date of this proposed TAD, in consultation with the National Taxpayer Advocate, revise the Internal Revenue Manual (IRM) to provide guidance on abating assessments or correcting refund amounts where the IRS is holding a taxpayer liable for repayment of a refund or portion of a refund that the taxpayer never received due to return preparer fraud.

Please provide a written response to this proposed TAD on or before June 23, 2011.

I. Authority

This directive is being issued pursuant to Delegation Order No. 13-3, which grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers.¹ This authority may not be redelegated.

¹ Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives*, (July 16, 2009).

In June 2009, Systemic Advocacy Analysts convened a cross-functional team to develop procedures to handle cases where a return preparer defrauded the taxpayer. Since that time, TAS has been working unsuccessfully with the other IRS functions to establish procedures to protect the government's and taxpayers' interests in cases of preparer fraud. On March 23, 2011, Director Jane E. Looney, Accounts Management (AM), informed TAS that AM will not take any action on these accounts, because "investigating preparer fraud and determining if the taxpayer benefitted from the alleged fraud is outside the scope of AM."² She did not suggest who within the IRS does have the jurisdiction to implement procedures. Pursuant to IRM 13.2.1.6.1.2, a proposed TAD is an appropriate response to the IRS's failure to implement procedures that would protect the rights of taxpayers and prevent undue burden.

II. Background

TAS has at least 82 cases where preparers have defrauded the government and harmed taxpayers by filing fraudulent returns to obtain larger refunds than taxpayers expect and are entitled to. These preparers altered taxpayers' tax returns without their knowledge or consent by inflating income, deductions, credits, or withholding. The taxpayers generally received refunds from the preparers in the amount the preparer advised each taxpayer that he or she should receive; each taxpayer became aware of the preparer's fraudulent activity upon hearing from the IRS when it assessed or attempted to collect the erroneous excess refund amount. Here is a basic example to illustrate the actions of the preparer.

Taxpayer A provides her tax return preparer with her W-2 and relevant information. The preparer completes Form 1040, reflecting a zero tax liability, and indicating Taxpayer A is eligible for a \$350 refund. After providing Taxpayer A with a printed copy of that return, the preparer electronically files a different return with the IRS.

Taxpayer A is not aware that the preparer altered the return before he electronically filed it by inflating income and the credit for income tax withholding; the preparer reported a tax liability of \$500 and withholding of \$3850, thereby increasing the refund to \$3,350. Unbeknownst to Taxpayer A, the return preparer designated two bank accounts into which the \$3,350.00 refund is split: \$350.00 is direct-deposited into Taxpayer A's account and the balance of \$3,000.00 is direct-deposited into the preparer's own account. Thus, Taxpayer A has received the refund to which she thought she was entitled, based on the copy of the return she approved and the preparer provided to her.

The IRS selects Taxpayer A's return for examination the following year. The IRS disallows Taxpayer A's excess withholding and proposes a deficiency of \$3,000.00 (plus penalty and interest).

² Jane E. Looney, Memorandum re: *Taxpayer Assistance Order ****** (Mar. 23, 2011) (taxpayer name redacted).

In cases where a tax liability in excess of the taxpayer's true liability is assessed as a result of the preparer's actions, the IRS has refused to abate the excess tax as required by law and per advice from the Office of Chief Counsel, discussed below. In addition, even if the preparer's actions resulted in a larger refund than what the taxpayer was entitled to receive but did not result in an additional tax assessment, the IRS has refused to adjust the taxpayers' accounts for the erroneous balances due from the fraudulent portions of the refunds. Instead, the IRS holds taxpayers liable for any understatement of tax, penalties, and interest, as well as the amount of the refund that the IRS issued to the preparer. The IRS's failure to provide guidance to its employees about the proper handling of this type of case is evident by the following response received from Accounts Management in response to an Operations Assistance Request issued by TAS:

The refund was traced and the financial institution indicates that the refund was deposited as requested and the funds are not available - per IRM 21-4.1.3.4 NOTE: If the taxpayer alleges preparer fraud as the reason for non-receipt of the refund, advise the taxpayer that while the IRS will conduct a trace to determine the deposition of the refund, the restoration of the refund to the taxpayer may become a civil matter.³

In that particular TAS case, the actions of the preparer resulted in the IRS offsetting the taxpayer's refunds in the following two tax years. Instead of offsetting the taxpayer's refunds, however, the IRS should have instituted procedures to adjust the taxpayer's account and not hold the taxpayer liable for the portion of the refund that the preparer received.

III. Reasons for Issuing this Proposed TAD

The IRS has failed to develop procedures that are consistent with the Internal Revenue Code and legal advice provided by the IRS Office of Chief Counsel. In this regard, Counsel has issued two memorandums (copies attached) that directly relate to this issue. The memorandum regarding *Horse's Tax Service* (Attachment 1) addresses whether an electronically filed tax return that was altered without the taxpayer's knowledge is a valid return.⁴ Counsel analyzed the four-part test set forth in *Beard v. Commissioner*,⁵ and concluded that when the taxpayer is unaware of the alterations to the return and the version that the taxpayer reviewed is not what the preparer filed with the IRS, the taxpayer did not sign that return under penalties of perjury. Consequently, the return filed by the preparer is a nullity and any assessment on the IRS's books and records relating to that return is invalid. Counsel further advised that the taxpayer should file an *original* return (not an amended return) so that the IRS can then adjust the taxpayer's Master File account to reflect the correct tax information. Thus, in situations where the taxpayer can prove that the version of

³ TAS, TAMIS Case File No. 4903292. IRS, OAR 1543701 Response (Jan. 28, 2011).

⁴ IRS Office of Chief Counsel, PMTA 2011-013 (May 12, 2003). The name of the preparer was changed to remove the identity of the preparer due to confidentiality concerns.

⁵ *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). The test for a valid return is: (1) there must be sufficient data to calculate tax liability; (2) the document must purport to be a return; (3) there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) the taxpayer must execute the return under penalties of perjury.

the tax return that he or she reviewed is not the version the preparer filed with the IRS, the IRS should reverse the accounting entries on the taxpayer's module.

Even in situations where the taxpayer cannot produce a copy of a return from the preparer that is different than what the preparer filed with the IRS, Counsel has nonetheless advised that certain adjustments to the taxpayer's account are appropriate so that the taxpayer is not held liable for a refund (or portion thereof) fraudulently obtained by the preparer. In this regard, the memorandum entitled *Refunds Improperly Directed to a Preparer* (Attachment 2) specifically discusses the ability of the IRS to abate any improper amount of tax and withholding based on Internal Revenue Code (IRC) § 6404(a).⁶ The memorandum specifically states:

The portion of each refund that reflected the difference between the refund amount the client thought was being obtained and the amount that the Preparer included on the electronically filed return... deposited to the Preparer's account) should be attributed to the Preparer, and not to the client.

While abatement may not be appropriate in every case (*e.g.*, the preparer's actions resulted in a larger refund but did not result in an additional tax assessment, so there would be no tax to abate), the memorandum makes clear that the IRS "can and should adjust" each affected taxpayer's account for any refund (or portion thereof) illegally obtained by the preparer.

Moreover, part of the Wage and Investment Division's mission is "to protect the public interest by applying the tax law with integrity and fairness to all."⁷ Requiring a taxpayer to repay a refund that he or she did not receive or have knowledge of is inequitable and unjust. The preparers defrauded the taxpayers by filing altered returns to illegally obtain refunds from the IRS. The IRS should take all available actions to protect taxpayers, to abate any improper assessments, and to expunge the refunds or portion of refunds from the taxpayers' accounts that the preparers received. Otherwise, the IRS itself is victimizing the disreputable preparer's victims.

IV. Conclusion

In light of the significant harm taxpayers are suffering as a result of the IRS's inability to develop a process for providing relief to these taxpayers over the last two years, I direct the IRS to:

- Cease any collection actions on liabilities assessed against taxpayers in connection with a refund or portion of a refund that the taxpayer never received due to return preparer fraud within ten days of this directive;

⁶ IRS Office of Chief Counsel, POSTN-145098-08 (Dec. 17, 2008).

⁷ See http://win.web.irs.gov/aboutus/aboutus_goals.htm#Mission (last viewed May 5, 2011).

- Issue an interim guidance memorandum (IGM), developed in consultation with the National Taxpayer Advocate, within 45 days of this directive; and
- Revise the IRM within 90 days of this directive to instruct IRS employees how to correct the taxpayers' accounts to reflect the removal of the inflated refund received by the return preparer.

I issued the attached interim guidance memorandum that the IRS can use as a model to identify accounts with preparer refund fraud issues and the documentation needed to ensure that taxpayers are only held liable for the actions of their preparer in appropriate circumstances.

Attachments:

- (1) Office of Chief Counsel, PMTA 2011-13, *Horse's Tax Service* (May 12, 2003).
- (2) Office of Chief Counsel, POSTN-145098-08, *Refunds Improperly Directed to a Preparer* (Dec. 17, 2008).
- (3) National Taxpayer Advocate, *Interim Guidance on Recognizing and Assisting Victims of Refund Preparer Theft*, TAS-13.1.10-0311-004 (Mar. 14, 2011).

cc w/attachments: Steve Miller, Deputy Commissioner, Services and Enforcement

MSP
#4**Expansion of Math Error Authority and Lack of Notice Clarity Create Unnecessary Burden and Jeopardize Taxpayer Rights****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
 Faris Fink, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Under Internal Revenue Code (IRC) §§ 6213(b) and (g), the IRS is authorized, in specific instances, to use its math error authority to summarily assess tax without first providing the taxpayer with access to the pre-payment forum of the U.S. Tax Court. Both the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) have recently urged the IRS to increase its use of this authority, stating that it is a cost-effective way to process new items on tax returns, such as the First-Time Homebuyer Credit (FTHBC).¹ The primary driver behind this call for expansion of IRS math error authority is the desire to protect revenue by preventing the payment of tax refunds where a credit, such as the FTHBC, is claimed improperly. In response to TIGTA and GAO's recommendations, the IRS is considering expanding the use of math error authority to other refundable credits (including the small business health care tax credit and the adoption credit).² As these types of refundable tax credits continue to grow, the IRS is more likely to seek expanded math error authority because the dollar amounts at stake become increasingly attractive for both one-time fraud cases and larger schemes.³ However, failure to narrowly craft and implement math error provisions will harm taxpayers who are trying to comply with their tax obligations.⁴

Math error authority can be an effective processing tool when used appropriately in limited circumstances. The early legislative history of math error authority clearly shows that the deviation from deficiency procedures was intended to be limited in scope.⁵ The IRS was to use math error authority only when errors were apparent on the face of the return or from information provided on the return.⁶ Its recent expansion to more complicated and facts-and-circumstances-based provisions comes with a high cost for taxpayers, such as a risk

¹ TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011); GAO, GAO 10-349, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed* (Feb. 2010).

² IRC §§ 45R and 36C, and IRS Briefing, *Overview of the Accelerated Refund Assurance Program (ARAP)* (Oct. 6, 2011). This briefing sets out areas where the IRS is considering requesting congressional expansion of its math error authority.

³ See also TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 28, 2011).

⁴ For an in-depth discussion of tax expenditures and the challenges to running social benefits through the Code, see National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Programs Through the Tax System*) and National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101 (*Evaluating the Administration of Tax Expenditures*).

⁵ General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess., 372-74 (1976); 1976-3 (Vol. 2) C.B. 1, 384-86.

⁶ H.R. Rep. 94-658, at 183 (Nov. 12, 1979), which defined mathematical or clerical errors as, "Arithmetic" errors, including "errors in addition, subtraction, etc." where "such an error will be apparent and the correct answer will be obvious."

of losing their right to dispute the assessment in Tax Court (the only pre-payment forum available). Inappropriate expansion of math error authority into more complex or fact-intensive areas undermines IRS efficiency by increasing the risk of inaccurate assessments and creating more work downstream for the IRS.

The National Taxpayer Advocate has previously identified problems with the IRS's administration of the math error program and the significant burden it places on millions of taxpayers each year.⁷ Taxpayer protections are eroded by unclear notices, post-processed math error assessments, and reliance on inaccurate third-party data systems. In particular, problems with the IRS use of math error authority include the following:

- Math error notices are still not clearly written despite the IRS's efforts to revise them, making it difficult for taxpayers to determine what specifically has been corrected on their returns and decide if they should accept the adjustment or request an abatement.⁸
- The IRS does not process taxpayer responses to math error notices timely.⁹ This failure not only delays the math error process but may also delay taxpayers' refunds, which in turn will cause more calls and letters to the IRS, and even Taxpayer Advocate Service cases.
- The IRS often does not work taxpayer responses to math error adjustments accurately. A TIGTA review found that 43 out of the 260 responses it reviewed were not worked accurately,¹⁰ which may be the result of using math error authority in situations where a facts-and-circumstances analysis is more appropriate.
- The IRS can resolve some math error discrepancies through internal research, relieving some of the burden on taxpayers. In fact, as discussed in Volume 2 of this report, *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*, a TAS research study found that missing or incorrect Taxpayer Identification Numbers (TINs) on a return could be reconciled through prior return

⁷ National Taxpayer Advocate 2006 Annual Report to Congress 311; National Taxpayer Advocate 2003 Annual Report to Congress 113; National Taxpayer Advocate 2002 Annual Report to Congress 25, 186; National Taxpayer Advocate 2001 Annual Report to Congress 33. See also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Hearing on Complexity and the Tax Gap, Making Tax Compliance Easier and Collecting What's Due Before the Committee on Finance*, 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

⁸ TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010). Three different technical analysts reviewed more than 500 paragraphs of text explaining problems with the return, IRS changes, and actions required by taxpayers to resolve the problem, and found more than 40 inadequate explanations of IRS changes to the return. Explanations were considered unclear if two of the three analysts found the passages confusing, inaccurate, incomplete, or expansive. This is a conservative estimate since the analysts who conducted the review have extensive experience with IRS documents and likely understood more than the average taxpayer would. The group also reviewed 300 paragraphs for taxpayer notices relating to business returns and did not find any verbiage that multiple analysts thought was inadequate.

⁹ TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011). This TIGTA review showed an estimated 12,232 out of 130,616 responses may not have been resolved timely during the specified period (January 1 to July 23, 2010).

¹⁰ *Id.* The errors found in the 260 responses reviewed resulted in the IRS paying \$7,988 in erroneous refunds and incorrectly denying \$5,894 in benefits to taxpayers.

information 56 percent of the time.¹¹ However, IRS procedures do not permit employees to conduct this kind of research, which would enable them to easily resolve routine matters, such as incorrect entries of dependent TINs on returns.¹² Conducting this type of preliminary research may prevent rework later on. For example, when the IRS used math error authority to disallow exemptions for dependent children on approximately 330,000 returns for tax year (TY) 2006, the IRS was obliged to fully reverse its adjustments about 50 percent of the time.¹³

- Math error authority includes adjustments to returns “post-processing,” which means a taxpayer who thought his or her return had been accepted as filed may be notified months or even years later that the IRS has assessed additional tax due to a math error. This approach confuses taxpayers and does not protect revenue, since refunds are already processed and paid based on the original return. It also confuses the IRS, which can fail to provide or follow certain statutorily mandated rights or procedures.¹⁴

ANALYSIS OF PROBLEM

Background

What the Use of Math Error Authority Means for Taxpayers

Math error authority enables the IRS to increase its tax return processing capacity by quickly resolving simple mathematical or clerical mistakes and summarily assessing the adjusted tax. If given authority under IRC § 6213(b) or (g), the IRS can make an assessment without filing a statutory notice of deficiency (SNOD).¹⁵ Once the IRS notifies taxpayers of math errors, they have 60 days to request abatement of the additional tax. If the taxpayer makes a timely request, the IRS will abate the assessment and follow formal deficiency procedures to reassess the tax (*i.e.*, send the taxpayer a SNOD).¹⁶ However, if the taxpayer fails to

¹¹ See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS analysis of data collected (manually using a data collection instrument) in October 2011. The sample of records was selected using IRS Compliance Data Warehouse (CDW) Individual Returns Transaction File (IRTF) and Individual Master File (IMF) TY 2009 data. TAS analyzed data collected from a statistically valid sample of 500 accounts with math error codes 604, 605, or 743. The review showed the IRS abated its math error assessment and had internal data available to resolve 56 percent of code 605 and 743 (incorrect dependent TIN) accounts.

¹² See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). IRS, IMF Math Error Report (Dec. 24, 2010). In 2010, the IRS issued 10,569,945 IMF math error notices for tax year 2009 returns (and an additional 1,288,746 for prior year returns). In 2010, there were 228,383 notice code 605 (dependent TIN mismatches) reported for TY 2009 (56,014 on prior year returns) and in 2009, 233,558 for TY 2008 (53,712 math errors issued on prior year returns).

¹³ TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). The analysis found a full abatement or reversal rate of 49.4 percent for the math error notice 605, for invalid dependent TIN, on adjustments to TY 2006 accounts; this is an indicator that the tax was correctly computed by half of this population. There were 162,013 full reversals of the 327,787 returns with notice 605.

¹⁴ See IRS Servicewide Electronic Research Program (SERP) Alert 110514 (July 27, 2011) (announcing the IRS was reversing FTHBC credits based on third-party information showing taxpayers had an ineligible purchase date). During the week of July 27, 2011, the IRS inappropriately issued 36,000 letters disallowing the FTHBC, and without providing an explanation of the taxpayers' statutory right to contest the math error adjustment within 60 days. See also SERP Alert 100512 (Oct. 6, 2010) (directing the reversal of the FTHBC using math error procedures if the taxpayer did not respond with documentation showing a qualifying purchase date).

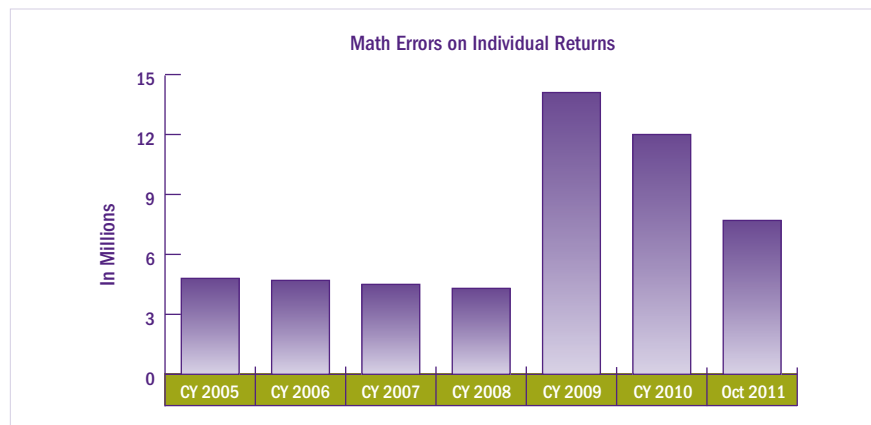
¹⁵ IRC § 6213(b)(2)(A).

¹⁶ *Id.* The ability of a taxpayer to protest a math error assessment, even without substantiating explanation, is addressed in Internal Revenue Manual (IRM) 21.5.4.4.4 (Oct. 1, 2010) and IRM 21.5.4.4.5 (Sept. 9, 2010).

request abatement timely, the IRS may collect the additional tax.¹⁷ At this point, the assessment cannot be appealed in the U.S. Tax Court. This is significant, because the Tax Court is the only pre-payment judicial forum (*i.e.*, the taxpayer does not have to pay the liability to contest the assessment in Tax Court, unlike in Federal District Court or the Court of Federal Claims where the taxpayer has to pay the tax and then file for a refund claim).¹⁸

In 2010, the IRS sent 10.6 million math errors, compared to only four million in 2005.¹⁹

FIGURE 1.4.1, Math Errors on Individual Tax Returns, Calendar Years through 2010²⁰



As illustrated in this chart, the use of math error authority has increased significantly since 2008, as Congress created refundable credits and granted the IRS math error authority to disallow them in an effort to prevent inappropriate payments. Considering the current budget strains on the IRS, and the growing number of large refundable credits, the National Taxpayer Advocate fully expects the number of math error notices to rise even more over the next few years. In fact, the IRS is currently identifying new ways to use its existing authority and exploring areas where new authority could be useful.²¹

Legislative History

The legislative history shows that Congress, when passing this provision, weighed the benefits of allowing IRS to assess tax quickly in the case of a mathematical or clerical error against the costs to taxpayers of the IRS's summarily assessing tax (*i.e.*, not utilizing

¹⁷ IRC §§ 6213(g)(2)(A) through 6213(g)(2)(E).

¹⁸ IRC § 6511.

¹⁹ IRS Databook 2010, 38. There were 10,554,735 IMF math errors for TY 2009 returns (the IRS determined an additional 1,285,706 math errors on TY 2008 and prior year returns in CY 2010, excluding Forms 1040NR).

²⁰ IRS, IMF Math Error Reports (Dec. 2005 through Dec. 2010, and Nov 5, 2011). The totals include all individual tax return math errors in each calendar year. Original figures for 2008 were overstated because a counter was not reset at the end of 2007. For this chart, 2008 figures were revised by subtracting 2007 figures from the reported 2008 figures.

²¹ IRS Briefing, *Overview of the Accelerated Refund Assurance Program (ARAP)* (Oct. 6, 2011).

deficiency procedures). Considering these two objectives, Congress (1) mandated that IRS follow deficiency procedures when taxpayers timely contest math error adjustments and (2) made clear the kinds of cases in which the IRS could use its limited summary assessment authority.²² Congress was very specific about the protections given the taxpayer:

The amendment provides that where the Internal Revenue Service uses the summary assessment procedure for mathematical errors ... the taxpayer must be given an explanation of the asserted error... , the taxpayer must be given a period of time during which he or she may require the Service to abate its assessment ... , and the Service is not to proceed to collect on the assessment until the taxpayer has agreed to the assessment or has allowed his or her time for objecting to expire... .²³

Congress went on to describe what it considered a mathematical error or inconsistent treatment on a return by a taxpayer. “Arithmetic” errors include “errors in addition, subtraction, etc.” where “such an error will be apparent and the correct answer will be obvious.”²⁴ Additionally, Congress stated that the inconsistent entries category was intended to “encompass those cases where it is apparent which of the inconsistent entries is correct and which is incorrect.”²⁵ Congress also made it clear that the IRS is not to use summary assessment procedures merely to resolve an uncertainty against the taxpayer.²⁶

The current use of math error notices falls well outside these initial parameters, including situations requiring analyses of facts-and-circumstances.

Expansion of Math Error Authority Far Exceeds Congress’s Original Purpose and Relies Too Heavily on IRS Discretion.

As the IRS has begun administering larger and more complex refundable credits such as the Earned Income Tax Credit (EITC), and the FTHBC, Congress has gradually expanded math error authority.²⁷ It now covers 16 categories of mistakes or omissions.²⁸

The most recent example of the types of problems that can occur when math error authority expands beyond its original intention comes from the FTHBC. The credit permitted taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009, to claim a credit equal to ten percent of the purchase price (up to \$7,500).²⁹ The credit operated as an interest-free loan to be paid back over a 15-year period beginning two years after

²² General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess., 372-74 (1976); 1976-3 (Vol. 2) C.B. 1, 384-86.

²³ S. Rep. No. 938, 94th Cong., 2d Sess. 375 (1976); 1976-3 (Vol. 3) C.B. 49, 413.

²⁴ H.R. Rep. 94-658, at 183 (Nov. 12, 1979).

²⁵ *Id.*

²⁶ *Id.*

²⁷ Besides the five “mathematical or clerical” error types listed in IRC § 6213 (g)(2)(A) through (E), math error authority also includes mistakes such as missing TINs for dependency exemptions or EITC, and missing verification of the FTHBC, in IRC § 6213(g)(2)(F) through (P). IRC §§ 6213(g)(2)(F) and (H) through (P).

²⁸ IRC § 6213(g)(2).

²⁹ The credit was established in the Housing and Economic Recovery Act of 2008 (HERA), Pub. L. No. 110-289.

the credit was claimed.³⁰ During its first implementation period, taxpayers made numerous errors when claiming the credit, and its design exposed the IRS to improper claims from taxpayers trying to take advantage of the system. In 2009, Congress extended and expanded the credit, added documentation requirements, and amended IRC § 6213(g) to include math error authority for the FTHBC.³¹

The math error authority provided in IRC § 6213(g)(2)(O) and(P) applies where the taxpayer 1) omitted the increase in tax required by the recapture provisions included in IRC 36(f); 2) was not 18 years old at the time the home was purchased; 3) provided information on a prior return inconsistent with eligibility for the FTHBC; or 4) failed to attach to the return a copy of the settlement statement.³² This last provision placed the IRS in the position of making a facts-and-circumstance determination about whether an attached settlement statement was properly executed. While it would seem to be a relatively simple determination, expanding math error authority to include review of the documentation for the FTHBC has caused problems for both the IRS and taxpayers.

Example: Initially, the IRS determined that a properly executed settlement statement would need to show all parties' names and signatures, the property address, sales price, and date of purchase. Normally, this is the properly executed Form HUD-1, *Settlement Statement*.³³ If this information was not included, the IRS considered the statement to be not properly executed, and disallowed the FTHBC using math error authority. This approach caused problems for many taxpayers because states have many different types of settlement statements and do not require the IRS-mandated information for the statements to be valid under state law. The IRS later found that not all states require complete addresses, and reversed this decision.³⁴ Now, for the settlement statement to be considered valid, it is not necessary for it (*i.e.*, HUD-1 Settlement Statement) to contain the buyer's and seller's signatures.³⁵

Example: In Alaska, people often buy land with cash and build homes, which means there is no financing involved and no settlement statement. This type of case would fall under IRS math error authority, even though a taxpayer may have validly claimed the credit and could document the purchase and construction, but not in the

³⁰ Pub. L. No. 110-289. Congress revised the credit in the American Recovery and Reinvestment Act of 2009. This revision extended the FTHBC to purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum amount to \$8,000; and eliminated the repayment requirements as long as the taxpayer retains the residence for at least 36 months. Taxpayers qualifying for the revised credit may claim the \$8,000 on tax year 2008 or 2009 individual returns. Pub. L. No. 111-5, 123 Stat. 115 (2009).

³¹ The credit was revised again in the Worker, Homeownership, and Business Assistance Act of 2009. Pub. L. No. 111-92, 123 Stat. 2984 (2009).

³² IRC § 36(d)(4) requires the taxpayer to attach to his or her return a properly executed copy of the settlement statement.

³³ IRS, News Release, New Homebuyer Credit Form Released; Taxpayers Reminded to Attach Settlement Statements and Other Key Documents (Jan. 15, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=218336,00.html> (last visited Nov. 2, 2011).

³⁴ IRS, IR-2010-006, <http://www.irs.gov/newsroom/article/0,,id=218336,00.html> (last visited Oct. 14, 2011). See also IRS SERP Alert 100290 (May 25, 2010).

³⁵ IRM 21.6.3.4.2.11.6 (6) (SERP update Apr. 18, 2011). See also IRS SERP Alert 100066 (Feb. 12, 2010). Mobile home purchasers may submit an executed retail sales contract including the names, address, purchase date and purchase price and signatures of both taxpayers if applicable. If the home was newly constructed, a copy of the occupancy permit is sufficient.

IRS-required form, and certainly not in a form that would easily be attached to an income tax return (*e.g.*, including copies of all receipts for lumber, plumbing, etc.).

These instances show that what at first may appear to be a clear-cut matter (*i.e.*, is documentation attached?) in fact has many variations. In these examples, the IRS is using math error authority to determine the *sufficiency* of documentation, in violation of Congress's original mandate that the IRS not use math error authority to resolve an uncertainty against the taxpayer.

Math Error Provisions Should Be Narrowly Tailored.

The National Taxpayer Advocate understands that a credit such as the FTHBC has substantial amounts of money at stake, making it attractive to individuals who want to abuse the system and get a quick, large refund for which they are not eligible.³⁶ The IRS uses math error authority as a low-cost way to protect revenue by preventing these returns from being processed and the refunds from going out. However, as noted above, failure to narrowly craft and implement math error provisions will harm taxpayers who are trying to comply with their tax obligations.³⁷

Further, the continued expansion of math error authority into FTHBC-type facts-and-circumstances determinations could prevent eligible taxpayers from receiving a credit, undermine the policies for which the tax benefit was enacted, and cause a taxpayer to lose his or her right to dispute the IRS's determination in Tax Court.³⁸ In an effort to prevent these types of problems, where the IRS is seeking or Congress has enacted additional math error authority, the IRS should, as the GAO has recommended, develop a report to Congress in conjunction with the National Taxpayer Advocate on how math error authority expansion would meet the standards and criteria set forth by Congress and how it might impact taxpayer protections.³⁹ The National Taxpayer Advocate believes this report should be submitted to Congress at least six months before implementation of the proposed math error authority.⁴⁰

³⁶ IRC § 36. See also TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 28, 2011).

³⁷ For an in-depth discussion of tax expenditures and the challenges of running social benefits through the Code, see National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 75 (*Running Social Programs Through the Tax System*) and National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 101 (*Evaluating the Administration of Tax Expenditures*).

³⁸ See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

³⁹ GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011). The National Taxpayer Advocate believes this report would be most effective if it was sent to Congress several months before implementation. If the provision has immediate effect, then the report should be submitted before the second filing season.

⁴⁰ See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

Current Problems with the Administration of Math Error Authority

Math Error Notices Are Still Confusing.

The lack of clarity in math error notices makes it difficult for taxpayers to decide if they should accept the adjustment or request reversal.⁴¹ For example, the IRS issued nearly 100,000 more self-employment tax math error notices in the first six months of calendar year (CY) 2011 than in CY 2010, but did so for reasons that the notice did not explain.⁴² In many cases, the IRS mistakenly recomputed the tax without explanation, leaving taxpayers and preparers guessing why the IRS assessed additional tax.⁴³ Providing taxpayers with a clear explanation of why they are receiving the notice and what mathematical or clerical error has been identified helps make the process understandable so taxpayers can address the notice accordingly. The following example, taken from legislative history, demonstrates that in exchange for granting the IRS expanded math error authority, Congress expected the IRS to provide taxpayers with clear notice of the changes made to the return:

Example: A notice regarding an inconsistency in the number of dependents listed on the taxpayer's return might read as follows: "You entered six dependents on line x but listed a total of seven dependents on line y. We are using six. If there is one more, please provide corrected information."⁴⁴

If notices are not simple and clear taxpayers cannot understand the rationale for the change to their returns, they may fail to request abatement within the 60-day period, thereby forfeiting their opportunity to contest the assessment in Tax Court and instead face IRS collection action.

The IRS has improved some math error notices, but others are still inadequate. TAS reviewed the verbiage included in more than 500 types of notices sent to taxpayers for problems with individual tax returns and found more than 40 inadequate explanations of IRS changes to the returns.⁴⁵ A common explanation given to taxpayers is that IRS adjusted the income reported on the return, without describing the item of income adjusted.

⁴¹ A TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010) identified over 40 math error notice types for individual tax returns that lacked clarity or failed to explain taxpayer rights. Taxpayer Notice Codes (TPNC) may sometimes be referred to herein as math error notice types, identified by the notice number.

⁴² IRS, IMF Math Error Reports 480-62-11 (July 2, 2011) and (July 3, 2010). By mid-2011 the IRS had issued 142,524 math error notices 268, increased from 43,841 at mid-2010.

⁴³ See Systemic Advocacy Management System (SAMS) Issues 20620 and 20973; IRS SERP Alert 110434 (June 10, 2011) (acknowledging the processing errors).

⁴⁴ H.R. Rep. No. 94-658, 94th Cong., 2nd Sess. (1976).

⁴⁵ TAS study of math error notices conducted by Field Systemic Advocacy, Technical Analysis and Guidance, and Systemic Advocacy Systems (May 22, 2010). Three different technical analysts reviewed more than 500 paragraphs of text explaining problems with the return, IRS changes, and actions required by taxpayers to resolve the problem on the individual tax return. Explanations were considered unclear if two of the three analysts found the passages confusing, inaccurate, incomplete, or expansive. This is a conservative estimate since the analysts who conducted the review have extensive experience with IRS documents and likely understood the notice more readily than an average taxpayer would. The group also reviewed 300 paragraphs for taxpayer notices relating to business returns and did not find any verbiage that multiple analysts thought was inadequate.

Easy-to-understand math error notices are essential, because taxpayers need to know what was changed so they can decide whether they agree, and, if not, what steps they should take.⁴⁶

The IRS Does Not Process Taxpayer Responses to Math Error Notices Timely or Accurately.

Not only are some math error notices unclear and fail to explain why the taxpayer is receiving the notice and what to do next, but when taxpayers do understand the notices and respond, the IRS may not handle their responses timely or correctly. A TIGTA review of IRS processing such responses between January 1 and July 23, 2010, found that 40 percent (104 of 260) of the responses were not worked timely.⁴⁷ Based on this review, about 12,000 of 131,000 responses may not have been resolved timely during the specified period (January 1 to July 23, 2010).⁴⁸ These delays could result in taxpayers not receiving benefits timely. An untimely response rate will only increase the number of taxpayer calls to the IRS and potentially add to TAS's case inventory.

Additionally, in the same review TIGTA found that 43 of the 260 responses were not worked accurately. These errors resulted in the IRS paying about \$8,000 in erroneous refunds and incorrectly denying \$6,000 in benefits to taxpayers.⁴⁹ TIGTA estimated about 18,000 of 131,000 taxpayers may not have had their responses accurately resolved during this period. TIGTA further estimated that inaccuracies in resolving responses to math error notices could cost the federal government approximately \$39.5 million in lost revenue and cost taxpayers about \$29.2 million over the next five years. One possible explanation of this inaccuracy rate is the use of math error authority in more complex situations, such as the FTHBC examples illustrated above.

Math Error Authority May Not Always Be the Best Way to Resolve Cases.

Third-Party Databases Are Not Always Reliable.

Over the years, Congress has expanded math error authority to apply where comparison of tax return entries to information in non-IRS governmental databases indicates an error on the return. An appropriate example of this expanded authority is the use of the Social Security Administration's (SSA) NUMIDENT database.⁵⁰ Use of external data, a traditional audit indicator, is not justified for *summary* denial where the underlying database is inaccurate or incomplete or when reconciling the discrepancy involves the use of judgment or involves complex or evolving fact situations. For this reason, the National Taxpayer

⁴⁶ S. Rep. No. 938, 94th Cong., 2d Sess. 375 (1976); 1976-3 (Vol. 3) C.B. 49, 413.

⁴⁷ TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011).

⁴⁸ *Id.* TIGTA estimated 12,232 of 130,616 responses may not have been timely resolved.

⁴⁹ *Id.* TIGTA estimated the IRS may not have accurately resolved 17,627 of 130,616 taxpayers' responses. TIGTA found IRS incorrectly denied \$5,894 in benefits and improperly paid \$7,988 to taxpayers.

⁵⁰ See IRM 2.3.32.8 (July 1, 2008); IRM 2.3.32.17 (Jan. 1, 2005). NUMIDENT information is a complete history of changes, such as name changes, as reported to SSA by the user of the SSA account number.

Advocate previously recommended repealing the use of the Federal Case Registry of Child Support Orders (FCR) under math error authority for summary assessment because this database does not accurately verify a child's residence.⁵¹ This reasoning would apply equally to proposals to use certain state databases to determine eligibility, especially with respect to an individual's status as a qualifying child for EITC purposes, which is a complicated determination that requires an evaluation of facts-and-circumstances. Even if virtually all of the entries in a directory are accurate when entered, they were compiled for a different purpose, do not disprove eligibility under the tax law, were compiled at a prior date and may not be current, and should not deprive a taxpayer of a due process right to present his or her own facts. These databases would be used best as an indicator that the IRS should look more closely at the return in an examination — not math error — context.

The IRS's Own Internal Records May Be More Useful for Checking Taxpayers' Returns.

As mentioned above, the audit findings of GAO and TIGTA have called for increasing, not limiting, the use of math error authority.⁵² But as discussed, this expansion may come at a high price, entailing increased complexity, confusion, inaccuracy, and burden. This is why it is imperative that the IRS move carefully when considering math error expansion.

Last year, the IRS addressed return processing errors, most of which are due to taxpayer mistakes in paper return preparation, by sending out 10.6 million math error notices.⁵³ However, by using its own internal records to glean specific information, such as TINs for dependents used on prior tax returns and Social Security numbers (SSNs) provided to the IRS by SSA,⁵⁴ and to analyze discrepancies between the taxpayer's return and third-party information, the IRS would reduce taxpayer burden, and potential IRS rework (*i.e.*, if the third-party information turns out to be inaccurate and the taxpayer disputes the summary assessment).

This internal research may be highly effective in preventing unnecessary math error adjustments and notices. For example, the IRS reversed about 50 percent of the math error disallowances of personal exemptions for dependent children in tax year 2006. TAS analyzed tax account data for 341,000 math errors issued in TY 2009 disallowing dependency exemptions and tax credits tied to dependents and found the IRS later reversed

⁵¹ See National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*). Congress mandated that the IRS complete a study in conjunction with the National Taxpayer Advocate before implementing the use of the FCR; the study demonstrated that the FCR was unreliable and the IRS did not implement that math error authority. See IRS, Federal Case Registry Final Report, Project 5-02-12-3-005 (CR-39) (Sept. 2003). See also *Hearing on Improper Payments in the Administration of Refundable Tax Credits Before the Subcommittee on Oversight, Committee on Ways and Means* 26, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

⁵² The IRS has established a task force to identify areas where the IRS could expand its use of math error authority. In this report, the National Taxpayer Advocate has made a legislative recommendation as to what type of expansions Congress should consider. See Legislative Recommendation: *Mandate That the IRS, In Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

⁵³ IRS, *IMF Math Error Report* (Dec. 24, 2010). The IRS issued 10,569,945 Individual Master File math error notices for TY 2009 returns.

⁵⁴ See IRM 2.3.1 (Jan. 1, 2008) for Integrated Data Retrieval System (IDRS) command code RTVUE.

184,000 — or about 55 percent — of the disallowances.⁵⁵ Further, a recent TAS study of a statistically valid sample of the same 184,000 reversals showed the IRS had internal data to immediately resolve 56 percent of those reversals, rather than deny the taxpayers their dependency exemptions and related tax credits and their tax refunds.

FIGURE 1.4.2, TY 2009 Data Shows Opportunity for IRS to Resolve Incorrect Dependent TINs and Avoid Math Error Adjustments⁵⁶

Sample Results Using Internal IRS Data	Incorrect Dependent TINs, with credits other than EITC	Incorrect Dependent TINs with EITC	Total Incorrect Dependent TINs
Resolved All TINs Completely	51%	50%	50%
Resolved Some TINs	6%	5%	6%
Total Completely and Partially Resolved	57%	55%	56%

This high abatement rate indicates that additional screening and internal research should be required before imposing on taxpayers the burdens of replying to the math error notices and waiting an average of 13.4 weeks for their refunds.⁵⁷

The IRS should examine its math error abatement rates after each filing season to identify high abatement areas and then adjust procedures accordingly, considering alternatives such as not using math error authority or developing a pre-screening system using internal IRS information.

At the same time that the IRS requests additional math error authority to summarily deny tax benefits based on third-party information, it neglects to use readily available third-party information to resolve routine discrepancies such as incorrect or missing dependent TINs. Researching the accuracy of the information on a taxpayer’s return through internal records may help the IRS ensure that its math error assessments are correct and not used indiscriminately.⁵⁸

⁵⁵ See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS Research (Sept. 2011). TAS analysis of TY 2006 and 2009 data from CDW IRTF and IMF (Dec. 2010). For tax year 2009 Notice Code 604 (missing TIN), 47 percent, or 36,000 of the notice assessments, were resolved fully or partially; for Notice Code 605 (incorrect TIN), 55 percent, or 114,000 were resolved fully or partially; and for Notice Code 743 (incorrect TIN for EITC), 61 percent, or 35,000 were resolved fully or partially. Although the IRS later reversed 47 percent of math errors with missing TIN data (Notice Code 604), these math errors are often associated with Individual Taxpayer Identification Number (ITIN) returns, and the IRS does not have the information needed to fill in missing TINs. Consequently, the analysis was narrowed to include only returns with math errors 605 or 743.

⁵⁶ See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents). TAS analysis of TY 2009 data from CDW IRTF and IMF (Oct. 2011). A sample of about 400 accounts in which the IRS abated its math error assessment showed that the IRS had internal data to resolve 56 percent of code 605 and 743 accounts. The column titled Incorrect Dependent TINs, with credits other than EITC reflects TPNC 605 accounts; the column titled Incorrect Dependent TINs with EITC reflects TPNC 743 accounts.

⁵⁷ TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). See also National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents).

⁵⁸ The principal math error notices for disallowed dependent exemptions are TPNC 605 and 743.

The Use of Math Error Authority Post-Processing Is Not a Revenue Protector.

The IRS, in October 2010, instructed employees to disallow the FTHBC on taxpayers' TY 2008 returns, even though the refunds had already been processed and paid based on the original returns, because the purchase date entered on Form 5405, *First-Time Homebuyer Credit and the Repayment of the Credit*, for the identified returns fell outside the time for which the credit was available, and therefore was inconsistent with another item on the return (*i.e.*, the claiming of the credit).⁵⁹ However, it is not clear that this issue falls within math error authority.

The IRS relies on IRC § 6213(g)(2)(C), which refers to “an entry on a return of an item which is inconsistent with another entry of the same or another item on such return.” The IRS views the inconsistency as arising between the Form 1040 and Form 5405 (*i.e.*, it is inconsistent for the taxpayer to enter a date of purchase prior to April 8, 2008 on Form 5405, which would be before the credit is available, and then claim the credit on Form 1040). In the view of the National Taxpayer Advocate, it is uncertain that this explanation falls within IRC § 6213(g)(2)(C). Although the taxpayer does put the date of purchase on the Form 5405, nowhere on the face of the Form 1040 or Form 5405 is the taxpayer required to state that he or she has acquired a home during the eligible time periods. Thus, there is no item on the return that can create an inconsistency. A better way to ensure that the inconsistency clearly falls within math error authority would be for the IRS to ask on Form 5405 “Did you purchase your home within the eligibility period from x date to y date? (answer checkbox yes or no). If no, you are not eligible. If yes, enter date of purchase.” This example, answering yes on the form, but then entering an ineligible date, is clearly an inconsistent entry and would fall within IRC § 6213(g)(2)(C). *It is essential that the IRS make it clear to the taxpayer what it considers inconsistent, so if there is an inconsistency, it will be more likely to be a genuine mathematical or clerical error.*

Notably, in this situation, the IRS made these adjustments to taxpayer's returns “post-processing.” Thus, a taxpayer may be notified months or even years later that the IRS is making an assessment under its math error authority.⁶⁰ The IRS also used math error authority post-processing to assess additional tax on taxpayers who did not pay the FTHBC recapture amount.⁶¹ Using math error authority in fact-specific situations may lead to improper assessments, such as in the following example:

Example: A taxpayer purchases a principal residence in May of 2008 and receives a \$7,500 FTHBC for tax year 2008, which generally will be repaid by imposing a \$500 increase in his tax liability for 15 taxable years beginning in 2010. In 2010, the taxpayer

⁵⁹ IRS SERP Alert 100512 (Oct. 6, 2010). After initially accepting the returns as filed the prior year, the IRS made math error post-processing adjustments determining that the date of purchase of the house listed on the Form 5405 was incorrect (*i.e.*, the date of purchase was before April 8, 2008).

⁶⁰ See *id.* This alert instructed IRS employees to use math error procedures when a taxpayer entered a purchase date on Form 5405 that was outside the time period for which the credit was available, and directed the FTHBC to be reversed using math error procedures if the taxpayer did not respond with documentation showing a qualified purchase date.

⁶¹ IRS SERP Alert 110515 (July 25, 2011) (announcing that the \$500 FTHBC recapture will be automatically assessed on some accounts).

sells the house at a loss, which means he is not required to pay any further recapture amount,⁶² but he does not file Form 5405 with his 2010 tax return to report the loss on the sale. Therefore, through its math error authority under IRC § 6213(g)(2)(P), the IRS retroactively (*i.e.*, after issuing the full refund shown on the return) makes a summary assessment for omitting the recapture payment, even though no such payment was required. The taxpayer then faces the burden of explaining the facts and circumstances of his situation to avoid math error assessments for multiple years.

This example illustrates how difficult it is to apply math error authority to a facts-and-circumstances situation and the harm that can come to the taxpayer (*i.e.*, a summary assessment on a credit already received). Using math error authority this way (after processing a taxpayer's return) confuses taxpayers and may not achieve the IRS's desired result of revenue protection. Deficiency procedures may be more effective in these situations and give the taxpayer at least 90 days, as opposed to 60 days, to gather documents and communicate with the IRS. Especially where time has elapsed since the filing of the return, it makes sense to grant taxpayers that additional time.

Math error authority was designed to streamline IRS processing for simple mistakes, and was created *before* there were significant refundable credits, such as the FTHBC. However, with the growth of these credits, math error authority has also become important as a revenue protection strategy. Applying math error authority post-processing does little to protect revenue because the IRS has already paid the refund based on the original return. The confusion caused by such an adjustment after the return has been processed can cause a good deal of IRS rework and taxpayer burden.

CONCLUSION

Tax return changes designated as math errors carry significant consequences that can harm taxpayer rights. It is therefore essential that the IRS proceed carefully before using this broad authority. Rather than issuing math error notices whenever it is authorized to do so, the IRS should carefully consider its ability to address the error through its own research. Additionally, several math error notices remain unclear. The expansion of math error authority adds complexity to the notices, confuses taxpayers, and may result in their failing to protest the assessments and losing their appeal rights. For these reasons, it is imperative that the IRS carefully consider all other means of correcting the error before exercising its authority. It should make sure that math error notices, and the process for contesting assessments, are clear.

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Direct employees to conduct internal research to resolve clerical errors, such as incorrect entries of the dependents' TINs or surnames.

⁶² IRC § 36(f)(3).

2. Examine math error abatement rates after each filing season to identify high abatement areas and adjust procedures accordingly, including avoiding use of math error authority or developing a pre-screening system using internal IRS information.
3. Revise the descriptive paragraphs (TPNCs) in math error notices to identify precisely the reason for a tax return change and which entries are inconsistent.
4. Conduct a study in collaboration with the National Taxpayer Advocate before implementing any new math error authority to evaluate whether the application of the new authority is accurate, negatively impacts taxpayers, or has a high abatement rate, and whether the IRS can resolve the cases through existing data.

IRS COMMENTS

Math error authority under § 6213 of the Internal Revenue Code provides the IRS with a valuable tool to address mathematical or clerical errors on tax returns in appropriate cases. It allows the IRS to adjust the tax return to reflect the correct tax liability without referring the case to Examination for a resource-intensive audit of the return. Over the years, Congress has incrementally expanded the authority to allow the IRS to automatically correct returns for additional types of mathematical or clerical errors, including instances where the IRS receives reliable third party information. This authority has enabled the IRS to effectively and efficiently adjust returns and stop erroneous refunds from being issued. The IRS recognizes that taxpayer rights are an important consideration in the use of math error authority.

The IRS appreciates the National Taxpayer Advocate's acknowledgment that math error authority can be an effective processing tool. In those instances where math error authority is available, taxpayer errors can be addressed quickly, resulting in less burden and faster refunds to taxpayers as compared to an examination. In addition nearly all returns with similar errors can be treated consistently, thus creating equity between compliant and noncompliant taxpayers. Math error authority is also used to help ensure eligible taxpayers receive tax benefits they underclaimed. Lastly, the IRS is able to use costly Examination resources that would otherwise be spent on math errors to pursue other forms of noncompliance that require facts and circumstances based determinations.

The IRS agrees that the expansion of math error authority should be considered carefully taking into account taxpayer rights issues. The GAO, in its report to Congress dated February 2010, reported that the IRS could benefit from broader math error authority. We are exploring whether there are opportunities for additional authority that would improve tax administration without impacting taxpayer rights. Due to technical advances and increased access to reliable data, the IRS is able to collect information from various sources to verify entries on taxpayers' returns. Even when information in the IRS's possession indicates that a taxpayer's return contains an error, without specific math error authority the IRS cannot adjust the tax return during processing to reflect the correct tax liability. We continue to work with the National Taxpayer Advocate in this effort and will continue

to recognize the importance of respecting taxpayer rights, including assuring that information used in a math error determination is accurate and reliable.

The IRS disagrees with the National Taxpayer Advocate's assertion that the math error program creates significant burden or hardship to taxpayers. The IRS provides taxpayers with their rights provided by law, including administrative appeal and judicial review. The IRS sends a notice to the taxpayer identifying the alleged error with an explanation. The notice also informs the taxpayer that the taxpayer has 60 days to request the IRS abate the assessment. If the taxpayer disagrees with the assessment and requests an abatement of this amount, the IRS is required to abate the tax. If the IRS determines that the deficiency should be assessed, it then follows deficiency procedures that afford the taxpayer additional time to address the issue and the opportunity to obtain judicial review before the tax is reassessed and paid.

With respect to IRS notices, the IRS shares the National Taxpayer Advocate's interest in developing plain language effective notices that help taxpayers take the appropriate action to resolve their tax issues. The IRS received top honors, the Grand ClearMark Award, for the clearest language on notices such as the Additional Child Tax Credit. The IRS continues to review and rewrite notices in plain language. Two redesigned math error notices, CP10 and CP11, went into production in July 2010. Three more, CP12, CP13, and CP16 went into production in January 2011. With the redesign, the IRS incorporated plain language that is easier for the taxpayer to understand and added line numbers from the tax form to assist taxpayers in locating the errors on their own return. We are working with Research to determine effectiveness of the redesigned notices, and will make additional changes based on those results.

The IRS agrees there was an increase in math error notices in 2010 compared to 2005. The increase was primarily due to the Making Work Pay Credit. This credit accounts for 5.6 million of the 10.6 million math error notices issued in 2010. Eighty-five percent of the notices for the MWP credit informed the taxpayer that the IRS had figured the credit for them (because the taxpayer failed to claim the credit). Historically, the error rate and number of notices rise sharply whenever the IRS offers to calculate a credit for taxpayers. The credit was in effect for tax year 2009 and 2010. In 2010, the IRS sent five million math error notices, adjusted for MWP, compared to four million in 2005. Per TIGTA report 2011-40-059, more than 98 percent of the individuals receiving a math error notice between January 1 and July 23, 2010, agreed with the adjustments made to their tax returns.

With respect to the recommendations in the draft report, we note the following:

With respect to the recommendation to direct employees to conduct internal research to resolve errors, the Internal Revenue Manual directs IRS employees to conduct internal research to resolve clerical errors with taxpayer TINs during the processing of math or clerical errors (referred to as math errors). Employees are also instructed to search the return and attachments for dependent TINs. If the information is found during internal research

or from information on the return and attachments, the IRS will perfect the clerical error. If the IRS is unable to perfect the clerical error, a math error notice is issued to the taxpayer explaining the error(s) identified and the amount of any resulting adjustment(s).

An analysis of all math error notice data from four cycles in 2010 (one cycle per quarter) shows an overall reversal rate of 13 percent. The IRS agrees to perform additional analysis to review the data by type of math error to determine whether procedures may need to be adjusted. It should be noted that the top four Taxpayer Notice Codes (TPNCs) in this analysis related to the MWP credit and account for 77.4 percent of the math error notices with the reversal rate for all four being lower than the average.

With respect to notices, although we cannot tailor language to each individual taxpayer's situation, we agree that notices should be clear and understandable to taxpayers. The Return Integrity and Correspondence Services office will continue to review and rewrite notices using plain language.

In addition, the IRS will continue to collaborate cross functionally as we consider potential opportunities for new math error authority. We look forward to continuing work with the National Taxpayer Advocate in this effort.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate agrees that math error authority can be an effective processing tool when used appropriately (*i.e.*, not in situations that require a facts-and-circumstances determination or reliance on unreliable third-party data). The National Taxpayer Advocate further agrees that expansion of math error authority is appropriate in certain limited circumstances and can reduce IRS costs and taxpayer burden.⁶³ We commend the IRS for making some progress in improving the clarity of math error notices and are pleased that the IRS has offered to work with the National Taxpayer Advocate as the IRS determines what type of expansions are appropriate. This sort of collaboration has not occurred in the recent past, so we welcome the opportunity to work with the IRS and have our concerns addressed before proposals are set in stone.

Inappropriate Use of Math Error Authority Can Cause Taxpayer Burden and Hardship.

The National Taxpayer Advocate disagrees with the IRS statement that math error authority does not increase taxpayer burden or hardship, because the inappropriate use of this authority can produce exactly that effect. For example, using math error authority to include review of the documentation for the FTHBC has caused problems for both the IRS and taxpayers. In fact, having the IRS determine whether a taxpayer had attached a properly

⁶³ For a discussion regarding the types of math error expansion the National Taxpayer Advocate agrees with, see Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights, infra.*

executed settlement statement proved difficult, particularly in states that did not require the same information on the statement as the IRS. This put the IRS in the position of imposing its own judgment for that of the taxpayer, which is precisely the type of determination Congress found inappropriate for math error authority. Making a math error adjustment based on this judgment creates more IRS re-work by requiring the taxpayer to contact the IRS and then provide the necessary documentation before the IRS can finally issue the refund. As discussed, this process alone can take an average of 13.4 weeks.⁶⁴ Additionally, using any math error authority to make this type of judgment risks the taxpayer losing his or her right to go to Tax Court and dispute the IRS determination. In these fact-specific situations, deficiency procedures may be more effective and provide the taxpayer at least 90 days, as opposed to 60 days, to gather documents and communicate with the IRS.

Information from Third-Party Sources to Verify a Taxpayer's Return Must Be Reliable.

The National Taxpayer Advocate agrees that expansion of math error authority may be appropriate where reliable, accurate third-party information is available to verify the information on a taxpayer's return. The real issue then becomes: what is reliable information? As noted above, one example of reliable external data is the SSA NUMIDENT database.⁶⁵ Conversely, the Federal Child Support Registry is an example of an unreliable database that was compiled for a different purpose entirely and should not be used to make summary denials. This is why the National Taxpayer Advocate agrees with the GAO's recommendation that where the IRS is seeking (or Congress has enacted) additional math error authority, the IRS and the National Taxpayer Advocate should report to Congress on how the expansion would meet the standards and criteria set forth by Congress and might impact taxpayer protections.⁶⁶

Math Error Notice Clarity Is Critical.

The National Taxpayer Advocate commends the IRS for its continued efforts to provide taxpayers with clear, easy-to-understand notices. She is encouraged that the IRS has recently taken steps to improve some math error notices and hopes this effort continues with TAS playing a role. It is essential that the IRS provide clear, simple notices so taxpayers can understand the rationale for the changes to their returns and their right to request abatement within 60 days, preserving their opportunity to contest the adjustment in Tax Court.

The Number of Math Error Notices Sent to Taxpayers Has Recently Increased.

The National Taxpayer Advocate understands that a significant portion of the increase in math error notices is the result of Congress granting the IRS new math error authority,

⁶⁴ TAS analysis of TY 2006 data from CDW IRTF and IMF (Dec. 2010). See also National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra*.

⁶⁵ See IRM 2.3.32.8 (July 1, 2008); IRM 2.3.32.17 (Jan. 1, 2005). NUMIDENT information is a complete history of changes, such as name changes, as reported to SSA by the user of the SSA account number.

⁶⁶ GAO, GAO-11-691T, *Enhanced Prerefund Compliance Checks Could Yield Significant Benefits* (May 25, 2011). The National Taxpayer Advocate believes this report would be most effective if it was sent to Congress several months before implementation. If the provision has immediate effect, then the report should be submitted before the second filing season.

such as the Making Work Pay credit and the FTHBC.⁶⁷ However, it may not be appropriate to use math error authority where the IRS is disbursing tax credits. In the legislative recommendation section of this report, the National Taxpayer Advocate provides criteria to be considered to determine if using math error in these circumstances is appropriate.⁶⁸

The TIGTA report referenced in the IRS response proclaims that more than 98 percent of the individuals receiving a math error notice between January 1 and July 23, 2010, agreed with the adjustments to their returns.⁶⁹ However, this figure includes taxpayers who received a math error notice and did not respond to the notice within the 60-day timeframe. The National Taxpayer Advocate does not believe that the lack of a response from the taxpayer regarding the math error notice can be equated to an agreement as to the adjustment. In fact, there may be a number of reasons why the taxpayer did not respond (e.g., he or she did not understand the notice). Further, the report most certainly does not mean that the adjustments were right. For example, as described in Volume 2, *Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*, of this report, TAS analyzed tax account data for 341,000 math errors issued in TY 2009, disallowing dependency exemptions and tax credits tied to dependents and found the IRS later reversed 184,000 — or about 55 percent — of the disallowances.⁷⁰

IRS Internal Research to Fix Taxpayer Errors Does Not Go Far Enough.

Although IRS employees are instructed to conduct internal research to correct taxpayer mistakes, this only includes checking the return and any attached documents.⁷¹ TAS proposes that the IRS use internal records such as TINs for dependents used on prior tax returns and SSNs provided by SSA.⁷² In other words, the IRS should use the same information to fix taxpayer errors as it does to make math error adjustments. In the TAS research study mentioned above, a statistically valid sample of the 184,000 reversed disallowances showed the IRS had internal data to immediately resolve 56 percent of those reversals, rather than deny the taxpayers their exemptions, credits, and refunds. Revising IRS procedures to require more internal research could prevent many unnecessary math error notices from being sent to taxpayers.

⁶⁷ IRC §§ 36A and 36.

⁶⁸ See Legislative Recommendation: *Mandate that the IRS, in Conjunction with the National Taxpayer Advocate, Review Any Proposed Expanded Math Error Authority to Protect Taxpayer Rights*, *infra*.

⁶⁹ TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (July 7, 2011).

⁷⁰ See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2, *infra* (*Math Errors Committed on Individual Tax Returns: A Review of Math Errors Issued on Claimed Dependents*). TAS analysis of TY 2006 and 2009 data from CDW IRTF and IMF (Dec. 2010). For tax year 2009, Notice Code 604 (missing TIN), 47 percent, or 36,000 of the notice assessments were resolved fully or partially; for Notice Code 605 (incorrect TIN), 55 percent, or 114,000 were resolved fully or partially; and for Notice Code 743 (incorrect TIN for EITC), 61 percent, or 35,000 were resolved fully or partially. Although the IRS later reversed 47 percent of math errors with missing TIN data (Notice Code 604), these math errors are often associated with ITIN returns, and the IRS does not have the information needed to fill in missing TINs. Consequently, the analysis was narrowed to include only returns with math errors 605 or 743.

⁷¹ IRM 3.12.3.4.3.18 (Jan. 1, 2011).

⁷² See IRM 2.3.1 (Jan. 1, 2008) for IDRS command code RTVUE.

In regard to the math error adjustments that the IRS does abate, the National Taxpayer Advocate is pleased that the IRS has agreed to examine its abatement rates after each filing season to identify high abatement areas and change its procedures accordingly.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Direct employees to conduct internal research to resolve clerical errors, including incorrect entries of the dependents' TINs or surnames.
2. Examine math error abatement rates after each filing season to identify high abatement areas and adjust procedures accordingly, including avoiding the use of math error authority and developing a pre-screening system using internal IRS information to minimize improper math error adjustments.
3. Revise the descriptive paragraphs (TPNCs) in math error notices to identify precisely the reason for a tax return change and which entries are inconsistent.
4. Conduct a study in collaboration with the National Taxpayer Advocate before implementing any new math error authority to evaluate whether the application of the new authority is accurate, negatively impacts taxpayers, or has a high abatement rate, and whether the IRS can resolve the cases through existing data.

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Automated “Enforcement Assessments” Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers

RESPONSIBLE OFFICIALS

Faris Fink, Commissioner, Small Business/Self-Employed Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The IRS’s wholesale use of automated “enforcement assessments” has increased dramatically over the past decade, placing a considerable drain on IRS Collection resources with questionable benefits for revenue collection and tax compliance.¹ These automated processes do not emphasize personal contact with the affected taxpayers; in fact, the IRS’s methods of contacting these taxpayers may discourage communication rather than promote productive responses and timely case resolutions. While the basic operating premise of the Automated Substitute for Return (ASFR) program holds that substantially inflated proposed assessments will drive taxpayers to file the delinquent returns, 83 percent of ASFR returns in fiscal year (FY) 2010 were “defaulted” assessments, (*i.e.*, the taxpayers did not respond or otherwise agree with the proposed amounts).² Further, 76 percent of the tax dollars applied to ASFR assessments from FY 2006 through FY 2010 were actually “pre-paid credits” (*i.e.*, withholding credits, estimated tax payments, or other payments credited to the taxpayers’ accounts *prior to the due dates of the returns*).³

The high volumes of automated “enforcement assessments” have substantially inflated the IRS’s inventory of Collection accounts receivable, although IRS data indicate the majority of these assessments are ultimately abated or reported as uncollectible.

- By FY 2011, the number of returns generated by the Automated Substitute for Return process had increased by 896 percent as compared with the number assessed in FY 2002.⁴
- As of March 2011, automated “enforcement assessments” accounted for 43 percent of the IRS’s potentially collectible accounts receivable.⁵

¹ In this report, the term “enforcement assessments” refers to the Automated Substitute for Return (ASFR) program, which establishes tax liabilities in situations involving individual income tax return delinquencies.

² IRS response to TAS information request (July 13, 2011).

³ *Id.* Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

⁴ IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report* (2002–2011).

⁵ Data provided by the Chief Financial Officer (CFO) to the Collection Governance Council (Apr. 13, 2011). The IRS Potentially Collectible Inventory (PCI) is a subset of the IRS inventory of unpaid assessments. The IRS has determined the PCI to be cases with the most potential for successful resolution with collection resources.

- In FY 2011, the IRS abated 2.4 times as many ASFR Taxpayer Delinquent Account (TDA) dollars as it collected (including refund offsets), and reported as currently not collectible (CNC) approximately four times the amount collected.⁶
- From FY 2006 through FY 2011, the IRS collected less than ten percent of the TDA dollars established through the ASFR process.⁷

The high volume of automated enforcement assessments clogs the collection process with unproductive work, and wastes resources that the IRS could otherwise invest in more worthwhile areas (*e.g.*, outgoing calls to taxpayers by the Automated Collection System (ACS) and expanded use of the offer in compromise (OIC) program). Further, the raw numbers of these assessments have distorted the composition of the IRS’s Collection inventory in a manner that diverts Collection resources from cases that may be more collectible and tax assessments that are significantly more valid.

ANALYSIS OF PROBLEM

Automated “enforcement assessments” are key tools for enforcing filing compliance.

ASFR is the key program for enforcing filing compliance by taxpayers who have not filed individual tax returns, but have incurred a “significant” tax liability.⁸ The program estimates the liability by computing tax, penalties, and interest based upon information reported to the IRS by third-party payers.⁹ When a taxpayer with reported income is delinquent in filing a return, the IRS attempts to secure the return through correspondence. If the attempt is unsuccessful, the IRS is authorized by the Internal Revenue Code (IRC) to prepare a substitute return for the taxpayer.¹⁰

Generally, a return delinquency meets ASFR criteria when income information obtained through the IRS Information Return Program is available for the delinquent tax module, the module is no older than five years prior to the current processing year, there are no related TDAs, and the proposed tax liability is over a certain dollar threshold.¹¹ When the IRS selects a return delinquency for ASFR processing, the program calculates an estimated tax liability based on available income information with an assumed filing status of “single” or “married filing separate” with one exemption. Generally, this proposed liability exceeds

⁶ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

⁷ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

⁸ Internal Revenue Manual (IRM) 5.18.1.2 (May 1, 2005). To meet ASFR processing criteria, the proposed tax liability must meet or exceed a predetermined dollar threshold established by the IRS for the ASFR program. Currently, the ASFR threshold is substantially lower than the dollar amount used to determine TDA issuance criteria.

⁹ IRM 5.18.1.2 (May 1, 2005). The IRS can use information returns (*e.g.*, Forms W-2 and 1099) filed by employers, banks, and other third parties to report various types of payments to individuals. These payments include wages, interest, and dividends, as well as payments to self-employed taxpayers for services rendered. The IRS collects and maintains this information through the Information Return Program (IRP).

¹⁰ IRC § 6020(b).

¹¹ IRM 5.18.1.3.1 (Jan. 28, 2010).

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what the taxpayer actually would owe on a self-reported return.¹² The IRS notifies the taxpayer of the proposed assessment via a “30-day letter.”¹³ The taxpayer may respond with an original return, an agreement to the proposed ASFR assessment, or a statement indicating disagreement with the assessment. If the taxpayer disagrees or fails to resolve the return delinquency during this 30-day period, the IRS sends a Statutory Notice of Deficiency (90-day letter) to the taxpayer by certified mail.¹⁴ If the taxpayer does not resolve the return delinquency or petition the Tax Court for relief within 90 days, the ASFR program assesses the proposed tax, penalties and interest, and collection action proceeds on any unpaid balance due.¹⁵

Internal and external reviews raise questions about the overall benefits of the ASFR program.

The ASFR program has been analyzed extensively since it began in 1988. Several of these studies have been critical of the program, raising particular concerns about the impact of high volumes of ASFR assessments on the IRS’s inventory of delinquent accounts receivable, the collectibility of ASFR assessments, and the increased taxpayer burden created by the ASFR process.

For example, as early as 1991, the IRS determined that “only a small percentage of the (ASFR) dollars and modules are collected during the assessment process and notice routine. More should be done in determining collectibility prior to making the (ASFR) assessment and in collecting the liability prior to and while in notice status.”¹⁶ Another IRS analysis completed in 1998 concluded:

The IRS needs to place much greater emphasis on establishing contact with the taxpayers represented in the ASFR inventory, obtaining ‘agreed’ assessments for the tax years in question, and resolving all aspects of the taxpayers’ delinquency problems, including collection, through one stop service.¹⁷

The GAO made the following observation in 1995: “The establishment of a receivable as a result of an IRS compliance effort which overstates a taxpayer’s liability makes additional

¹² General Accounting Office (GAO, now the Government Accountability Office), GAO/GGD-00-60R, *IRS’ Substitute for Returns* 8 (Feb. 2000). In this report, the GAO observes, “According to IRS officials, the “married filing separately” status is used because only the taxpayer can claim the “married filing jointly” status. Also, the “married filing separately” status is to encourage the potential nonfilers to file a correct return if they can claim the “married filing jointly” status.” Further, “IRS also does not use information from the taxpayer’s most recent tax return. This information includes marital status and dependent data. However, the IRS has no assurance that this information is accurate for the current tax year.”

¹³ IRM 5.18.1.7.5 (Jan. 28, 2010). The ASFR “30-day letter” provides the taxpayer with the proposed assessment amounts, and gives the taxpayer 30 days to respond. At the conclusion of the 30-day letter suspense period, if there is no/insufficient response, ASFR generates a Statutory Notice of Deficiency (90-day letter).

¹⁴ IRM 5.18.1.7.6 (Oct. 1, 2005). The ASFR “90-day letter” (i.e., the statutory notice of deficiency) notifies the taxpayer that a deficiency has been established, and instructs the taxpayer on how to petition the Tax Court to contest the determination.

¹⁵ IRM 5.18.1 (Apr. 20, 2010).

¹⁶ IRS, *Currently Not Collectible Study Group Report* 82 (Feb. 1991).

¹⁷ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 3 (Nov. 1998).

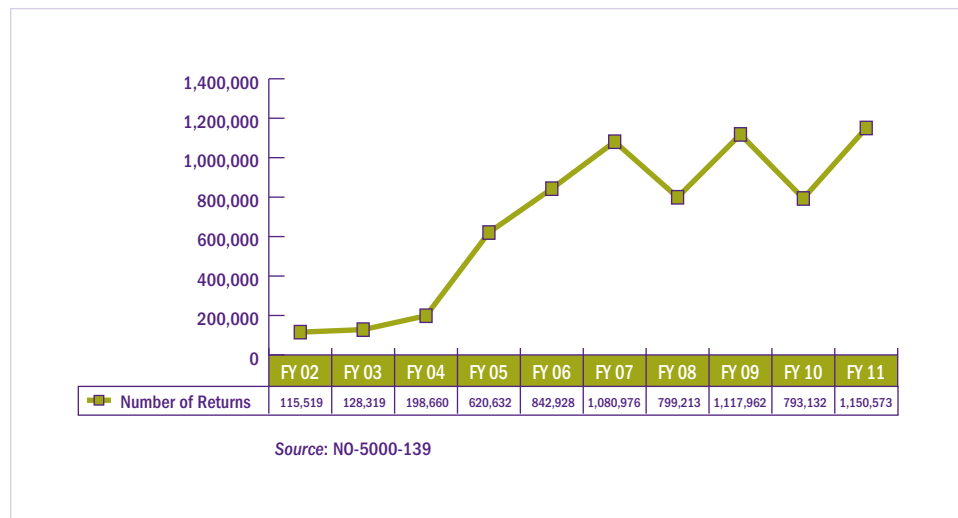
work for collection personnel with no guarantee of revenue generation.”¹⁸ In the same report, GAO commented that high levels of dollar abatements indicated, “a significant portion of the accounts receivable inventory should not have been established in the first place.”¹⁹

In the 2007 Annual Report to Congress, the National Taxpayer Advocate reported similar concerns with the ASFR program’s “high default assessments, low collection percentages, and significant downstream consequences in the form of TAS casework.”²⁰ This report identified a need to improve the automated selection process to reduce taxpayer burden, and recommended enhanced customer service options such as telephone contacts prior to finalizing assessments to resolve more ASFR cases early in the process.

The “bulk processing” of automated enforcement assessments continues to produce questionable benefits in the area of revenue collection.

Despite the concerns with “enforcement assessments” dating back to 1991, these problems remain evident in current ASFR program results. Enforcement assessments are inflating the IRS’s inventory of delinquent accounts receivable to unprecedented levels. By FY 2011, the number of ASFR-generated returns increased by 896 percent of the number assessed in FY 2002 (see Figure 1.5.1).²¹ As of March 2011, ASFR assessments accounted for 43 percent of the IRS’s potentially collectible accounts receivable.²² At the end of FY 2011, 36 percent of all TDA dollars in open inventory involving individual tax returns (Individual Master File or IMF) were associated with ASFR assessments.²³

FIGURE 1.5.1 ASFR ASSESSMENTS (2002-2011)



¹⁸ GAO, GAO/HR-95-6, *Internal Revenue Service Receivables* 15 (Feb. 1995).

¹⁹ *Id.*

²⁰ National Taxpayer Advocate 2007 Annual Report to Congress 246.

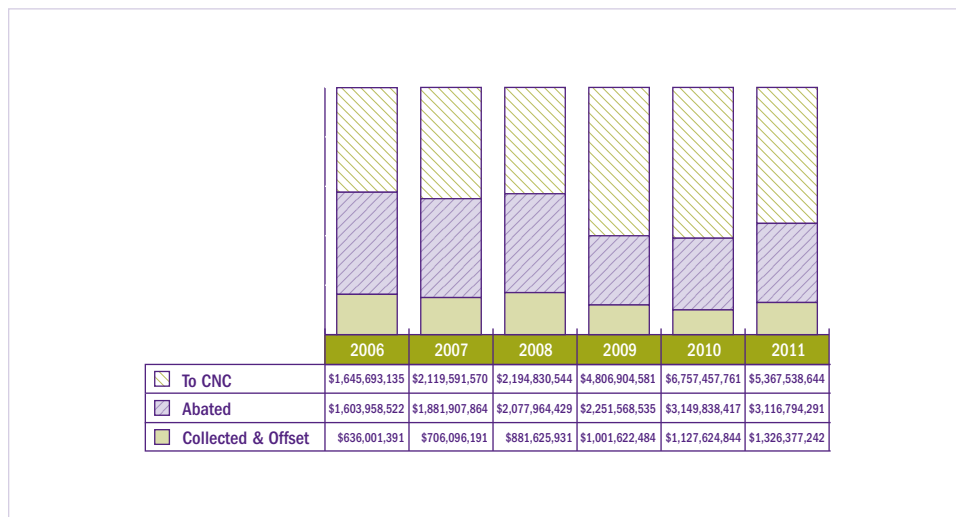
²¹ IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report* (2002 - 2011).

²² Data provided by the CFO to the Collection Governance Council (Apr. 13, 2011).

²³ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

The IRS actually collected less than ten percent of the TDA dollars established through the ASFR process from FY 2006 through FY 2011.²⁴ Moreover, the IRS abates or reports as currently not collectible increasingly high percentages of these accounts (see Figure 1.5.2). In FY 2011, while collecting approximately \$1.3 billion on ASFR TDA accounts (including \$499 million in refund offsets), the IRS reported \$5.4 billion as CNC, and abated another \$3.1 billion.²⁵ The dollar value of ASFR TDAs reported as uncollectible has increased by 226 percent from FY 2006 to 2011,²⁶ while the ASFR dollars abated increased by 94 percent.²⁷

FIGURE 1.5.2, ASFR Program Results (2006 - 2011)



While the basic operating premise of the ASFR program holds that substantially inflated proposed assessments will drive taxpayers to file the delinquent returns, 83 percent of ASFR returns in FY 2010 were “defaulted” assessments (*i.e.*, the taxpayers did not respond or otherwise agree with the proposed amounts).²⁸ Moreover, IRS data indicate that in ASFR cases closed from FY 2006 through FY 2010, only 2.5 percent of the assessed dollars (excluding interest and penalties) were collected through collection notices, and 2.8 percent were collected by the Automated Collection System (ACS).²⁹ However, 39 percent of open ASFR TDAs were assigned to the Collection Queue at the end of FY 2011, where they could remain inactive for years.³⁰ Even more noteworthy is that 76 percent of the tax dollars

²⁴ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

²⁵ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

²⁶ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (2007 - 2011).

²⁷ *Id.*

²⁸ IRS response to TAS information request (July 13, 2011).

²⁹ *Id.* Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

³⁰ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011). The Collection Queue is an automated inventory where active but unassigned collection cases reside until IRS resources are available to work them, or they are otherwise systemically reported as currently not collectible.

applied to ASFR assessments from FY 2006 through FY 2010 were actually “pre-paid credits” (*i.e.*, withholding credits, estimated tax payments, or other payments credited to the taxpayers’ accounts *prior to the due dates of the returns*).³¹ These results raise serious questions about the overall effectiveness and efficiency of the ASFR process, the program’s impact on the non-filer population, and the validity of the program’s operating assumptions of taxpayer behavior.

Automated “enforcement assessments” sacrifice taxpayer service for processing efficiencies.

Prior studies have reported that the IRS frequently establishes “enforcement assessments” for taxpayers under old and incorrect addresses.³² The ASFR process will generate assessments even when notices have been returned as undeliverable or unclaimed.³³ Yet, the IRS concluded in a 1998 analysis that the time lag between the due date of the tax return and the proposed ASFR assessment contributes to a high volume of cases where taxpayers may not have received *any* actual notice of the ASFR assessment process.³⁴ In 1999, after this study, the IRS stopped establishing ASFR assessments in cases without a confirmed address. However, in March 2004, the IRS determined that postal tracer checks (*i.e.*, using Form 4759, *Postal Tracer*, to confirm with local post offices the validity of individual taxpayer addresses) were “redundant” and eliminated this safeguard from the ASFR process to reduce cycle time.³⁵ Subsequently, in FY 2005 the number of ASFR assessments was 484 percent of the figure for FY 2003!³⁶

In recent years, identity theft has emerged as a very serious problem.³⁷ The decision to eliminate the “confirmed address” safeguard does not appear prudent or responsible, considering the potential impact of identity theft in “no response” ASFR cases, and the need for the IRS to ensure the information used as the basis for ASFR assessments is valid for the affected taxpayers. The IRS does not even track the number of ASFR notices returned as undeliverable or unclaimed.³⁸ In 1998, an IRS study revealed that from FY 1994 through

³¹ IRS response to TAS information request (July 13, 2011). Data provided by the IRS from the Enforcement Revenue Information System (ERIS) database on the Compliance Data Warehouse.

³² IRS, *Currently Not Collectible Study Group Report* 80 (Feb. 1991). This study concluded that the “currentness (sic) of a taxpayer’s address has a significant impact on collectibility of an assessment, and approximately 30 percent of all SFR 30-day letters are returned undeliverable.” See also, IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 4 (Nov. 1998). This study concluded that a high percentage of ASFR assessments are made in situations where the taxpayers have not received notice of the proposed deficiencies. “We estimate approximately 50 percent of ASFR assessments fall into this category.”

³³ For a detailed discussion of the IRS’s problems with undelivered mail, see National Taxpayer Advocate 2010 Annual Report to Congress (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

³⁴ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 4 (Nov. 1998).

³⁵ Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 7 (Apr. 2005).

³⁶ IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report* (2003 - 2005).

³⁷ For a discussion of the impact of identity theft on IRS operations, see National Taxpayer Advocate 2008 Annual Report to Congress (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); see also National Taxpayer Advocate 2009 Annual Report to Congress (Status Update: *IRS’s Identity Theft Procedures Require Fine-Tuning*) and Most Serious Problem: *Identity Theft, supra*.

³⁸ IRS response to TAS information request (July 13, 2011).

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FY 1997, 85 percent of resolved ASFR assessments were “unagreed,” with the vast majority representing “no response” situations.³⁹ Current IRS data indicate that very little has changed in this regard — in fiscal year 2010, 83 percent of ASFR assessments were established as “unagreed.”⁴⁰

The IRS makes little effort to personally contact taxpayers before setting up ASFR assessments.

The ASFR process does not require the IRS to try to reach taxpayers by phone to initiate personal contacts prior to assessments.⁴¹ According to a 2005 TIGTA report, the IRS had planned to incorporate predictive dialer technology into the ASFR process in 2005 to facilitate outgoing calls.⁴² TIGTA cited the positive results from a 1998 IRS test as evidence of the potential gains that increased telephone contacts could achieve.⁴³ This test was also referenced in the IRS’s own 1998 analysis of the ASFR program, which concluded, “the test demonstrated that the telephone contact in the ASFR program allowed the Service to help people understand their tax obligations and how to meet them, remedy the delinquency problem prior to enforcement action, and work with the taxpayers directly.”⁴⁴ This same study concluded, “There is considerable evidence that the ASFR program, when taxpayer contact is involved, provides meaningful service to “nonfiler” taxpayers.”⁴⁵ However, the IRS does not use predictive dialer technology in the ASFR program, nor has it increased emphasis on pre-assessment telephone contacts.⁴⁶

ASFR notices are confusing, misleading, and may discourage responses from taxpayers.

The ASFR “90-day letter” (*i.e.*, the statutory notice of deficiency) notifies the taxpayer that a deficiency *has been* established, and instructs the taxpayer how to petition the Tax Court to contest the determination. Nowhere is the taxpayer advised that an original, self-reported tax return will stop the ASFR process. Instead, the notice advises the taxpayer that an assessment will be made in 90 days unless the taxpayer contests it by filing a petition with the Tax Court. This longstanding problem has been identified in past studies of the ASFR process.⁴⁷ The IRS’s Office of Taxpayer Correspondence (OTC), with participation by TAS,

³⁹ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 12 (Nov. 1998).

⁴⁰ IRS response to TAS information request (July 13, 2011).

⁴¹ IRM 5.18.1 (Apr. 20, 2010).

⁴² Predictive dialer technology uses computer-directed outbound telephone dialing systems to dial a list of telephone numbers and connect answered dials to designated assistants of the business making the outgoing calls.

⁴³ TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 8 (Apr. 2005). TIGTA cited a test conducted by the IRS in 1998 of the effectiveness of telephonically contacting taxpayers during the 30-day and 90-day letter process. The test data showed a 40 percent taxpayer response rate compared to 23 percent in FY 1997, the prior fiscal year during which outgoing telephone contacts were not part of the ASFR process, and a 33 percent return-secured rate compared to 13 percent in FY 1997.

⁴⁴ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 9 (Nov. 1998).

⁴⁵ *Id.* at 11.

⁴⁶ IRS response to TAS information request (July 13, 2011).

⁴⁷ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 8 (Nov. 1998).

has created a revised “90-day” letter that could improve taxpayer service in this critical area. However, the release of the new letter has been reprioritized and delayed a number of times, and is currently not scheduled until July 2012.⁴⁸

The IRS has a long history of taxpayer service problems in administering the ASFR reconsideration process.

The ASFR process is designed to produce proposed assessments that exceed the likely self-reported liabilities of the affected taxpayers. This approach intends to encourage taxpayers to file original returns in order to take advantage of filing status elections, exemptions, deductions, and credits that will substantially reduce the proposed taxes due.⁴⁹ However, taxpayers who do not respond and file original returns until after the ASFR assessments have been made are subject to the ASFR reconsideration process.

Unfortunately, the IRS’s administration of the reconsideration process has been a problem area for many years. Prior studies have identified untimely resolution and inaccurate adjustments of ASFR cases as serious problems that “could adversely affect taxpayer relations” and are described by tax practitioners as “the most frustrating aspect of the entire program.”⁵⁰ In its 1998 analysis of ASFR, the IRS reported these reconsideration cases “have consistently been one of the most identified problems areas in PRP (the Problem Resolution Program) casework.”⁵¹ This same report identified the complexity of adjusting ASFR reconsideration cases as a primary factor contributing to problems in this area.⁵² In recent years, cases requiring reconsiderations of automated “enforcement assessments” have routinely been among the top problem issues in TAS cases.⁵³

⁴⁸ IRS response to TAS information request (June 15, 2011).

⁴⁹ IRS, Letter 2566 (SC/CG) (Apr. 2005).

⁵⁰ TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 18 (Apr. 2005). See also IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 10 (Nov. 1998).

⁵¹ IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 10 (Nov. 1998). The Problem Resolution Program (PRP) was a taxpayer assistance and dispute resolution program and was the predecessor of the Taxpayer Advocate Service.

⁵² *Id.* at 11. This report observed, “When ASFR audit reconsiderations are done, rather than completely reverse the ASFR assessments, including associated penalties and interest, and then post the original return amounts, the accounts are “adjusted.” Using the original return information, the ASFR assessments are changed to reflect the original return. Practitioners were unanimous that these “adjustments” often are not done correctly. We heard anecdotal accounts of situations where taxpayers continued to be billed for penalties and interest when original returns were filed showing refunds due. We believe the current process is overly, and needlessly, complicated. These service issues could be resolved with a more simplified process.”

⁵³ Taxpayer Advocate Management Information System (TAMIS) data show that TAS closed 9,202 cases involving automated enforcement assessments (TAS Issue Codes 620 and 760) during the first half of FY 2011, 19,679 in FY 2010, and 18,370 in FY 2009.

The impact of automated “enforcement assessments” on the future voluntary compliance of affected taxpayers has yet to be determined.

In its 2005 audit, TIGTA raised a concern that the IRS does not track or report the subsequent voluntary compliance rates for individual taxpayers who are treated by the ASFR program.⁵⁴ The GAO expressed a similar concern in 2000.⁵⁵

Despite these concerns, the IRS has not found a routine way to track the future filing compliance of taxpayers subject to ASFR assessments. In FY 2011, the IRS reported as CNC approximately four times the amount collected.⁵⁶ Of particular note, 69 percent of the dollars reported as CNC involved cases closed as “unable to locate or contact” and “surveyed” (*i.e.*, not pursued because the IRS determined the cases did not warrant the expenditure of additional collection resources).⁵⁷ With virtually no taxpayer contact required in these case dispositions, these results certainly raise significant questions about the impact of the current ASFR process on taxpayer compliance.

CONCLUSION

While it appears that the IRS’s use of automated “enforcement assessments” may generate considerable potential accounts receivable, by design these assessments generally represent balances due that are inflated and inaccurate. Further, we find little evidence that this approach is effective in actually collecting delinquent revenue or promoting the future compliance by the affected taxpayers.

There is no dispute that the “nonfiler” population is a legitimate area of concern for the IRS. However, a truly effective “liability determination process” requires more emphasis on personal contact with the affected taxpayers. For many, the potential consequences of ASFR assessments can be severe. The IRS needs to place significantly more emphasis on delivering ASFR notices to correct addresses, and making subsequent communication efforts more service-oriented and designed to achieve “agreed” resolutions to the highest degree possible.

To address the concerns raised in this report, the National Taxpayer Advocate preliminarily recommends that the IRS:

1. Reinstate the policy of not making automated enforcement assessments without confirming that the taxpayer’s address of record is valid.

⁵⁴ TIGTA, Ref. No. 2005-30-073, *The Small Business/Self-Employed Division Has Made Significant Changes to Enhance the Automated Substitute for Return Program, but Opportunities Exist for Further Improvement* 1 (Apr. 2005); see also IRS, *Automated Substitute for Return (An Analysis from the Customer’s Perspective)* 8 (Nov. 1998).

⁵⁵ GAO, GAO/GGD-00-60R, *IRS’ Substitute for Returns* 2 (Feb. 2000). In this report the GAO observed, “IRS does not routinely collect data on the costs to prepare and process substitute for returns and the impacts of the SFR program on compliance. For example, IRS does not collect data on whether the taxpayer files for future tax years.”

⁵⁶ IRS, Collection Activity Report, NO-5000-242, *Type of Assessment Reports* (Oct. 2011).

⁵⁷ *Id.*

2. Require use of Form 4759, *Postal Tracer*, to confirm taxpayer addresses prior to making assessments in all “unagreed – no contact” situations.
3. Expedite the implementation of the revised ASFR “90-day” letter.
4. Revise ASFR processing procedures to emphasize telephonic contacts in all potentially “unagreed” ASFR assessments.
5. Revise ASFR selection criteria to reflect a minimum “likely balance due” of at least the amount of the current TDA issuance criteria. The ASFR selection process calculation can be based on last return filed information (*e.g.*, filing status, exemptions, and deductions). While the IRS may face legal restrictions in making elections for the taxpayer in establishing assessments, there are no such restrictions in considering this information in the criteria for selecting appropriate, productive cases for the ASFR treatment.
6. Revise procedures for processing audit reconsiderations on ASFR assessments. Rather than make “adjustments,” all ASFR assessed amounts, including penalties and interest, should be completely reversed and replaced with the amounts reflected on the taxpayer’s self-reported return.
7. Apply a pre-assessment “collectibility” determination to all potential ASFR assessments, including consideration of potential “unable to locate” and “little or no tax due” situations, and the potential for economic hardship based on the taxpayer’s income level. Consider the taxpayer’s last return filed information in making this determination.

IRS COMMENTS

The Automated Substitute for Return program is one of the tools the IRS uses to bring taxpayers that fail to file a return into compliance. The program is an important part of tax administration and the IRS continually strives to improve the accuracy of Substitute for Return assessments. One of these changes to be implemented in the near future will allow better prioritization of cases. In April 2012, the IRS will implement programming that will select cases in a more optimal manner. The IRS is also implementing a new ASFR reconsideration tool in 2012 that will improve the reconsideration process. The tool will eliminate repetitive manual input by the IRS examiner and provide the examiner systemic reminders for needed tax information to ensure the examiner properly considers all related necessary adjustments. This tool will reduce the complexity of making these adjustments and ensure consistency among all examiners and all campuses.

The National Taxpayer Advocate’s report described ASFR’s “bulk processing” of assessments and their effect on collectability. The IRS agrees improvements can be made in the inventory selection methodology to improve collectability of the ASFR assessments and has made improvements to potentially increase collectability of ASFR assessments. To that end, an analysis was performed in 2009 and 2010 on the ASFR assigned inventory. Based on the review, processing changes were made in 2010 to prevent any delinquent module from entering the ASFR inventory if there is a balance due module for the same taxpayer.

Another change to be made in 2012 will block taxpayers who already have uncollectible modules from assignment to ASFR.

The National Taxpayer Advocate’s report also noted returns generated by the ASFR process increased 896 percent from 2002 to 2011. It is important to note that prior to 2002, the ASFR program was affected by budget cuts. Although the program continued to work responses from taxpayers, the number of Substitute for Return assessments decreased significantly. Beginning in 2002, as funding increased, ASFR began to increase SFR processing to ensure a balanced tax administration system.

The National Taxpayer Advocate’s report refers to studies conducted in 1991 and 1998 to support conclusions that ASFR should not generate enforcement assessments for cases when notices have been returned as undelivered or unclaimed. The report points out, based on these studies, the IRS instituted a policy to not establish ASFR assessments in cases without a confirmed address. The IRS utilized postal tracers to confirm addresses. The use of postal tracers was discontinued in March 2004 when the IRS determined the postal tracer checks were redundant to utilization of the National Change of Address Linkage (NCOA), which IRS was already using to confirm addresses since January 2001. Eliminating redundant steps conserves our resources while maintaining prudent and responsible program policies.

The National Taxpayer Advocate’s report makes seven preliminary recommendations to improve the ASFR program. The IRS is taking or has taken the following actions with respect to these recommendations.

With regard to confirming taxpayers’ addresses prior to automated enforcement assessments, the ASFR program performs due diligence in obtaining the most current address prior to each notice issuance. Significant changes have been made to ASFR processing to ensure the most current address is used. The IRS licenses the NCOA from the United States Postal Service (USPS). The consolidated data file with change-of-address information, based on updated address information received from postal customers, is received regularly from USPS.⁵⁸

Although NCOA does not replace the postal tracer, it substantially reduces the need for it, and allows for additional resources to work ASFR taxpayer responses. Address changes received from NCOA and IRS contacts with taxpayers are systemically updated to ASFR prior to each notice issuance to ensure the most current address is being used. When notices are returned “undelivered” from the USPS, ASFR suspends activity on accounts and requests additional address research (using the Address Research System). Accounts are updated with new address information when the taxpayer confirms the address via letter 2797C or other contact, and notices are re-issued. ASFR continues enforcement activity only after all attempts to secure an updated address have failed. Unclaimed notices are

⁵⁸ IRM 5.1.18.12.

notices the USPS delivers to the taxpayer’s address of record, but are refused or unclaimed. ASFR does not consider those notices “undeliverable” because delivery is attempted to the correct address. Beginning in January 2012, balance due inventory that is currently not collectable due to “unable to locate” designations will not be reassigned to ASFR. The IRS will continue to perform due diligence in obtaining the most current addresses when ASFR letters are returned by the USPS. In addition, for field examinations, IRM 4.10.2.7.2.2, *Unlocatable Taxpayers—Mandatory Steps to Locate*, provides the steps to be followed by field examiners including research of internal sources, the asset locator service, the internet, the Currency Banking Retrieval System, and sending a postal tracer.

With respect to a revised ASFR 90-day letter, the IRS has already developed a revised letter, which will be ready for use by IRS systems in 2012.

The IRS agrees with the National Taxpayer Advocate that telephonic contact may assist taxpayers identified through the ASFR program; as such, we are currently pursuing the use of the predictive dialer. The predictive dialer program attempts to contact the taxpayer by telephone using the last known telephone number. Implementation will be dependent on resolution of systemic integration issues and contingent on available resources.

The IRS disagrees with the National Taxpayer Advocate’s draft recommendation to revise ASFR selection criteria to reflect a minimum “likely balance due” of at least the amount of the current Taxpayer Delinquent Account (TDA) issuance criteria. The ASFR program applies its current selection criteria to address non-compliance at its earliest stages. Early intervention and payment lessens the taxpayer’s exposure to additional interest and penalty and brings the taxpayer back into full compliance. Balance due assessments, which are lower than the current TDA issuance criteria, may still be paid by taxpayers in full or they may enter into installment agreements. In addition, ASFR does not factor in claimed entitlements from prior years when building inventory for the following reasons:

- The previously filed year may be two or more years prior to the unfiled year and may not be current information;
- A taxpayer’s employment, marital status, or dependents may have changed and may be the reason for not filing; and
- Subsequent actions for filed returns, such as underreporting of income, civil penalties, and examinations of dependents and EITC may not be present at the time the delinquent record is built.

The IRS disagrees it would be better for taxpayers to revise procedures for processing audit reconsiderations on ASFR assessments to completely reverse the ASFR assessment. We believe it is in the taxpayer’s best interest to adjust previously assessed amounts based on the received return. The Collection Statute Expiration Date (CSED) is ten years from the date of the Summary Record of Assessment (Form 23C). Each additional assessment of tax carries its own CSED of ten years. Abating the original ASFR assessment of tax, then

assessing the entire amount would set the CSED at ten years from the date of the new assessment.⁵⁹ It is for this reason returns (ASFR and amended) are not abated in full and re-assessed. ASFR Reconsiderations are worked similarly to amended returns. Line items are validated using information provided by taxpayers. The IRS will continue to strive to improve the accuracy of Substitute for Return assessments and reconsideration adjustments through training and systemic tools. As noted earlier, a new ASFR Reconsideration tool is currently under development and is due to be implemented by 2012.

As previously discussed, the IRS is already taking steps to improve the ASFR case selection criteria. The IRS will implement programming in April 2012 that will change the prioritization of started ASFR cases. The IRS is also considering a proposal to implement “scoring” for ASFR inventory that will enable taxpayers to be examined for collectability prior to entering the ASFR treatment stream. ASFR inventory is selected based on dollar criteria that limits “little or no tax due” situations; but lower dollar inventory has been received in ASFR as reassignments from other collection areas. In February 2011, a change was made to IRM 5.19.2.6.4.3 instructing other collection areas within IRS to not refer modules to ASFR unless they meet established dollar criteria.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS is striving to improve the accuracy of ASFR assessments, and welcomes the assurances that changes are planned for fiscal year 2012 to improve the prioritization of cases selected for the ASFR program. We are also pleased that the IRS plans to implement a new ASFR reconsideration tool in FY 2012 that has been designed to reduce the complexity involved in making adjustments in the ASFR reconsideration process. The new tool will eliminate repetitive manual input by IRS examiners, and provide systemic reminders to ensure that all necessary adjustments are properly considered. This initiative appears to have good potential to improve the service and quality of work performed at the “back-end” of the ASFR process. Further, the progress on the development of a revised ASFR “90-day” letter is encouraging. The implementation of this process improvement is long overdue, and we look forward to seeing the new letter put into service in FY 2012, as planned.

The IRS response contends that the astounding 896 percent increase in ASFR assessments from 2002 to 2011 was a product of increased funding for the program “to ensure a balanced tax administration system.” Nevertheless, IRS data reveal that 2.7 million ASFR

⁵⁹ IRM 25.6.1.12(2) and (4).

initial notices were issued in FY 2003, with only 128,319 ASFR assessments made that year.⁶⁰ By FY 2005, although the number of ASFR initial notices had actually *decreased* by five percent, the number of ASFR assessments was 484 percent of the number of assessments made in FY 2003.⁶¹ The most significant change to the ASFR program during this timeframe, which occurred in March 2004, was the discontinued use of postal tracers to confirm the validity of taxpayer addresses used in ASFR assessments.

The IRS response indicates that ASFR assessments are completed “only after all attempts to secure an updated address have failed.” While this statement may be accurate, the National Taxpayer Advocate remains concerned that the attempts by the IRS to confirm taxpayer addresses prior to establishing these enforcement assessments are inadequate. The IRS claims that although the use of the National Change of Address database does not replace the postal tracer, “it substantially reduces the need for it.” While the NCOA database may be a useful tool for identifying new addresses for some taxpayers, the manner in which the IRS Collection operation uses NCOA as the primary vehicle to confirm taxpayer addresses is a questionable practice. Significant concerns in the areas of address verification and the processing of taxpayer mail responses have recently been raised by the National Taxpayer Advocate and TIGTA.⁶²

As discussed in this report, IRS program data reveal that routinely over 80 percent of ASFR assessments have been established as “unagreed,” primarily due to no response from the taxpayers. Consequently, IRS data also indicate that less than ten percent of ASFR assessments are actually collected, while substantial portions of these assessments are reported as uncollectible or assigned to the Collection Queue inventory. Contrary to the IRS’s response, these results do not reflect program decisions that have conserved resources “while maintaining prudent and responsible program policies.” While the IRS indicates in its response that “balance due assessments, which are lower than the current TDA issuance criteria, *may* (emphasis added) still be paid by taxpayers in full or they may enter into installment agreements,” it provides no factual data to support this assumption.

It is noteworthy that the IRS response refers to the procedures used by the Examination function to locate taxpayers involved with Exam field audits, including field-generated substitute for return cases.⁶³ These procedures reflect a much more sincere and effective attempt to secure an updated address for the taxpayer, including the use of the Form 4759, *Postal Tracer*. Unfortunately, these practices are not reflected in the Collection ASFR

⁶⁰ IRS, Collection Activity Report, NO-5000-139, *National Delinquent Return Activity Report (2003–2005)*. IRS Data Book (2003–2005), Information Reporting Program, Table 25, at www.irs.gov/taxstats/index.html.

⁶¹ *Id.* In FY 2005, 2,578,000 ASFR initial notices were issued and 620,632 ASFR assessments were generated.

⁶² National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*); National Taxpayer Advocate 2010 Annual Report to Congress 235-249 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*); TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undeliverable Mail* (May 14, 2010); TIGTA, Ref. No. 2011-30-051, *Challenges Remain When Processing Undeliverable Mail and Preventing Violations of Taxpayers’ Rights During the Lien Due Process* (May 13, 2011).

⁶³ IRM 4.10.2.7.2.2, *Unlocatable Taxpayers—Mandatory Steps to Locate* (May 2, 2010).

program. The National Taxpayer Advocate is concerned that this situation is an example of how removal of the “human element,” which is too often indicative of IRS automated enforcement programs, results in reductions in quality casework and taxpayer service. From the taxpayers’ perspective, the ASFR process is no less an audit than those conducted by Examination.⁶⁴ Therefore, any less concern for protecting taxpayer rights is inappropriate. The absence of IRS-initiated contacts in the ASFR process exacerbates these concerns. Questions regarding the taxpayer’s marital status and dependents can be easily addressed with a personal contact at the front end of the process, eliminating significant burden from the affected taxpayer and the need for “back-end” adjustments by the IRS. The IRS claims to be considering the use of predictive dialer technology to facilitate more contacts. However, we have noted in this report that the IRS made a similar claim to TIGTA in response to a 2005 audit. Yet, the value of personal contacts during the auditing process continues to be undervalued and underutilized in the ASFR program.

The National Taxpayer Advocate acknowledges the legal barriers to adjusting ASFR assessments in the manner suggested, and we are modifying our preliminary recommendation. However, the fact remains that problems with ASFR reconsiderations consistently surface in TAS cases, and this “back-end” portion of the ASFR process requires improvement. We acknowledge the IRS commitment to improve the accuracy of ASFR reconsiderations through training and implementation of the new ASFR reconsideration tool, and look forward to confirming improvements in this area in FY 2012. Further, the matter of timeliness in addressing and resolving ASFR reconsiderations remains a concern. The IRS needs to ensure that adequate resources are allocated to the ASFR reconsideration process to ensure timely resolutions of these cases.

While the National Taxpayer Advocate is pleased the IRS has acknowledged the need to improve the case selection methodology used in the ASFR program, we have concerns with the response indicating that this work will be accomplished primarily through “programming” changes. These systemic changes, such as excluding from the ASFR process return delinquencies associated with other balance due modules — including those reported as uncollectible — do not address the root problems of the ASFR process; however, these changes could actually prove to be detrimental to the IRS’s overall non-filer strategy. We urge the IRS to recognize that although automation can certainly be a useful tool in the administration of the non-filer program, an effective program must be more concerned with collection of the proper amount of tax due from the delinquent taxpayers, with an ultimate goal of assisting these taxpayers to become and remain fully compliant. As discussed in this report, the current ASFR program does not appear to be successful in attaining either of these goals.

⁶⁴ See also *Introduction to Revenue Protection Issues: As the IRS Relies More Heavily on Automation to Strengthen Enforcement, There Is Increased Risk it Will Assume Taxpayers Are Cheating, Confuse Taxpayers About Their Rights, and Sidestep Longstanding Taxpayer Protections*, *supra*.

Recommendations

The National Taxpayer Advocate offers the following recommendations:

1. Reinstate the policy of not making automated enforcement assessments without confirming that the taxpayer’s address of record is valid, and require use of Form 4759, *Postal Tracer*, to confirm taxpayer addresses prior to making assessments in all “unagreed – no contact” situations.
2. Follow through on current plans to implement the revised ASFR “90-day” letter in FY 2012.⁶⁵
3. Revise ASFR processing procedures to emphasize the completion of telephonic, personal contacts with the affected taxpayers in all potentially “unagreed” ASFR cases prior to assessment.
4. Allocate adequate resources to the ASFR reconsideration process to ensure adjustments are initiated and completed in a timely manner.
5. Apply a pre-assessment collectibility determination to all potential ASFR assessments, including consideration of potential “unable to locate” and “little or no tax due” situations, and the potential for economic hardship based on the taxpayer’s income level. Consider the taxpayer’s last return filed information in making this determination.

⁶⁵ Generally, the National Taxpayer Advocate does not propose a formal recommendation in situations where the IRS has indicated in its response that the recommended action will be implemented. However, the IRS has been in agreement with the need for a revised ASFR “90-day” letter for several years; yet, the new letter has not yet been implemented. This recommendation urges the IRS to deliver on plans to implement the revised letter in FY 2012, without further delay.

MSP
#6**Changes to IRS Lien Filing Practices are Needed to Improve Future Compliance, Increase Revenue Collection, and Minimize Economic Harm Inflicted on Financially Struggling Taxpayers****RESPONSIBLE OFFICIALS**

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Farris Fink, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

A recent IRS focus group report ranked the filing of the Notice of Federal Tax Lien (NFTL) as the number one factor that affects a taxpayer's economic circumstances and credit report, ranking even higher than foreclosure and bankruptcy.¹ The preliminary findings from a new, comprehensive TAS research study empirically support these observations and show that lien filings under the criteria for the study period have a negative effect on the compliance behavior and financial viability of affected taxpayers.² The study shows that taxpayers with liens filed against them were generally over six percent less likely than comparable taxpayers without liens to be compliant in paying current liabilities within the first three years after the lien filing, and still over four and half percent less likely to reduce their initial liabilities than comparable non-lien taxpayers at least four to seven years after the lien was filed.³ In addition, taxpayers with liens were about 7.9 percent less likely to have an increase in their total positive income within the first three years after the lien filing, gradually declining to about 5.2 percent by the end of the full study period, and less likely to file required returns, with the increased likelihood of non-filing ranging between about one and three percent during the full study period.⁴ Some IRS lien filings may make no business sense at all — generating significant downstream costs for the government without attaching to any tangible assets.⁵

The National Taxpayer Advocate has repeatedly expressed concerns about the adverse impact of IRS lien filing policies on taxpayers and future compliance.⁶ She has proposed several administrative and legislative steps to improve these policies and procedures, and

¹ Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, Small Business/Self-Employed Division (SB/SE) Research, Denver, Project DEN0141 (Dec. 2010).

² See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

³ *Id.*

⁴ Total Positive Income is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution 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.

⁵ See T. Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011). (The author, a former attorney with the IRS Office of Chief Counsel and currently an Associate Professor of Law and Director of the Federal Tax Clinic at the Villanova University School of Law, provides a thorough and detailed discussion of downstream costs of an NFTL filing and the "long period of the NFTL maintenance" for the government.)

⁶ National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12-13; National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. See also National Taxpayer Advocate 2009 Annual Report to Congress 357-364.

to grant relief to taxpayers harmed by automatic filings.⁷ In response, the IRS announced a new effort to help financially struggling taxpayers get a “fresh start,” which included several positive changes in how it files and withdraws NFTLs.⁸

Despite these changes, the IRS filed 1,042,230 NFTLs in fiscal year (FY) 2011 against 713,524 taxpayers.⁹ Although the number of liens filed decreased by approximately 54,000 or five percent from FY 2010 levels, the IRS continued to file most NFTLs based on a dollar threshold of liability, without human review of the need for the lien based on the facts and circumstances of the case.¹⁰ As a result, the revised lien policies may not deliver the promised “fresh start” for many taxpayers who will grapple with the burden of NFTLs for years.

With the preliminary results of the new TAS study in hand, the National Taxpayer Advocate has offered to work with the IRS on new, meaningful lien filing criteria. These standards would be based on the effectiveness of filings in increasing revenue, promoting future compliance, and minimizing economic harm.¹¹ The IRS’s commitment to this collaborative effort has the potential to create a solid foundation for improved future compliance, increased revenue, and long-awaited relief for financially struggling taxpayers.

ANALYSIS OF PROBLEM

Background

The IRS filed nearly 1.1 million NFTLs in FY 2010, an increase of about 550 percent from FY 1999, despite scant evidence that liens generate commensurate tax revenue.¹² The IRS continues to file most NFTLs based on a threshold amount of liability, without considering the existence of assets, the likelihood that the taxpayer will acquire assets during the remaining statute of limitations, and the taxpayer’s history of compliance. The National Taxpayer Advocate has opposed this practice for years, and has proposed and advocated for

⁷ See Taxpayer Advocate Directive (TAD) 2010-1, *Immediately discontinue automatic lien filing on Currently Not Collectible (CNC) hardship accounts with an unpaid balance of \$5,000 or more, require employees to make meaningful notice of federal tax lien (NFTL) filing determinations, and require managerial approval for filings of an NFTL in all cases where the taxpayer has no assets* (Jan. 20, 2010); TAD 2010-2, *Withdrawal of a notice of federal tax lien (NFTL) where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released* (Jan. 20, 2010). For copies of the TADs, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix VIII, available at <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf>.

⁸ IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20. (Feb. 24, 2011).

⁹ IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011); IRS, Compliance Data Warehouse (CDW), Individual Master File Transaction (IMF) History Table and Business Master File (BMF) Transaction History Table, Fiscal Year (FY) 2011 (Extracted by TAS Research and Analysis).

¹⁰ IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 30, 2011); IRS, *Fiscal Year 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

¹¹ See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*).

¹² IRS, *Fiscal Year 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf. During FY 1999-2009, when adjusted for inflation, the total dollars collected actually declined by about seven percent from \$29.4 billion to \$27.2 billion (in terms of real dollars valued as of 2009). IRS, *Statistics of Income (SOI) Data Books, Table 16, Delinquent Collection Activities, 1999-2009*. See also Bureau of Labor Statistics, Dept. of Labor, *Consumer Price Index - All Urban Consumers (CPI-U)*, available at <http://www.bls.gov/CPI/>.

alternatives to current lien filing practices.¹³ The IRS filed 1,042,230 NFTLs in FY 2011, a decrease of about five percent from FY 2010, most likely due to the “fresh start” initiative.¹⁴ In terms of the number of taxpayers affected by NFTLs, 713,524 taxpayers had liens filed against them in FY 2011 compared to 776,054 in FY 2010, a decrease of 62,530 or about eight percent.¹⁵

TAS’s comprehensive analysis of IRS lien filing practices has shown that during the past few years:

- *NFTLs do not increase collection revenue.* The IRS raised lien filings by about 550 percent from FY 1999 to FY 2010 despite scant evidence that liens generate commensurate tax revenue.¹⁶
- *The IRS does not know how much money NFTLs bring in.* While less than half of the delinquent tax payments analyzed definitively identified the payment sources, payments associated with liens amount to less than \$1 out of every \$5 of payments.¹⁷
- *NFTL filing practices do not consider the existence of assets or equity in assets and harm taxpayers experiencing economic hardship.* NFTLs were responsible for only \$2 of every \$10 in payments collected from taxpayers in currently not collectible (CNC) status, while nearly \$6 of every \$10 collected from these taxpayers resulted from refund offsets.¹⁸ Nonetheless, the IRS filed NFTLs against more than 72 percent of these taxpayers in tax year (TY) 2009.¹⁹

¹³ National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 12-13; National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. See also National Taxpayer Advocate 2009 Annual Report to Congress 357-364; TADs 2010-1 and 2010-2.

¹⁴ IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011).

¹⁵ IRS, CDW, IMF and BMF Transaction History Tables, FY 2011 (Extracted by TAS Research & Analysis). Some taxpayers may have multiple NFTLs filed against them for separate accounts or liabilities incurred in subsequent tax periods.

¹⁶ During FY 1999-2009, when adjusted for inflation, the total dollars IRS collected actually declined by about seven percent from \$29.4 billion to \$27.2 billion (in terms of real dollars valued as of 2009). National Taxpayer Advocate 2010 Annual Report to Congress 302-310.

¹⁷ See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Study: *The IRS’s Use of Notices of Federal Tax Lien*). The IRS assigns a Designated Payment Code (DPC) to each subsequent, post-assessment payment it receives to identify the source. In 2009, TAS analyzed 1,886,683 total payment transactions, of which only 629,158 transactions had the DPC code assigned. 1,257,525 transactions were designated “miscellaneous” or “DPC indicator not present.” Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets. See also National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

¹⁸ TAS pulled the subset of 35,919 CNC hardship taxpayers with refund offset or specific DPC coding from the 270,399 individual taxpayers who first incurred new balance due delinquencies in TY 2002, had no previous unpaid tax liabilities at that time, and against whom NFTLs were filed in subsequent years. It does not include those payments that were coded as “Miscellaneous” or had no DPC coding. IRS, Compliance Data Warehouse (CDW), Individual Masterfile (IMF) Transaction File Cycle 200913. See also National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS’s Use of Notices of Federal Tax Lien*).

¹⁹ National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

Focus Group Reports Confirm That an NFTL May Devastate a Taxpayer's Financial Situation, Impair the Taxpayer's Ability to Pay Off Liabilities, and Hinder Collection and Future Compliance.

A recent IRS focus group report ranked the filing of the NFTL as the leading factor that affects a taxpayer's economic circumstances and credit report, with a greater effect than even foreclosure or bankruptcy.²⁰ Tax practitioners who took part in focus groups (at the IRS Nationwide Tax Forums) stated the liens hurt their clients and make it harder to obtain credit, including funds to pay off the very liabilities the NFTLs were supposed to secure.²¹ The focus group respondents indicated the NFTL filing would negatively affect credit reports, job applications, loan applications, insurance rates, refinancing, sales of property, rent or leasing opportunities, and interest rates.²²

Focus group participants stated NFTLs affect different types of taxpayers: seniors, people in poverty, wage earners, unemployed taxpayers, and business taxpayers such as sole proprietorships, small corporations, and self-employed taxpayers.²³ Participants in a recent TAS focus group also indicated that hasty filing of NFTLs could be especially devastating for small businesses that cannot obtain financing or bonding to continue in business.²⁴ Some businesses fail because they cannot meet their financial obligations when a lien filed early in the collection process derails future contracts.²⁵

Comments from those responding to the IRS survey include:

- The IRS is “pulling the switch on federal tax liens too early; small businesses don't get an opportunity to restructure their loans to pull money out to pay the liability.”
- The lien should be “the last thing the IRS uses. The revenue officer should have the ability to assess the taxpayer's situation and hold off on filing the lien.”
- The lien is “not doing what the IRS believes it is doing.”
- “Liens work against the government getting paid.”
- “The government assumes the taxpayer has money and the lien is needed to get that money. In reality the taxpayer doesn't have the money.”
- “The lien lowers the credit score 100 points but it won't go back up if the taxpayer pays the liability.”

²⁰ Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DENO141 (Dec. 2010).

²¹ SB/SE Report at 10. One participant stated that even if the taxpayer was in a financial position to borrow money, it could not obtain financing after the NFTL is filed.

²² *Id.* Some respondents indicated that many taxpayers whose credit is compromised adopt their children's Social Security numbers to obtain credit or open bank accounts, which may affect the children's ability to receive student loans or credit in the future. One participant mentioned a taxpayer who used a deceased parent's credit card because the account was in good standing and he could not obtain his own credit because of an NFTL.

²³ *Id.* at 11.

²⁴ TAS Focus Group Report: *Collection Issues for Small Businesses* 30, 2011 Nationwide Tax Forums (Oct. 2011).

²⁵ SB/SE Report at 10.

The suggestions offered by respondents from both focus groups to minimize the impact of the lien on taxpayers include:

- Allow appeal of the NFTL filing before the lien is filed. The process should be consistent with the appeal process for levies, which allows for reconsideration prior to the IRS issuing the levy.
- Permit face-to-face conferences between the taxpayer and collection personnel and allow cases to be transferred locally.
- Give the taxpayer more time to resolve the liability before filing an NFTL.
- Settle a case quickly so the taxpayer does not accrue unnecessary penalties and interest.
- File liens only as a last resort (after installment agreements default).²⁶

Most participants stated a lien has a negative effect on a taxpayer's future compliance.²⁷ Practitioners say some taxpayers will not file returns or will stop filing them, while more frustrated taxpayers will be forced into an underground economy where they will deal in cash only.

Preliminary Results From a TAS Research Study Indicate That NFTL Filings May Negatively Affect Future Tax Compliance.

At the request of the National Taxpayer Advocate, TAS Research & Analysis is conducting a multi-year, comprehensive study of the impact of NFTLs on delinquent taxpayers' current and future payment and filing compliance and their ability to earn income.²⁸ The results of this analysis will help the National Taxpayer Advocate and the IRS better understand the effectiveness of NFTLs.

TAS Research and Analysis analyzed data from all taxpayers who had no liabilities in the beginning of processing year (PY) 2002 and incurred liabilities during processing year (PY) 2002 (a total of 127,406 delinquent taxpayers).²⁹ Working with this population of taxpayers, TAS used a propensity score matching process to establish comparable groups of lien (*i.e.*, taxpayers against whom the IRS filed liens) and nonlien (*i.e.*, taxpayers against whom IRS *should* have had liens filed against, *but did not*) taxpayers that could be used to

²⁶ See Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DENO141 (Dec. 2010); TAS Focus Group Report: *Collection Issues for Small Businesses* 31, 2011 Nationwide Tax Forums (Oct. 2011).

²⁷ Final Report at 15.

²⁸ See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. See also National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*).

²⁹ The processing year is the calendar year in which the return was processed by the IRS. We chose tax year 2002 to allow a sufficient time interval to elapse to analyze subsequent payments.

study the impact of lien filing.³⁰ The resulting groups had 63,703 lien taxpayers and 63,703 nonlien taxpayers.³¹

TAS then analyzed 1,146,654 transactions for both groups in processing years 2002-2010 to evaluate the marginal effect of a lien filing on the following conditions:³²

- *Current payment activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups make sufficient payments to reduce their original liability incurred in PY 2002;
- *Future payment activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups make sufficient payments to reduce their total tax liability, excluding the original tax liability incurred in PY 2002;
- *Future filing activities, i.e.*, increasing or decreasing the likelihood that delinquent taxpayers in both groups will file the required tax returns in calendar years (CYs) 2003-2010; and
- *The ability to generate future income, i.e.*, increasing or decreasing the likelihood that the total positive income of delinquent taxpayers in both groups in the next periods is greater than the 2002 total positive income.³³

Preliminary results show that the lien filing was a significant factor that created negative marginal effects for all conditions and for all analyzed periods.³⁴ The lien taxpayers were about six percent less likely to make sufficient payments to reduce their original liability incurred in PY 2002 during CYs 2002-2005, with negative outcomes gradually decreasing over the years to about four and half percent for CYs 2002-2010. We found that through 2008, at least four years after the lien was filed, taxpayers with liens were still over five percent less likely to reduce their initial liabilities than comparable non-lien taxpayers. In addition, lien taxpayers were less likely to file required returns, with the increased likelihood of non-filing ranging between about one and three percent during the full study period, *i.e.*, through CY 2010. Finally, lien taxpayers were less likely to have an increase in

³⁰ See Rosebaum and Rubin (*The Central Role of Propensity Score in Observational Studies for Causal Effects, Biometrika*, 1983, Vol 70, 1, 41-55) developed this method. The propensity score method addresses the selection bias by pairing, in our case, lien taxpayers, and non-lien taxpayers, where they are similar in observable characteristics that influence the IRS's lien filing determination. For a detailed design of the study, see TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

³¹ These groups share the same characteristics based on then-existing lien filing requirements. IRM 5.12.1.13(2) (July 31, 2001); IRM 5.12.2.8.1(4) and (5) (Mar. 1, 2004); IRM 5.19.4.5.2(2)-(7) (Aug. 30, 2001).

³² The first three activities address the general conditions underlying tax compliance behavior. If taxpayers are filing timely and paying timely on current and future liabilities, we would conclude that these taxpayers are compliant. The last condition focuses on the potential harm that can emerge from an NFTL for delinquent taxpayers, including a negative effect on credit scores. The marginal effect reports the estimated percentage change in the probability of the event (payment, filing, or having more income), given the treatment (tax lien filing) has occurred.

³³ Total positive income is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution 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.

³⁴ The lien effect was examined over six defined timeframes, Pys 2002-2005, Pys 2002-2006, Pys 2002-2007, Pys 2002-2008, Pys 2002-2009, and Pys 2002-2010. These periods captured the characteristics of the subjects (delinquent taxpayers) at the endpoint years of the timeframe. The negative effects of an NFTL decrease over time, with the highest negative impact to be within first three to five years after the NFTL filing.

their total positive income, with the increased likelihood of negative outcomes starting at about 7.9 percent and gradually declining to about 5.2 percent by the end of the full study period. By CY 2010, the overall effect of the lien was that these taxpayers would have, on average, a 6.6 percent likelihood of lower total positive income.

Lien filing had positive affects on future payment activities. For example, the study shows that the lien taxpayers were about 5.6 percent more compliant on their future payment obligations than the non-lien taxpayers in the first three years after the lien filing, gradually declining to about one percent within seven years after the lien filing. It appears that the lien filing may have made the affected taxpayers more careful in the immediate years, but that care eroded over time. We should note that for future income, the cumulative effect of such a reduction may have interplay with the generally negative trend for future payment compliance.

In summary, delinquent taxpayers in the study with liens filed against them were less likely than comparable taxpayers without liens to pay current liabilities, timely file required returns in the future, and generate greater positive income in future tax periods.

The TAS study demonstrates that liens filed under current criteria can be detrimental to compliance and the financial viability of affected taxpayers. TAS Research & Analysis plans to investigate criteria that could change the lien filing outcomes to have a positive impact on filing and payment compliance without needlessly harming taxpayers. We also may explore whether the future payment compliance improved because of payments not attributable to the lien (*e.g.*, refund offsets, levies, or installment agreements). TAS invites the IRS to take part in this research project and use its findings for redesigning lien filing criteria.

The IRS's Fresh Start Initiative is a Step in the Right Direction.

The IRS is to be commended for trying to take “common sense” approaches to collection policy. TAS worked very closely with the Collection function in developing and clearing procedural guidance related to the “Fresh Start” initiative,³⁵ which included:

- Doubling the dollar threshold for filing most NFTLs from \$5,000 to \$10,000, resulting in fewer NFTLs;³⁶
- Changing procedures for NFTL withdrawals after lien releases;³⁷
- Withdrawing liens in most cases where a taxpayer enters into a DDIA;³⁸ and

³⁵ IRS Announcement IR-2011-20, IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes Made to Lien Process, at <http://www.irs.gov/newsroom/article/0,,id=236540,00.html> (last visited July 11, 2011).

³⁶ SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0311-039 (Mar. 28, 2011).

³⁷ SB/SE, *Interim Guidance Memorandum*, Control No. SB/SE-05-0611-037 (June 10, 2011). This guidance was issued in response to TADs 2010-1 and 2010-2. See also National Taxpayer Advocate FY 2012 Objectives Report to Congress 12.

³⁸ SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0411-036 (Apr. 7, 2011).

- Setting the minimum lien filing threshold on subsequent tax modules at \$2,500 or more.³⁹

These changes, however, do not rescind the IRS policy of automatically filing liens based on a dollar threshold of the unpaid tax liability, instead of basing a lien-filing determination on a thorough analysis of the taxpayer's circumstances. Although the short-term impact of changes from the Fresh Start appears promising, the decrease in NFTL filings so far has been minimal, given the millions of liens filed in recent years.⁴⁰

Without Meaningful Criteria the IRS Cannot Improve its Lien-Filing Decision Process, Which Harms Taxpayers, Collection Revenue, and Future Compliance, Especially for Low Income and No-Assets Cases.

TAS research studies and focus group reports have sufficiently demonstrated that current lien filing policies and practices actively and unnecessarily harm taxpayers and tax compliance, without increasing revenue.⁴¹ Particularly for low income and currently not collectible accounts, the IRS has no sound policy or revenue basis for filing liens based on a dollar threshold of liability, without prior personal contact with the taxpayer and verification of assets and equity.

Lien filings should make business sense.

The IRS incurs significant downstream costs for each filing but cannot measure its effectiveness in terms of collected revenue.⁴² These downstream costs begin with the upfront costs: an NFTL mailing fee, the certified mail fee for the Collection Due Process (CDP) notice, and the NFTL recording fee.⁴³ However, administrative costs may be significant and involve substantial time for higher-graded employees at the Office of Appeals, the

³⁹ SB/SE, *Interim Guidance Memorandum*, Control No. SBSE-05-0511-050 (May 13, 2011).

⁴⁰ The IRS filed 5,200,913 NFTLs during FYs 2004-2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf. The number of NFTL filings in FY 2011 decreased by only 54,000 or about five percent compared to FY 2010 as described above. This figure is consistent with Collection Process Study estimates that a change in threshold would reduce the IRS's 1.1 million annual lien filings by only 40,000 to 41,000, or about four percent. IRS, *Collection Process Study (CPS)* 122 (Sept. 30, 2010).

⁴¹ See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*. National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 89-100 (TAS Research and Related Studies: *Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative*); National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*). See also Final Report: *Federal Tax Liens, the General Public, and Credit Report Considerations* iv, 2010 Nationwide Tax Forum Focus Groups, SB/SE Research, Denver, Project DEN0141 (Dec. 2010); TAS Focus Group Report: *Collection Issues for Small Businesses* 31, 2011 Nationwide Tax Forums (Oct. 2011).

⁴² The IRS cannot track the source of payments on past due accounts to measure the effectiveness of its collection actions. See National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

⁴³ See T. Keith Fogg, *Systemic Problems with Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011) for a thorough and detailed discussion of downstream costs of an NFTL filing and the "long period of the NFTL maintenance" for the government). For example, the IRS estimates that a lien filing costs between \$25 and \$100, plus labor costs. IRS, *Collection Process Study (CPS)* 122 (Sept. 30, 2010). The IRS may spend up to \$109 million in lien filing costs annually, not including labor costs, based on 1,096,376 NFTLs filed in FY 2010. IRS, *Fiscal Year 2010 Enforcement Results*, available at http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf. There are no estimates for the downstream costs of time spent by the IRS Offices of Appeals, CFF, Taxpayer Advocate Service, and Chief Counsel in resolving an NFTL case, including a CDP hearing and supporting the case through the court system. TAS direct costs for resolving lien issues exceeded \$2.3 million and 31,600 hours in FY 2011. FY 2011 lien case counts include issue codes 720, 721, 722, 723, 724, and 729. The FY11 average salary includes benefits for case advocates, intake advocates, lead case advocates, and technical advisors.

Collection Field function (Cff), the Taxpayer Advocate Service, and the Office of Chief Counsel, when the filing is contested at a CDP hearing or in the U.S. Tax Court.⁴⁴ Therefore, filing an NFTL on a relatively small liability, such as \$10,000 or even \$50,000, may open the government to significant expenses. This does not mean the IRS should not file liens to protect the government's interest in the taxpayer's assets or equity in assets. However, the IRS should do it judiciously, after considering all facts and circumstances, and definitely not based merely on the size of the unpaid balance.⁴⁵

Notices of Federal Tax Lien must be filed in a proper jurisdiction to protect the government's interest in taxpayer assets or priority in bankruptcy.

Because the IRS does not verify the taxpayer's address or determine where the assets are located before filing a lien, some NFTLs may be filed in the wrong jurisdiction, making them potentially worthless, and stripping the government of its protected interest in taxpayer assets or priority in bankruptcy.⁴⁶ The Treasury Inspector General for Tax Administration (TIGTA) repeatedly found that CDP notices were undeliverable or not sent to the taxpayer's last known address.⁴⁷ Another TIGTA report estimated that about ten percent of all IRS correspondence with taxpayers was returned as undeliverable.⁴⁸ Assuming that the IRS sent the notices to addresses recorded in its databases, and because the IRS does not verify the existence of assets of delinquent taxpayers or the equity in those assets, many NFTL filings may not properly attach to equity in real or personal property of the taxpayer.⁴⁹ As a result, these worthless NFTLs harm taxpayers' ability to obtain credit and simultaneously

⁴⁴ Litigation creates additional costs for the government, including the time spent by judges and other personnel. For example if the taxpayer succeeds in the Tax Court, the IRS may incur additional administrative costs while releasing or withdrawing the NFTL. If the taxpayer loses, he or she has a right to appeal the case, resulting in additional costs for the government at the circuit court level. Filing an NFTL to collect \$10,000 potentially opens the government up to significant downstream costs as it defends the NFTL in the CDP process. See Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011).

⁴⁵ The "fresh start" initiative increased the NFTL filing threshold from \$5,000 to \$10,000 as discussed above. CPS recommended raising the threshold to \$50,000. CPS at 121-122.

⁴⁶ See, e.g., IRM 5.12.2.6(6) (Oct. 30, 2009) ("NFTLs must show the taxpayer's last known address."). A valid NFTL must be generally filed in an office designated by the state where the real property is located (usually the clerk of the court in the county it is located), with the Secretary of State (for personal property where the taxpayer resides at the time of the filing), or with the U.S. District Court (when the state has not designated one office for filing). See generally IRC § 6323(f)(1); Treas. Reg. § 6323(f)-1.

⁴⁷ See, e.g., TIGTA, Ref. No. 2011-30-051, *Challenges Remain When Processing Undeliverable Mail and Preventing Violations of Taxpayers' Rights During the Lien Due Process* (May 13, 2011); TIGTA, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (July 9, 2010); TIGTA, Ref. No. 2009-30-089, *Additional Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (June 16, 2009). IRC § 6320 requires the IRS to notify taxpayers in writing within five business days of the filing of an NFTL. The last known address is the one shown on the most recently filed and properly processed tax return, unless the IRS is notified of a different address.

⁴⁸ TIGTA, Ref. No. 2010-40-055, *Current Practices Are Preventing a Reduction in the Volume of Undelivered Mail 2* (May 14, 2010). See also National Taxpayer Advocate 2010 Annual Report to Congress 221-234 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*).

⁴⁹ Most lien notices are mailed to taxpayers by certified or registered mail rather than being delivered in person. The IRS Automated Lien System (ALS) generates a certified mail list that identifies each notice to be mailed. The stamped certified mail list is the only documentation the IRS has that certifies the date when the notices were mailed. TIGTA, Ref. No. 2011-30-051, at 1-2. For example, 10,370 or about four percent of all CDP lien notices mailed in FY 2011 by the Cff were returned as undeliverable. IRS, CDW, Individual MasterFile (IMF) and Business MasterFile (BMF) Transaction History Tables, FY 2011. The IRS Automated Collection System (ACS), which files most NFTLs, does not track issued CDP lien notices at all. TAS estimates that the number and percent of undeliverable CDP lien notices is higher for ACS because ACS employees generally do not maintain contact with taxpayers. See, e.g., IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators Reports* (Sept. 2010) (Of the 1,096,376 NFTLs filed in FY 2010, 554,331 (50.6 percent) were filed by the ACS.).

hinder the IRS's ability to collect revenue.⁵⁰ The IRS should conduct a statistically valid study of how many liens are filed in the right jurisdictions and actually attach to the delinquent taxpayers' assets. In any case, the fact that many NFTLs may be improperly filed undermines the case for filing without verifying the existence and location of assets and contacting the taxpayer.

The IRS must rethink its policy of filing NFTLs against CNC taxpayers.

As discussed in detail in prior reports to Congress and Taxpayer Advocate Directives issued to IRS executives,⁵¹ there is no sound business reason for the current policy of filing NFTLs against CNC taxpayers (who in most cases have no assets), both when the IRS cannot locate or contact the taxpayer and when the taxpayer is experiencing an economic hardship.⁵² In many cases, an IRS employee may have talked to the taxpayer and evaluated his or her financial information or other evidence of financial difficulty (including a medical hardship) prior to reporting the taxpayer's account as CNC (Unable to Pay - Hardship).⁵³ A prior TAS study of collection payment data from a subset of taxpayers in CNC (hardship) status also shows that approximately 20 percent of the total dollars collected from these taxpayers are attributable to NFTLs.⁵⁴ At the same time, refund offsets — which do not require an NFTL — comprise about 59 percent of the total dollars collected and about half of all payment transactions for this group.⁵⁵ Therefore, the NFTL filing may harm the taxpayers and the government at the same time.⁵⁶

Lien filings should employ sound judgment.

Sound business judgment suggests the IRS should defer filing an NFTL against a cooperative taxpayer who responds to IRS requests, complies with current filing and payment requirements, and tries to resolve past debts through collection alternatives (*e.g.*, an installment agreement (IA) or offer in compromise (OIC)). It is true that the general economic environment or individual circumstances of taxpayers suffering an economic hardship

⁵⁰ Undeliverable CDP notices also violate an important statutory right to a CDP hearing. TIGTA repeatedly found potential violations of CDP rights because the IRS did not timely notify taxpayers or their representatives or failed to deliver CDP notices to the taxpayer's last known address. See, *e.g.*, TIGTA, Ref. No. 2011-30-051, at 2.

⁵¹ See TAD 2010-1; Memorandum for Steven T. Miller, Deputy Commissioner for Services and Enforcement, from Nina E. Olson, National Taxpayer Advocate, *Sustaining Taxpayer Advocate Directive 2010-1* (Mar. 31, 2010). See also National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

⁵² IRM 5.19.4.5.2 (May 20, 2011).

⁵³ See IRM 5.19.1.7.1.5 (Sept. 7, 2011); Policy Statement P-5-71, IRM 1.2.14.1.14 (Nov. 19, 1980). See also IRM 5.16.1.1 (Apr. 29, 2011) and IRM 5.16.1.2.9 (Apr. 29, 2011). The basis for a hardship determination is from information about the taxpayer's financial condition provided on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses*. See also IRM 5.15.1, *Financial Analysis Handbook* (Oct. 2, 2009).

⁵⁴ National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*).

⁵⁵ Pursuant to IRC § 6402(a), the IRS may credit a taxpayer's overpayment to any federal tax liability prior to making a refund. This application of a tax overpayment is called a refund offset.

⁵⁶ NFTL filings harm low income and minority taxpayers the most. See, *e.g.*, T. Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011) (discussing negative effects of NFTL filings on low income taxpayers); Fortune, *The IRS's Problem with Minorities* (Dec. 2, 2010) (citing study entitled *IRS Enforcement's Impact on Minority Communities*, exclusively conducted for Fortune by Thomas M. Evans, CEO of TaxLifeboat, a firm that advises taxpayers on resolving their problems with the IRS)..

today, or repaying liabilities under an IA, may improve in the future, resulting in equity in assets. At that time, the government might reap some benefit from filing the NFTL.⁵⁷ Therefore, a sound and prudent lien and collection strategy would require a regular review of taxpayer information and meaningful lien determinations, such as verifying that the NFTL attaches to assets and does not hamper collection from and future compliance by a generally cooperative taxpayer.

Lien filings where the taxpayer qualifies for an NFTL withdrawal at the outset under IRC § 6323(j)(1) are counterproductive.⁵⁸

The National Taxpayer Advocate's guidance to TAS employees advises them to use sound judgment in evaluating the facts and circumstances surrounding the filing of an NFTL in cases involving IAs, OICs, or CNC determinations.⁵⁹ When a taxpayer's situation meets one of the IRC § 6323(j)(1) requirements for an NFTL withdrawal, TAS employees are instructed to advocate against the filing of an NFTL. This "reverse" analysis of NFTL withdrawal criteria before filing the lien will save IRS resources and alleviate unnecessary harm to taxpayers.

A Notice of Federal Tax Lien determination should involve human review.

The National Taxpayer Advocate believes the IRS should adhere to its longstanding policy and the spirit of the IRS Restructuring and Reform Act of 1998, and file NFTLs only after an individual lien filing determination is made by an employee and is reviewed and approved by his or her immediate supervisor.⁶⁰ This does not mean the IRS cannot use technology in selecting NFTL cases for human review and base its lien filing determinations on meaningful criteria, as discussed above.⁶¹ TAS offers its assistance in developing such a meaningful lien filing determination algorithm.

⁵⁷ The IRS does have the tools necessary to determine the existence and the value of assets or equity in assets, such as Information Returns Program (IRP) data (which provide verifiable third party documentation), and Accurint (to confirm real estate, business property, and motor vehicle records). The IRP allows IRS employees to request either on-line or hardcopy Information Returns Processing (IRP) transcripts from the Information Returns Master File (IRMF), e.g., Form 1098, *Mortgage Interest Statement* (demonstrating home ownership) or Form 1099-INT, *Interest Statement* (demonstrating asset ownership). Accurint is a service provided by Lexis-Nexis, with which the IRS has an unlimited annually renewable contract. See Accurint, <http://www.accurint.com> (last visited Oct. 31, 2011).

⁵⁸ IRC § 6323(j)(1) provides the NFTL may be withdrawn when one of the following criteria is met: (A) The IRS filed the NFTL prematurely or otherwise not in accordance with procedures; (B) The taxpayer entered into an installment agreement to satisfy the liability (unless the IA provides otherwise); (C) The withdrawal would facilitate collection; or (D) The withdrawal is in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

⁵⁹ National Taxpayer Advocate, *Interim Guidance Memorandum*, Control No. TAS-13.1-0310-003 (Mar. 31, 2010). For a copy of this memorandum, see National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress, Appendix IX, available at <http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal.pdf>.

⁶⁰ Section 3421 of RRA 98 provides that, where appropriate, a supervisor review the proposed lien filing, considering the amount due and the value of the taxpayer's assets. RRA 98, Title III, § 3421, Pub. L. No. 105-206, 112 Stat. 685, 758 (1998). IRS Policy Statement 5-47 states: "...All pertinent facts must be carefully considered as the filing of the notice of lien may adversely affect the taxpayer's ability to pay and thereby hamper or retard the collection process." IRM 1.2.14.1.13 (Oct. 9, 1996).

⁶¹ Some of these factors include: existence and value in assets, compliance history, reasons for noncompliance, potential to hamper collection, undue harm to taxpayer that reduces collection potential, cooperation of the taxpayer, willingness to resolve the liability, payment before collection statute expiration date (CSED), etc. National Taxpayer Advocate, *Interim Guidance Memorandum*, Control No. TAS-13.1-0310-003 (Mar. 31, 2010). See also Keith Fogg, *Systemic Problems With Low-Dollar Lien Filing*, 2011 TNT 194-9 (Oct. 6, 2011).

TAS Collaboration with the Enterprise Collections Strategy Function May Provide a Strong Foundation for Improvements to NFTL Filing Policies.

The IRS recently established a new Enterprise Collection Strategy (ECS) office within the SB/SE division.⁶² As stated above, TAS works closely with the new office and is represented on the Collection Governance Council, overseeing the IRS Collection strategy. The National Taxpayer Advocate is pleased with the IRS's interest in basing any future policy decisions on a data-driven approach.⁶³ The IRS's commitment to such a collaborative effort with TAS on developing meaningful NFTL filing criteria may lay a foundation for improved future compliance, increased revenue, and minimization of economic harm for financially struggling taxpayers.⁶⁴

CONCLUSION

TAS research studies have demonstrated empirically that current IRS lien filing policies are not working properly from either the taxpayer or the IRS perspectives. These policies actively and unnecessarily harm taxpayers and discourage current and future compliance, without increasing revenue. The IRS should carefully redesign these policies using meaningful lien filing criteria discussed above. In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Based on the results of the TAS study and in collaboration with the National Taxpayer Advocate, develop new, meaningful NFTL filing determination criteria based on thorough review of objective factors, such as the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date (CSED), assurance that the NFTL is filed in proper jurisdiction, etc. These new criteria will replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability.
2. Discontinue NFTL filing on currently not collectible taxpayers based on dollar threshold of unpaid liability, and instead make a lien filing determination at the time of the CNC determination.
3. Replace the mandatory NFTL filing on CNC taxpayers and taxpayers with no assets with a system of subsequent filing determinations based on periodic monitoring of

⁶² Enterprise Collection Strategy Organization Chart (Oct. 30, 2011).

⁶³ See, e.g., Memorandum for Nina E. Olson, National Taxpayer Advocate, from Steven T. Miller, on Taxpayer Advocate Directives 2010-1, 2010-2, and 2010-3 (June 10, 2010).

⁶⁴ The meaningful criteria should balance the need to protect the government's interests in the taxpayer's assets with a corresponding concern for the financial harm the lien will create for that taxpayer. An NFTL filing determination should be made by a revenue officer after considering all facts and circumstances of a particular taxpayer.

whether the taxpayers have acquired assets or their financial situations have improved, using information from Accurant and IRS internal databases.

4. Require managerial approval for NFTL filings in cases where no attempted personal contact was made or the notice to the taxpayer was returned as undeliverable.

IRS COMMENTS

The IRS is committed to assisting taxpayers with their voluntary filing and payment responsibilities. We must balance the interests of taxpayers with our responsibility to protect the government's interest when federal taxes are not paid. Several steps are taken through our normal processes prior to consideration of a Notice of Federal Tax Lien. Before an NFTL is filed, an assessment must be made, demand for payment must be made, and the taxpayer must have neglected or refused to pay. A lien protects the government's interest by publicly recording the debt owed by the taxpayer as a notice to possible future creditors and establishes a priority among other secured creditors. The lien attaches to property currently owned and to property the taxpayer may acquire in the future. In order to protect the government's interest, filing of a lien is necessary in many cases even if specific assets have not been identified.

As noted by the National Taxpayer Advocate, the IRS has made changes to its NFTL filing policies through Fresh Start initiatives. In February 2011, IRS announced that it significantly increased the dollar threshold when liens are generally filed. Additionally, the IRS also modified procedures to make it easier for taxpayers to obtain lien withdrawals. Changes to both the lien threshold and lien withdrawals were coordinated with the National Taxpayer Advocate staff prior to implementation. IRS employees also have the discretion to not file liens if it would hamper collection of the taxes owed, there is doubt as to the liability, or forthcoming information could lead to either of the above. The IRS continually monitors whether additional changes in this area are appropriate.

The National Taxpayer Advocate relies on several data sources in reaching conclusions in the draft report. The IRS has not yet been provided the study in which the National Taxpayer Advocate states that the results show taxpayers against whom the IRS has filed an NFTL tend to be less compliant in tax filing and payment in subsequent tax years. We are interested in these findings and would appreciate the opportunity to analyze the results of this study. The National Taxpayer Advocate's position also relies on an IRS focus group report. The IRS focus group report did demonstrate that the IRS could improve communication of procedures in handling delinquent accounts thereby dispelling false perceptions of the overall collection process. To this end, we are continually taking steps to improve our communications to taxpayers and practitioners. The NFTL was included as a topic in the National Tax Forums this year. We have also updated the lien web page on IRS.gov. As resources become available, additional educational videos will be developed and posted.

The National Taxpayer Advocate also states some IRS lien notice filings may not make business sense due to downstream costs. The IRS is unlike a private sector creditor who

can extend or deny credit based on a risk analysis. In the case of the IRS, filing lien notices to establish creditor standing is the only legal means the IRS has to protect the American taxpaying public's interest.

The National Taxpayer Advocate contends that NFTL filing does not produce revenue. It should be noted that the decrease in overall collection revenue is discussed without regard to factors such as the current downturn in the economy, which are significant to any analysis. In addition, with respect to the 2009 study by the National Taxpayer Advocate regarding Designated Payment Codes, this study concluded that only payments with a lien DPC were attributable to the filing of the lien. However, most remittances are received in a bulk processing operation and are not assigned a DPC. In addition, taxpayers are rarely explicit in describing their reasons for sending a payment. Therefore, we believe that the DPC process is not an appropriate gauge to demonstrate the effectiveness of the NFTL in promoting payment. It could be argued, because of the lien notice's impact, any payment received after the notice is filed would be directly or indirectly attributable to the lien.

The IRS has commissioned several studies by the SB/SE Research function regarding NFTL filing policies. In June 2011, SB/SE Research published the results of the study, *Estimating the Impact of Federal Tax Lien Filing on BMF and IMF Cases Assigned to the Queue*. This study found lien filing has the potential to increase full and partial resolution for both IMF and BMF cases in the queue.

The National Taxpayer Advocate states that a significant number of NFTLs are filed incorrectly, citing TIGTA reports on undelivered mail. A review of the TIGTA report findings stated that IRS consistently complies with legal and procedural guidelines. In TIGTA report 2010-30-072, TIGTA found an error rate of less than 2.5 percent in mailing lien notice filing due process rights to the last known address. TIGTA commented that the IRS needs to better protect the government's interest in regards to delinquent taxes. In fact, in a separate report, TIGTA stated if liens are not filed when accounts are closed as currently not collectible, the probability of any future collection on the cases is reduced.⁶⁵

The IRS recognizes the need to continually provide information for taxpayers and practitioners about what it means to have a lien, what it means when a lien notice is filed, what can be done about it, and who to contact. To that end, we have revised the instructions and provided an application form to request a release of an NFTL when the NFTL is filed in order to address concerns regarding selling and refinancing property. In March 2011, we also posted to IRS.gov a video support guide to assist with the release of lien application forms and the process.

The National Taxpayer Advocate makes four preliminary recommendations. The IRS has taken, or is taking the following actions with respect to these recommendations:

⁶⁵ Report 2011-30-051 (May 13, 2011).

The IRS has initiated several research studies (including one in conjunction with the National Taxpayer Advocate) to determine the effectiveness of lien notice filing. We will continue to utilize the findings from these and future studies when considering Internal Revenue Manual (IRM) and policy changes to ensure employees are filing appropriate and effective NFTLs.

In some cases, the IRS makes the NFTL determination concurrently with a CNC determination. However, with Field Collection assigned cases, the notice filing determination is generally made several months (and sometimes years) prior to the CNC determination. The CNC determination is based on collection information and supporting documentation substantiating the reporting of a case as CNC.

We will take into account the views included in the report, but anticipate that institution of a monitoring system on CNC cases to prompt lien notice filing if it becomes necessary would not be effective or efficient. In addition to significant cost of revisiting the NFTL decision multiple times, relying on an arbitrary timeframe for performing the subsequent reviews may not be sufficient to protect the government's interest. For instance, during this period, a taxpayer who has acquired assets may file bankruptcy and the government claim will not be protected.

While the IRS agrees that appropriate efforts should be made to contact taxpayers prior to NFTL filing, at this time, we do not believe it is appropriate to require managerial approval in cases where no attempted personal contact was made. Generally, the IRS sends multiple letters for each tax period owed. In most cases, the IRS further attempts to make contact via telephone or in person. It is normally after the taxpayer has had several opportunities to respond, and did not voluntarily resolve their account, that a Notice of Federal Tax Lien will be filed, if it meets the filing threshold.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate commends the IRS for the changes in the lien filing procedures through the Fresh Start Initiative and for collaborating with the TAS research function on studies to determine the effectiveness of NFTL filings.

In the months leading up to the printing of this report, the National Taxpayer Advocate shared the data and methodology of the recent TAS Lien Study (published in its entirety in Volume 2 of this report) with SB/SE Research and IRS National Office Research staff.⁶⁶ She also personally discussed the methodology and findings of the study with the IRS Commissioner, the SB/SE Commissioner, the SB/SE Director of Collection Field Function, and Enterprise Collection Strategy leadership. We will continue to review and analyze the results of this study with the IRS.

The 2012 phase of this groundbreaking, longitudinal lien study will investigate when NFTLs are likely to be most effective, and we invite the IRS to collaborate with us in the design and analysis of this phase. Possible areas of future research, among others, include the impact of lien filing on taxpayers in CNC status, and whether removal of these taxpayers from our study cohort would significantly improve compliance outcome measures for the remaining lien taxpayers. We may also investigate whether lien filing is more effective for taxpayers who have significant assets. Finally, we may build on previous research and further explore the extent to which payments credited to lien taxpayers were attributable to sources other than the lien.⁶⁷

In conducting our lien study, we included in the models independent variables that capture all the factors that we believe significantly influence the model outcome variables. Additional modeling to determine the interaction between these variables, tax compliance, and lien filing will provide the IRS with valuable empirical data upon which to base informed lien-filing policies. For example, to model the tax compliance behavior of delinquent taxpayers, the models include the factors that we believe may impact a taxpayer's compliance. The models have independent variables for taxpayer characteristics and indicators that reflect IRS collection activities associated with the taxpayer's liability. Individual taxpayer characteristics include marital status, number of exemptions, and an age category. Also, income information is included in several forms such as total positive income, average total positive income, presence of the earned income tax credit (EITC), and business or partnership income.

Since taxpayer compliance may be influenced by IRS audit and collection activities, the models include independent variables that capture whether the taxpayer has undergone an

⁶⁶ See TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

⁶⁷ In prior research, TAS found that most payments for lien taxpayers were attributable to sources other than the lien, such as refund offsets. See National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18 (*The IRS's Use of Notices of Federal Tax Lien*).

audit, as well as information about important collection-related activities, such as whether the taxpayer had an installment agreement or defaulted on an IA, whether the taxpayer was placed in CNC status, or whether the IRS levied on the taxpayer. We have also captured whether the taxpayer filed for bankruptcy.⁶⁸

With these studies in hand, TAS is committed to working with the IRS on new, meaningful NFTL filing criteria, based on a thorough review of objective factors, to replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability. These objective factors may include the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date (CSED), and assurance that the NFTL is filed in the proper jurisdiction.

While pleased with recent improvements in the NFTL withdrawal process and communications with taxpayers and practitioners, the National Taxpayer Advocate remains concerned about the systemic filing of liens without full consideration of facts and circumstances. The IRS files almost half of its liens through the Automated Collection System, and files over two-thirds of these without any significant employee review of the cases.⁶⁹ The National Taxpayer Advocate does not believe the IRS should be precluded from filing NFTLs, but it should use this powerful collection tool judiciously as warranted by the circumstances of the delinquency.⁷⁰

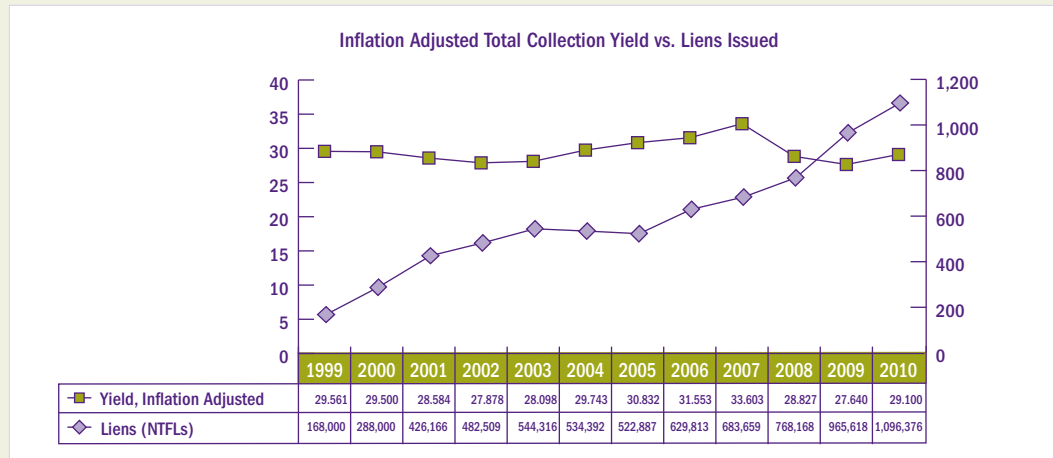
While NFTL filings fell to an all-time low after the enactment of the Revenue and Reconciliation Act of 1998, they have since increased, and have risen precipitously since 2005. In fact, the 2011 volume of 1,042,230 filings is about six times the number for 1999. The following chart shows the volume of IRS lien filings and the total dollars collected since that year.

⁶⁸ For a detailed discussion of the models and independent variables used in the recent TAS lien study, see TAS Research Study: *Estimating the Impact of Liens on Taxpayer Compliance Behavior and Income*, Vol. 2, *infra*.

⁶⁹ IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators* (Oct. 11, 2011). Of the 1,042,230 NFTLs filed in FY 2011, 45.6 percent were filed by the ACS Automated Collection System (ACS) *Customer Service Activity Reports (CSAR), FY 2011 BOD report and Support Site Report* (Oct.1, 2011)

⁷⁰ For a more detailed discussion, see National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2009 Annual Report to Congress 17-40.

FIGURE 1.6.1, Inflation-Adjusted Total Yield vs. Liens Issued⁷¹



As illustrated above, overall inflation-adjusted collection revenue has not kept pace with the growth in lien filings.⁷² While other economic conditions certainly affect the total collection yield, the fact that increased lien filings do not necessarily increase collections makes the practice of filing an NFTL questionable in various situations.

The IRS’s statement “that the DPC process is not an appropriate gauge to demonstrate the effectiveness of the NFTL in promoting payment” is rather disingenuous. For the third consecutive year, the National Taxpayer Advocate raises concerns about the IRS’s inability to accurately track the source of *subsequent, post-assessment* tax payments received on past due accounts.⁷³ The IRS’s own internal guidance interprets that DPCs are “*congressionally mandated and will be accumulated on a national basis to determine the revenue effectiveness of specific collection activities.*”⁷⁴ DPCs are designed to provide the IRS and outside stakeholders with meaningful information regarding the revenue outcomes of IRS compliance activities. DPCs are also very important for gauging the IRS’s performance in *objective, quantifiable, and measurable* terms. The IRS’s use of the DPCs, however, does not provide good data for use in this manner. A TAS analysis of IRS payment source data has found that the DPC is not present on payment vouchers in 81 percent of all post-assessment tax payments received in 2009. Even with transaction codes that require DPCs, about 75 percent of all entries either had no DPC or defaulted to DPCs of “00” (undesignated payment) or “99” (miscellaneous). Thus, in most cases, the IRS does not know and

⁷¹ IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2010*; IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 11, 2011).

⁷² The inflation-adjusted totals reflect the yearly total collection yields adjusted to 2010 dollars using the U.S. Consumer Price Index-All Urban 2010, U.S. Bureau of Labor Statistics.

⁷³ National Taxpayer Advocate 2010 Annual Report to Congress 302-310; National Taxpayer Advocate 2010 Annual Report to Congress 250-266; National Taxpayer Advocate 2009 Annual Report to Congress 17-40; National Taxpayer Advocate 2009 Annual Report to Congress vol. 2, 1-18. Most pre-filing, voluntary payments are already identifiable from their source, e.g., payments with return (TC 610); federal tax deposits (TC 650); estimated tax payments (TC 660), etc.

⁷⁴ IRM 5.1.2.8.1.3, *Identify the Event That Resulted in a Payment* (Aug. 15, 2008) (emphasis added).

cannot determine what event or action prompted the subsequent payment on a past due account. The IRS also has not taken action on the National Taxpayer Advocate recommendation to link each subsequent payment to specific IRS enforcement activities and service initiatives.⁷⁵

The National Taxpayer Advocate also disagrees with the IRS's statement that "unlike a private sector creditor [it cannot make lien filing determinations] based on a risk analysis." It is also not true that the lien filing is the "only legal means the IRS has to protect the American taxpaying public's interest." Unlike a private creditor, the IRS has a number of powerful collection tools at its disposal, including levies and seizures. In the current budget environment, the IRS can and should employ the most cost-effective methods of collecting revenue. Risk analysis, verification of address and assets, and elimination of downstream costs may save millions of dollars in unnecessary filing fees, re-work, and litigation. The IRS's role as the nation's tax administrator requires it to use public resources responsibly, and maximize revenue collection without imposing undue burdens on taxpayers.

In addition, as stated in prior reports to Congress, an NFTL filing does not necessarily result in increased collection in bankruptcy.⁷⁶ The IRS itself acknowledges that in CNC cases, the amount of the secured claim in bankruptcy would be at or close to zero.⁷⁷ FY 2011 data clearly support this premise: the IRS collected more in bankruptcy proceedings on *unsecured* priority claims than on secured claims.⁷⁸ Therefore, it would be prudent for the IRS to make the NFTL determination concurrently with a CNC determination. In Field Collection cases, when NFTL determinations are made several months prior to CNC determination, the IRS can use its discretionary authority to withdraw the NFTL concurrently with making the CNC determination based on financial information and documentation substantiating the CNC status.

Instituting a monitoring system for CNC and no-assets cases would improve the efficiency of NFTL filings and save IRS resources. The IRS can and should use technology to identify assets and prompt a review of a case when the taxpayer acquires an asset or his financial situation improves. The CNC process has a built-in monitoring system, based on the dollar threshold and closing code established for review of the account. If a taxpayer exceeds that amount, the IRS can reactivate the account and make a new NFTL determination based on the taxpayer's improved circumstances.

⁷⁵ For a detailed discussion of designated payment codes, see National Taxpayer Advocate 2010 Annual Report to Congress 250-266 (Most Serious Problem: *The IRS Should Accurately Track Sources of Balance Due Payments to Determine the Revenue Effectiveness of Its Enforcement Activities and Service Initiatives*).

⁷⁶ See, e.g., National Taxpayer Advocate 2010 Annual Report to Congress 302-310; Taxpayer Advocate Directive 2010-1 (Mar. 31, 2011).

⁷⁷ See IRM 5.16.1.2.9(1) (stating that "[g]enerally, these [CNC hardship] cases involve no income or assets, no equity in assets or insufficient income to make any payment without causing hardship."). IRM 5.16.1.2.9(1), Hardship (Apr. 29, 2011).

⁷⁸ IRS, Collection Activity Report NO-5000-31, *IMF Report of Bankruptcies* (Sep. 28, 2011), Total - All Chapters, line 2.1. In FY 2011, the total collection for all chapters showed \$253,420,479 collected from unsecured priority claims and \$53,105,549 collected from secured claims. The IRS also collected \$33,283,222 from general unsecured claims. For definitions, see 11 U.S.C. §§ 506(secured claim); 507(a)(8) (priority claim).

The National Taxpayer Advocate agrees with TIGTA that the IRS needs to better protect the government's interests. We contend that better research of the taxpayer's true last known address and personal contact with the taxpayer would provide more up-to-date information to ensure that the IRS files the NFTL with the most current address and in the proper jurisdiction to ensure legal attachment to assets.

The National Taxpayer Advocate believes an NFTL filing must have a manager's approval when the IRS has not made personal contact with the taxpayer and its notices have been returned as undeliverable. This level of approval should ensure that the benefit to the government outweighs the harm to the taxpayer and that the NFTL will attach to assets.

Recommendations

In conclusion, the National Taxpayer Advocate recommends that the IRS:

1. Collaborate with the National Taxpayer Advocate and TAS Research on the next phase of the TAS lien study to explore when lien filing might be most effective, and the impact of certain independent variables on taxpayer compliance, with or without a lien.
2. Based on the results of the TAS study and in collaboration with the National Taxpayer Advocate, develop new, meaningful NFTL filing determination criteria based on thorough review of objective factors, such as the existence and value of the taxpayer's equity in assets, compliance history, reasons for noncompliance, effect on collection potential, harm to the taxpayer and his or her ability to comply in the future, prior contact and cooperation of the taxpayer, willingness to resolve the liability (including through collection alternatives), payment before the collection statute expiration date, and assurance that the NFTL is filed in the proper jurisdiction. These new criteria will replace the current policy of automatically filing liens based on a dollar threshold of unpaid liability.
3. Discontinue NFTL filing on currently not collectible taxpayers based on the dollar threshold of unpaid liability, and instead make a lien filing determination at the time of the CNC determination.
4. Replace the mandatory NFTL filing on CNC taxpayers and taxpayers with no assets with a system of subsequent filing determinations based on periodic monitoring of whether the taxpayers have acquired assets or their financial situations have improved, using information from Accurint and IRS internal databases.
5. Require managerial approval for NFTL filings in cases where the IRS has not made personal contact with the taxpayer or the notice to the taxpayer was returned as undeliverable.