Honorable Members of Congress,

It is my pleasure to submit to you for your review the National Taxpayer Advocate’s Annual Report to Congress. In this year’s report, we highlight the impact of tax law complexity on tax administration. The report is a little different in format from previous years in that we have carried this theme – tax administration in a complex and changing tax environment – throughout each of the report’s sections. Particularly in the Most Serious Problems section, we look at the impact of complexity and the challenges of the 21st century with respect to each aspect of the tax system, from the taxpayer’s perspective.

Given the current debate about tax reform, we believe that this is a particularly appropriate time to make a comprehensive review of IRS operations, to acknowledge and praise its successes, and to identify significant challenges. We hope this information is useful to policy-makers as they consider tax law simplification and reform. Certainly, reform efforts must take into account the impact of such proposals on the IRS and the IRS’ ability to fairly and effectively administer any changes.

To be sure, this report documents many success stories. As we note in the Legislative Recommendations section, there has been significant activity on the legislative front. Most notably, we now have a uniform definition of a child for five of the most basic family status provisions in the Internal Revenue Code.1 Three other proposals we recently recommended have become law – an "above-the-line" deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,2 authorization for the IRS to enter into partial-pay installment agreements,3 and the availability of income averaging for commercial fishermen.4

There is, however, one nagging problem that has not been adequately addressed – the Alternative Minimum Tax (AMT) for individuals. The need for AMT relief looms like the proverbial elephant in the room, and for that reason we once again, for the third year, recommend its repeal.5 We also present nine other legislative recommendations, some proposing simplification, some addressing taxpayer rights, and still others that are technical in nature.

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4 American Jobs Creation Act, Pub. L. No. 108-357, § 314 (2004); see National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2001), 226. In addition, at least a dozen of our recommendations have passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act, or the full Senate as part of S. 882, the Tax Administration Good Government Act.
5 See Key Legislative Recommendation, AMT, infra.
43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration, and that where the taxpayer received additional EITC, he or she received, on average, 94 percent of the EITC amount claimed on the original return. Moreover, when Taxpayer Advocate Service (TAS) employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employee.13

The findings of the EITC Audit Reconsideration Study actually bring me to a discussion of the challenges that the IRS faces as it administers the tax system in the 21st century. The IRS constantly feels the press of having to do too much with too little. As budget constraints limit its ability to hire new collection and examination employees and to replace retiring employees, the IRS tries to create workforce savings and efficiencies by eliminating or minimizing processes that require human intervention or contact. This approach is appropriate for programs involving submission and correspondence processing, where e-filing and correspondence imaging improve both accuracy of tax return data – eliminating errors attributable to keystrokes – and processing times. But in the Examination and Collection functions, the movement away from direct human interaction can create problems for the tax system as well as for taxpayers. The EITC Audit Reconsideration Study clearly demonstrates this fact.

The Office of the Taxpayer Advocate is focusing on several primary challenges to the IRS as it wrestles with maintaining a balance between taxpayer service and taxpayer rights on the one hand, and a vigorous examination and collection presence on the other.14 These concerns are:

- The impact of program centralization on customer service and taxpayer interaction;
- The substitution of automated processes for human interaction; and
- The level of corporate-wide support for “safety valves” for IRS processes and programs, including Collection Due Process hearings, Offers-in-Compromise, the Taxpayer Advocate Service, and a truly independent Office of Appeals within the IRS.

Let us consider the Offer-in-Compromise (OIC) program, which is identified as a Most Serious Problem and is the subject of a legislative recommendation herein, in light of these three concerns. The OIC program is, in essence, an equitable remedy that takes into account the particular facts and circumstances of the individual taxpayer and

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13 See National Taxpayer Advocate, Annual Report to Congress Volume II – The National Taxpayer Advocate’s Earned Income Tax Credit (EITC) Audit Reconsideration Study, Publication 2104, (Rev. 12-2004). The study reviewed an equal number of EITC audit reconsideration cases worked solely by the IRS Correspondence Examination function, which rarely calls the taxpayer, and cases worked by the Taxpayer Advocate Service and then decided by IRS Correspondence Examination. TAS employees made, on average, two contacts (either by phone or by letter) with the taxpayer after the initial contact letter, while IRS Correspondence Examination made only one contact per two taxpayers.

14 We discuss our concerns with respect to IRS Examination and Collection strategy in two Most Serious Problems, infra.
attempts to come up with a resolution that results in a payment that is less than the amount legally due and owing. By definition, OIC cases will require more attention and more resources than "batch processing" programs like Automated Collection System and correspondence examination. And yet the majority of OIC cases are worked in the campus environment where IRS employees are rarely encouraged to pick up the phone and call taxpayers to clear up matters, and are trained to process documents according to strict procedures, without exercising individual discretion. If the IRS does not train its OIC employees in campuses about the exercise of judgment and does not permit them to call taxpayers and discuss their cases with them, then the centralization of OIC cases subverts the purpose of the OIC program.  

The IRS' responses to the Most Serious Problems, including the OIC response, suggest that the IRS does not adequately recognize that programs such as OIC or TAS – regardless of the small number of cases they represent in comparison to the overall casework of the IRS – actually are the backbone to taxpayer compliance. Thus, the IRS dismisses the National Taxpayer Advocate's concerns about the implementation of the OIC program by pointing out that OIC cases constitute less than one percent of IRS collection cases and less than two percent of TAS cases. These observations miss the point of the OIC program.

Safety valves such as OIC, Collection Due Process, TAS, and an independent Appeals Office are available when all the IRS' dotted i's and crossed t's don't provide adequate relief. These safety valves make taxpayers feel that the tax system is, after all, ultimately fair and balanced. All the enforcement initiatives in the world will not reassure taxpayers about the fairness of the tax system if there is no well-developed mechanism for dealing with IRS errors, or taxpayer mistakes and special situations. These mechanisms are absolutely essential given the mind-numbing complexity of the tax law and the tax system.

In closing, I note that the IRS has repeatedly assured both Congress and taxpayers that its current restoration of an enforcement presence, which I believe is both necessary and appropriate, will not come at the expense of customer service. Yet, in many of the Most Serious Problems we address, there is evidence that the IRS may be reducing customer service in order to shift existing resources to the Examination and Collection functions. For example, in the Taxpayer Assistance Centers (TACs), the IRS is requiring its employees to undertake examination and collection duties. Since TACs are not receiving additional

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15 Throughout this Most Serious Problems section, the IRS' responses question the relevance of TAS cases to a problem analysis by saying or implying that the number of TAS cases is nominal and not large enough to be representative of the overall taxpayer population. Congress apparently thinks otherwise. In IRC § 7803(c)(2)(B)(ii)(II), Congress requires the National Taxpayer Advocate to report on recommendations made by persons with the authority to issue Taxpayer Assistance Orders (i.e., the National Taxpayer Advocate and the Local Taxpayer Advocates). TAS employees are instructed to identify systemic problems raised in their casework. TAS then conducts substantial research before identifying something as a systemic problem. In fact, the IRS has no other comparable way of capturing detailed information about taxpayer problems.

16 For a detailed discussion of each of these programs, see Most Serious Problems, Offers in Compromise, Appeals Independence and Access to the Taxpayer Advocate Service; and Key Legislative Recommendations, Collection Due Process Hearings and Offer In Compromise: Effective Tax Administration.
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National Taxpayer Advocate Annual Report to Congress - Volume II, Earned Income Tax Credit (EITC) Audit Reconsideration Study
MOST SERIOUS PROBLEMS
ENCOUNTERED BY TAXPAYERS

PROBLEM

MOST SERIOUS PROBLEM: THE CONFOUNDING COMPLEXITY OF THE TAX CODE

DEFINITION OF PROBLEM

The most serious problem facing taxpayers and the IRS alike is the complexity of the Internal Revenue Code.

ANALYSIS OF PROBLEM

Section 7803(c)(2)(B)(ii)(IX) of the Internal Revenue Code requires the National Taxpayer Advocate’s Annual Report to Congress to “identify areas of the tax law that impose significant compliance burdens on taxpayers or the Internal Revenue Service, including specific recommendations for remedying these problems.” Focusing on the tax system as a whole, this is an easy mandate to fulfill: Without a doubt, the largest source of compliance burdens for taxpayers and the IRS alike is the overwhelming complexity of the tax code, and without a doubt, the only meaningful way to reduce these compliance burdens is to simplify the tax code enormously. In the balance of this part of the report, we identify and discuss 20 additional serious problems encountered by taxpayers, as required by IRC § 7803(c)(2)(B)(ii)(III). Most serve as case studies that illustrate the consequences of tax law complexity.

The Internal Revenue Code now consists of substantially more than a million words.¹ The most obvious consequence of complexity, of course, is that taxpayers and practitioners often struggle to figure out what the tax laws require or permit. However, another significant, if less obvious, consequence of complexity is the enormous burden it places on the IRS as the tax administrator.

From a taxpayer perspective, understanding and complying with the laws can be nearly impossible. To cite a few examples, many low income taxpayers must grapple with the confusing requirements of the earned income tax credit (EITC) to determine whether they qualify for the EITC and, if so, how much of a credit they may claim. Yet the EITC population is low income and many qualified applicants do not speak English as their primary language, making it precisely the population least able to comprehend and substantiate compliance with the eligibility requirements.

High income and increasing numbers of middle income taxpayers are finding themselves ensnared by the alternative minimum tax (AMT). Originally enacted in 1969 to apply to wealthy taxpayers who were using loopholes to escape tax altogether, the AMT is now

¹ A study published in April 2001 by the Joint Committee on Taxation put the number of words in the Code at approximately 1,395,000. See Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), 4 (Comm. Print 2001). Subsequent tax legislation has expanded the number of words considerably.
projected to affect nearly 35 million taxpayers in 2010.\(^2\) Yet most taxpayers subject to the AMT don’t know it before they prepare their taxes. As a result, many taxpayers discover too late that they underpaid their tax and are therefore subject to a penalty for failure to pay sufficient estimated tax. Indeed, taxpayers often must complete a 12-line worksheet,\(^3\) read eight pages of instructions,\(^4\) and complete a 55-line form\(^5\) simply to determine whether the AMT applies. To say the least, this “surprise” factor – a direct result of the AMT’s complexity – is not conducive to building public confidence in the fairness of our tax laws. In our 2003 report to Congress, we designated the individual AMT as the most serious problem facing taxpayers and provided an extensive discussion of the genesis and evolution of the AMT, the way the AMT is computed, and the significant problems created by the AMT.\(^6\) In the Key Legislative Recommendations section of this report, we again recommend that Congress repeal the individual AMT or, if Congress determines that repeal is not feasible at this time, that it substantially revamp the AMT to achieve its original objective.\(^7\)

Business taxpayers face an even more bewildering array of laws including, for example, a patchwork set of rules that govern the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious “correct” answer. To reduce the tax burdens on small businesses, this report contains a Key Legislative Recommendation setting forth a package of proposals for Congress to consider.

From an IRS perspective, the challenges resulting from code complexity are equally daunting. The IRS must find a way to digest and explain the one million-plus-word statute in a way that taxpayers can understand. It must also explain the law, and its limitations, to its own employees in a clear enough manner to enable them to assist taxpayers on the front end, and to identify and pursue violations on the back end.

Not all serious problems encountered by taxpayers are a function of the law’s complexity, of course. But most of them are, at least to a significant degree.

The problems described in the balance of this part of the report are loosely grouped into five categories:

\(^2\) Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004). These data, updated to reflect the effects of legislation enacted during the 108th Congress, project that 34.8 million taxpayers will be affected by the AMT in 2010.

\(^3\) 2004 Form 1040 Instructions, 35.

\(^4\) 2004 Instructions for Form 6251.


\(^6\) National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2003), 5.

\(^7\) We also made these recommendations in our 2001 report to Congress. See National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2001), 166.
which, as noted, is projected to hit nearly 35 million taxpayers in 2010 – 75 percent used paid preparers.\textsuperscript{14} Something is seriously wrong with a tax system so complex that a significant majority of taxpayers lack either the ability or the time to comply with it on their own.

In this section, we discuss problems with inadequate training and monitoring of return preparers, electronic tax preparation and filing, and the Volunteer Income Tax Assistance (VITA) program.

3. IRS Processing. Many of the processing challenges the IRS faces result more from the sheer volume of documents than from complexity, but complexity is a significant exacerbating factor. For example, the IRS sends out more than 340 notices to approximately 100 million taxpayers each year,\textsuperscript{15} yet taxpayers frequently complain that they cannot understand what the notices say. While we strongly believe that the IRS can improve the clarity of its notices, the law often is too complex to explain in simple terms.

In this section, we discuss problems with inconsistent campus procedures, return processing, notice clarity, miscalculation of the period of limitations applicable to collection actions, and processing issues relating to applications and returns filed by tax-exempt organizations.

4. Tax Law Enforcement and the Tax Gap. The IRS research function has projected that more than $300 billion a year goes unreported, under-reported, or simply unpaid.\textsuperscript{16} The complexity of the tax code contributes significantly to the IRS’s difficulty in detecting and collecting the full amount of revenue due. Indeed, the IRS is not called upon merely to enforce the code as written. In extreme cases, the IRS must go beyond the literal language of the code to make a case-by-case determination regarding the objectives of the code. On one side of the coin, taxpayers sometimes claim tax benefits based on transactions that comply literally with the code but lack substance, and the IRS attacks such transactions under a variety of doctrines, including the doctrine of “substance over form.” On the other side of the coin, taxpayers sometimes find themselves in debt to the IRS due to complexities in the law (e.g., taxpayers who experienced the so-called “ISO/AMT problem”) or simply dire financial circumstances, and the IRS is called upon under the offer in compromise program to try to do justice in the particular case – even if it means

\textsuperscript{14} Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).
\textsuperscript{16} See IRS National Headquarters Office of Research, \textit{Tax Gap Map for Year 2001} (Feb. 24, 2004). After IRS compliance efforts, the estimated “gross” tax gap of $311 billion is estimated to fall to about $255 billion. These numbers, although the best currently available, are based on old models. A new study of the tax gap is now being completed and is likely to be released in 2005.
forgiving all or part of a tax debt and allowing the taxpayer to make a fresh start. For the IRS, making case-by-case decisions in thousands of cases presenting unique sets of facts is no easy task.

To be fair, many of the enforcement challenges the IRS faces result not solely from complexity but also from resource constraints and the absence of reliable research showing how the IRS can most efficiently target its enforcement dollars. In his final report to the IRS Oversight Board, former Commissioner Rossotti discussed the critical compliance problems facing the IRS and provided a laundry list of examples (as of late 2002): 60 percent of identified tax debts are not pursued; 75 percent of taxpayers who do not file a tax return are not pursued; 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued; 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued; and 78 percent of cases identified through document matching (10.4 million taxpayers), with estimated underreported tax of $6.96 billion, are not pursued.17

In the short-term, the IRS has decided to target as its number one enforcement priority corporate tax shelters and tax evasion by high income individuals.18 In light of the extensive publicity these subjects have received and the corrosive effect that such publicity could have on tax compliance, we believe this is a reasonable approach. Indeed, most indications suggest that the IRS has been extremely successful in stopping the targeted transactions.

However, as these transactions stop and the revenue stream from IRS audits of earlier transactions begins to dry up, the IRS will need to re-evaluate how to deploy its limited enforcement resources most efficiently. By far the largest chunk of the tax gap – an estimated 67 percent – results from non-reporting and under-reporting by self-employed persons, generally on income that is not subject to information reporting.19 There is no way that the IRS can make significant progress in reducing the tax gap unless it can develop an effective strategy to go where the money is. The greatest revenue gains may result not from the direct assessment of taxes against taxpayers who are audited but rather from the “indirect” effects that a full panoply of compliance activity has on other taxpayers who are deterred from “pushing the envelope,” or even cheating, because they fear that they, too, will be caught. Better research is needed to help the IRS target its limited resources to obtain the biggest bang for the buck in combating tax noncompliance in all sectors of the economy. This should be the focus of intensive IRS research now.

MOST SERIOUS PROBLEM: OFFERS IN COMPROMISE

DID YOU KNOW?

- The number of Offer in Compromise (OICs) returned to taxpayers increased from 43,936 (or 39 percent) in FY 2001 (prior to centralization in IRS campuses) to 70,911 (or 57 percent) in FY 2004 (after centralization).¹

- Although the percentage of OICs “disposed of” within the IRS’ six-month goal has increased from 32 percent in FY 2001 (prior to centralization) to 55 percent in FY 2004, the average OIC processing time increased from 310 days in FY 2001 to 380 days in FY 2003.² (No comparable data is available for FY 2004).

- The number of OICs accepted declined from 38,643 (or 34 percent) in FY 2001 to 19,546 (or 16 percent) in FY 2004, while the number rejected increased from 13,976 (or 12 percent) in FY 2001 to 25,654 (or 21 percent) in FY 2004.³

- A recent IRS study found that:⁴
  - Approximately 30 percent of the OICs received by the IRS were previously returned to the taxpayer.
  - When returned OICs were resubmitted, 24 percent were ultimately accepted, 55 percent were returned again and dropped out of the system, 12 percent were rejected, and 10 percent were withdrawn.
  - About 80 percent of the taxpayers with accepted OICs remained substantially compliant during the following five years.
  - Twenty percent of the individual tax accounts and 45 percent of the business tax accounts associated with rejected or withdrawn OICs were classified as “currently not collectible.”
  - The IRS eventually collected less than 80 percent of what individual taxpayers were offering in 54 percent of the OICs that it rejected and in 66 percent of the OICs that it returned after acceptance for processing.
  - The IRS eventually collected less than half of what individual taxpayers were offering in 44 percent of the OICs that it rejected, and in 59 percent of the OICs that it returned after acceptance for processing.
  - The IRS collected nothing from individual taxpayers in 21 percent of the OICs that it rejected and in 37 percent of the OICs that it returned after acceptance for processing. The IRS collected nothing from business taxpayers in 46 percent of the OICs that it rejected and in 60 percent of the OICs that it returned after acceptance for processing.

¹ SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 and FY 2004.
RESPONSIBLE OFFICIALS

Kevin M. Brown, Commissioner, Small Business/Self Employed Operating Division
David B. Robison, Chief, Appeals

DEFINITION OF PROBLEM

The Internal Revenue Service’s (IRS’) “offer in compromise” (OIC) program allows for the compromise of tax liabilities based upon “doubt as to liability” or “doubt as to collectibility,” or in furtherance of “effective tax administration.” The IRS’ goal for the OIC program is to achieve collection of what is reasonably collectible at the least cost and at the earliest possible time, and to promote future compliance by providing taxpayers with a “fresh start.” OICs also promote future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years. In 1998, Congress expanded the bases for compromise to include “effective tax administration,” based on its belief that OICs promote voluntary compliance. The intended effect of this expansion was generally to increase the IRS’ flexibility in accepting OICs. The conference report for this legislation explained:

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

Notwithstanding this legislative history, IRS policies and practices adopted since 1998 in many cases do not enable the IRS to be flexible or make it easy for taxpayers to enter into OICs. To the contrary, IRS practices and policies continue to make it very difficult for taxpayers to enter into OICs. Moreover, a recent IRS study suggests that in a majority of cases when an OIC is rejected or returned to the taxpayer, the IRS eventually collects less than the amount that was offered.

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3 See Treas. Reg. § 301.7122-1, et. seq.; Form 656, Offer in Compromise (Rev. 7-2004).
4 Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992).
7 Form 656, Offer in Compromise (Rev. 7-2004). A recent IRS study found that about 80 percent of taxpayers in its sample with accepted OICs remained substantially compliant during the requisite period. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, 6, September 2004.
8 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that “[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes…. The conferees believe that the ability to compromise tax liability … enhances taxpayer compliance.”)
9 Id.
The IRS is increasingly returning or rejecting OICs received from taxpayers. Unnecessary OIC returns and rejections are inconsistent with OIC program goals of providing taxpayers with a legitimate alternative method of resolving their tax liabilities (i.e., an alternative to the use of “protracted installment agreements” or classification as “currently not collectible”) and a fresh start toward maintaining future compliance, as well as the IRS’ overall goal of “improving customer service.” Further, the high rate of OIC returns and rejections has not been shown to be cost effective because, in many cases, returned OICs will be submitted again for processing, and many rejected OICs will be processed again by the IRS’ Appeals function.

The National Taxpayer Advocate believes that the increase in OIC returns and rejections reflect IRS’ use of inflexible policies and automated processes to reduce OIC inventory without regard to how they affect individual taxpayers or whether they actually achieve their goals. We discuss various aspects of these concerns below.

**ANALYSIS OF PROBLEM**

**Background**

In August 2001, faced with an increasing number of OICs and rising processing delays, the IRS adopted an OIC inventory reduction strategy. This involved centralizing OIC processing for simple offers (from wage earners) to be worked in the Brookhaven and Memphis campuses (previously called service centers), while still processing complex offers in the field. Today, approximately 66 percent of all OICs are fully processed in the campuses rather than the field.

The inventory reduction strategy also led the Small Business / Self Employed Operating Division (SB/SE), on August 29, 2001, to reduce the number of attempts it would make to process OICs.

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12 A “protracted installment agreement” is currently defined as an installment agreement extending beyond the statutory period of limitations for collection plus five years. IRM 5.8.1.3(1) (Rev. 11-15-2004). An account classified as “currently not collectible” will not be subject to immediate collection action, but the liability will remain outstanding. See generally IRM 5.16 (Rev. 1-01-2004).

13 Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992) (describing OIC policy); Form 656, Offer in Compromise 1 (Rev. 7-2004) (same); IRS Strategic Plan 2005-2009, Publication 3744 (Rev. 6-2004), 12 (identifying “customer service” as a goal); SB/SE Strategic Plan FY 2004-2005 (Rev. 3-31-2004), 8 (discussing SB/SE’s goal of providing “top-quality service to each taxpayer in every interaction”).

14 SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Programs, 3 (Sept. 2003).


16 See General Accounting Office, IRS Should Evaluate the Changes to Its Offer in Compromise Program, GAO-02-311 (March 15, 2002).

17 SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2004. All offers are initially screened at the campuses to determine processability, but then some are transferred to the field. Id; IRM 5.8.2.2(3) (Rev. 11-15-2004).
to obtain information before returning an OIC from “at least two” to one. After an OIC has been accepted for processing, a single communication attempt by phone, in person, or by letter remains the only prerequisite for returning an OIC on the basis of the taxpayer’s failure to provide information.

In an effort to offset the cost of processing offers that are ultimately rejected or returned and deter the submission of frivolous OICs, the IRS imposed a user fee on OIC submissions. Since November 1, 2003, the IRS has required taxpayers submitting offers, except those based solely on doubt as to liability, to include a $150 user fee or a low income fee waiver form with their OICs. Offers received without the fee (or the form) are returned as “not processable.” Although the fee may be deterring OIC submissions, it is unclear which submissions are being deterred or whether other OICs are being processed more quickly. We do know, however, that the fee increases the cost to taxpayers when OICs are returned or rejected, regardless of the reason for the return or rejection.

COIC Efficiency with Substantive OIC Processing Not Documented
Centralized offer in compromise (COIC) processing has reduced OIC “cycle times” and inventory backlogs by returning more offers to taxpayers rather than by accepting and rejecting more offers. The volume of OICs returned as either “not processable” or after acceptance for processing has increased from 39 percent in FY 2001 to 57 percent in FY 2004, as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison. As a result, IRS has been evaluating the substance of fewer offers since centralized OIC processing was adopted.

18 Memorandum from Deputy Director, Compliance Policy, regarding Return Criteria for Offers in Compromise (Aug. 29, 2001).
19 IRM 5.8.7.2.2 (Rev. 11-15-2004).
21 Id.
22 Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.01; Form 656, Offer in Compromise (Rev. 7-2004) 2. Procedures for returning a “not processable” offer do not always include contacting the taxpayer before the OIC is returned. See IRM 5.8.3 (Rev. 11-15-2004).
23 SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 and FY 2004 (reflecting cycle time improvement). “Cycle time” generally refers to OIC processing time, i.e., the period between IRS’ determination that an OIC is processable and disposition of the OIC.
24 Since centralization was adopted in 2001, the ending inventory has been reduced each year, from 94,931 in FY 2001 to 47,113 in FY 2004. SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 through FY 2004.
26 52,619 OICs (or 46 percent) were accepted or rejected in FY 2001 as compared to 45,200 (or 36 percent) in FY 2004, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year Comparison.
As the IRS has been substantively evaluating fewer OICs, the percentage of OICs disposed of within the IRS’ six-month goal has increased from 32 percent in FY 2001 (prior to centralization) to 55 percent in FY 2004, but the average time to process an OIC has also increased from 310 days in FY 2001 to 380 days in FY 2003. (The IRS has no comparable data for FY 2004). While statistics showing cycle time improvements may reflect actual improvements, they could instead be explained by the fact that OIC returns (after acceptance for processing), which occur at the beginning of the OIC evaluation process, are counted as dispositions. The IRS’ focus on the aggregate number of “dispositions” or OICs “processed” over a given period is misplaced because such statistics show improvement as OIC returns increase. The IRS does not track whether COIC processing is actually more efficient at substantive OIC processing. Thus, IRS data suggest that COIC processing may be efficient only at quickly returning OICs and may not be more efficient than IRS field offices at substantively evaluating them to reach acceptance or rejection decisions.

27 Id. These numbers include dispositions by Appeals as well as Compliance because IRS statistics do not break-out “rejections” by Compliance. E-mail from Director, Appeals Tax Policy and Procedures (SBSE and W&I) (Jul. 6, 2004). However, since only rejections by Compliance are appealed, if Compliance numbers were reported separately, the number of acceptances would be lower and the number of rejections would be higher.


29 SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) Database, Closed Date Compressed Report – National Results, FY 2001 and FY 2003. Of course, cycle times could be affected by shifts in IRS personnel. For example, some OIC specialists have been reassigned to traditional field collection assignments. SB/SE Strategy and Program Plan, FY 2004-FY 2005 (Rev. 9-25-2003) 30, 34. IRS should determine which offers are taking longer under existing procedures and take appropriate steps to address such delays.


31 The aggregate number of OIC “dispositions” that occur in less than 6 months are reported to the IRS Oversight Board. In addition, one IRS Performance Plan measure is the number of OICs “processed” during the period. IRS, Fiscal Year 2004 Annual Performance Plan (Feb. 3, 2003), A-4. Focusing on this aggregate cycle time data may communicate the message that IRS views OIC returns as a positive result rather than as a failure to educate taxpayers and work with them as Congress intended. See H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998).

32 E-mail response to TAS Information Request from SB/SE (Nov. 10, 2004).
OIC Returns Lengthen Real “Cycle Times” and Waste Resources
IRS cycle time statistics are also understated because a recent study found that about 30 percent of all OIC receipts were previously returned. Therefore, the IRS could reduce its OIC receipts, as well as the actual time it takes to process them, by reducing OIC returns. Further, in many cases even the taxpayer’s costs to resubmit a returned OIC will ultimately be borne by the government because those costs (as well as others incurred before the OIC is accepted) will reduce the amount available to be paid to the government. A true measure of cycle time would break out cycle time by type of disposition (e.g., return, acceptance, rejection, withdrawal or termination). It would also measure the time the IRS and taxpayers waste when the OIC is returned and then resubmitted.

OIC Returns Indicate Lack of Communication
The high OIC return rates suggest that the IRS is not taking time to effectively communicate with taxpayers. In each fiscal year since COIC processing was adopted, the IRS has returned at least 57 percent of all OICs, either before or after accepting them for processing. Seventy-two percent of OICs that were not processable in FY 2003 (and 41 percent in FY 2004) were given this classification because the taxpayer had not filed all required tax returns, as shown on Table 1.19.2, Reasons for “Not Processable” OIC Returns, below. Communicating with taxpayers and giving them a reasonable period of time to file any delinquent tax returns prior to returning an OIC would reduce erroneous OIC returns, educate taxpayers, and enable the IRS to both collect money being offered and secure delinquent returns in one fell swoop!

34 In November 2001, SB/SE Research warned that “[c]ompliance should consider monitoring the OIC cases that are returned to customers to make sure that offers examiners and offers specialists are not exceeding the return criteria in order to lower inventory levels. While returning a case may help short-term with OIC inventory levels, it harms customer satisfaction and causes the IRS to handle the same offers several times instead of just once.” SB/SE Research Headquarters, Offer in Compromise – Centralized Processing Profile, Project 13.29 Final Report, 17 (November 2001).
36 IRS currently returns OICs from nonfilers even if no tax was due for the period of nonfiling. See IRM 5.8.3.4.1 (Rev. 5-15-2004).
A lack of communication also contributes to the high rate of OICs returned after acceptance for processing. Sixty-seven percent of OICs that were returned after acceptance for processing in FY 2003 (and 61 percent in FY 2004) were returned because, according to the IRS, the taxpayer did not submit sufficient financial verification, as shown on Table 1.19.3, Reasons for OIC Returns after Acceptance for Processing, below. The statistics do not indicate the extent to which the IRS contacted taxpayers and their representatives to obtain sufficient financial verification, whether those efforts were reasonable, or whether the verification that the IRS was seeking was reasonable. Practitioners tell us that in some cases the IRS is returning offers without any apparent attempts to communicate with the taxpayer or their representative, and in other cases COIC employees place calls into different time zones or during COIC “swing shifts” outside of the hours during which the taxpayer or representative may reasonably be available. Regardless of whether IRS or taxpayers are responsible for communication failures in a given instance, the IRS could reduce OIC returns by increasing communication with taxpayers and their representatives.

The IRS, however, intentionally reduced communication attempts before returning offers from “at least two” to one so that it could reduce the time employees spend processing

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**Table 1.19.2, Reasons for “Not Processable” OIC Returns**

<table>
<thead>
<tr>
<th>Reason</th>
<th>FY 2003</th>
<th>FY 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns not filed</td>
<td>21,752</td>
<td>15,905</td>
</tr>
<tr>
<td>Open bankruptcy proceeding</td>
<td>4,882</td>
<td>3,501</td>
</tr>
<tr>
<td>Form 433-A not included</td>
<td>2,855</td>
<td>3,823</td>
</tr>
<tr>
<td>Previous 2 quarters of employment tax not filed/paid</td>
<td>1,969</td>
<td>1,664</td>
</tr>
<tr>
<td>Obsolete Form 656</td>
<td>1,137</td>
<td>333</td>
</tr>
<tr>
<td>Obsolete Form 433-A/B</td>
<td>1,111</td>
<td>320</td>
</tr>
<tr>
<td>Current employment tax deposit not timely</td>
<td>880</td>
<td>694</td>
</tr>
<tr>
<td>Form 433-B not included</td>
<td>164</td>
<td>353</td>
</tr>
<tr>
<td>Not a verbatim duplicate</td>
<td>33</td>
<td>125</td>
</tr>
<tr>
<td>Fee not with offer</td>
<td>0</td>
<td>20,688</td>
</tr>
<tr>
<td>Returns not filed - both spouses</td>
<td>0</td>
<td>1,020</td>
</tr>
</tbody>
</table>

A lack of communication also contributes to the high rate of OICs returned after acceptance for processing. Sixty-seven percent of OICs that were returned after acceptance for processing in FY 2003 (and 61 percent in FY 2004) were returned because, according to the IRS, the taxpayer did not submit sufficient financial verification, as shown on Table 1.19.3, Reasons for OIC Returns after Acceptance for Processing, below. The statistics do not indicate the extent to which the IRS contacted taxpayers and their representatives to obtain sufficient financial verification, whether those efforts were reasonable, or whether the verification that the IRS was seeking was reasonable. Practitioners tell us that in some cases the IRS is returning offers without any apparent attempts to communicate with the taxpayer or their representative, and in other cases COIC employees place calls into different time zones or during COIC “swing shifts” outside of the hours during which the taxpayer or representative may reasonably be available. Regardless of whether IRS or taxpayers are responsible for communication failures in a given instance, the IRS could reduce OIC returns by increasing communication with taxpayers and their representatives.

The IRS, however, intentionally reduced communication attempts before returning offers from “at least two” to one so that it could reduce the time employees spend processing

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57 SB/SE, Automated Offer In Compromise 4196 Report, FY 2003 and FY 2004. Because OICs are sometimes returned for multiple reasons, these numbers exceed the total number of OICs returned as “not processable” and these percentages exceed 100 percent. The percentages were calculated by dividing the returns in each category by the total number of OICs returned as “not processable,” as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison.

58 The IRS may return an offer for insufficient information after a single request has been made by phone, in person or by letter when the information is not received by the deadline set by the IRS employee. IRM 5.7.2.2.2 (Rev. 5-15-2004). Practitioners have suggested that IRS’ OIC return policies are unreasonable. See, e.g., Brant Goldwyn, Dispute Resolution: IRS Revises OIC Letters Sent to Taxpayers; Practitioners Advise IRS of OIC Concerns, 20 DAILY TAX REPORT G-7 (Feb. 2, 2004) (stating that “[i]t's not giving additional time or calling practitioners and explaining what’s needed; [IRS is] seizing the opportunity to return the offer”). However, IRS procedures now allow for some additional communication before returning offers based upon inadequate expense documentation in cases where the taxpayer has substantially responded to the IRS’ information request. See IRM 5.8.3.16 (Rev. 11-15-2004).
OIC submissions that it deemed not to be serious. The premise of this decision was that returning offers would allow IRS employees to consider serious OICs more quickly. It was never contemplated that serious offers would be returned without reasonable communication attempts. The IRS has not determined whether reduced communications have actually resulted in faster substantive evaluation of other OICs or saved IRS resources.

**Table 1.19.3, Reasons for OIC Returns After Acceptance for Processing**

<table>
<thead>
<tr>
<th>Reason</th>
<th>FY 2003</th>
<th>FY 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial verification not provided</td>
<td>39,915</td>
<td>19,656</td>
</tr>
<tr>
<td>Estimated tax payments not made</td>
<td>4,736</td>
<td>4,337</td>
</tr>
<tr>
<td>Returns not filed</td>
<td>4,624</td>
<td>2,916</td>
</tr>
<tr>
<td>Missing periods</td>
<td>1,272</td>
<td>682</td>
</tr>
<tr>
<td>No basis for compromise</td>
<td>1,070</td>
<td>776</td>
</tr>
<tr>
<td>Other pending investigation</td>
<td>1,053</td>
<td>1,133</td>
</tr>
<tr>
<td>Current employment tax deposit not timely</td>
<td>1,034</td>
<td>857</td>
</tr>
<tr>
<td>Previous 2 quarters of employment tax not filed/paid</td>
<td>903</td>
<td>609</td>
</tr>
<tr>
<td>Open bankruptcy proceeding</td>
<td>804</td>
<td>479</td>
</tr>
<tr>
<td>Financial verification nonliable party</td>
<td>758</td>
<td>521</td>
</tr>
<tr>
<td>To delay collections</td>
<td>749</td>
<td>784</td>
</tr>
<tr>
<td>Form 433-a missing information</td>
<td>619</td>
<td>290</td>
</tr>
<tr>
<td>Resubmission of prior rej/ret offer</td>
<td>511</td>
<td>585</td>
</tr>
<tr>
<td>Erroneous periods included</td>
<td>448</td>
<td>242</td>
</tr>
<tr>
<td>Form 433-a not included</td>
<td>400</td>
<td>177</td>
</tr>
<tr>
<td>More than the balance due</td>
<td>303</td>
<td>159</td>
</tr>
<tr>
<td>Obsolete form 656</td>
<td>296</td>
<td>75</td>
</tr>
<tr>
<td>Offer amount not entered</td>
<td>293</td>
<td>119</td>
</tr>
<tr>
<td>Payment terms missing</td>
<td>248</td>
<td>91</td>
</tr>
<tr>
<td>Form 433-b not included</td>
<td>233</td>
<td>165</td>
</tr>
<tr>
<td>Waiver of fee not substantiated</td>
<td>0</td>
<td>447</td>
</tr>
<tr>
<td>Dishonored check for user fee</td>
<td>0</td>
<td>282</td>
</tr>
</tbody>
</table>


40 See id.

41 In the context of Earned Income Tax Credit (EITC) audits, a recent study suggested that increased up-front communications with taxpayers may reduce IRS expenses by reducing audit reconsideration requests. National Taxpayer Advocate, *Annual Report to Congress Volume II, The National Taxpayer Advocate’s Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104, (Rev. 12-2004) 6, 13-16. Similarly, increased up-front communication might reduce the cost of OIC processing by reducing offer resubmissions and Appeals.

42 SB/SE, Automated Offer In Compromise 4196 Report, FY 2003 and FY 2004. Because OICs are sometimes returned for multiple reasons, these numbers exceed the total number of OICs returned after acceptance for processing and these percentages exceed 100 percent. The percentages were calculated by dividing the returns in each category by the total number of OICs returned after acceptance for processing, as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison. Items representing less than one percent are not included.
OIC Form Revision May Reduce Returns

In July 2004 the IRS made progress in improving communication with taxpayers by revising its OIC form (Form 656). The new form was developed with comments from the Taxpayer Advocate Service (TAS) and practitioner groups. The revised form may help to reduce OIC returns resulting from the failure to include a user fee with the OIC application because the user fee requirement is clearly stated on the new form. It may also be helpful in reducing OIC returns based on the failure to have filed all tax returns because the new form has space for taxpayers to include an explanation if they were not legally required to file a return. While additional revisions could make the OIC forms and worksheets even less complex and confusing for taxpayers, the new form is an improvement.

OIC User Fee is an Unintended Barrier to OIC Processing

The user fee has become a barrier to OIC processing, which exacerbates the problem of OIC returns. The fee was not intended to be a barrier to OIC processing or to multiply the burden associated with the return of an OIC to a cooperative taxpayer. It was intended to reduce the number of frivolous offers as well as the number withdrawn, returned, or rejected because the taxpayer would not provide adequate information for the IRS to process the offer or would not offer an amount that reflected the taxpayer’s ability to pay. When they issued the user fee regulations, the IRS and the Treasury Department assumed that once an offer was accepted for processing, the IRS would “work closely with taxpayers to perfect incomplete or inadequate offers before returning or rejecting them,” thereby avoiding unnecessary returns based upon a lack of reasonable communication.

To the extent a lack of reasonable communication by the IRS is responsible for OIC returns, the fee is being imposed, sometimes multiple times, in cases where it was not intended to be imposed at all.

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43 Form 656, Offer in Compromise (Rev. 7-2004) 2.
44 Id.
45 Between November 2003 (when the user fee became effective) and September 2004, 20,688 offers were returned because the taxpayer failed to include the fee or the waiver form, surpassing failure to file returns as the number one reason for offers to be not processable. SB/SE, Automated Offer In Compromise 4196 Report, FY 2004. However, a recent study suggests that the percentage of offers returned for failure to include the fee declined from over 60 percent in December 2003 to under 15 percent in July 2004. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, 5-6 (Sept. 2004).
47 Id.
48 See Treasury Inspector General for Tax Administration, Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program, Reference 2003-30-182, 1 (Sept. 2003) (indicating that 15 percent of the OICs returned after acceptance for processing were inappropriately returned); SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, 4-5 (Sept. 2004) (indicating that 24 percent of all resubmitted offers are ultimately accepted). In a recent case, married taxpayers submitted an OIC for both joint and separate liabilities with two fees ($300). It was erroneously returned after acceptance for processing because IRS believed the taxpayers had not filed all required returns. Even if the IRS had been correct that the taxpayers had not filed all returns, the OIC should have been returned with the fee before acceptance for processing. The taxpayers actually had no filing requirement for the years in question, but had to wait for IRS to process the OIC twice and resubmit the OIC with two more fees ($600 total) when a single phone call could have resolved the situation and allowed the OIC to be processed without additional fees or delay. Although TAS was able to get two of the fees ($300) abated, this process seemed unreasonable from the taxpayers’ perspective.
Returning Offers Unnecessarily

The IRS sometimes unnecessarily returns an offer that could have been evaluated based on available information. For example, an OIC submission was returned because four out of 50-60 pages of the OIC packet, which were not needed to complete the analysis, were not received. The OIC was later resubmitted and rejected without the missing pages. The OIC was returned because IRS did not evaluate whether the missing information was needed to process the offer. The decision to return an OIC amounts to a de facto rejection because the liability remains outstanding and IRS retains the fee, but the taxpayer is denied appeal rights that would be available if the OIC were rejected. An IRS manager is required to sign the OIC return letter if the return is based upon a taxpayer’s failure to provide requested financial information. However, we understand that the level of managerial review that actually occurs in such cases is minimal and other OIC return decisions are not subject to review. Thus, the IRS is not fully accountable for the reasonableness of its OIC return decisions.

Nonprocessability of OICs from Taxpayers in Bankruptcy

Another problem is that OICs from taxpayers in bankruptcy are not considered processable. Nine percent of all “not processable” offers (and one percent of all offers returned after acceptance for processing) are returned because the taxpayer is in bankruptcy, as shown on Table 1.19.2 and Table 1.19.3. The reason given for this policy is that the IRS believes that its centralized “bulk processing” operations can not process an OIC under the time constraints likely to be imposed by bankruptcy courts. From September 1999 through January 1, 2000, before COIC processing was adopted, the IRS processed OICs

49 The few missing pages did not prevent the "reasonable collection potential" (RCP) from being calculated, so the OIC return was not in accordance with IRS procedure. IRM 5.8.3.16 (4) (Rev. 11-15-2004).
50 See IRC § 7122(d) (providing for appeal of rejected OICs); Treas. Reg. § 301.7122-(f)(5)(i) (same); IRM 5.8.7.2 (Rev. 11-15-2004) (providing that in the case of a "processable return" the IRS will retain the OIC fee and the taxpayer will not receive appeal rights); Treas. Reg. § 301.7122-(f)(5)(ii) (same). Under a new IRS process OIC returns will be reconsidered by SB/SE in limited circumstances, such as where there was a fire, flood, or death in the taxpayer’s immediate family, which prevented the taxpayer from meeting IRS deadlines for submission of information. See IRM 5.8.7.3 (Rev. 11-15-2004).
51 IRM 5.8.7.2.2 (Rev. 11-15-2004). See also Treas. Reg. 301.7122-(f)(5)(ii).
52 IRM 5.8.7.2.2 (Rev. 11-15-2004).
54 See Chief Counsel Notice CC-2004-025 (July 12, 2004) (explaining that "[t]imeframes for the consideration of claims and payment proposals in a bankruptcy case do not mesh with the bulk processing operations established for the high volume of administrative offers in compromise received by the Service."); IRM 25.17.4.7 (Rev. 7-01-2002) (stating that "[t]oo many administrative and legal problems would be created if a tax liability was simultaneously the subject of a court-supervised bankruptcy case and the administrative offer-in-compromise process."). The IRS could also be concerned that any compromise made in connection with a bankruptcy would primarily benefit other creditors rather than the taxpayer, but its policy of excluding taxpayers from the OIC process is not limited to taxpayers facing such situations.
from taxpayers in bankruptcy.\textsuperscript{55} Processing such offers during that period must have been determined to be feasible before the IRS adopted its current centralized “bulk processing” operations. Thus, IRS’ extensive use of centralization and “bulk processing” appears to be driving its current policy of excluding bankrupt taxpayers from the OIC process.

The IRS’ policy, however, denies taxpayers the ability to have their OICs considered, and in so doing, effectively denies them a “fresh start” towards future compliance even after completing a bankruptcy proceeding, which is specifically designed for that purpose.\textsuperscript{56} Perhaps this is one reason bankruptcy courts have rejected IRS’ policy, overturning it in a number of cases by requiring OICs from bankrupt taxpayers to be processed.\textsuperscript{57}

In response to court decisions overturning IRS’ policy of not processing OICs from taxpayers in bankruptcy, the IRS Office of Chief Counsel recently issued a notice indicating that, in lieu of considering an OIC, the IRS would in limited circumstances consider accepting less than the debtor would otherwise be required to pay under the Bankruptcy Code in the context of approving a bankruptcy plan.\textsuperscript{58} The IRS will not agree to accept less, however, unless no lower priority creditor is paid.\textsuperscript{59} This policy applies even if paying a lower priority creditor is necessary for the production of income or otherwise makes sense for the government.\textsuperscript{60} The reason for such inflexibility is not explained. In addition, under its new procedures the IRS will not consider confirming a bankruptcy plan based upon Effective Tax Administration considerations, even if those considerations would theoretically be considered in connection with an OIC outside of bankruptcy.\textsuperscript{61}

**Restrictions on Acceptable Offers Unlikely to Increase Collections**

OICs based upon “doubt as to collectibility” (DATC) that are not returned are subject to a rigid evaluation process that in some cases ignores reality. To the extent this process reduces the IRS’ ability to realistically evaluate each individual offer, it is inconsistent with the IRS’ goal of collecting liabilities at the earliest possible time and at the least cost to the government.\textsuperscript{62} The overall result of several IRS OIC policies can be illustrated by the following example.

\textsuperscript{55} See CCA 200011046 (March 17, 2000).


\textsuperscript{58} See Chief Counsel Notice CC-2004-025 (July 12, 2004).

\textsuperscript{59} See id.

\textsuperscript{60} See id.

\textsuperscript{61} The standard criteria for evaluating an OIC will not be used to evaluate plans/offers submitted by taxpayers in bankruptcy. See id. The criteria IRS will use for evaluating plans/offers submitted in bankruptcy is whether the plan/offer is in the government’s best interest, subject to various unexplained limitations. Id. This combination of general acceptance criteria and specific limitations is likely to result in the acceptance of few plans/offers under the new criteria.

\textsuperscript{62} Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992).
Example: A taxpayer filed an offer for $15,000, to be funded by loans from relatives. The IRS returned the offer because the taxpayer was in bankruptcy. Following bankruptcy, he submitted the OIC again, but it was rejected on the grounds that the taxpayer needed to increase the offer amount to more than $28,000. Due to the taxpayer’s bankruptcy and financial condition, he could not borrow the suggested amount. The decision was sustained by Appeals. The IRS later classified the taxpayer’s account as “currently not collectible” based on his financial statement indicating that his necessary living expenses exceeded his monthly income. Because the IRS returned the offer, the taxpayer had to spend the time and resources to submit it twice; and by returning and rejecting the offer, the IRS had to process it twice and ultimately lost the opportunity to collect $15,000 in cash.

At the National Taxpayer Advocate’s request, SB/SE agreed to work with the IRS’ Office of Program Evaluation, Research, and Analysis (OPERA) to study the outcome of rejected offers. This study confirms that by returning and rejecting OICs, the IRS is missing opportunities to collect what can reasonably be collected at the earliest possible time and at the least cost to the government.

Rejection of OICs in Favor of Extended Installment Agreements
An offer based upon doubt as to collectibility will be summarily rejected if, based upon the IRS’ projections of the taxpayer’s future income, he or she could fully pay the liability within the original collection statute of limitations period plus five years. This is because such taxpayers qualify for long-term installment agreements. As an illustration, consider the following two hypothetical cases:

Example: In both cases, ten years remain until the collection statute of limitations expiration date (CSED). In the first, the IRS projects that the taxpayer could fully pay the liability within 15 years. Because the taxpayer could fully pay within the CSED plus five years the IRS will reject the tax-

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65 See IRM 5.8.1.1.3 (Rev. 11-15-2004) (stating: “Offers will not be accepted if it is believed that the liability can be paid in full as a lump sum or under current installment agreement guidelines.”); IRM 5.8.3.12(2) (Rev. 5-15-2004) (same); IRM 5.8.4.5 (Rev. 11-15-2004) (same); IRM 5.14.2.1 (Rev. 3-30-2002) (providing that to be eligible for an installment agreement a taxpayer must fully pay within the collection statute of limitations period, which the IRS will extend for up to 5 years); IRM 25.6.18.2 (Rev.10-1-2002) (same).
66 Id.  Section 843 of the American Jobs Creation Act of 2004 (P.L. 108-357), allows partial payment installment agreements, consistent with the recommendation of the National Taxpayer Advocate. See National Taxpayer Advocate, FY 2001 Annual Report to Congress, Publication 2104 (Rev. 12-2001), 210-214. While the new law is likely to reduce the number of offers submitted, it remains to be seen how it will affect IRS’ existing offer policy. TAS will be monitoring IRS’ implementation of the new law to ensure that it is not used to reduce access to the OIC program.
payer’s OIC. In the second, the IRS projects that the taxpayer could fully pay the liability in 16 years. Because he could not fully pay within the CSED plus five years, he is eligible for an OIC requiring him to pay an amount that only takes into account his future income for four or five years, depending on the OIC payment terms.

This policy may have particularly harsh consequences when full payment of the liability would subject the taxpayer to “economic hardship” because the IRS’ internal guidance does not make it clear that economic hardship should be taken into account in this “full pay” determination, even though it would be taken into account in determining an acceptable offer amount after the “full pay” determination. OICs are intended as an alternative to both protracted installment agreements and placing taxpayers in “currently not collectible” (CNC) status based on the IRS’ implicit determination that “protracted installment agreements” and CNC status are less effective in collecting liabilities and in promoting future compliance. An IRS study recently concluded that the “CSED plus five” policy should be eliminated based upon evidence that it may actually reduce collections.

Example: A 72-year-old taxpayer with severe mental and physical disabilities offered to pay over $2,000 to settle a $22,000 liability. A COIC employee rejected the offer because he or she projected that the taxpayer could “full pay” the liability over almost 14 years. The calculations

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67 If this can be determined based upon information submitted by the taxpayer, no communication with the taxpayer is required prior to rejecting the offer. IRM 5.8.4.5 (Rev. 11-15-2004).

68 Form 656, Offer in Compromise (Rev. 7-2004), 6-7; IRM 5.8.5.5.4(2) (Rev. 11-15-2004).

69 An “economic hardship” is the inability to meet basic living expenses. Treas. Reg. § 301.6343-1(b)(4); Treas. Reg. § 301.7122-1(b)(3). In addition, factors such as the taxpayer’s age and employment status; number, age and health of the taxpayer’s dependents; cost of living in the area the taxpayer resides; and any extraordinary circumstances such as special education expenses, a medical catastrophe or natural disaster may be taken into account. IRM 5.8.11.2.1(5) (Rev. 5-15-2004).

70 See IRM 5.8.1.1.3(2) (Rev. 11-15-2004) (prohibiting acceptance, without exception for hardship); IRM 5.8.1.1.3(3) (Rev. 11-15-2004) (discussing hardship, but not indicating relevance to the full pay analysis); IRM 5.8.3.12(2) (Rev. 5-15-2004) (no exception); IRM 5.8.4.4(3) (Rev. 11-15-2004) (no exception); IRM 5.8.4.5(2) (Rev. 11-15-2004) (no exception); IRM 5.8.4.5(3) (Rev. 11-15-2004) (discussion of special circumstances, but not indicating relevance to full pay analysis); IRM 5.8.4.6 (Rev. 11-15-2004) (conflicting flow chart entries); IRM 5.14.2.1.1(5) (Rev. 3-30-2002) (vague exception for “age or ill health,” but not indicating relevance to full pay analysis); IRM 5.8.11.2.1(3) (Rev. 5-15-2004) (discussing compromise based on hardship where full payment is possible, but not indicating relevance to full pay analysis process). Even if economic hardship is taken into account in the full pay analysis, IRS is unlikely to be able to fully evaluate it without communicating with the taxpayer (which is not done in connection with the full pay analysis) since the analysis may involve subjective judgments about the extent of the hardship that is created by collection.

71 See SB/SE Payment Compliance and OPERA, IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, September 2004, 11-13. See also, Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992); Form 656, Offer in Compromise (Rev. 7-2004), p 1. However, IRS has recently redefined the term “protracted” so as to lose all restrictive meaning. See IRM 5.8.1.1.3(1) (Rev. 11-15-2004) (stating that “a protracted installment agreement is defined as being one that extends beyond the period allowed under IRS issued guidelines.”).

assumed that the taxpayer could access the equity in his mobile home, even though a second mortgage or refinancing would be impossible. The employee also assumed that the taxpayer could access equity in his car, even though the car loan exceeded the car’s blue book value. In addition, the IRS’s analysis did not address economic hardship. A few months after the offer was rejected the taxpayer’s account was placed in CNC status and the taxpayer died.

\[\text{Calculating a Reasonable Offer Amount}\]

The IRS continues to have difficulty calculating a reasonable offer amount.\(^73\) Absent special circumstances, the IRS will not accept an OIC based upon DATC unless the taxpayer offers to pay his or her “reasonable collection potential” (RCP).\(^74\) A taxpayer’s RCP equals the net equity in the taxpayer’s assets plus the amount the IRS could collect from his or her future income (less necessary living expenses) over a set number of months (48 months, 60 months, or the period remaining before expiration of the collection statute of limitations period, depending on the type of offer).\(^75\) If RCP is not calculated utilizing reasonable assumptions, many offers will be unnecessarily rejected. A recent IRS study has concluded that the IRS needs to reevaluate its method of determining reasonable collection potential because the significant number of taxpayers in CNC status who cannot qualify for an OIC suggest that the RCP does not actually reflect the “reasonable” collection potential.\(^76\)

\[\text{Declining OIC Acceptance Rate Unexplained}\]

The unexplained reduction in OIC acceptance rates, from 39 percent in FY 2001 before COIC was adopted to 16 percent in FY 2004, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year Comparison, suggests that OIC acceptance policies have become stricter, decision quality in the COIC program is declining, or taxpayers have become less reasonable in making offers. If quality is improving, the declining acceptance rate suggests that the IRS has a deteriorating taxpayer communication problem (prompting taxpayers to submit unrealistic OICs) or continues to adopt policies that result in the rejection of reasonable OICs.\(^77\) IRS should research the declining OIC acceptance rates to determine the cause.

\(^73\) According to IRS quality measures, the IRS’ ability to determine the correct offer amount declined from 67 percent in FY 2001 (before COIC processing) to 58 percent in FY 2003. SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) database, Closed Date Compressed Report – National Results, FY 2001 and FY 2003. IRS has no statistics to indicate whether COIC decision quality has improved in FY 2004 or continued to decline.

\(^74\) See Form 656, Offer In Compromise (Rev. 7-2004) 5. “Special circumstances” are commonly based on an “economic hardship,” described above. IRM 5.8.11.2.1(2) (Rev. 5-15-2004).

\(^75\) See Form 656, Offer In Compromise (Rev. 7-2004) 6.

\(^76\) SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, 13 (Sept. 2004).

\(^77\) It is possible that misinformation is being disseminated by a few practitioners, but that would also be a communications/enforcement problem that the IRS should identify and address.
Calculating RCP – Deviating from Expenses Guidelines

Taxpayers and practitioners complain that IRS employees sometimes strictly adhere to the expense guidelines, notwithstanding facts and circumstances which indicate that they are not appropriate in a given case. The RCP is determined based in part on an analysis of the taxpayer’s basic living expenses. The IRS established national and local standards as guidelines for certain expenses such as groceries, household expenses, housing and transportation. Despite these guidelines, the Code requires IRS employees to evaluate the facts and circumstances of each taxpayer in determining an acceptable offer amount.

One recent court case illustrates a rigid application of the expense guidelines. In Fowler v. Commissioner, T.C. Memo 2004-163, the taxpayer submitted an OIC for $2,400 to be paid in monthly installments of $100. The IRS determined the minimum acceptable amount was a lump sum of $2,400 based on the value of the taxpayer’s automobile, decided the taxpayer could not make the $100 payments over time, and rejected the offer. In making this determination, IRS used the national standard expenses, which were higher than the expenses claimed by the taxpayer. The Tax Court held that use of the national standards was an abuse of discretion, noting that there was no explanation of why the taxpayer’s expenses were too low or why the national standard expenses were more accurate. While one case is not conclusive, the fact that the IRS did not take a realistic look at the taxpayer’s offer, provide a convincing rationale for its decision or settle this case (which was not decided within two years) suggests that in some cases IRS may be having difficulty deviating from the expense standards.

Another recent case suggests that IRS’ difficulty in accepting a taxpayer’s claimed expenses (rather than using the expense guidelines) sometimes results from documentation requirements that are not clearly communicated to the taxpayer.

**Example:** An offer submitted by a 72-year-old taxpayer was rejected based upon the disallowance of expenses such as transportation (cab fares), over-the-counter drugs and insurance premiums, which were not documented to SB/SE’s satisfaction. On appeal the OIC was accepted for an amount significantly less than required by SB/SE because TAS worked with the taxpayer to obtain further documentation of his expenses. The OIC could have been more realistically evaluated and accepted without the necessity of an appeal if time had been taken to communicate IRS documentation requirements more clearly to this elderly taxpayer.

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78 See, e.g., 2003 Nationwide Tax Forum Focus Groups Customer Satisfaction Issues of Practitioners, Project 01.08.005.03, 4; Robert Zarzar, AICPA Submits Survey Results On Offer In Compromise Program, 2003 TNT 200-38 (Oct. 15, 2003) (providing survey results reflecting the “nearly unanimous” opinion of surveyed AICPA members that the IRS is intentionally looking for reasons to reject an OIC).

79 See Form 656, Offer In Compromise (Rev. 7-2004) 5.

80 IRM 5.15.1(7) (Rev. 11-15-2004).

81 IRC § 7122(c)(2); Treas. Reg. § 301.7122-1(c).
SB/SE should evaluate the extent to which its perceived inflexibility in deviating from the expense guidelines results from a practice of imposing unnecessary substantiation requirements or from a failure to effectively communicate the requirements to taxpayers or their representatives.

**Calculating RCP – Determining the Number of Months of Future Income**

The amount of future income to be taken into account in determining an acceptable offer amount depends upon how quickly the taxpayer proposes to pay the liability. Regardless of the payment period a taxpayer is never required to offer an amount that the IRS could collect out of future income for a period beyond the end of the statutory period for collecting the tax. However, we have been advised by practitioners that campuses sometimes reject offers that do not take into account future income over 48 or 60 month periods, regardless of how many months are actually left on the statutory period for collection.

**Calculating RCP – Future Income Projection**

The Internal Revenue Manual maintains a rigid income-averaging calculation as the basis for determining future income for sporadic earners, even though other estimates may prove to be more accurate. That is, the future income of a taxpayer who is currently unemployed may be calculated based on his or her past earning history, regardless of job market prospects or other external factors. This policy may also result, for example, in the assumption that income from a one-time windfall will be received again in the future. This approach will lead the IRS to reject reasonable offers because it ignores the facts of the taxpayer’s case in determining a reasonable offer amount.

**Calculating RCP – Excluding State Tax Expenses**

The IRS’ treatment of state and local tax expenses in calculating RCP is also unrealistic. In calculating future income, monthly payments to state or local taxing agencies for delinquent taxes are not taken into account as expenses, even if the state or local taxing agency is collecting funds through a wage attachment or installment agreement. In contrast, the IRS allows these expenses when calculating future income for an installment agreement that provides for full payment of the liability.

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82 Form 656, Offer in Compromise (Rev. 7-2004), 6-7; IRM 5.8.5.5.4(2) (Rev. 11-15-2004).
83 Perhaps this is a result of the oversimplification provided in IRM 5.8.5.5(1) and IRM 5.8.5.6(2), which state the general 48 and 60 month rules but omit the important exception found in IRM 5.8.5.5.4 that “for cash and short term deferred offers, when there are less than 48 or 60 months remaining on the statutory period for collection, use the number of months remaining.” In addition, one version of the software used by SB/SE personnel to estimate a taxpayer’s ability to pay erroneously provides that “48 months is the minimum factor used to calculate future payment ability per OIC guidelines.”
84 IRM 5.8.5.5.2(8) (Rev. 11-15-2004); IRM 5.8.5.5.6(2) (Rev. 11-15-2004). By “sporadic earner” we mean persons with a history of irregular employment or income. In many such cases, the use of a collateral agreement is a reasonable alternative to income averaging. A collateral agreement requires a taxpayer to provide additional consideration for an offer in compromise in the event that the taxpayer’s future income exceeds agreed thresholds. See Form 2261, Collateral Agreement - Future Income (Individual) (Rev. 4-1995); IRM 8.13.2.4.6 (Rev. 6-8-2000).
85 See IRM 5.8.5.5.2(8) (Rev. 11-15-2004); IRM Exhibit 5.15.1-2 (Rev. 3-31-2000); IRM Exhibit 5.19.1-12 (Rev. 12-15-2002).
86 See IRM 5.8.5.5.2(8) (Rev. 11-15-2004).
The IRS’ rationale for excluding delinquent state and local tax expenses from the OIC RCP calculation is that a federal tax lien would take priority over a state tax lien on future income in the context of enforced collection. The IRS may have concluded that allowing such expenses in cases where the IRS accepts less than full payment gives the state and local authorities a greater priority than they would receive in the context of enforced collection at the expense of the federal government. However, this reasoning ignores the fact that the OIC program is an alternative to enforced collection. Unless the government determines that its interest is best served by enforced collection, the priority of the federal government’s tax lien on future income is not determinative of what constitutes a reasonable offer.

Alternatively, the IRS could have concluded that a taxpayer’s remedy is to negotiate with the state and local authorities. However, this is unrealistic because the IRS’ future income formula allows for no amount to be paid to state and local authorities, and so it leaves no room for compromise. The IRS’ disallowance of state and local tax expenses is likely to drive taxpayers out of the OIC program even in cases where the IRS would collect a smaller amount through bankruptcy or through enforced collection (e.g., because the taxpayer is funding the offer, in part, with exempt assets or assets from friends or family). This policy will not help the IRS reach a reasonable settlement with taxpayers, and may not make sense if IRS collects less than half of the amount offered in 44 percent of the rejected offers from individuals, as suggested by a recent study.

**Appeals’ Response to Increasing OICs**

As OIC rejections have increased, so have OIC appeals. OIC appeals make up an increasing percentage of Appeals’ total case receipts, rising from about ten percent in fiscal year 2002 to about 17 percent in fiscal year 2004. Appeals has responded to increasing OIC receipts by increasing its focus on cycle time. It reports reducing its OIC cycle time by 25 percent since May 2002. Appeals’ cycle time reduction initiatives include moving the majority of its OIC work to the campuses.

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87 IRM 5.8.5.2(8) (Rev. 11-15-2004).
89 Taxpayers appeal about 58 percent of all rejected OICs. Letter from Mark W. Everson, Commissioner, Internal Revenue Service, to Charles E. Grassley, Chairman, Committee on Finance, United States Senate, 4 (Oct. 28, 2004).
90 IRS, Business Performance Management System, Key Statistical Chart for Appeals, FY 2002 and FY 2004. No comparable statistics are available for FY 2001 prior to the adoption of COIC.
91 IRS, Roadmap to Success – Guidance to Appeals Field Operations FY 2004, 10.
92 IRS, Business Performance Review, Appeals Division, 9 (Feb. 24, 2004).
93 Id., at 15. In addition, Appeals has directed its Area Directors to require taxpayers to provide any additional information in no more than 30 days. IRS, Roadmap to Success – Guidance to Appeals Field Operations FY 2004, 10. This presents fairness issues for taxpayers whose cases have languished in Appeals’ inventory for more than a year and for whom responding within the 30 day period may present a hardship.
However, survey results show that Appeals’ OIC customers are more dissatisfied with Appeals than other customers exposed to the Appeals process.\(^94\) The survey indicates that the highest priority of both satisfied and dissatisfied customers was “fairness in resolving your case.”\(^95\) Thus, any reductions in cycle time that come at the expense of fairness, as increasing use of campus processing could, are unlikely to improve customer satisfaction.

Appeals could further reduce its OIC inventory without sacrificing customer satisfaction by assisting SB/SE in improving its OIC decision quality. Appeals accepts offers from about 28 percent of taxpayers appealing a rejection by SB/SE.\(^96\) Since Appeals employees are reviewing the work of SB/SE employees when they review OIC appeals, they are in an excellent position to identify areas where SB/SE makes the most frequent errors (or at least areas where Appeals and SB/SE disagree). Appeals refers many of the OICs that it accepts to a quality reviewer and is undertaking a more comprehensive review of these offers to identify areas where Appeals and SB/SE may have differing views of the IRM.\(^97\)

We commend these efforts. However, Appeals could further reduce its OIC inventory by routinely and systematically identifying areas where SB/SE employees make frequent errors (or, if not errors, where Appeals and SB/SE have disagreement) so that SB/SE can focus its training and guidance efforts accordingly. Appeals could track the reasons for reversing SB/SE’s OIC rejections on a computer database so that SB/SE could quickly identify problem areas and take immediate corrective action. This might improve the quality of SB/SE decisions, increase the number of OICs accepted by SB/SE, and reduce OIC appeals.\(^98\)

**Non-Hardship Effective Tax Administration (ETA) Offers**

The IRS remains unable or unwilling to accept ETA offers based upon equity and public policy considerations.\(^99\) In FY 2004, a single offer was accepted by the IRS’ ETA offer group, which is responsible for processing them. In addition, the IRS Office of Chief Counsel has declined the National Taxpayer Advocate’s request to revise the ETA regulations under IRC § 7122 to provide more specific guidance regarding how ETA authority...
should be used. The National Taxpayer Advocate believes that the IRS’ narrow interpretation of the scope of ETA, as discussed in the National Taxpayer Advocate’s June 2004 report, is wrong and ignores relevant legislative history.

Instead, the National Taxpayer Advocate believes that IRS policies have narrowly construed equity and public policy (i.e., non-hardship ETA offers) as a basis for compromise, and that the specific circumstances under which IRS would accept a non-hardship ETA offer are unclear. In the Joint Review of Non-Hardship ETA Program Cases, conducted in June 2004, TAS reviewed the portions of case files sent to the ETA group. Facts relevant to the analysis were missing in many of the case files. Because IRS has not provided significant specific guidance, other than the examples in the regulations, regarding when non-hardship ETA offers should be accepted, it is difficult for both IRS personnel and taxpayers to focus on relevant facts and circumstances. If the applicability of non-hardship ETA remains a mystery, as a practical matter, it will cease to exist. The National Taxpayer Advocate believes that legislation is required to keep IRS from essentially eliminating non-hardship ETA offers as a basis for compromise. Such a legislative proposal, titled Offer in Compromise: Effective Tax Administration, is provided in section 2 of this report.

Hardship Effective Tax Administration (ETA) Offers

The IRS has provided little specific guidance, other than the examples in the regulations, to assist taxpayers and IRS employees in determining when compromise based upon economic hardship is appropriate. An analysis of economic hardship may involve an evaluation of future expenses which are difficult to project and document, making the IRS reluctant to consider them. According to Appeals, analyzing doubt as to collectibility offers with special circumstances (which generally involve an economic hardship analysis) is an area where SB/SE and Appeals most frequently have differing opinions.

100 The conference report for the ETA legislation stated, "[t]he conferrees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferrees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer’s income tax liability would promote effective tax administration. The conferrees anticipate that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer’s liability.” H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998).

101 See generally Treas. Reg. § 301.7122-1(b)(3); IRM 5.8.11 (Rev. 5-15-2004).

102 The purpose of this review was not to identify cases that were decided incorrectly. Because IRS has no specific standards for determining when to accept a non-hardship ETA offer and taxpayers have no guidance regarding which facts are relevant, such an exercise would have required further factual development and an analysis of legal arguments that had not been developed by taxpayers. This would have been impractical.

103 Facts that the NTA believes should be relevant to the analysis are described in the legislative proposal entitled Offer in Compromise: Effective Tax Administration, infra.

104 See generally Treas. Reg. § 301.7122-1(b)(3); IRM 5.8.11.2 (Rev. 5-15-2004).

105 E-mail response to request for information from Director, Appeals Tax Policy and Procedure (SB/SE and W&I) (Sept. 22, 2004).
This suggests the need for more guidance regarding the specific analysis that IRS will follow in determining when OICs should be accepted based on economic hardship (under both ETA and doubt as to collectibility with special circumstances). Furthermore, because the National Taxpayer Advocate believes that the existing rules, which confine the hardships that may be considered to economic hardships of individual taxpayers are overly restrictive, a legislative proposal, entitled Offer in Compromise: Effective Tax Administration, is provided in section 2 of this report to expand those rules.

Combination Offers
In addition to submitting an offer solely on the basis of “doubt as to collectibility” (DATC), “doubt as to liability” (DATL), or in furtherance of “effective tax administration” (ETA), offers can be submitted based on any combination of the three (called a "combination offer"). When an OIC is submitted on the grounds of both DATL and DATC, IRS policy requires that the DATC claim be processed first. The OIC may be returned based upon a failure to provide information that may be irrelevant to consideration of the DATL issues. If the offer is accepted on the basis of DATC, DATL is not considered. Thus, the current policy could result in a taxpayer agreeing to pay a debt that is not owed. SB/SE has agreed that this is a problem, but has yet to revise its procedures to address it.

IRS COMMENTS
For the past several years, the National Taxpayer Advocate (NTA) has identified the Offer in Compromise (OIC) program as one of the “most serious problems” facing taxpayers in the area of tax administration. In response, the IRS has worked closely with the NTA to identify opportunities to improve the quality of OIC case decisions, the timeliness of resolving OIC cases, and the service provided to taxpayers attempting to use the OIC process to settle their tax debts. Less than one percent of all IRS collection cases are resolved through the OIC process and only about two percent of cases worked by the Taxpayer Advocate Service (TAS) involve OIC matters. Based on TAS’ TAMIS database, this percentage has been consistent over the last three years.

During the past year, timeliness of processing OICs has continued to improve and backlogs of unassigned OIC cases have been virtually eliminated. Currently, the inventory of open OIC cases is at its lowest level since early 1999. In addition, the OIC application package,
Form 656, has been revised to improve the clarity of communications with taxpayers and practitioners regarding the requirements for submitting complete, processable OICs. Feedback from the practitioner community regarding this revision has been very positive.

Maintaining manageable inventory levels contributes to the IRS goal of making quality OIC case decisions in a timely manner. In November 2003, the IRS implemented the OIC application fee to help offset the significant costs of the OIC program and to discourage inappropriate or frivolous OIC submissions. In 2004, the IRS completed a major revision of the Internal Revenue Manual on OICs (IRM 5.8) to:

- provide more clarity in procedural direction,
- improve the quality of case decisions, and
- improve taxpayers’ opportunities to communicate with the IRS regarding the processing of their offer cases, particularly in cases which the IRS plans to reject or return the OICs.

The IRS devoted considerable time and attention in FY 04 to outreach activities designed to increase the public’s awareness of the proper role of the OIC as a collection alternative and to clarify the expectations and requirements for taxpayers to submit processable OICs that can be evaluated and resolved in a timely manner. In particular, the OIC page on the IRS web site is updated regularly and is now much easier for the public to find and navigate. TheIRS executives and senior managers participated in numerous outreach sessions specifically addressing the OIC program, including the 2004 National Tax Forums. Additionally, the SB/SE Collection and the Taxpayer Education and Communication (TEC) cadre of speakers, who have been trained to address OIC issues, provided similar presentations at local and regional tax practitioner forums.

The IRS believes that many of the recommendations in the NTA’s 2004 Annual Report would increase the costs of the OIC program significantly.

**Background**

The inventories of open OICs grew dramatically from 1992 to 2001. By 2001, even though revenue officer staff hours devoted to the program had more than doubled from the 1998 staffing levels, the IRS was continuing to fall behind in maintaining the currency of the OIC inventory, with large backlogs of OIC casework accumulating in every field office.

As a result of implementing the Centralized OIC processing sites in July 2001, and revising operating procedures to improve the efficiency of the OIC process, the IRS reversed the upward trends in inventory growth. Currently, the inventory of open OICs is at its lowest point since early 1999. The program remains a very costly one with over 1000 Collection personnel devoted to processing OICs. The IRS firmly believes that it is in
the best interests of tax administration to ensure the OIC program is managed efficiently and provides quality service to those taxpayers who are sincerely attempting to resolve their tax problems through the OIC process.

**COIC Efficiency and Returns**

“Returns” generally fall into two categories - those returned before and those returned after the initial processability determination. For an offer to be processable, it must meet the following conditions:

1) the taxpayer must have filed all legally due and required tax returns;
2) a business taxpayer must be in full compliance with employment tax filing and payment requirements for the two quarters immediately preceding the submission of the OIC, as well as the current quarter;
3) the taxpayer cannot be involved in an open bankruptcy proceeding;
4) the OIC must include the $150 OIC application fee (or a Form 656-A requesting a waiver of the fee); and
5) the OIC must be submitted with the most current OIC application forms.

An OIC which does not meet all of these conditions is returned to the taxpayer, along with any associated application fee. If the taxpayer resolves the problem conditions, he or she submits a new OIC for consideration. The recently revised OIC application package, Form 656, gives considerable direction and guidance to taxpayers to help them avoid submitting OICs that are not processable. The IRS anticipates receiving fewer unprocessable OICs in FY 05.

The number of OICs returned to taxpayers as not processable increased significantly due to the implementation of the OIC application fee, peaking in December 2003 at 64 percent of OIC receipts (44 percent involved the application fee issue). Due to the IRS’ increased communication efforts and taxpayers’ increased familiarity with the fee requirement, the percentage of OICs that were returned as not processable decreased to 33 percent by September 2004. Fifteen percent of these returned receipts involved the application fee, and only eight percent were returned as unprocessable solely due to the fee issue.

Generally, a processable offer is returned when the taxpayer fails to provide complete and timely responses to the IRS requests for additional information. Since the IRS has already invested considerable resources in the processability determinations, application fee processing, and initial financial analysis of the OICs, the IRS retains the application fee. If a taxpayer chooses to submit another OIC at a later date, another application fee is required.

The IRS has made a number of processing changes this year to ensure that processable returns are handled reasonably and responsibly. For example, in situations where taxpay-
ers have made substantially complete responses to additional information requests, the IRS will now attempt an additional contact with the taxpayers to obtain the missing information, prior to returning the OICs. Return reconsideration procedures have been developed and implemented to address situations where the taxpayers could not respond timely due to circumstances beyond their control. As a result, OICs returned following acceptance for processing declined 34 percent in FY 04.

Collectibility Determinations (Reasonable Collection Potential) – Rejection of OICs in Favor of Extended Installment Agreements
In March 1998, the IRS determined that an appropriate period of time for an installment agreement was no longer than five years beyond the CSED. Agreements extending beyond this period are not allowed under our current procedures. If the taxpayer can full pay the tax liability within the parameters of an installment agreement, i.e., the time remaining until the CSED, plus five years, the IRS generally does not accept an OIC.

As noted in the NTA report, the IRS recently analyzed its practice of including the “plus five years” in the analysis of the taxpayer’s ability to make future payments and issued direction to discontinue that practice. The IRS believes this change should significantly improve both the accuracy of our RCP calculations and the overall quality of our OIC disposition decisions, and also result in more accepted offers. The percentage of processable offers that were accepted increased by 10 percent last year. The Treasury Inspector General for Tax Administration (TIGTA) also reported positive results regarding the quality of the IRS’ case decisions in their recent reviews of the COIC and Field OIC programs.

Calculating Reasonable Collection Potential (RCP) – Deviating From National And Local Standards
National and local standards were developed to promote consistency among the IRS collectors in the amounts routinely allowed for taxpayer expenses. The IRS employees are, however, authorized to deviate from these standards in certain situations.

The IRS reemphasizes this direction to OIC personnel on a regular basis. Earlier this year, the IRS issued additional guidance in the area of reasonable allowances for transportation expenses. During the past year, the IRS has also asked TAS and the American Institute of Certified Public Accountants (AICPA) to provide examples of any unreasonably rigid adherence to the national standards in OIC casework for evaluation. Upon receipt of these examples, the IRS plans to use them to enhance OIC processing.

Calculating RCP – Future Income Projection
The IRS does not agree that the OIC IRM “maintains a rigid income-averaging calculation as the basis for determining future income for sporadic earners, even though other
estimates may prove to be more accurate.” The IRM (5.8.5.5) allows for alternative methods in appropriate situations:

In some instances, a future income collateral agreement may be used in lieu of including the estimated value of future income in reasonable collection potential (RCP). When investigating an offer where current or past income does not provide an ability to accurately estimate future income, the use of a future income collateral agreement may provide a better means of calculating an acceptable offer amount. Future income collateral agreements should not be used to enable a taxpayer to submit an offer in a lesser amount than the current or past financial condition dictates. However, if the future is uncertain, but it is reasonably expected that the taxpayer will be receiving a substantial increase in income, it may be appropriate.

The IRS does agree that a few more examples may be helpful regarding this issue, and we will expand the direction accordingly in the next IRM revision.

Calculating RCP – Excluding State Tax Expenses
When determining RCP, payment of current tax obligations is considered a necessary expense and always is allowed. In contrast, delinquent state or local tax obligations are treated like other debts and are deducted from reasonable collection potential only to the extent the state tax obligations take priority over the federal tax debt. Affording special status to state and local taxes as allowable expenses would result in taxpayers with the same collection potential being treated differently based solely on the identities of their other creditors. The IRM encourages offer specialists to consult with Counsel if the relative priorities are unclear.

Effective Tax Administration (ETA) OICs
The “non-hardship” ETA OIC is a situation where no doubt exists that the liability is valid, and payment of the tax would not create economic hardship for the taxpayer. However, due to circumstances of the case, the inequity of requiring the taxpayer to pay the entire liability would be so apparent that the IRS should allow the taxpayer to compromise the tax debt for less than the amount owed. This component of the OIC program was designed to allow the IRS to settle difficult or unusual cases, where other collection alternatives did not seem appropriate. In practice, however, we have received very few cases that meet these criteria.

In FY 03, the IRS centralized the processing of “non-hardship” ETA OICs in one field group to ensure consistency in processing these cases and to facilitate oversight of the process. During the summer of 2004, representatives from the Small Business/Self
Employed (SB/SE) Division, TAS, Counsel and Appeals conducted a joint review of this process. This team reviewed the work papers of all referrals into the ETA group and all OICs worked to completion within the field group during its first year of operation. In its findings, the review team identified opportunities to improve the referral process and document case decisions. However, the team did not identify any cases in which the IRS rejected an offer that should have accepted as a “non-hardship” ETA OIC. As part of their review, the team also concluded that a combination of factors could lead the IRS to accepting such an offer. Based on examples developed by the review team, the IRS expects to issue enhanced guidance in FY 05.

The team’s analysis indicates the most problematic component of the “non-hardship” ETA OIC is the requirement that the taxpayer have a clear ability to full pay the tax liability without economic hardship. The examples TAS provided as potential candidates, as well as many of the cases included in the joint review, would actually create the appearance of inequity if the IRS accepted the offers. Routine acceptance of offers in such cases would have a detrimental impact on voluntary compliance.

Generally, experience shows that the inequitable conditions that contribute to the tax delinquencies also tend to create economic hardship on the affected taxpayers. The IRS routinely accepts ETA OICs based on economic hardship, as well as doubt as to collectibility (DATC) OICs involving special circumstances. These OIC categories are worked within all OIC field groups, as well as COIC. Because DATC OICs with special circumstances do not involve situations where the taxpayers can clearly full pay the tax debts, the ETA group does not control them. Rather, the IRS handles them as routine cases, and local management has the authority to approve these case decisions.

The TAS report indicates that the Advocate is including legislative proposals involving the ETA issue. The IRS has not reviewed these proposals for administrability and impact on resources.

Nonprocessability of OICs from Taxpayers in Bankruptcy
In 1998, the IRS decided to exclude from OIC consideration any taxpayer in bankruptcy. The IRS’ temporary change of policy in 1999, to again allow some taxpayers in bankruptcy to file OICs, stemmed from an assumption that this reversal in policy was legally mandated. When the Office of Chief Counsel subsequently disagreed with this interpretation of § 525 of the Bankruptcy Code, the IRS reversed its policy to once again exclude taxpayers in bankruptcy from the OIC process. More recently, courts have held that the IRS’s policy does not violate § 525.

Taxpayers who file bankruptcy are protected by the automatic stay while their non-exempt assets are liquidated for the benefit of creditors or, in the case of a Chapters 11, 12, or 13,
until a payment plan is approved whereby all creditors are paid over a period of time. In exchange for the protections and benefits provided by the Bankruptcy Code, taxpayers must abide by Congressional choices that balance a taxpayer’s need for a financial fresh start against the competing concerns of various creditors. By filing bankruptcy, taxpayers make a deliberate choice to follow the Bankruptcy Code’s scheme for resolving their debts. Taxpayers who receive a discharge, or otherwise complete a bankruptcy proceeding, are entitled to avail themselves of the OIC process to resolve tax debts that were not discharged or paid through the bankruptcy case.

In those cases where a determination is made that a taxpayer in bankruptcy cannot comply with the requirements of the Bankruptcy Code, the IRS will consider accepting payment of less than is required to be paid under the Bankruptcy Code. Taxpayers filing bankruptcy are required to file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases, and a statement of financial affairs. In most cases, this information will be sufficient for the local Insolvency office to determine whether it is in the IRS’ best interests to agree to receive less than is required to be paid under the Bankruptcy Code.

Combination OICs

The IRS recently completed a pilot project regarding the processing of “combination” OICs where the taxpayers have requested consideration on the basis of both doubt as to collectibility (DATC) and doubt as to liability (DATL). The IRS found that very few DATL OICs actually involve true liability issues, i.e., there are no disagreements that the tax assessments are valid. Generally, these cases involve requests for interest and/or penalty abatements, or other adjustments to the balances due that do not require re-examination of the tax returns.

In order to address these combination OICs in a timely manner, the IRS routinely processes the DATC offers first. If the DATC offer is recommended for rejection, the DATL OIC is forwarded to Examination for consideration. The pilot project confirmed that most of these DATL claims can be processed efficiently by one collection unit in the Brookhaven Campus, and the IRS intends to expand this approach in FY 05 to include all DATL OICs. The relatively rare DATL claims that involve actual liability issues will continue to be forwarded to Examination for consideration.

Appeals

The IRS agrees with the recommendation in the TAS report that systemic identification of errors made on OIC rejections would be beneficial to both SB/SE and Appeals. In fact, Appeals already is proceeding with plans to provide systemically driven feedback reports to all IRS operating divisions. For the OIC program, Appeals already has conducted one informal Offer program review through the Automated Quality Measurement (AQMS)
staff and one joint review with the SB/SE Offer program on Appeals’ accepted offers. Based on those reviews Appeals has agreed to strengthen its discussion and documentation surrounding our acceptance of offers for two reasons: 1) to enhance guidance and, 2) to ensure Appeals decisions comport with the IRM policies and procedures thus providing credibility to any recommendations we might make for program improvement.

TAXPAYER ADVOCATE SERVICE COMMENTS
The National Taxpayer Advocate believes that the IRS has made significant improvements to the OIC program over the last year. Specifically, the IRS should be commended for:

- Discontinuing the practice of rejecting OICs on the basis that a taxpayer could pay the liability over the CSED plus five years;
- Revising its procedures to make its allowances for transportation expenses more reasonable;
- Improving the OIC forms and instructions;
- Revising procedures so that when taxpayers make substantially complete responses to information requests, they are contacted before their OICs are returned based on a lack of information;
- Instituting OIC return reconsideration procedures in cases where taxpayers could not timely respond to information requests due to certain circumstances that were beyond their control;
- Reducing the number of OICs returned after acceptance for processing;
- Developing guidance regarding when a “non-hardship” ETA offer should be accepted, which may soon be issued;
- Allowing for compromise of liabilities via the bankruptcy process in certain limited circumstances; and
- Developing plans to allow for systematic feedback between Appeals and SB/SE.

SB/SE worked closely with TAS in developing many of these improvements and we have enjoyed a good working relationship throughout the year. However, the IRS comments suggest that the OIC program is operating so smoothly that it should not be discussed as one of the IRS’ most serious problems. The IRS cites data showing that OIC cases represent less than one percent of IRS collection cases and about two percent of cases worked in TAS. These very statistics suggest that OIC cases make up a disproportionate number of TAS referrals given the small size of the OIC program. Further, many taxpayers do not know about TAS, or do not seek TAS’ assistance because they do not believe that TAS can be of help to them.\[111] This is often true since TAS usually cannot change unreasonable policies as applied to a given case and is generally limited to helping the IRS correctly apply such policies or to recommending systemic change.

\[111\] See the Most Serious Problem entitled Access to TAS, infra.
In addition, because collection decisions involved in evaluating OICs are among those that have the greatest potential to result in hardships for taxpayers, the IRS should have little tolerance for errors or inequitable policies in this area. The OIC program is also one of the most visible to taxpayers and has the potential to communicate to the public that the IRS is a reasonable, efficient and fair tax administrator, willing to take the time to work with taxpayers that are trying to fulfill their tax obligations. Instead, as media coverage shows, taxpayers exposed to the OIC process sometimes get the message that the IRS does not care about reason, fairness or true overall efficiency. This perception may also be damaging to voluntary compliance among the general population. Thus, neither the IRS nor the National Taxpayer Advocate can afford to ignore such an important program.

The information and analysis provided about programs selected as “most serious problems” are intended to spark debate and to be useful to those seeking to improve them. We hope that this report is received in that spirit. That said, we must specifically address a few of the points reflected in IRS comments regarding effective tax administration (ETA) offers as follows:

- The IRS states that as part of the joint review of non-hardship ETA OICs, TAS did not identify cases that the IRS should have accepted. As stated previously, the purpose of this review was not to identify specific cases that were decided incorrectly. Because the IRS has no specific criteria that, if present, would result in the acceptance of an OIC based on non-hardship ETA considerations, it would have been impossible to identify cases that were decided incorrectly even if the limited case file excerpts provided to reviewers included all relevant information.

- IRS comments state that “experience shows that the inequitable conditions that contribute to the tax delinquencies also tend to create economic hardship on the affected taxpayers. The IRS routinely accepts ETA OICs based on economic hardship…” However, IRS has informed TAS that it does not record such data. Thus, we have no way of verifying IRS’ statement.

112 See e.g., Robert Zarzar, AICPA Submits Survey Results On Offer In Compromise Program, 2003 TNT 200-38 (Oct. 15, 2003) (stating: “Based on the concerns expressed by many of our members, we do fear that the IRS’ employees at the COIC sites might be reducing OIC inventory levels based on implementation of rigid procedures; tight rules regarding what constitutes a "processable" offer and short time frames for submitting updated or missing documents.”). A 2003 IRS focus group found that “virtually all the practitioners believe that the Offer in Compromise program is not working.” 2003 Nationwide Tax Forum, Focus Groups, Customer Satisfaction Issues of Practitioners, Project 01.08.005.03 (consisting of focus groups at six Tax Forum sites with eight to thirteen participants from a wide geographic area, each screened by SB/SE Research staff). See also, Michael J. Knight, THE IRS OFFER IN COMPROMISE PROGRAM (OR THE ‘OH I CAN’T DEFENSE), 2004 TNT 125-29 (June 29, 2004); Brant Goldwyn, Dispute Resolution: IRS Revises OIC Letters Sent to Taxpayers; Practitioners Advise IRS of OIC Concerns, 20 DAILY TAX REPORT G-7 (Feb. 2, 2004) (stating that “[b]y not giving additional time or calling practitioners and explaining what’s needed, [IRS is] seizing the opportunity to return the offer”). Brant Goldwyn, Dispute Resolution: TAX COLLECTION: OFFER-IN-COMPROMISE PROGRAM CONTINUES TO BE PROBLEM, IRS AND PRACTITIONERS SAY’10 DAILY TAX REPORT G-5 (Jan. 15, 2003); Robert E. McKenzie, Statement of Robert McKenzie on behalf of the American Bar Association Section of Taxation IRS Oversight Board Hearing Washington, DC January 27, 2003, reprinted in Robert E. McKenzie, Representation Before the Collection Division of the IRS, Appendix 13 (April 2004).

113 Response to TAS Information Request (June 2, 2004).
RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations for improving the OIC program:

Reducing Unnecessary OIC Returns

- The IRS should contact taxpayers and allow a reasonable period of time for them to file delinquent returns before returning OICs on that basis. Because this would delay OIC processing, such periods could be broken out and reported separately from aggregate cycle time measures.

- The IRS should make at least two attempts to contact taxpayers before returning any OIC, and otherwise encourage employees to contact taxpayers by telephone or using face-to-face meetings, especially with taxpayers for whom other modes of communication are unlikely to be successful. Calls should be made to taxpayers and their representatives only at times when they are most likely to be available.

- The IRS should give employees discretion to determine that an OIC should not be returned in cases where required documentation is missing if they believe that additional communications would likely produce such documentation. If the IRS determines that it cannot accept an OIC based upon insufficient documentation from a cooperative taxpayer, guidance should emphasize that it should be rejected rather than returned so that the taxpayer has an opportunity to appeal the decision.

- The IRS should process OICs received from taxpayers in bankruptcy. IRS’ standards for evaluating such offers should deviate from standard OIC criteria only when there is a clearly articulated reason for such a deviation. For example, it may be reasonable to reject OICs based on doubt as to collectibility in cases where compromise by the IRS would only benefit the taxpayer’s other creditors and not the taxpayer.

- The IRS should work with taxpayers and practitioners to reduce taxpayer (and IRS employee) burden and make it easier to understand OIC requirements by revising the Form 656 and its accompanying collection information statements. It should also continue its efforts at outreach and education, which we applaud.

- The IRS should review the OIC submissions received before and after implementation of the OIC application fee to determine which types of submissions have been deterred by the fee or returned for failure to include it. If the fee has not significantly reduced frivolous submissions and submissions from uncooperative taxpayers or if it presents a significant barrier to taxpayers who are legitimately trying to comply, it may not be worth the burden that it imposes on all taxpayers submitting an OIC. If this is the case, IRS should abolish the fee.

- The IRS should revise its Offer in Compromise form (Form 656) to clarify what it means by “doubt as to liability” so that taxpayers know that items such as innocent spouse relief, and

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Yet another court has recently ordered the IRS to process an OIC from a taxpayer in bankruptcy. See In re Peterson, 2004 WL 2750095 (Bankr. D. Neb. 2004), adhered to on reconsideration (Nov. 4, 2004).
interest and penalty abatement requests are made on other forms. Revising the Form 656 to
make this distinction clear at the outset would help taxpayers avoid wasting the time waiting
for the IRS to process the wrong form. However, when the IRS receives such requests on
Form 656, it should immediately contact the taxpayer and route the taxpayer’s request to the
area responsible for processing it.

Reducing Unnecessary Rejections

◆ The IRS should research the reasons why OIC rejections have increased and acceptances have
dropped. It should determine how increased communications could increase acceptance of rea-
sonable offers. 115

◆ The IRS should revise the current methods of determining Reasonable Collection Potential
(RCP):
  ◆ It should allow expenses for delinquent state tax payments. Ignoring such expenses is
    likely to result in minimum offer requirements that leave taxpayers without the ability
to meet “basic living expenses,” notwithstanding regulatory guidance indicating that
offers should not do that, even in cases where IRS would not use involuntary collection
tools. 116 If IRS believes that other policies produce similar results those policies should
also be reexamined.

◆ The IRS should estimate future income based upon the best estimates available, rather
than rigidly adhering to an income-averaging approach. The IRS believes that its policy
providing for the use of collateral agreements provides flexibility. However, the IRS
is prohibited from accepting an offer for an amount less than would be permitted based
on an income-averaging calculation using a collateral agreement. 117 Thus, IRS policy
allows the use of collateral agreements only in cases where they would benefit the gov-
ernment, not in cases where they would benefit a taxpayer. Many taxpayers would
undoubtedly characterize this policy as rigid. Moreover, it ignores the reality faced by
taxpayers whose future income will be less than it was in the past.

◆ The IRS should revise the IRM and job aids to more clearly state that the months of future
income to be used in determining the offer amount should never extend beyond the statute of
limitations expiration date.

115 As previously noted, the legislative history of RRA98 states that “[t]he Senate amendment provides that the
IRS will adopt a liberal acceptance policy for offers-in-compromise… the conferees believe that the IRS
should make it easier for taxpayers to enter into offer-in-compromise agreements.” H.R. Conf. Rep. 599,
105th Cong., 2d Sess., 288-289 (1998). The IRS comments indicate that the percentage of processable offer
acceptances have increased in FY 2004. To be clear, however, processable offer rejections have increased by
an even greater percentage. Both percentage increases are due to a reduction in the number of offers returned
after acceptance for processing, rather than increases in the number of acceptances or rejections. The actual
number of acceptances and rejections has declined, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year
Comparison, above.


117 IRM 5.8.5.5(6) (Rev. 11-15-2004).
The IRS should more clearly communicate the forms of documentation that will be acceptable for purposes of deviating from the expense guidelines, especially in cases where receipts are unlikely to be available or where estimates of future expenditures are involved. However, IRS should be careful not to eliminate an employee’s discretion to accept alternative documentation.

Appeals should promptly execute its plan to routinely and systematically identify areas where Appeals and SB/SE have frequent disagreements so that SB/SE can focus its training and guidance efforts accordingly. Appeals should track the reasons for reversing SB/SE’s OIC rejections on a computer database so that SB/SE can quickly identify problem areas and take immediate corrective action. This feedback loop should not be used to eliminate Appeals' ability to reach common sense outcomes, which may sometimes be inconsistent with IRM provisions.

The IRS should evaluate ETA offers and doubt as to collectibility offers with special circumstances using the analysis described in the Key Legislative Proposal entitled Offer In Compromise: Effective Tax Administration in section two of this report. Similarly, the bases for offers submitted on more than one basis (combination offers) should be analyzed in the order requested by the taxpayer, as provide in the legislative proposal.

**Cycle time and Quality Measures**

- The IRS should survey taxpayers and practitioners who submit OICs to determine how to best to improve the OIC program.
- The IRS should measure cycle time by breaking it out by type of disposition (e.g., return, acceptance, rejection, withdrawal or termination). Its cycle time measures should also systematically track the time wasted by the IRS and taxpayers when the IRS returns an OIC that is later resubmitted.
- The IRS should evaluate whether the new Embedded Quality Measurement System (EQMS) provides the proper incentives to employees and enables it to rapidly identify specific systemic problems that could be addressed through training or guidance. IRS should also determine ways of converting CQMS quality measures into EQMS measures so that it can track recent quality trends. Quality trends may be more useful than static measures at determining whether systemic changes are effective.\(^{118}\)

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**Footnote:**
\(^{118}\) IRS comments indicate that TIGTA recently reported positive results regarding the quality of IRS’ OIC case decisions. We note that the quality component of the TIGTA’s review involved an analysis of 100 field offers closed in FY 2003 (50 accepted and 50 rejected but not appealed) and found that 37 involved errors in financial analysis, 12 of which affected the outcomes. See Treasury Inspector General for Tax Administration, *Improvements Are Needed in the Timeliness and Accuracy of Offers in Compromise Processed by Field Offer Groups*, 2005-30-013, 12-14 (December 2004). The results were likely affected by the fact that TIGTA did not include rejected OICs that were appealed. Id. at Appendix I. Moreover, the purpose of the report was not to evaluate overall OIC quality. Because the report used a judgmental sample (rather than a random sample), the results were not statistically projected to the field component of the OIC program. Id. The IRS response indicates that IRS believes the errors may be attributable to unrealistic IRS policies in calculating reasonable collection potential. Id. at 34. As noted above, the NTA agrees that such unrealistic policies should be revised without
INTRODUCTION

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

Immediately following this introduction, we present a chart showing how recent National Taxpayer Advocate legislative recommendations fared in the just-concluded 108th Congress. We are pleased to note that four proposals we recently recommended have become law – a uniform definition of a child,1 an “above-the-line” deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,2 authorization for the IRS to enter into partial-pay installment agreements,3 and the availability of income averaging for commercial fishermen.4 In addition, at least a dozen of our recommendations have passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act, or the full Senate as part of S. 882, the Tax Administration Good Government Act.5 While the last Congress ended before the House and Senate had an opportunity to bring these bills to conference, we anticipate that most of the provisions will be considered again in the 109th Congress.

In this report, we are presenting two broad categories of Key Legislative Recommendations – one dealing with the need for tax simplification and the other dealing with the protection of taxpayer rights.

The Key Legislative Recommendations dealing with tax simplification are as follows:

**Alternative Minimum Tax (AMT).** The AMT, originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions, has morphed into a second layer of taxation that is increasingly affecting middle income taxpayers and is projected to expand to affect nearly 35 million taxpayers in 2010. In our

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3 Id. at § 843.
4 Id. at § 314.
5 The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled Federal income tax preparers.
2003 report, we designated the AMT as the most serious problem facing taxpayers. We recommend that Congress repeal the AMT or revamp it substantially to achieve its original objective.

**Small Business Tax Burdens.** The Internal Revenue Code imposes significant burdens on small businesses. We recommend that Congress adopt a number of proposals designed to alleviate some of these burdens. Our proposals include allowing self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes; extending the deadline by which a newly formed corporation must file an election to be treated as an S corporation until the date on which the corporation is required to file its first tax return; and protecting businesses that use payroll service providers from tax deposit fund misappropriation, or even fraud, by requiring payroll services to meet certain minimum qualifications. We also reiterate our previous proposals to reduce the maximum penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent and to exempt husband-and-wife co-owned businesses from the partnership tax filing requirements in most cases.

**Education Tax Incentives.** The Internal Revenue Code provides a complex set of incentives to encourage saving for and spending on education, set forth in at least nine different provisions. The requirements, definitions, and income phase-outs vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are both aware of each of the education tax incentives and familiar with their particulars. We make several specific recommendations to streamline and simplify these provisions.

**Retirement Saving Tax Incentives.** Much like education incentives, retirement planning incentives are numerous and complex. More than a dozen tax-advantaged retirement planning vehicles are available, and they are subject to different sets of rules governing eligibility, contribution limits, the tax treatment of contributions and distributions, withdrawals, the availability of loans, and portability. We recommend that Congress take a hard look at the confusing array of options, and we suggest guidelines that Congress could consider to streamline the available options.

The second category of Key Legislative Recommendations, which relate to the protection of taxpayer rights, is as follows:

**Effective Tax Administration Offers in Compromise.** In 1998, Congress authorized the IRS to compromise tax debts based upon factors such as equity, public policy and hardship in cases where doing so would promote the effective administration of the tax laws (ETA offers). However, the IRS has interpreted the congressional authorization narrowly
so that, for example, the IRS group charged with evaluating such offers accepted only a single ETA offer based upon equity or public policy in FY 2004. We believe that the IRS’ reluctance to compromise in inequitable situations may lead taxpayers to disregard the law or erode their faith in the fairness of the income tax system. We recommend that Congress provide more specific guidance to the IRS to ensure that offers submitted under a new “Equitable Considerations” standard are accepted in a broader array of cases.

Collection Due Process Hearings. In this section, we make the case that Collection Due Process (CDP) hearings are an important vehicle for ensuring that the IRS follows the appropriate and required administrative and legal procedures and considers all reasonable collection alternatives in the course of collecting outstanding tax liabilities. To keep the focus on collection activity, we recommend that taxpayers continue to be permitted to raise concerns about the underlying liability during the administrative CDP hearing but propose repeal of the ability to have de novo judicial review of the underlying liability. We also recommend a number of technical legal and administrative improvements, including proposing forms and notices to help taxpayers navigate and prepare for CDP hearings and create a more accurate administrative hearing record.

Free Basic Electronic Return Preparation and Filing. In 1998, Congress directed the IRS to work toward a goal of having 80 percent of all returns filed electronically by 2007. This is a desirable goal because e-filing benefits taxpayers and the IRS alike. However, taxpayers who self-prepare their returns find that paper filing is free but e-filing may require them to pay two separate fees to a private vendor – one fee for preparing their return electronically and a second fee for filing their return electronically. In 2002, the IRS entered into a three-year agreement with the Free File Alliance to provide free e-filing to at least 60 percent of all taxpayers. We recommend that Congress take the next step by requiring the IRS to post fill-in forms on its website and make e-filing free for all taxpayers who self-prepare their returns. (Taxpayers who prefer to avail themselves of the additional benefits of a sophisticated software program would, of course, remain free to purchase and use one.)

The Tax Gap. The final discussion in the section on taxpayer rights relates to the tax gap. The most recent IRS estimate of the net tax gap, for 2001, was $255 billion. Last year, 128 million taxpayers filed individual income tax returns. Thus, every taxpayer is forced to pay an average of about $2,000 extra in taxes each year to subsidize noncompliance. At a hearing on the tax gap convened by the Senate Finance Committee in July, virtually all witnesses agreed that the cash economy and other types of income not currently subject to document matching are the biggest sources of the tax gap.6

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6 Cash economy noncompliance was discussed with each of two panels at the hearing. During the first panel, Joseph Bankman, professor of law and business at Stanford Law School, defined the cash economy as cash or checks not subject to third-party reporting. During the second panel, Senator Max Baucus referred to the problem as involving “sole proprietorships and cash accounting.”
The Office of the Taxpayer Advocate has two primary concerns with respect to the growing tax gap. First, the mere fact that honest taxpayers are paying so much extra in taxes due to noncompliance constitutes an extraordinary abridgement of taxpayer rights and raises fundamental issues of fairness. To help alleviate the tax gap’s burden, we are presenting an extensive list of options that Congress and the IRS should evaluate. Second, any new or enhanced enforcement measure has the potential itself to abridge taxpayer rights. For that reason, we must analyze these options from the perspective of taxpayer rights. In a chart describing possible options, we note the obvious benefits and burdens of each option. As the IRS and Congress begin to grapple with the tax gap in the near future, we will raise specific concerns and even objections, depending on the extent to which the development and implementation of new enforcement measures undermine the rights of specific taxpayers.

Additional Legislative Recommendations. Finally, we offer two technical legislative recommendations. One would suspend the statutory period for filing a petition in the U.S. Tax Court with respect to certain Code provisions while a taxpayer is prohibited from filing a petition due to an automatic stay imposed by a U.S. bankruptcy court. The other would allow the IRS to issue refunds or credits after a Tax Court decision is entered in a small case proceeding but before the decision becomes “final.”
KEY LEGISLATIVE RECOMMENDATION: ALTERNATIVE MINIMUM TAX

PROBLEM
The individual alternative minimum tax (AMT) is a parallel and complex tax structure that is imposed on top of the regular tax structure. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax avoidance transactions, it now affects large groups of middle-class taxpayers with no tax avoidance motives at all. For example, many taxpayers are subject to the AMT simply because they have children or live in a high-tax state.

The AMT is ensnaring an ever-growing number of taxpayers because the amount of income exempt from the AMT (the AMT “exemption amount”) is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was $30,000 for all taxpayers. If that amount had been indexed, it would be equal to about $153,500 today. Instead, the exemption amount, after a temporary increase that will expire after 2005, is $45,000 for married taxpayers and $33,750 for most other taxpayers. As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT. Among the categories of taxpayers hardest hit, 94 percent of married couples with adjusted gross income (AGI) between $75,000 and $100,000 and with two or more children will owe AMT.

The burden that the AMT imposes is substantial. In dollar terms, it has been estimated that the average AMT taxpayer will owe an additional $6,000 in tax in 2004. In terms of complexity and time, taxpayers often must complete a 12-line worksheet, read eight pages of instructions, and complete a 55-line form simply to determine whether they are sub-

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1 Department of Labor, Bureau of Labor Statistics, Consumer Price Index – All Urban Consumers (CPI-U) (Nov. 17, 2004). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above $200,000 had paid no federal income tax for the 1966 tax year. See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress’ attention back then would be making over $1.16 million today. Yet the AMT today is not primarily affecting taxpayers with incomes over $1.16 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under $200,000 – and 37 percent will have incomes under $100,000. See Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, table 4 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

2 IRC § 55(d).

3 Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).


6 2004 Form 1040 Instructions, at 35.

7 2004 Form 6251 Instructions.

拥挤到的 AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners to prepare their returns.9

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. As a result, many taxpayers are unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has morphed into something that was never intended: It is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is penalizing taxpayers for such non tax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

EXAMPLES
The following two examples illustrate the impact of the AMT on individual taxpayers:

- A mother of five earned $55,000 in 2003. She was separated from her husband during the latter half of the year and thus claimed "married filing separately" filing status. Because of the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of $1,760 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of $45.

- A taxpayer filed a joint return claiming two exemptions for 2003. The taxpayer had an adjusted gross income (AGI) of $185,000 and paid state income and property taxes totaling $27,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional tax liability of $3,908 due to the AMT. Because of the AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of $101.

To be viewed as fair, a tax system must be transparent. Yet the complexity of the AMT is such that many if not most taxpayers who owe the AMT do not realize it until they prepare their returns. It adds insult to injury when many of these taxpayers discover that they also owe a penalty for failure to pay sufficient estimated tax because they did not factor in the AMT when they computed their withholding exemptions or estimated tax payments. Taxpayers subjected to this treatment may wonder whether their government has dealt fairly with them. To say the least, “gotcha” taxation is not good for taxpayers or the tax system.

The National Taxpayer Advocate recommends that Congress repeal the provisions of the Internal Revenue Code that pertain to the Alternative Minimum Tax for individuals.10

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10 In our 2003 Annual Report to Congress, the National Taxpayer Advocate designated the AMT as the most serious problem facing taxpayers. See National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at 5-19. This report was recently cited by the American Bar Association in presenting its recommendation that Congress repeal the individual AMT. See Report of the American Bar Association Section of Taxation to the American Bar Association House of Delegates (Aug. 2004) (transmitted with Letter from Kenneth W. Gideon, Chair, American Bar Association Section of Taxation, to Senators Grassley and Baucus and Congressmen Thomas and Rangel (Nov. 29, 2004)). In our 2001 Annual Report to Congress, the National Taxpayer Advocate previously recommended that the AMT be repealed or, at a minimum, that the AMT be substantially revamped to accomplish its original objective of preventing high-income taxpayers from escaping taxation through the use of tax-avoidance techniques. See National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), at 166-177. The individual AMT and its problems are discussed in more detail in our 2003 and 2001 reports. As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining § 53 of the Code.
KEY LEGISLATIVE RECOMMENDATION:
OFFER IN COMPROMISE: EFFECTIVE TAX ADMINISTRATION

PROBLEM

Prior to 1998, the Internal Revenue Service (IRS) would consider offers to compromise tax liabilities for less than the full amount based upon “doubt as to liability” or “doubt as to collectibility.” In 1998, Congress clarified that the bases on which the IRS could accept an offer in compromise (OIC) also included “effective tax administration” (ETA). The conference report to the 1998 legislation stated that the IRS was to “take into account factors such as equity, hardship, and public policy.”

The IRS’ administrative guidance indicates that compromises based on equity and public policy will be made only in rare and exceptional circumstances. Consistent with this guidance, anecdotal evidence suggests that the IRS has rarely used its authority to compromise based on such considerations. In fiscal year 2004, the IRS’ ETA Offer Group, which is responsible for processing offers based upon equity and public policy, accepted a single offer. One reason for this is that the IRS “assumes that Congress imposes tax liabilities only where it determines it is fair to do so.” However, a logical extension of this principle would eliminate equity and public policy as a basis for compromise (rather than just making acceptance on this basis “rare”), since every tax liability is imposed by law.

Tax laws, however, are not always “fair” when applied to a given set of circumstances. Equitable and fair tax laws are simple and predictable. They do not subject taxpayers to unreasonable surprise or require payment at a time when the taxpayer has not received a

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1 See, e.g., Form 656, Offer in Compromise (Rev. 1-1997).


3 Id.


5 However, IRS does not track receipts or dispositions of ETA offers. Response to TAS Information Request (June 2, 2004).

6 See, e.g., IRM 5.8.11.2.2(1) (Rev. 5-15-2004). See also, IRM 5.8.11.2.2(3) (Rev. 5-15-2004) (stating: “Compromise on public policy or equity grounds is not authorized based solely on a taxpayer’s belief that a provision of the tax law is itself unfair. Where a taxpayer is clearly liable for taxes, penalties, or interest due to operation of law, a finding that the law is unfair would undermine the will of Congress in imposing liability under those circumstances.”) The preamble to the final regulations notes that “the IRS will presume that the correct application of the tax laws produces a fair and equitable result, absent exceptional circumstances.” T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble). Few exceptional circumstances are identified, potentially leading some to conclude that facts and circumstances must match those of an example in the regulations in order to qualify.

7 Such a logical extension of this principle is obviously faulty given the existence of examples in the regulations illustrating situations in which compromise on the basis of equity and public policy is appropriate. See Treas. Reg. § 301.7122-1(c)(3)(iv).
net amount sufficient to satisfy the liability.8 They do not impose an income tax on a transaction in excess of the economic benefit received from it. They do not penalize taxpayers for the IRS’ administrative action or inaction, such as through the accrual of interest and penalties (in excess of the time value of money) during periods of unreasonable delay by the IRS in determining a taxpayer’s liability.9 The absence of a remedy for such inequities may lead the public to either disregard the law or lose faith in the fairness of the income tax system.10

EXAMPLES

Example 1: Incentive Stock Options and the Alternative Minimum Tax11

A customer service supervisor at a technology company was granted incentive stock options (ISOs) as part of his compensation package. He exercised them in early 2001, when the fair market value of the stock was much higher than the exercise price of the options. The benefit of an ISO, as compared to other options, is that (1) ISOs are not subject to regular income tax (or income tax withholding) upon exercise and (2) if the stock received upon exercise of the option is held for the requisite period, any gains are ultimately taxed at favorable long term capital gains rates.12 The taxpayer did not anticipate that exercising his options to purchase stock could subject him to Alternative Minimum Tax (AMT) liability disproportionate to his economic benefit from the transaction. Because the difference between the stock purchase price and the value of the stock (when purchased) is added back to income in determining AMT, the stock purchase created AMT liability of over $265,000 (as compared to his regular tax liability for the year of less than $1,600) even though the taxpayer had not yet sold the stock and had not been subject to withholding.13 The following year, before the AMT liability was required to be paid, the stock value dropped sharply to less than the AMT liability. The result was that the tax liability exceeded the taxpayer’s economic benefit from the transaction. The taxpayer filed an OIC with the IRS seeking relief from the AMT liability based upon ETA. The IRS rejected the offer.

8 The Treasury Department has suggested that these principles are one reason to consider a consumption tax in lieu of the current tax system. See Department of the Treasury, Blueprints For Basic Tax Reform, 42-43 (January 17, 1977) (available at www.treas.gov/offices/tax-policy/library/blueprints).
10 This may have been part of the reasoning behind the statement in the 1998 legislative history linking ETA to voluntary compliance. H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that ”[t]he conferees believe that the ability to compromise tax liability … enhances taxpayer compliance.”).
11 The National Taxpayer Advocate has previously recommended fixing the AMT. See, e.g., National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2003), 5.
12 See Ginsburg and Levin, Mergers, Acquisitions, and Buyouts, ¶1502.2.1 (June 30, 2003).
13 Although the taxpayer’s tax liability was triggered at the same time that it would have been triggered if his option were not an ISO, in that case his employer would have had an income tax withholding obligation. This would have allowed the taxpayer to avoid the most inequitable consequences of the tax rules because employer withholding would have prepaid much of his tax and put him on notice (before the stock value declined) that a tax liability resulted from the option exercise.
Example 2: Attorney Fee Awards in Nonphysical Injury Cases

A taxpayer who was subject to age discrimination filed a lawsuit, with his attorney agreeing to accept a portion of any recovery as his fee. When the suit was settled in the early 1990s, the taxpayer agreed to a lesser amount based upon his reasonable understanding that he would not be taxed on the amount paid to his attorney. A court recently decided that the portion of the settlement that went to pay the taxpayer’s attorney was taxable to him. Thus, the taxpayer’s total tax liability on the settlement exceeded the net settlement amount after reduction for costs and attorney fees. The taxpayer submitted an OIC based on equity/public policy ETA considerations, which the IRS did not accept.

Example 3: Unreasonable IRS Delay

In the late 1990s, a taxpayer entered into a closing agreement with the IRS to settle a tax shelter investment with respect to tax years in the early 1980s. The agreement that the IRS drafted required reversals of tax shelter items. The IRS made the reversals that increased the taxpayer’s liability but not the reversals that would have reduced it. During the years following the execution of the closing agreement, the taxpayer repeatedly contacted the IRS about the reversals. The taxpayer did not pay liabilities associated with the years at issue, in part because the IRS had not made the reversals, which he believed would offset much, if not all, of the liability and interest for those years. In 2004, the IRS made all of the outstanding reversals. However, during the years that the taxpayer’s net liability was unsettled, a punitively high rate of interest accrued on the liability because it related to a tax shelter investment. The taxpayer submitted an OIC based upon ETA. The IRS would not accept an offer amount reduced by interest that accrued during the full period of unreasonable IRS delay in making the reversals.

RECOMMENDATION

The National Taxpayer Advocate recommends that the IRS be given more specific direction to compromise tax liabilities in cases where it is inequitable to collect them, notwithstanding the fact that such amounts are legally due pursuant to a technical application of the Code and not subject to abatement under other rules. Specific recommendations follow:

Add new paragraph 7122(c)(4) of the Code to read as follows:

“SPECIAL RULES RELATING TO OFFERS BASED UPON EQUITABLE CONSIDERATIONS. – Notwithstanding any other provision of this title, the
Secretary shall compromise a liability when it is inequitable to collect any unpaid tax (or any portion thereof, including penalties and interest).

(A) It shall be deemed inequitable to collect an income tax liability in excess of the economic benefit received from the transaction to which the liability relates. For purposes of this section, a transaction shall include all related transactions.

(B) In other cases, the Secretary shall consider all of the facts and circumstances, including:

i. whether the taxpayer acted reasonably and in good faith under the circumstances, such as, by taking reasonable actions to avoid or mitigate the situation;

ii. whether an income tax liability is disproportionate to (even if not in excess of) the economic benefit received from the transaction to which the liability relates;

iii. whether the taxpayer is a victim of a third-party bad act or other unexpected event;

iv. whether the taxpayer has a recent history of compliance with tax filing and payment obligations or a reasonable explanation for noncompliance;

v. whether any IRS employee has not followed standard procedures in connection with the case, including applicable published administrative guidance (such as the Internal Revenue Manual);

vi. whether IRS action or inaction has unreasonably delayed resolution of the taxpayer's case; and

vii. any other relevant fact or circumstance indicating that justice, equity or public policy justifies the compromise.

No single fact or circumstance described in clause (i)-(vii), above, shall be determinative of whether to compromise a liability under subparagraph (B). This determination shall be made without regard to the taxpayer's ability to fully pay the liability. Compromises under this paragraph 7122(c)(4) may require appropriate adjustments to basis, carryovers, or other tax attributes.

Equitable consideration offers (ECOs) would replace equity/policy ETA offers as a basis for compromise.

PRESENT LAW
Historic Background
The debate over the extent to which the IRS should compromise a liability based upon equitable considerations has been ongoing for at least the last century. In 1863, a predecessor of the statute providing the IRS' current authority to compromise was enacted, in
part, so that each case was not brought before Congress. Neither the original statute nor the current compromise statute place explicit limits on this authority. In 1933, however, Attorney General Cummings issued an opinion that the IRS had no power to compromise tax liabilities based solely upon equitable considerations. While this opinion was consistent with a few prior opinions, the IRS’ willingness to compromise based upon equitable considerations had previously been somewhat unsettled.

Recent Developments

In 1998, Congress clarified that offers could be accepted based upon “effective tax administration” (ETA). Factors such as equity, hardship, and public policy were to be considered. Under Treasury regulations, these three bases for compromise were collapsed into two: “economic hardship” and “equity/public policy.”

Treasury regulations explain that “equity/public policy” offers (sometimes called “non-hardship” ETA offers) may be accepted in exceptional circumstances, regardless of the taxpayer’s financial circumstances, if (a) there are no other grounds to compromise, (b) collection of the liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner, (c) the taxpayer can demonstrate circumstances that justify compromise even though a similarly situated taxpayer may have paid his liability, and (d) the proposed compromise would not undermine tax compliance.


18 Compare T.D. 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999) (preamble) (noting consistency with prior opinions), with 36 Op. Atty. Gen. 40 (May 8, 1929) (quoting and distinguishing 17 Op. 213, in which Attorney General MacVeagh expressed the opinion that “while, in considering any compromise submitted to your judgment, you are not at liberty to act from motives merely of compassion or charity, you are at liberty, until Congress sees fit to limit your authority, to consider not only the pecuniary interests of the Treasury, but also general considerations of justice and equity and public policy.”). Subsequent analyses have questioned the reasoning of the Cummings opinion. See GCM 24147 (August 13, 1942).


20 Id. Because the Code places no express limits on IRS’ ability to compromise, this clarification was accomplished via legislative history, without expressly expanding IRS’ authority to compromise. Id.

21 Treas. Reg. § 301.7122-1(b)(3).

22 Treas. Reg. § 301.7122-1(b)(3). A general requirement for the acceptance of any ETA offer is that compromise must not undermine compliance which generally means that the taxpayer must have a history of tax filing and payment compliance and must not have either taken deliberate actions to avoid the payment of taxes or encouraged others to refuse to comply with the tax laws. Treas. Reg. § 301.7122-1(b)(iii); Treas. Reg. § 301.7122-1(c)(ii); IRM 5.8.11.2.1(7) (Rev. 5-15-04). In addition, equity/policy ETA offers are only considered if there is no basis to compromise based upon “doubt as to liability” and “doubt as to collectibility.” Treas. Reg. § 301.7122-1(b)(i); IRM 5.8.11.1.3 (Rev. 5-15-2004); IRM 5.8.22.2(1) (Rev. 1-1-2000). However, ETA considerations are also taken into account in offers based upon doubt as to collectibility with special circumstances. IRM 5.8.11.2(2) (Rev. 5-15-2004).
The IRS will not compromise solely on the basis that the law is unfair. The IRS will not compromise solely on the basis of delay by the IRS, particularly delay that does not support relief under the interest abatement rules. The IRS has also extended this rationale to penalties. Similarly, the IRS will not compromise solely on the basis of the misdeeds of third parties.

**REASON FOR CHANGE**

The conference report to the 1998 legislation stated that –

… [offer-in-compromise] regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer’s income tax liability would promote effective tax administration. The conferees anticipate that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer’s liability… the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements…

As discussed above, the IRS has not fully embraced this statement, perhaps because of concurrence by some with Attorney General Cumming’s 1933 opinion that compromises based upon justice, equity, or public policy should be made only “at the insistence of Congress.” The National Taxpayer Advocate believes that Congress needs to “insist” by providing more specific guidance regarding how equitable considerations will be taken into account. Although the National Taxpayer Advocate believes that the IRS has the authority to adopt the proposals provided herein, it has not done so.
Tax Traps

A technical application of complex tax laws sometimes produces inequitable results. Such results may favor the government (called “traps for the unwary” or “tax traps”) or the taxpayer (called “tax shelters”) in any given instance.\footnote{According to Department of Treasury, “[c]orporate tax shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity…. Discontinuities exist in the tax law for several reasons. Most importantly, the Code does not measure economic income precisely. Rather, the Code incorporates a number of simplifying conventions to address various concerns, such as liquidity, complexity (including valuation concerns), and administrability. These simplifying conventions, however, provide opportunities for manipulation and are a major source of tax shelter activity.” Department of Treasury, White Paper, The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals (July 1, 1999) (available at http://www.treas.gov/press/releases/reports/cstwhtie.pdf) at 10.} IRS guidance that a compromise based upon equity/public policy may not be made based upon the unfairness of the tax rules is inconsistent with the reality that even generally fair tax rules may, in certain circumstances, produce unfair results. Oral arguments before the Supreme Court regarding the attorney fee “tax trap,” similar to Example 2 (above), recently included the following exchange:\footnote{Oral arguments before the Supreme Court for the consolidated appeal of Banks v. Commissioner, 345 F.3d 373 (6th Cir. 2003) and Banaitis v. Commissioner, 340 F.3d 1074 (9th Cir. 2003), conducted November 1, 2004 at 5-26 (available at http://www.supremecourtus.gov/oral_arguments/argument_transcripts/03-892.pdf).}

JUSTICE BREYER: …a Congress that seems to be willing to take away deductions for expenses that lead to the income, could produce an income tax that in many cases, not just a few, exceeds the income that an individual has. And I would like to know what in the law is there to guard against that result….

JUSTICE KENNEDY: Other – other than the mercy of the Internal Revenue Service. (Laughter.)

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JUSTICE KENNEDY: This is not income in any – in any real sense.

JUSTICE BREYER: Is there any constitutional protection? The Sixteenth Amendment refers to an income tax, and perhaps that doesn’t include a tax that grossly exceeds in many cases a person’s income. That would be quite a far-out theory at the moment.

JUSTICE BREYER: But I – that’s why I ask you. Is there any protection in the law whatsoever? Or if Congress decides to tax a set of people who, let’s see - say, earn $10,000 a year and because they’re small business people, they happen to have $20,000 expenses. So it taxes them on $20,000, and the tax exceeds the income. There’s no protection in your view against that result. And you just said, well, Congress decided to do it, it decided to do it.

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JUSTICE BREYER: What about an assumption, for example, that when we read the code, we read it with a view towards thinking Congress did not want to produce such unfair results? (Emphasis added).
The Court’s discussion reflects the common sense notion that net income (rather than gross income) is the only proper measure of a taxpayer’s income. When a tax liability is disproportionate to the economic benefit derived from a transaction, the tax is likely to upset reasonable expectations and notions of fairness. This is not unlike the unfairness that results when a tax shelter transaction results in tax benefits that exceed the true economic costs of the transaction.

Although some taxpayers may be able to avoid tax traps by obtaining timely advice of qualified counsel, others will not be as well prepared. This may further the perception that the tax rules are not fair and place disproportionate burdens on taxpayers least able to handle them. Such a perception would be consistent with pre-existing notions that “only little people pay taxes,” which are based on the idea that rich and well-advised taxpayers can minimize their taxes by engaging in legal tax shelter transactions. Thus, tax traps may have the potential to erode voluntary compliance in much the same way as the perception of unfairness created by the existence of tax shelters.

The tax shelter problem, however, has been addressed more aggressively than the tax trap problem. The IRS has authority, procedures and motivation to fix many tax shelters administratively. For example, taxpayers are required to report transactions that meet

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32 See, e.g., Marvin A. Chirelstein, Federal Income Taxation, A Law Student’s Guide to the Leading Cases and Concepts, 95 (8th ed. 1997) (noting that “[o]ur income tax system is premised on the idea that enrichment is the best measure of a taxpayer’s ability to bear the costs of government. While gross income may give some indication of the taxpayer’s income status, it would obviously be arbitrary and in many instances highly unfair to accept that figure as final.”) (Emphasis added).

33 Taxing a person on income from which they received no significant benefit is also a factor in considering whether equitable relief should be available under the innocent spouse rules. See, e.g., Treas. Reg. § 1.6015-2(d); Rev. Proc. 2003-61, 2003-32 I.R.B. 296; H.R. Rept. No. 432, 98th Cong., 2d Sess., pt. 2, at 1502 (1984).

34 In contrast to the IRS’ approach to tax traps, the IRS has been willing to settle various partnership tax shelters by eliminating both phantom income and phantom deductions. IRM 35.24.3.1(1)(g)(2)(b) (Rev. 3-9-1994); IRM Exhibit 35.24.3-8 (Rev. 3-9-1994) (Sample letter for Rule 248(b) Cash Out-of-pocket Settlements).


36 See, e.g., IRC § 269 (permitting IRS to disallow any deduction, credit or other allowance where control of a corporation is acquired and “the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of such deduction, credit, or other allowance”), § 482 (permitting IRS to distribute, apportion, or allocate gross income, deductions, credits, or allowances between taxpayers owned or controlled directly or indirectly by the same interests, if necessary to prevent evasion of taxes or to clearly to reflect income), § 446(b) (permitting the Secretary to put a taxpayer on a method of accounting that “clearly reflects income”). See also, Treas. Reg. § 1.701-2 (partnership anti-abuse rules); Treas. Reg. § 1.1502-13(b)(1) (consolidated return anti-abuse rules); Treas. Reg. § 1.1502-17(c) (providing anti-abuse rule concerning methods of accounting); Treas. Reg. § 1.1502-19(c) (providing anti-abuse rule concerning excess loss accounts). Various judicial doctrines (e.g., “economic substance” or “substance over form”) effectively give the IRS additional authority to eliminate many other tax shelters administratively or through litigation.
In contrast, no comprehensive procedures exist to identify and fix tax traps quickly before significant loss to taxpayers can occur. Thus, some traps will remain undetected or at least unfixed for extended periods, especially those that affect only a small number of taxpayers. In some cases, changing the law to eliminate tax traps would have broad ramifications in areas outside of a given case, potentially creating complexity, tax shelters or other tax traps. Congress’ or IRS’ inability to provide proactive relief to all taxpayers (via legislative or administrative guidance) should not prevent taxpayers that submit an OIC from obtaining relief. In fact, one reason that the IRS was given the power to compromise tax liabilities was to eliminate the need for taxpayers to ask Congress for relief. Instead, the IRS was to provide relief on a case by case basis, as appropriate.

The IRS is concerned that using the OIC process to alleviate inequitable situations is itself inequitable because other similarly situated taxpayers may have paid the liability and not submitted an OIC. However, the inequity presented when a taxpayer who would be eligible for an OIC does not submit one is no worse than the inequity presented when the taxpayer fails to take a deduction to which he or she would have been entitled. Further, under the IRS’ reasoning tax shelter investors could argue (incorrectly) that it is unfair when they are made to pay because other similarly situated investors are not always made to pay. Sometimes, as a practical matter, equitable relief can be provided only on a case-by-case basis.

**IRS Responsibility for Liability**

In some cases a liability for tax, interest or penalties may accrue by reason of unreasonable IRS action or inaction, such as unreasonable delay. In such cases where IRS bears some responsibility for the liability, collection of the liability in full may nonetheless be inequitable because taxpayers should not be penalized for IRS errors. An example in the final Treasury regulations of when an equity/public policy ETA compromise is appropriate:

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38 Treas. Reg. § 1.6011-4(e)(1).
42 As the Supreme Court has said “taxes are the lifeblood of government, and their prompt and certain availability an impensurable need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection...[therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified.” *Ball v. US*, 295 U.S. 247, 259-260 (1935). Applying this reasoning to tax traps, the operation of the tax trap is itself a “mistake” and the OIC process presents a way to have the mistake rectified before collection occurs.
ate illustrates this principle. In the example, the IRS provides inaccurate written advice to a taxpayer regarding how to roll over his IRA while preserving its tax benefits and avoiding penalties. The taxpayer relies on this advice and incurs liability for tax, penalties, and additions to tax. The example concludes that compromise is appropriate.

However, implicit limitations on the general principle (illustrated by the example in the regulations) that taxpayers should not be penalized based upon unreasonable IRS action or inaction would deny relief in most such cases. The example states that had it not been for the erroneous written advice, the taxpayer would have avoided the penalty. Thus, even in cases where the IRS concludes that it was at fault, the IRS is likely to distinguish the facts of the example from the taxpayer’s case unless he or she has received erroneous written advice from IRS and can prove what would have transpired in the absence of such advice. In fact, IRS guidance indicates that IRS will not compromise based solely upon delay or other IRS actions that do not support relief under penalty or interest abatement provisions.

The form of the IRS’ erroneous advice, evidence regarding what might or might not have occurred in the absence of such advice, and the ability or inability of IRS to abate a liability for interest or penalties under the Code’s abatement provisions should not be determinative of whether interest or penalties should be compromised in connection with an OIC. Rather, equitable considerations should be the focus of the inquiry. Like substantive tax rules, the Code’s interest and penalty relief provisions may not always operate equitably or even as intended. Moreover, legislators must have determined that those relief provisions would not always produce an equitable result when the conferees explained that the IRS may “utilize this [ETA] authority, to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability.”

Although the IRS’ policy of not compromising “solely” based upon delay or other actions that do not support relief under penalty or interest abatement provisions theoretically leaves room for compromise if other factors are present, no other facts or circumstances have been identified, except the example from the Treasury regulations (described above), that would lead to a conclusion that relief is appropriate.

**Unexpected Events and Third Party Acts**

Unexpected events (including third party bad acts) that result in an unpaid tax liability are relevant to the determination of whether a compromise is equitable. Such events put the

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43 Treas. Reg. § 301.7122-1(c)(3)(v)(Ex. 2).
44 IRM 5.8.1.2.2(3) (Rev. 5-15-2004). IRM 5.8.11.2.2(4) (Rev. 5-15-2004); IRM 4.18.3.4(3) (Rev. 1-1-2000). See also T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002). However, IRS Commissioner Everson has publicly stated that the IRS does not believe the compromise of interest not subject to abatement is precluded. Mark Everson, IRS Responds to Taxwriters’ Offer in Compromise Concerns, 2004 TNT 231-25, 6 (Dec. 1, 2004).
46 IRM 5.8.11.2.2(3) (Rev. 5-15-2004). IRM 5.8.11.2.2(4) (Rev. 5-15-2004); IRM 4.18.3.4(3) (Rev. 1-1-2000).
taxpayer’s actions in context and help explain the taxpayer’s failure to recognize a tax trap as well as the reasonableness of the taxpayer’s actions under the circumstances. An example in the Treasury regulations illustrates this point. A taxpayer does not file or pay his taxes because he is incapacitated by illness, and the example concludes that compromise is appropriate because the illness prevented the taxpayer from fulfilling his obligations. The IRS’ decision to compromise should not change simply because the taxpayer’s incapacitation was caused by a third party rather than by an illness. The focus should instead be on whether the taxpayer acted reasonably under the circumstances and whether compromise would be equitable.

As with interest and penalty cases, the IRS’ policy of not compromising “solely” based upon third party acts theoretically leaves room for compromise when a taxpayer has suffered at the hands of third parties if other factors are present, but no other facts or circumstances have been identified that would lead to a conclusion that relief is appropriate in such instances.

EXPLANATION OF RECOMMENDATION

In cases involving “tax traps,” which result in tax liability in excess of the economic benefit from a transaction, the law is operating inequitably regardless of the reasonableness of a taxpayer’s actions. In such cases, factual inquiries are avoided by simply requiring the IRS to compromise to the extent the liability exceeds the economic benefit (further reduction of the liability, however, would require additional factual inquiry). This may result, for example, from a technical application of the annual accounting rules (gains and losses in different years), deduction limitation rules, realization rules (phantom income realized and real income not obtained), or the character rules (gains not offset by losses). Regulations would

48 IRS is concerned that compromise on the basis of unexpected events such as third-party acts would make the government a de facto insurer of poor business decisions or financial misdeeds suffered at the hands of third parties. See T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble). However, the only difference between de facto “insurance” against illness, illustrated by the example provided in the final ETA regulations, and “insurance” against embezzlement by third parties seems to be the level of difficulty in determining whether the taxpayer acted reasonably in protecting himself from the illness or theft, respectively. In addition, because compromises on the basis of third party acts would typically involve the compromise of liabilities resulting from such acts, such compromises would merely reduce the adverse tax consequences suffered by the victim. Just as the theft loss deduction does not make taxpayers abandon all precautions against theft, compromise in such cases would not make taxpayers abandon precautions against third party bad acts, especially since the reasonableness of the taxpayer’s actions would be at issue in connection with an ECO.
49 IRM 5.8.11.2.2(10) (Rev. 5-15-2004) (stating “[t]he Service will not compromise on public policy or equity grounds based solely on the argument that the acts of a third party caused the unpaid tax liability.”).
50 Refining the definition of an “economic benefit” could involve some of the same challenges as the defining net income. However, the IRS has been able to define “significant benefit” in the context of innocent spouse claims, which is a very similar concept.
51 Of course this analysis should also take into account time value of money concepts.
52 Although this may result in a relatively greater number of OIC submissions during economic downturns when tax liabilities resulting from a transaction may be more likely to exceed the economic benefits from it, such trends may be helpful in alerting policymakers to the existence of tax traps so that they can be addressed through legal or administrative guidance. Any resulting administrative burden that this places on the IRS could be minimized through the adoption of standard settlements initiatives, such as those used for resolving tax shelter cases.
clarify the scope of what constitutes a “transaction” and a “related transaction” for purposes of these rules, with the expectation that the definition would be broadly drawn to take into account true economic benefits realized by the taxpayer at the time he or she was required to pay the liability. The IRS would require correlative adjustments to tax attributes in connection with accepted ECOs to ensure that the taxpayer is not relieved of tax liability while retaining corresponding tax benefits, such as basis increases or loss carryforwards resulting from the transaction giving rise to the compromised liability.

In other cases, a central inquiry would be whether a taxpayer facing an unexpected liability acted reasonably and in good faith under the circumstances. The taxpayer’s compliance record may be relevant to determining whether he or she acted in good faith. An analysis of reasonableness requires an individual evaluation of each taxpayer seeking relief to determine what could reasonably be expected from him or her under the circumstances. Thus, factors relevant to this analysis may include the taxpayer’s level of education, experience, mental and physical impairment, third party bad acts, and the extent to which the IRS’s actions or procedures or the tax rules impaired his or her ability to avoid or mitigate the situation. The IRS already conducts such an analysis in providing relief to taxpayers from joint and several liability under IRC § 6015 (“innocent spouse” relief).53

HARDSHIP CONSIDERATIONS

PROBLEM

Although IRS will compromise a liability on the basis of an individual taxpayer’s “economic hardship,” it does not take into account the hardships of third parties, such as the community, employees, customers, and relatives, except perhaps indirectly when the third parties are dependents. \(^54\)

Example 4: Third Party Hardship

A church with a spotless record of tax compliance had an 80-year-old bookkeeper who, after consistently filing and paying payroll taxes for 17 years, failed to file and pay these taxes for the last 22 quarters. After a new bookkeeper discovered the problem, the church filed returns but could not fully pay its delinquent taxes. The church’s activities included religious education, youth programs, attending to the elderly, and providing food, shelter and clothing to the needy in a low income community. The church acted reasonably in relying on a bookkeeper with a 17 year history of accurately fulfilling her duties. Full payment of interest and penalties would have jeopardized the availability of the church’s programs, potentially resulting in hardship for needy third parties. The church submitted an offer to pay the tax liability, requesting a compromise only of interest and penalties based upon ETA. The IRS did not accept it. \(^55\)

RECOMMENDATION

Add new paragraph 7122(c)(5) of the Code to read as follows:

“RULES RELATING TO OFFERS BASED UPON HARDSHIP. --
Notwithstanding any other provision of this title, unless the taxpayer has a recent unexplained history of noncompliance with tax filing or payment obligations, the Secretary may compromise a liability if collection of unpaid tax (or any portion thereof, including penalties and interest) would cause a hardship for the taxpayer or for a third party, without regard to whether the taxpayer is a person or an entity. This determination shall be made without regard to the taxpayer’s ability to fully pay the liability.


\(^55\) Some penalties and interest may ultimately have been abated in this case. A similar case involved an offer from a small borough to compromise employment tax penalties, the rejection of which was based upon the assumption that borough assets available to pay the tax included a building, office equipment, a playground and a police car.
PRESENT LAW

Historical Background

In 1933, in the wake of the Depression, Acting Secretary of the Treasury Acheson suggested that the IRS should compromise tax claims where collection would “destroy a business, ruin a tax producer, throw men out of employment, or result in the impoverishment of widows or minor children of a deceased taxpayer.” Following Attorney General Cummings’ response, which indicated the IRS had no such authority, there were calls for Congress to expand IRS’ authority to compromise such cases.

Recent Developments

In 1998, Congress clarified that the Secretary had authority to accept “effective tax administration” (ETA) offers to compromise tax liabilities on the basis of “hardship.” Under current regulations, this means “economic hardship,” which is defined by reference to the standard used to determine whether IRS should release a levy, i.e., whether collection would leave the taxpayer unable to meet basic living expenses. A nonexclusive list of factors includes:

(A) Taxpayer is incapable of earning a living because of a long term illness, medical condition, or disability, and it is reasonably foreseeable that taxpayer’s financial resources will be exhausted providing for care and support during the course of the condition;

(B) Although taxpayer has certain monthly income, that income is exhausted each month in providing for the care of dependents with no other means of support; and

(C) Although taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses.

Factors such as the taxpayer’s age, employment status, and the age, health and employment status of the taxpayer’s dependents may also be considered.

LEGISLATIVE RECOMMENDATIONS

SECTION TWO

OFFER IN COMPROMISE: EFFECTIVE TAX ADMINISTRATION
Although the IRS tried to develop an economic hardship test that could apply to entities, it abandoned that approach when final regulations were issued based upon concerns that the IRS would be supporting nonviable businesses. Thus, the economic hardship standard applies only to individual taxpayers (and not to third parties or entities). In addition, IRS takes economic hardships which may be experienced by the taxpayer’s dependents into account only indirectly by assessing the economic hardship suffered by the taxpayer as a result of having to deplete income to care for dependents with no other means of support. This suggests, for example, that hardships suffered by a taxpayer’s nondependent children, employees or customers would not be taken into account.

**REASON FOR CHANGE**

The IRS’ collection actions may disrupt services to customers or create hardships for nondependent children or other third parties, as illustrated in Example 4. Under current law, the IRS will not compromise a liability on the basis that collection from an entity would, for example, “destroy a business, ruin a tax producer, [or] throw men out of employment,” or otherwise result in hardship for third parties, even though such considerations have historically been associated with the authority to compromise based upon hardship. Although IRS should not compromise a liability that will subsidize a nonviable business at the expense of its competitors on the basis of hardship, the IRS should reasonably consider all of the consequences of collecting the liability in full, including consequences to third parties in determining whether to compromise a liability.

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65 Treas. Reg. § 301.7122-1(b)(3). Although factors such as the age and health of the taxpayer’s dependents may be taken into account, IRS has not documented how such factors are to be taken into account. Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1(5) (Rev. 5-15-2004). Does a taxpayer need to get a doctor’s note estimating the total cost of treatment? What if the dependent’s expenses are likely to be incurred after they become independent? Although the effect on third parties may be considered in determining which collection alternative to pursue, how such effects are considered is similarly unspecified. IRM 5.10.1.3.2(3) (Rev. 10-1-2004).

66 However, IRS can sometimes take the support of a dependent that is not claimed as such on his or her tax return (such as a foster child) into account in determining which national expense standard to apply. IRM 5.8.5.5.1(3) (Rev. 11-15-2004).

67 T.D. 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999) (preamble, quoting Treasury Secretary Acheson’s 1933 letter to the Attorney General); Proceedings and Debates, 69th Cong. 1st Sess., Special Session of the Senate Vol. LXVII—Part 1 (Dec. 11, 1925) at 1150 (discussion of an amendment offered by Mr. Breedy for expanding compromise authority because “there is a demand for it by legitimate business and on the part of concerns where to pay the full tax would mean throwing them into bankruptcy”); American Bar Association Testimony at Senate Hearings before the Committee on Finance on the Revenue Act of 1938, H.R. 9682, 75th Cong., 3rd Sess. (March 17, 1938) at 301-302 (recommending an expansion of IRS’s authority to compromise).
Although the IRS does not track the number of compromises received or accepted based on economic hardship, anecdotal evidence suggests that IRS has rarely used its authority to compromise on the basis of economic hardship. If true, this may be because IRS employees prefer to compromise hardship cases on the basis of doubt at to collectibility rather than ETA. Since a compromise based upon collectibility is evaluated under the same general standard as "economic hardship," i.e., whether collection would leave a taxpayer without the ability to pay "basic living expenses," the ability to compromise on the basis of economic hardship does not provide the IRS with significantly more authority than they had (or should have had) under preexisting rules.

EXPLANATION OF RECOMMENDATION

Under the proposal, the IRS’s authority to compromise based upon “hardship” would be expanded beyond an evaluation of the taxpayer’s ability to pay reasonable basic living expenses. The IRS would analyze the facts and circumstances relating to each offer to determine whether collection of the full liability is likely to produce a hardship for the taxpayer or third parties, regardless of whether the taxpayer is an individual or a business entity and regardless of whether the third parties are the taxpayer’s legal dependents. In such cases, a compromise would be appropriate unless the taxpayer had a recent unexplained history of noncompliance. The existing “economic hardship” considerations based upon the taxpayer’s ability to pay basic living expenses could be incorporated into the analysis of offers based upon doubt as to collectibility.
OFTEN PROCESSING ORDER

PROBLEM

An offer in compromise (OIC) can be submitted on the basis of “doubt as to collectibility” (DATC), “doubt as to liability” (DATL), or in furtherance of “effective tax administration” (ETA), or any combination of these bases. In considering combination offers, the IRS always determines what it could collect before it determines how much the taxpayer owes or whether compromise based upon equity/public policy ETA considerations is appropriate. Consider the following hypothetical example:

EXAMPLE

A taxpayer is subject to a $10,000 assessment for a trust fund recovery penalty resulting from unpaid business employment tax liabilities. A bookkeeper embezzled the business’ payroll tax deposits and was recently convicted for that crime. The taxpayer believes that although he cannot pay the assessed liability, he actually owes nothing (e.g., because he is not a “responsible person”), and even if he does owe the tax it would be inequitable to collect any such liability from him given the intervening bad act. He hires a tax advisor to help him submit an OIC for $1 based upon DATL, DATC, and ETA along with the $150 fee. The taxpayer fails to sufficiently document certain expenses and does not receive the IRS’ communication requesting additional documentation in time to respond. After two months, the offer is returned with the IRS retaining the fee. One month later, the taxpayer submits the offer again with updated financial information. In accordance with its procedures, the IRS first conducts a financial analysis, and within six months determines that the taxpayer can pay only $3,000. Given the risk that the DATL and ETA issues would not be resolved in the taxpayer’s favor after another long wait and that he might have to submit another offer and financial analysis to resolve the liability for only $3,000, the taxpayer who has spent more than a thousand dollars (in OIC processing fees and tax advisor fees) to submit the offer, decides to agree to pay $3,000 to resolve the matter.

RECOMMENDATION

Add new sub-paragraph 7122(c)(3)(C) of the Code to read as follows:

“In the case of an offer-in-compromise submitted on more than one basis, the Secretary shall evaluate the taxpayer’s bases for compromise in the order indicated by the taxpayer, and the Secretary’s decision to compromise on one basis shall not depend on whether the Secretary would be willing to compromise on another basis; and”

72 IRM 5.8.4.10(1) (Rev. 11-15-2004).
73 IRM 5.8.4.10(3) (Rev. 11-15-2004); Treas. Reg. § 301.7122-1(b)(3)(ii).
74 Treas. Reg. § 301.7122-1(b)(3). Similarly, an ETA offer based on hardship may only be considered after it is determined that the liability could be collected in full, i.e., that DATC does not exist. Id. However, an ETA offer based on hardship could be accepted without a determination that DATL does not exist.
75 IRM 5.8.4.10(3) (Rev. 11-15-2004).
PRESENT LAW

No statutory provision governs the order in which combination offers are processed. Current regulations provide that an offer may not be considered on the basis of non-hardship ETA if DATC or DATL exist.\(^{74}\) Internal Revenue Manual procedures provide that when an OIC is submitted on more than one basis, DATC issues will be processed first, followed by DATL issues, and only after DATC and DATL have been considered and rejected will an equity or public policy offer based on ETA be considered.\(^{75}\) An OIC may be returned based up on a failure to provide financial information that is relevant only to DATC issues even if it is also submitted on the basis of DATL or ETA.\(^{76}\) If the offer is accepted on the basis of DATC, neither DATL nor ETA is considered.\(^{77}\)

REASON FOR CHANGE

Under current procedures, taxpayers that submit combination offers must wait for IRS to analyze their personal financial information before the IRS will consider whether they owe the tax or whether the tax should not be collected based upon equitable considerations. This is unnecessarily burdensome for both the IRS and for taxpayers. If a taxpayer fails to provide sufficient and timely documentation of financial information, IRS may return the entire offer without considering whether the taxpayer actually owes the tax or whether it would be inequitable for the IRS to collect it, even though the taxpayer’s financial condition may not be relevant to IRS’ consideration of those issues.

EXPLANATION OF PROVISION

Under the proposal, when an OIC is submitted on more than one basis, the taxpayer has the opportunity to select the order in which the bases will be considered. A taxpayer faced with a liability that is not properly due or that it would be inequitable to collect will be able to get his or her offer accepted on those bases without the delay of having the IRS first consider whether compromise on another basis would be possible.\(^{78}\) Since a taxpayer’s financial information is relevant only to collectibility or hardship issues, offers would not be returned based on a lack of financial information unless the IRS is actually considering a compromise on those bases. Unless a taxpayer requested DATC issues to be considered before DATL issues, they would not be faced with the choice of compromising for more than the correct amount of tax to resolve the matter or waiting for IRS to complete the DATL analysis.\(^{79}\)

\(^{74}\) IRM 5.8.4.10(4) (Rev. 11-15-2004).

\(^{75}\) Id. Item 8(i) on Form 656 prohibits taxpayers from contesting the liability “in court or otherwise.” However, once IRS determines to accept a combination offer based on DATC, they will now give the taxpayer the option to either take the DATC offer or to pursue the DATL issues. Memorandum from Director, Collection Policy regarding Processing Changes for Offers in Compromise Submitted as Doubt as to Collectibility (DATC) and Doubt as to Liability, November 17, 2004.

\(^{76}\) Once a basis for compromise is found the IRS would retain the ability to consider all relevant factors in determining whether an offer amount is acceptable. Treas. Reg. § 301.7122-1(c)(1).

\(^{77}\) Although some taxpayers could submit DATL or ETA offers raising frivolous issues for purposes of delay and request that those issues be decided first, the IRS would retain the ability to summarily return or reject such offers. In addition, Congress has been considering enhanced penalties and procedures to deal with frivolous offers. See Tax Administration Good Government Act, S. 882, 108th Cong. § 209 (2003).
The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) established Collection Due Process (CDP) hearing rights under Internal Revenue Code (IRC) sections 6320 (liens) and 6330 (levies). By creating informal due process procedures for taxpayers prior to the IRS taking collection action, Congress moved to afford taxpayers the type of protections they would receive in dealing with any creditor.

Since its enactment, CDP has been the subject of much debate. Opponents of the process, both inside and outside the IRS, decry CDP hearings as a waste of taxpayer, IRS, and judicial time and resources. Proponents, on the other hand, maintain that CDP hearings afford taxpayers an opportunity to be heard before or immediately after collection is initiated and, through the mechanism of judicial review, ensure that the Service’s procedures conform to notions of fairness and due process.

The National Taxpayer Advocate believes that CDP is a much-needed safeguard and taxpayer protection, given the Internal Revenue Service’s unrivaled powers as a creditor. She also acknowledges that both legislative and administrative improvements to the CDP hearing process are warranted. The National Taxpayer Advocate makes the following recommendations:

- Retain the Collection Due Process procedure as a necessary, essential, and statutory taxpayer right.
- Amend IRC § 6330(d) to limit judicial review to issues other than the existence or amount of the tax liability underlying the collection action. Continue to allow taxpayers to raise challenges to the existence or amount of the underlying tax liability at the Appeals’ hearing level, pursuant to present law under IRC § 6330(c)(2)(B).

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2 Id., § 3401, 112 Stat. 685.
3 S. Rep. No. 105-174, 105th Cong., p. 67 (1998); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1999, 81 and 83 (JCS-6-98).
6 Since we also recommend that the liability determination should play into the "balancing" part of the Appeals Hearing Officer's analysis and determination, the court would still undertake an "abuse of discretion" review of liability determinations when it reviews the decision to allow collection to proceed.
Amend IRC § 6330(c)(2)(B) to provide that, regardless of whether the taxpayer actually received a statutory notice of deficiency, had an opportunity to dispute such liability, or self-assessed the liability on a tax return, the taxpayer may raise issues relating to the existence or amount of any liability that is eligible for an audit reconsideration or a Doubt as to Liability Offer in Compromise. Amend IRC § 6330(c)(3)(C) to provide that the Office of Appeals shall not issue a Notice of Determination in said case until such reconsideration and administrative appeal of the underlying liability has been concluded and the results taken into consideration in making the determination under that paragraph.7

Amend the flush language of IRC § 6320(a)(2) to provide that the Secretary shall send the notice required under IRC § 6320(a)(1) not more than five business days after the day the notice of lien is mailed or otherwise submitted for filing. Further, amend IRC § 6320(a)(3)(B) to provide that the taxpayer has 30 days from date the notice is provided under IRC § 6320(a)(2) to request a hearing.

The National Taxpayer Advocate makes the following administrative recommendations:

- The Office of Appeals should clearly inform taxpayers that they are entitled to face-to-face hearings in cases raising the appropriateness of collection alternatives, unless they elect out of a face-to-face hearing or raise only frivolous issues prior to the hearing.
- The Office of Appeals should clearly inform taxpayers that where they are entitled to a face-to-face hearing, they have the right to record such hearing at their expense.
- The Office of Appeals should develop a separate form that is sent to each taxpayer with acknowledgement of the CDP hearing request, setting forth all collection alternatives to lien and levy actions (including subordination, partial discharge, and withdrawal of lien, full and partial pay installment agreements, offers in compromise, currently not collectible status, and grounds for penalty and interest abatement) and instructing the taxpayer to identify all relevant collection alternatives and supporting facts on the form provided.

7 The National Taxpayer Advocate suggests that, unless the taxpayer objects, the Appeals Hearing Officer, if qualified and knowledgeable in the matter at issue, should be able to act as the Appeals Settlement Officer if a taxpayer appeals the audit reconsideration or offer in compromise during a CDP hearing. Of course, taxpayers must be clearly told that they have the right to object.
EXAMPLE
Taxpayer A ran a small business that sustained severe fire damage in 2000. In 2002, the IRS audited Taxpayer A’s return, including his Schedule C, Profit or Loss from Business (Sole Proprietorship), for the year of the fire. Taxpayer A was unable to provide documentation in support of most of his business expenses because many of his books and records were destroyed in the fire. The IRS disallowed all business expenses claimed on the Schedule C. Because Taxpayer A was struggling to save his failing business, he did not request an Appeals conference or timely file a petition in the United States Tax Court in response to Notice of Deficiency, that he received. The IRS then assessed $7,000 in additional income and self-employment tax.

Taxpayer A has tried to explain to IRS collection personnel that he doesn’t owe this tax because he had legitimate business expenses, but he has not been successful in getting anyone to listen to him. The IRS is now proposing to levy on his paycheck and issued a Notice of Intent to Levy and Right to Collection Due Process Hearing.

Taxpayer A timely filed a request for a CDP hearing and has tried to prove to the Appeals Officer that the underlying liability is erroneous. Because Taxpayer A actually received the Notice of Deficiency, the Appeals Officer will not consider the underlying liability at the hearing. The Appeals Officer issues a determination letter sustaining the IRS’ proposed levy action and triggering the 30-day period for Taxpayer A to petition the United States Tax Court. However, the Appeals Officer has said she will suspend the collection action while Taxpayer A seeks an audit reconsideration from the IRS, which could take up to 6 months. Taxpayer A will probably file a petition in Tax Court because he does not want to lose his appeal rights, even though he thinks he could resolve the matter in audit reconsideration.

PRESENT LAW
The Collection Due Process legislation was enacted with the goal of establishing “formal procedures designed to ensure due process where the IRS seeks to collect taxes by levy (including by seizure).” The legislation affords taxpayers the opportunity to ask for a meaningful review of certain IRS collection actions, by an impartial officer of the IRS’ Office of Appeals, at two separate points in the collection process: after the filing of a Notice of Federal Tax Lien (NFTL) and prior to a levy of the taxpayer’s property. At both steps, the IRS must send a notice to the taxpayer’s last known address by certified or registered mail, providing the taxpayer an opportunity to request a CDP hearing. A taxpayer who desires a hearing must request one in writing within 30 days of the date of the notice. If the taxpay-

9 IRC § 6320(b) governs a taxpayer’s rights to a CDP hearing after the filing of a federal tax lien, and IRC § 6330(b) governs a taxpayer’s rights to a CDP hearing prior to the levy of the taxpayer’s property.
10 IRC §§ 6320(a)(2)(C) and 6330(a)(2)(C). The IRS may also give the notice in person or leave the notice at the dwelling or usual place of business of such person. IRC §§ 6320(a)(2)(A) and (B); IRC §§ 6330(a)(2)(A) and (B).
er makes an untimely request, the Office of Appeals will hold an “equivalent hearing” which resembles a CDP hearing in all respects except that no judicial review is available.\textsuperscript{12}

The term “hearing,” as defined by the Treasury Regulations, does not necessarily guarantee the taxpayer an opportunity to appear face-to-face before an IRS representative. The regulations suggest that a mere exchange of correspondence may constitute a hearing.\textsuperscript{13} However, the Treasury Regulations indicate that a face-to-face hearing will be granted if the taxpayer specifically makes such a request.\textsuperscript{14}

At the hearing, the taxpayer may raise one or more of the following issues relating to the unpaid tax:

\begin{itemize}
  \item Appropriateness of collection actions;\textsuperscript{15}
  \item Collection alternatives such as installment agreement, offer-in-compromise, posting a bond or substitution of other assets;\textsuperscript{16}
  \item Appropriate spousal defenses;\textsuperscript{17} and
  \item The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.\textsuperscript{18}
\end{itemize}

The Appeals Officer conducting the hearing must also obtain verification from the IRS that all requirements of applicable laws and administrative procedures were, in fact, satisfied.\textsuperscript{19}

After the hearing, the Office of Appeals issues a Notice of Determination that sets forth

\textsuperscript{11} IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C1 and 301.6330-1(c)(2), Q&A-C1.
\textsuperscript{12} Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C7 and 301.6330-1(c)(2), Q&A-C7.
\textsuperscript{13} Treas. Reg. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.
\textsuperscript{14} Treas. Reg. §§ 301.6320-1(d)(2), Q&A-D7 and 301.6330-1(d)(2), Q&A-D7.
\textsuperscript{15} IRC § 6330(c)(2)(A)(ii).
\textsuperscript{16} IRC § 6330(c)(2)(A)(iii).
\textsuperscript{17} IRC § 6330(c)(2)(A)(i).
\textsuperscript{18} IRC § 6330(c)(2)(B).  The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding.  IRC § 6330(c)(4).
\textsuperscript{19} IRC § 6330(c)(1).
the findings and determinations on the issues raised by the taxpayer. In making his or her determination, the Appeals Officer must take into consideration the verification that all applicable law and administrative procedures were followed; the issues raised by the taxpayer at the hearing; and “whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary.”

Depending on the type of tax at issue, the taxpayer can appeal the Notice of Determination to the United States Tax Court or the appropriate United States district court. Except in limited circumstances, the standard of review for courts reviewing the actions of Appeals officers, including the findings of fact set forth in the Notice of Determination, is an “abuse of discretion” standard. This means the reviewing court will not overturn the action of the Appeals Officer unless the court determines he or she has acted arbitrarily or acted without a sound basis in fact or law. In contrast, the de novo standard of review allows the reviewing court to reach its own conclusions about disputed facts without affording deference to the findings of the Appeals officer. However, courts that hear appeals from CDP hearings use the de novo standard in certain circumstances, such as where the taxpayer is able to dispute the underlying tax liability.

REASONS FOR CHANGE

Why Collection Due Process?
The Internal Revenue Service’s collection powers are unrivalled in the United States. They are triggered either by the taxpayer’s own failure to pay the tax due according to his or her own self-assessment, by a summary assessment of tax under the Service’s “math error” authority, by jeopardy assessment or by administrative or judicial proceedings to determine a deficiency in tax in which the government enjoys the presumption of correctness. Once any of these events has occurred, the IRS merely needs to send a notice of tax due and demand for payment before it can take administrative levy and lien actions.
that any other creditor would have to obtain a judgment for prior to collecting. 27

While the vast majority of U.S. taxpayers timely file and pay their taxes, there are always some taxpayers who either cannot or will not pay their taxes. Within the “cannot” category, some taxpayers do not know that the tax is due or believe that the IRS was incorrect in assessing the tax; others know that they owe taxes but are not able to pay the amount due without some financial injury. Moreover, among those taxpayers who believe that they will be harmed financially if they pay all or even part of the tax due, there is a wide spectrum of opinions about what constitutes economic harm. Should all U.S. taxpayers underwrite someone’s college education at an Ivy League university or tithes to a religious institution? Or should economic harm be limited to a taxpayer’s ability to put food on the table and a roof over his or her head?

In addition to addressing these challenges, the IRS must decide precisely how it will collect outstanding taxes. Upon issuance of the “Notice and Demand” letter, the IRS can file a Notice of Federal Tax Lien without any additional judicial scrutiny. Moreover, upon 30 days notice of its intent to levy, the Service can levy on taxpayer wages, bank and securities accounts, Social Security and other retirement benefits, and seize tangible property. 28 Indeed, the IRS’s reach as a creditor extends to “all property and rights to property, whether real or personal, belonging to such person.”29 Even property transferred by the taxpayer to a third party is not beyond the IRS’ reach except in certain circumstances.30 Given these awesome powers, which of the taxpayer’s assets or income sources shall the IRS go after?

These are just a few of the very difficult decisions that the IRS must make in hundreds of thousands of collection cases each year. Clearly the IRS cannot make individualized decisions in all of these cases. In fact, the IRS has developed automated and batch processing procedures in the Automated Collection System, which notifies taxpayers about their tax debts through a sequence of notices and ultimately seeks out levy sources or files Notices of Federal Tax Liens against most of the taxpayers who are unresponsive to the notice sequence. Only a subset of taxpayers, based on considerations of type and amount of tax debt, are referred to the Collection Field function (CFf) for assignment to Revenue Officers (ROs).

27 See IRC § 6303, see also Bull vs. United States, 295 U.S. 247, 260 (1935) (the assessment process works a “reversal” of the normal collection process, in that payment precedes defense).
28 IRC § 6331(d)(2).
29 IRC § 63211.
30 IRC § 6323.
Collection employees daily determine how to wield the IRS’s extraordinary collection power. Prior to the enactment of RRA 98, there were very few checks on this authority. Indeed, the United States Supreme Court has held over and over that, where taxes are concerned, the government need only satisfy the constitutionally minimum due process requirements with respect to seizing a taxpayer’s property. This extraordinary deference was justified by the notion that “taxes are the lifeblood of government” and therefore the government must be able to proceed to collect what it needs for its existence without undue delay.

In RRA 98, however, Congress modified this approach a bit. Leading up to RRA 98’s enactment, both chambers of Congress heard testimony about problems with the way the IRS operated from taxpayers, practitioners, former Commissioners of Internal Revenue, other government officials, tax professional groups, academics and policy wonks, and also received a comprehensive report from the National Commission on Restructuring the IRS. Much attention has been paid to a few sensational testimonials by taxpayers, several of which turned out to be not quite accurate. But a close reading of the entire body of hearings shows that extremely thoughtful and experienced tax professionals and policymakers directed their best efforts to the tax system and tried to diagnose its problems and suggest possible solutions. That not all of the adopted proposals turned out to be flawless should be no surprise, but this does not diminish the serious and honest effort that went into improving the tax system in the years leading up to and immediately following RRA 98’s enactment.

Among other things, Congress created the procedure known as Collection Due Process. It stemmed from the notion “the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property.” (Italics added.) That is, in enacting the CDP provisions, Congress was concerned that the current state of affairs provided taxpayers with insufficient protections. Critics argue that CDP hearings do not solve this problem and instead create many others for the collection process. Within the IRS, many IRS officials charge that CDP has almost single-handedly brought collection to a standstill. It is appropriate to ask whether CDP actually provides taxpayers with the intended protections or instead thwarts the legitimate collection of tax.

Does CDP Provide the Protections It Was Designed to Address?

32 As the Supreme Court has said “taxes are the lifeblood of government, and their prompt and certain availability an imperative need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection...[therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified.” Bull v. US, 295 U.S. 247, 259-260 (1935).
One purpose of the collection process is for the IRS and ACS to “acquire the information necessary to make a classification” about whether the taxpayer fits into one of three categories – will pay, won’t pay, or can’t pay.36 In a perfect world, it is fine to talk about taxpayers being under an obligation to come forward and explain why they do or don’t owe taxes, or why they can’t pay. But we don’t live in a perfect world. We live in a world where perfectly intelligent and honest people quake when they get a letter from the IRS and where a subset of taxpayers with collection problems may be illiterate or have limited English proficiency.37 Moreover, we live in a world where the IRS designs its systems and procedures so that many of its collection, examination, and accounts management employees are not able to pick up the phone and call taxpayers to discuss their cases.38

At its RRA 98 hearings, the Senate Finance Committee heard testimony about how difficult it was to get collection personnel to stop and listen to taxpayers who were saying, “I don’t owe this tax,” or “Don’t file that lien – it will make it impossible for me to borrow to pay the tax.”39 This difficulty occurred in both ACS and CFf functions. With ACS, because of its automated nature, it was virtually impossible to get anyone to pay attention to the taxpayer much less transfer the case to audit reconsideration or discuss a collection alternative other than an installment agreement or currently not collectible status. Given the pressure ROs were under to close cases and not lose control of cases, collection actions proceeded even as taxpayers requested audit reconsideration.

In making collection decisions, the IRS has lots of incentive to make the right call about which “box” – will/can’t/won’t pay – the taxpayer fits in. No one wants to take a collection action that will deliberately harm the taxpayer, and IRS employees are trained to make the distinction between taxpayers genuinely attempting to resolve their tax problems and those who are actively ignoring, avoiding, or even evading their tax liabilities.

But IRS systems and directives often undermine this training. For example, IRS has a relentless need to demonstrate to both the executive and legislative branches that it is collecting tax in the least costly and efficient manner possible, in terms of absolute dollars and direct time on cases. It also must show that it is back on the enforcement beat by fil-

37 Twenty-five percent of the U.S. taxpayer population in 2000 is intimidated by the IRS and another 41 percent is distrustful of the IRS. Russell Marketing Research, Findings from Task 149 – The Taxpayer Advocate Service Research Program, With a Focus on the Detailed Study of the Underserved Segment, Phase II, Study #3 (July 2002) at 21.
38 For an analysis of the impact that IRS-initiated telephone contact can have on taxpayers’ ability to obtain the Earned Income Tax Credit, see the National Taxpayer Advocate, Annual Report to Congress Volume II, The National Taxpayer Advocate’s Earned Income Tax Credit (EITC) Audit Reconsideration Study, December 2004.
ing more liens and issuing more levies than in prior years. While each of these may be legitimate goals, these needs also have the potential to create an atmosphere in which it is more important to reduce your cycle time on a case than to spend the time necessary to determine whether the taxpayer fits into the can’t-pay or won’t-pay category. And without proper and due process, an incorrect taxpayer classification – whether intentional or inadvertent or process-driven – can have disastrous consequences for the taxpayer, given the extraordinary collection powers granted to the IRS.

This is where CDP hearings come into play. They were designed to provide the taxpayer with one opportunity to have an independent third party look at the first proposed levy action or the first actual Notice of Federal Tax Lien filing with respect to any tax period liability. Certainly, one can make a case for CDP hearings to occur later in the collection process, after the IRS has taken various collection actions and the taxpayer is particularly aggrieved. By placing CDP hearings at the beginning of the collection process and providing no opportunity for judicial review of most later collection actions, Congress arguably left the taxpayer without protection for later IRS missteps. But there are several protections available for taxpayers in the unfolding collection process, including the Collection Appeals Program (CAP), the ongoing jurisdiction by Appeals of collection actions in CDP cases, and the availability of an “equivalent hearing” where the taxpayer has missed the opportunity to file a formal CDP hearing request. Moreover, at the same time Congress created CDP hearings, it strengthened the authority and independence of the Office of the Taxpayer Advocate and expanded the relief available under Taxpayer Assistance Orders.

In light of these “downstream” protections, providing a CDP hearing at the beginning of the collection process makes sense. It provides the taxpayer with a formal opportunity to protest the will/can’t/won’t pay classification and to achieve some type of resolution very early in the tax dispute. It makes the IRS pay attention to the taxpayer’s position that the lien just filed impairs the taxpayer’s ability to resolve the tax. It forces the IRS to consider whether the taxpayer even owes the tax. Who really cares if the taxpayer has had several opportunities to protest the liability and misses them – if the taxpayer is before us now, do we really want to collect a tax that is not, in fact, due? As we have shown above, the competing pressures on both ACS and CFF do not create appropriate incentives for collection employees to learn vital information about taxpayers that might impact the collection determination. The CDP hearing is the one point when things stop and an independent third party takes a look at what is going on.

It is true that CDP stops collection in its tracks. That is the point of CDP. CDP gives the

40 IRM 5.1.9.4.
41 IRC § 6330(d)(2).
42 Treas. Reg. §§ 301.6330-1(i) and 301.6320-1(i).
taxpayer a chance to have someone review the IRS’ “won’t pay” determination. Often Appeals Officers are more helpful and successful in eliciting information from and conversing with the taxpayer than ACS employees. Appeals Officers are certainly less intimidating than ROs. So the CDP hearing may be the first time that the IRS even sees certain information from the taxpayer. This is very similar to what happens in Tax Court cases originating from the correspondence examination function. Because of the automated and batch processing nature of these cases, and taxpayers’ own “ostrich-like” behavior, taxpayers often get a Notice of Deficiency and petition the Tax Court without having given the IRS any information. The Appeals Officer or Chief Counsel attorney is often the first person to see any information relating to the proposed liability. Taxpayers in CDP hearings exhibit the same behavior. The only difference is that it is occurring in a collection context, which heretofore has operated without any external interference.

So what, really, is the effect of inserting this administrative and judicial oversight into the tax collection process? Well, here are some statistics relating to CDP hearings:

- As Table 2.6.1 demonstrates, only 1.07 percent of all CDP Levy Notices and 1.77 percent of all CDP Lien Notices issued in Fiscal Year 2004 resulted in CDP Hearing requests received in Appeals.44
- Under the IRS’ own internal procedures, a taxpayer who timely files a CDP hearing request may have to wait up to 120 days before receiving any acknowledgement or communication from the Office of Appeals about the CDP hearing request.45
- Appeals customer satisfaction data indicates that customers are least satisfied with the length of the Appeals process.46
- 182 CDP cases were litigated in the federal courts with decisions published by the courts between June 1, 2003, and May 31, 2004, a nine percent decrease from the 199 cases litigated in the previous 12 months. More importantly, the percentage of litigated CDP cases involving frivolous issues declined from 52 percent (103 cases) in the previous year to 23 percent (42 cases) in the current year.47

44 Internal Revenue Service, Collection Due Process (CDP) Talking Points for Group Managers. In this document, the IRS SB/SE Office of Compliance Policy states that “[w]hen the CDP provisions were first implemented in 1999, the thought was that most taxpayers, given the opportunity, would request a CDP hearing. After five years experience, the high rate of appeal initially anticipated has not materialized.”
45 IRM §§ 8.7.2.3.2(1) and 5.1.9.3.5.
47 For a detailed analysis of CDP litigation, see Most Litigated Issue: Collection Due Process infra. The criteria used to identify a case as frivolous were: (1) an IRC § 6702 penalty (commonly referred to as frivolous return penalty) upheld by the court, (2) an IRC § 6673 sanction asserted by the Tax Court (or Appeals Court), or (3) the court labeling as frivolous the arguments presented by the taxpayer.
Taking all of these facts into consideration, the National Taxpayer Advocate is hard pressed to see how the IRS can say that CDP wastes resources or causes delay. When only 1.24 percent of all taxpayers receiving these notices actually avail themselves of hearings, and only 182 cases are actually litigated in a year, and of those cases, several involved significant holdings pertaining to the rights under these procedures, CDP does not appear to be the cause of the breakdown in the collection process. Instead, CDP appears to be, for the most part, elected by taxpayers that are genuinely trying to resolve their collection problems.

In fact, the system is operating exactly as any due process review should. The vast majority of taxpayers work with the IRS or do not object to collection actions; but for those few taxpayers who do object, CDP is there. And for those still fewer taxpayers in which the IRS has abused its discretion, there is a system of both administrative and judicial review that provides a check on the IRS and makes sure it learns from those mistakes. The National Taxpayer Advocate believes that the United States tax system can well accommodate this minor cost and inconvenience in light of the significant protections afforded by CDP oversight. This is particularly true in an era of increasing “enforcement” activity, including the use of private collection agencies (PCAs) to collect the tax.

EXPLANATION OF PROPOSALS

For all the reasons set forth above, the National Taxpayer Advocate recommends that CDP Hearings be retained. She acknowledges, however, that the program can certainly be improved, both legislatively and administratively. Several proposals for such improvement are discussed below.

Legislative Recommendations

Judicial Review of Underlying Liability

The National Taxpayer Advocate admits to being surprised by CDP’s provision of “back door” access to the Tax Court on liability issues. Certainly, both before and during her

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**TABLE 2.6.1, COLLECTION DUE PROCESS – FY 2004**

<table>
<thead>
<tr>
<th>IRC § 6320 - Lien</th>
<th>NFTLs Filed</th>
<th>CDP Lien Requests*</th>
<th>% of CDP Requests</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACS</td>
<td>280,284</td>
<td>6,925</td>
<td>2.47%</td>
</tr>
<tr>
<td>CFf</td>
<td>257,539</td>
<td>2,612</td>
<td>1.01%</td>
</tr>
<tr>
<td>Total</td>
<td>537,823</td>
<td>9,537</td>
<td>1.77%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IRC § 6330 - Levy</th>
<th>CDP Levy Notices</th>
<th>CDP Levy Requests*</th>
<th>% of CDP Requests</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACS</td>
<td>1,628,467</td>
<td>13,951</td>
<td>.86%</td>
</tr>
<tr>
<td>CFf</td>
<td>110,394</td>
<td>4,645</td>
<td>4.21%</td>
</tr>
<tr>
<td>Total</td>
<td>1,738,861</td>
<td>18,596</td>
<td>1.07%</td>
</tr>
</tbody>
</table>

**Grand Total** | 2,276,684 | 28,133 | 1.24% |

* Number of CDP requests received in Appeals during FY 2004
tenure as the National Taxpayer Advocate, she has seen numerous cases in which the taxpayer was eligible for an audit reconsideration and even an administrative appeal (or Doubt as to Liability offer in compromise) and the IRS was determinedly, and for no good reason, refusing to provide such relief. But in these situations, the taxpayer now has access to the Taxpayer Advocate Service and the Taxpayer Assistance Order, which can make the IRS provide such a review in appropriate cases. Providing a second opportunity to go to court to a taxpayer who, for whatever reason, has already had one opportunity to challenge the underlying tax liability in Tax Court and missed it, diminishes the meaning of the Notice of Deficiency and pre-assessment review.

Where the IRS is proposing to collect a tax that the taxpayer believes he or she does not owe, a better approach is to permit the taxpayer to raise underlying liability issues at the Appeals CDP hearing. If the taxpayer meets the criteria for receiving an audit reconsideration (regardless of whether the taxpayer had an opportunity to raise the issue earlier), the Appeals Hearing Officer should suspend the CDP hearing and forward the issue to the examination function for review. Once the examination function makes its decision, the Appeals Hearing Officer could put his or her Settlement Officer hat on and review the decision, if the taxpayer wants to appeal the finding.

Once all examination issues are laid to rest, the Appeals Officer (wearing his or her Hearing Officer hat again) could conduct the balancing of interests in determining the collection alternatives. Upon the Appeals Officer issuing the Determination Letter, the taxpayer could seek judicial review of the determination. Although there would be no de novo judicial review of the underlying tax liability, the court could look at the adequacy of the Hearing Officer’s consideration of the underlying liability when it reviews, under an abuse of discretion standard, the Hearing Officer’s “balancing” analysis and the decision to allow collection to proceed.

Under this proposal, in those few cases that trigger CDP hearing rights, taxpayers will be assured that collection will only proceed for the correct liability. It may end up that there is no collection liability after the audit reconsideration decision, or that the taxpayer is able to pay the revised tax liability in full. Presently, the Office of Appeals has instructed its employees to issue Hearing Determination Letters sustaining, modifying, or rescinding the proposed collection action and starting the 30-day interval within which a taxpayer must petition the court for judicial review. It then sends the case over to audit reconsideration.

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49. Appeals should enter into a Service Level Agreement with the various IRS examination functions to ensure prompt handling of these cases while the CDP hearing is suspended.

50. The taxpayer should be given the option of having a different Appeals Officer review exam’s decision in certain circumstances. This may be appropriate where the underlying tax issue is beyond the expertise of the CDP Hearing Officer. It is anticipated, however, that most taxpayers will find it expedient to have the Hearing Officer also review the exam decision.

51. IRS, Office of Appeals, Liability Guide on CDP Cases.
This current approach is completely backwards – it results in the Hearing Officer making a collection determination about a liability that might not even exist, and it puts the taxpayer in a position of choosing between going to audit reconsideration or filing in the court. The only rationale for this illogical approach is that Appeals is trying to reduce the cycle time of cases in Appeals. Ironically, this approach ends up increasing cycle time of the case from the taxpayer’s, IRS’, and court’s perspective, because it does not fully resolve the dispute when there is an opportunity to do so.

Period for Taxpayer Response to CDP Lien Hearing Notice

Internal Revenue Code section 6320(a)(2) provides that the Secretary shall issue a notice, by certified mail or in person, informing the taxpayer of the filing of a Notice of Federal Tax Lien “not more than 5 business days after the day of the filing of the notice of lien.” (Italics added.) The notice also advises the taxpayer of his or her right to a CDP hearing during the 30-day period beginning on the day after the 5-day period described above. As explained below, because of the delays encountered by the numerous local jurisdictions in filing (recording) the Federal tax lien, some taxpayers who file outside of the 30-day period running from the date of mailing the CDP notice will file timely hearings while others will not.

Except in exigent circumstances where an RO must take an NFTL directly to the recording office for filing, all NFTLs are generated using the Automated Lien System (ALS). The Revenue Officer or ACS employee enters into ALS a request that an NFTL be filed. ALS will then generate an NFTL. A paper copy of the NFTL will be printed to be mailed to those recording offices without electronic submission capability. An electronic copy of the NFTL will be transmitted to recording offices that accept electronic submission. The date the NFTL is generated is shown in ALS. Because ALS employees are instructed to print no more NFTLs than can be mailed the same day as the printing, the date of printing is generally assumed to be the same date the NFTL is mailed for filing. A certified mail log is maintained at each ALS facility to document the mailing of the NFTL.

Letter 3172, the CDP notice under IRC § 6320, is generated and printed on the day after the NFTL is generated by ALS. Consequently, there should not be any difficulty figuring out the date the NFTL is sent (either electronically or by mail) to the recording office for fil-

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52 IRC § 6320(a)(2)(B).
53 IRM 5.12.6.2.
54 Id.
55 Id.
56 IRM 5.12.2.12.
57 IRM 5.12.2.11.
58 IRM 5.12.6.2.5.
59 IRM 5.12.6.3.2.
ing. On the other hand, the IRS would have to make individualized determinations about when the NFTL is actually filed by the recording office. Thus, under current law, which counts the CDP reply date from the date of lien filing, one taxpayer may have 30 days within which to respond to the CDP Lien notice and another taxpayer may have 60 days, simply because of the vagaries of U.S. mail or the backlog of filing work in some recording offices. Further, one taxpayer responding in 60 days from mailing of the CDP Hearing Notice will be entitled to a CDP Hearing with judicial review, while another responding within the same timeframe can only obtain an equivalent hearing, without judicial review.

In order to eliminate this disparate treatment of taxpayers, the National Taxpayer Advocate recommends that IRC § 6320(a)(2) be amended to provide that the CDP Hearing Notice be mailed (by certified mail) or delivered not more than 5 business days after the day the notice of lien is mailed or otherwise submitted for filing. In addition, IRC § 6320(a)(2)(B) should be amended to provide that the 30-day period in which a taxpayer can request a CDP hearing should begin on the day after the date the notice is provided under IRC § 6320(a)(2). This language will account for the many NFTLs that are sent electronically, or those that are filed by hand in exigent circumstances.

**Administrative Recommendations**

**CDP in the Context of Administrative Law**

In 1946 Congress enacted the Administrative Procedure Act (APA),\(^\text{60}\) which serves as the basis for most modern administrative procedure. The Act bifurcates administrative agency action into adjudication and rulemaking, and categorizes adjudicatory determinations, in turn, into formal and informal proceedings. While formal adjudications include the right to be heard before an Administrative Law Judge (ALJ) and formal trial-like safeguards, the APA provides little, if any, guidance about what constitutes an informal administrative practice.

IRS deficiency determinations are exempt from the APA’s formal adjudication requirements because they are subject to a subsequent trial \textit{de novo} in the Tax Court on issues of both law and fact.\(^\text{61}\) CDP hearings, on the other hand, clearly share many of the characteristics of informal agency hearings under the APA, including judicial review under an abuse of discretion standard.\(^\text{62}\)

Many Federal agency informal agency adjudications provide for face-to-face hearings, sworn testimony, limited discovery and recording or transcription of the proceedings.\(^\text{63}\)

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\(^{60}\) 5 USC §§ 551 et.seq.
\(^{61}\) Staff of Senate Judiciary Committee, 79th Cong., Administrative Procedure Act 23 (Comm. Print 1945) (Explanations of the provisions of the Administrative Procedure Act).
\(^{62}\) Davis v. Comm’r, 115 T.C. 35 (2000) (CDP hearings are informal);
\(^{63}\) See Defense Office of Hearings and Appeals, Pre-hearing Guidance and Department of Defense Directive 5220.6 (allowing for face-to-face adversarial proceeding, cross examination of witnesses, testimony while not under oath is subject to 18 U.S.C.A. §1001 making perjury criminal offense, and hearing recorded by court reporter); Board of Veterans’ Appeals: Understanding the Appeal Process and 38 C.F.R. § 20.700 et seq. (allowing for face-to-face or video conferencing, testimony under oath and audio recording of proceedings); Bid Protests at GAO: A Descriptive Guide and 4 C.F.R. § 21.01 et seq. (providing for face-to-face hearings, presentation of witnesses and audio recording of proceedings); Federal EEO Complaint Processing Procedures and 29 C.F.R. 1614.108 (providing for pre-hearing discovery, presentation of witnesses, audio recording of hearing and adjudication by administrative law judge).
In many informal administrative hearing processes, the petitioner receives notice of the hearing date together with an explanation of what will take place at the hearing. The agency involved often summarizes the rules of procedure in non-legal terms on the agency’s Internet site or mails them to the petitioner as part of an information packet. This information is especially important in administrative settings where the vast majority of petitioners are not represented by counsel, as is the case in CDP hearings.

**Face-to-Face Hearings**

Treasury Regulations present conflicting information as to the nature of the CDP hearing. For example, one part of the regulations pertaining to CDP hearings suggests that the CDP hearing need not be conducted face-to-face but may be the exchange of correspondence. In a subsequent provision, however, the regulations indicate the taxpayer will receive a face-to-face hearing upon request. The Office of Appeals currently treats all CDP hearings presumptively as telephonic and is providing only 14 days for the taxpayer to respond and request a face-to-face session. Moreover, the IRS has taken the position in a number of litigated cases that taxpayers are not guaranteed the right to a face-to-face hearing, even when such a hearing is requested.

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65 In the 2003 Annual Report to Congress, TAS analysis of published opinions concluded that less than 13 percent of taxpayers were represented in CDP hearings. National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2003), 322. For 2004, 75 percent of the litigants in CDP cases were pro se. See this report, Most Litigated Issues, Collection Due Process, infra.

66 Treasury Regulation § 301.6330-1(d), Q-D6 & A-D6 provides as follows:

A CDP hearing may, but is not required to, consist of a face-to-face meeting, one or more written or oral communications between an Appeals officer or employee and the taxpayer or the taxpayer’s representative, or some combination thereof.

Q-D7. If a taxpayer wants a face-to-face CDP hearing where will it be held?

A-D7. The taxpayer must be offered an opportunity for a hearing at the Appeals office closest to taxpayer’s residence or, in the case of business taxpayers, the taxpayer’s principal place of business. If that is not satisfactory to the taxpayer, the Appeals officer or employee will review the taxpayer’s request for a CDP hearing, the case file, any other written communications, if any, submitted in connection with the CDP hearing), and any notes of any oral communications with the taxpayer or the taxpayer’s representative. Under such circumstances, review of those documents will constitute the CDP hearing for the purposes of section 6320(b).

67 Appeals Letter 3855 (03/04).

68 Courts have held that where the taxpayer has not unduly delayed the proceedings, the taxpayer is entitled to a face-to-face hearing. Cavanaugh v. U.S., 93 A.F.T.R.2d 2004-1522, 2004 WL 880442, p. 6 (D. N.J. 2004). In Cavanaugh, the taxpayer requested a face-to-face hearing; however, the IRS took the position that the CDP hearing had taken place during a telephone conference with the taxpayer and that a face-to-face hearing was not required even where it was requested by the taxpayer. The United States District Court held that the Appeals officer abused her discretion in denying the face-to-face hearing, especially in light of the fact that the taxpayer claimed he did not even know that the telephonic hearing was (in the IRS’s view) his CDP hearing. See also Leineweber v. Comm’r, T.C. Memo 2004-17 (holding that Appeals officer did not abuse discretion when officer had several times attempted to schedule the taxpayer’s requested face-to-face hearing, but taxpayer would not agree to any of the suggested dates or offer any alternative dates); Mann v. Comm’r, T.C. Memo 2002-48 (holding that taxpayer failed to attend scheduled hearing and therefore, waived right to complain about not receiving a face-to-face hearing).
In furtherance of this shift away from face-to-face hearings, Appeals is beginning to send some CDP case files to the IRS campuses (formerly known as service centers). This practice will result in the files of taxpayers being sent to campuses which are not geographically proximate to the taxpayers. Although it is the understanding of the National Taxpayer Advocate that these cases will be returned to the appropriate local Appeals office if the taxpayer requests a face-to-face hearing (and if the taxpayer otherwise qualifies for such a hearing pursuant to IRM 8.6.1.2.5), this policy will inevitably result in delay when cases are sent back to the local Appeals office and may result in taxpayers being dissuaded from exercising their right to a face-to-face hearing.

This policy will also disparately impact low and middle income taxpayers who are generally unrepresented and who may benefit the most from a face-to-face hearing in presenting their cases. Moreover, if a taxpayer intends to address any substantive issue about his or her liability, it is clearly advantageous to have a face-to-face hearing to allow for an exchange of documents or the presentation of witnesses. As the Appeals’ Customer Service Surveys indicate, taxpayers often prefer face-to-face contact.

Of course, it is entirely possible for taxpayers to find a telephonic or correspondence hearing preferable to a face-to-face hearing. For example, where the taxpayer is only questioning whether all requirements of law and administrative procedures have been met, a face-to-face hearing may not be necessary. Further, where the taxpayer is raising only those issues that have been deemed groundless by the courts and Congress, and is not raising “verification” issues or collection alternatives, Appeals would be justified in limiting access to face-to-face hearings. Absent these concerns, however, Appeals should provide taxpayers with the option to select the type of hearing they want and allow adequate time for them to make that request.

The Administrative Hearing Record
Creating a record of what has transpired at an administrative hearing is an important part of the administrative process. A written transcript or audio recording of a hearing provides a court with a complete record of the administrative hearing so that it may review the propriety of government action.

70 Supra, Note 5.

71 The surveys include typical comments from taxpayers about their desire for face-to-face contact, including: “Provide face-to-face meetings with Appeals officers;” “It’s important to actually meet the officers to explain my situation;” and “Appeals officers should take the time to meet with the taxpayer. They would find out a whole lot more than just what was on paper.” Internal Revenue Service, Appeals Customer Satisfaction Survey, January 2004, 7.

72 The National Taxpayer Advocate generally supports this legislation. However, she is concerned that the language as presently drafted may be read to deny CDP hearings to those taxpayers who are legitimately seeking to delay collection in order to challenge the underlying liability or to present collection alternatives. 5.882.

ing court has an adequate basis for its decision. This is especially true where the court is employing an abuse of discretion standard, whereby the court confines its inquiry to matters contained within the record.74 An audio or written record of the proceedings is especially important for CDP hearings since the taxpayer may only seek judicial review of Appeals’ determination on those issues that were raised at the hearing.75

Treasury Regulations provide that “[a] transcript or recording of any face-to-face meeting or conversation between an Appeals officer or employee and the taxpayer or the taxpayer’s representative is not required.”76 Relying on these regulations, courts have held that Appeals officers are not required to allow taxpayers to record CDP hearings, particularly where the taxpayer is raising frivolous arguments.77 In Keene v. Commissioner, however, the United States Tax Court held that IRC § 7521 requires the Appeals officers to permit recordings if the taxpayer requests them and provides resources for a tape recording.78 Notably, the Tax Court held in Keene that “not having a transcript may contravene the intent of Congress in providing for a fair and impartial administrative hearing and may have a negative impact on this Court’s review of the Appeals Office determination.”79

Similarly, a concurring opinion in Keene noted:

Having a transcript of the section 6330 hearing will allow us to perform better review provided to taxpayers by section 6330(d). Until now, in order to determine what issues taxpayers raised at the section 6330 hearing, the Court was faced with “he said-she said” situations – needless “credibility contests” between the taxpayer


75 Treasury Regulations §§ 301.6330-1(f)(2) provide: Q-F5. What issue or issues may the taxpayer raise before the Tax Court or before a district court if the taxpayer disagrees with the Notice of Determination? A-F5. In seeking Tax Court or district court review of Appeals’ Notice of Determination, the taxpayer can only ask the court to consider an issue that was raised in the taxpayer’s CDP hearing.

76 Treas. Reg. §301.6320-1(d) A-D6 and Q-D6.

77 Horton v. Comm’r, T.C. Memo. 2003-197 (holding that it would not be productive to remand case so that taxpayer could record hearing where taxpayer makes frivolous arguments); Ray v. United States of America, 291 F.Supp.2d 1179, 1181 (D. Nev. 2003) (holding there was no right under the CDP statute or IRC § 7521 to record CDP hearing where Appeals did not permit taxpayer to record CDP hearing); Jewett v. Comm’r, 292 F.Supp2d 962, 966 (N.D. OH 2003) (holding Treasury Regulations did not require Appeals to allow taxpayer to record CDP hearing); Synder v. Comm’r, 93 A.F.T.R.2d 2004-425 (N.D. OH 2003) (holding taxpayer does not have right to record CDP hearing where taxpayer’s arguments were frivolous); Kemper v. Comm’, T.C. Memo. 2003-195 (holding that taxpayer does not have right to record CDP hearing where taxpayer’s arguments were frivolous); Brashar v. Comm’, T.C. Memo. 2003-196 (holding taxpayer does not have right to record CDP hearing where claims were frivolous); Yuen v. United States of America, 290 F.Supp.2d 1220 (D. NV 2003) (holding CDP hearings are informal and taxpayer has no right to record CDP hearing where taxpayer is advancing arguments that are frivolous); Muhammad v. United States of America, 91 A.F.T.R.2d 2003-1985 (D. SC 2003) (holding that while it may not have been an abuse of discretion to deny taxpayer the ability to record hearing there was an insufficient record for court to find for IRS as a matter of law); Norwood v. Killfoil, 93 A.F.T.R.2d 2004-1700 (holding that taxpayer has no right to record CDP hearing).

78 Keene v. Comm’r, 121 T.C. 8, 17 (2003).

79 Id.
and the Appeals officer. In many cases, this contest was not fully developed because the only evidence submitted to determine what issues were raised at the hearing was the notice of determination.80

While Appeals has changed its procedures in response to Keene, it allows only face-to-face hearings to be recorded, and then only upon the taxpayer’s specific request.81 Most taxpayers do not have the sophistication to appreciate the importance of recording the hearing, and a rational taxpayer may instinctively trust the hearing officer to look out for his or her procedural interests. Notwithstanding that the United States Tax Court noted in Keene that the lack of a record hinders its review of CDP hearings, Appeals does not presumptively establish hearings as subject to recording and does not even notify taxpayers of this important right. The Office of Appeals should clearly inform taxpayers that, where they are entitled to a face-to-face hearing, they have the right to record such hearing at their expense.

Notice as to the Nature of the CDP Hearing
Internal Revenue Code sections 6320 and 6330 require the IRS to send to a taxpayer subject to a lien filing or a levy a notice that describes “the procedures related to such appeals” in simple and non-technical terms.82 When the appropriate compliance function sends the taxpayer the Notice of Filing of Tax Lien and the Notice of Intent to Levy, the taxpayer is sent Publication 1660, Collection Appeal Rights, which addresses the general manner for obtaining an appeal. While the taxpayer may be sent Publication 1660 by the compliance officers working the collection case, this document provides no information about the CDP hearing (although it does describe how to obtain a hearing).83 Publication 1660 does not answer such basic questions as:

- What will occur at the hearing?
- Will the CDP hearing be in a courtroom setting?
- How does the hearing process work and what are the rules?
- Is the hearing recorded?
- How can I learn about collection alternatives?

Upon receipt of the CDP case in the Office of Appeals, Appeals sends to the taxpayer an acknowledgement letter (Letter 13221) along with Publication 4165, An Introduction to Collection Due Process Hearings. Publication 4165 is a one-page document divided into four sections: Mission, Expectations, Overview of Appeals Process, and Collection Due Process.84 This document references some important concepts such as “innocent spouse”

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81 IRM 8.6.1.2.5 (5-13-04).
82 IRC §§ 6320(a)(3)(C) and 6330(a)(3)(C)(iii).
83 IRS Compliance sends Publication 1660, Collection Appeals Rights, after a lien or prior to a levy. This publication provides general information on how to obtain a CDP hearing but does not explain the CDP hearing process.
84 Internal Revenue Service, An Introduction to Collection Due Process Hearings, Publication 4165 (Rev. 09-2003).
relief and “collection alternatives” but does not give the taxpayer the information that would make these concepts useful. The Appeals’ Customer Satisfaction Survey indicates that taxpayers want this information early in the process. Yet this document is sent as late as 120 days after the taxpayer files his or her CDP request, since Appeals does not acknowledge the CDP request until it actually receives the case from Collection.

When the case is actually assigned to a Hearing Officer’s inventory, a “substantive contact” letter is sent, Letter 3855. This letter recites in general what matters can be raised at the hearing, such as an offer in compromise, installment agreement or innocent spouse, and requests certain information from the taxpayer, including financial statements, tax returns, and proof of estimated tax payments, as appropriate. It also advises the taxpayer that the requested information must be provided within 14 days of the date of the letter.

Notice about Collection Alternatives
As noted above, the CDP hearing process provides the taxpayer with an opportunity to present collection alternatives, such as offers-in-compromise, installment agreements, lien subordination, or partial discharge of property from the effect of the lien. However, taxpayers currently do not receive a clear and concise explanation of all available collection alternatives. Consequently, taxpayers present incomplete or unrealistic collection alternatives, which result in further delays or unsatisfactory outcomes.

An example of effective pre-hearing communications can be found in the Board of Veterans’ Appeals 44-page publication Understanding the Appeals Process. Although we do not suggest that Appeals needs to produce a document of this length, this publication provides a large quantity of information in a readable format and takes the hearing participant through each step of the process and containing very helpful topics, including

- What is the Board of Veterans’ Appeals?
- What is an Appeal to the Board of Veterans’ Appeals?
- What can I appeal?
- When will my personal hearing be held?

85 The Customer Satisfaction Survey contains typical quotes from taxpayers regarding the way Appeals communicates with taxpayers, including: “My options were not clearly explained;” “I would like the Appeals officer to tell me exactly what be expects from me;” “At the end of the process, the officer should communicate the payment options and when they would start,” and “Provide better information to the taxpayer regarding which guidelines apply and what resources are available.” Pacific Consulting Group, IRS Customer Satisfaction Survey, Appeals National Report

86 Appeals is currently considering combining the acknowledgement and substantive contact letter where the manager can determine from the administrative file what taxpayer information is required before assignment to a Hearing Officer.

87 Appeals has previously taken the position that Publication 3498 (The Examination Process) provides all the necessary information about the main collection alternatives. National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2003), 53. Even if Publication 3498 offered useful information, this publication is not sent out to taxpayers in the CDP hearing process, but to those disputing results from an IRS-initiated examinations.
How long does the appeal process take?
Do I need a lawyer or other representative to help me with my appeal?

A particularly helpful section is “What should I avoid?” which informs petitioners of the common mistakes that other petitioners make. CDP hearing participants would greatly benefit from more information about the CDP hearing process. Since it will benefit both Appeals and taxpayers if taxpayers know more about the CDP hearing process, the Board of Appeals’ Understanding the Appeals Process would be an excellent model.

Another example of helpful procedures is closer to home in the tax world. The United States Tax Court provides on its website and mails on request a clear and informative booklet about Tax Court procedures as well as a sample, fill-in petition. This is appropriate for a court in which 83 percent of its petitioners are pro se. The court later sends to the taxpayer a Pretrial Memorandum form and the presiding judge’s specific instruction for courtroom demeanor and procedures, in order to ensure that petitioners present all relevant information as well as maintain orderly court proceedings, to provide notice to opposing counsel of issues and witnesses, and to develop a record. The layout of the Pretrial Memorandum walks the taxpayer through identifying legal and factual issues in dispute, witnesses to be called, and relevant case law.

The Office of Appeals should adapt this approach to CDP hearings. It should model its Publication 4165, An Introduction to Collection Due Process Hearings, after the Tax Court’s publication, Election of Small Tax Case Procedure and Preparation of Petitions, and the Board of Veterans’ Appeals publication, Understanding the Appeals Process. This revised publication should be sent to the taxpayer immediately upon receipt of the CDP hearing request.

The publication could explain that the taxpayer has the opportunity to continue working with the Collection function for a period. But all collection alternatives would be fully described, with examples, along with detailed information about the CDP hearing process. The publication could include a “CDP Hearing Memorandum,” modeled after the Tax Court’s Pretrial Memorandum. This early notification will enable a taxpayer to really think about collection alternatives and develop the necessary documentation. If, by the time the case is assigned to a Hearing Officer, the taxpayer has not submitted a CDP Hearing Memorandum, the Hearing Officer should send the taxpayer another CDP Hearing Memorandum form with the substantive contact letter.

This approach helps to ensure that taxpayers understand the process and have the opportunity to raise relevant issues. It also helps to develop a more complete record of issues to be raised at the hearing and aids the courts in giving appropriate review to the agency’s action in the case. The IRS’ current failure to provide taxpayers with a clear and helpful explanation of the hearing process and develop forms that enable the taxpayer to both understand and raise all collection alternatives available to them, diminishes taxpayer protections and undermines the meaningfulness of the hearing process. Without complete information, Appeals cannot properly complete its required balancing of the government’s and the taxpayer’s interests. It cannot develop a record upon which a court can determine whether an abuse of discretion has occurred. In short, the IRS’ current approach to CDP hearings reflects an inventory-driven system rather than a due process-driven approach. Thus, the IRS’ approach fails to satisfy the intent of IRC §§ 6320 and 6330 to provide taxpayers with an opportunity for meaningful reviews of collection alternatives.

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SUMMARY

The Collection Due Process hearing, established by the IRS Restructuring and Reform Act of 1998, provides taxpayers an opportunity for independent review of a lien filed by the IRS or a proposed levy action. The taxpayer may raise certain issues at the hearing, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.

As in 2003, Collection Due Process was the most frequently litigated tax issue in the Federal courts during the period analyzed for the Annual Report to Congress, although the number of CDP cases litigated decreased this year. The decisions reflect an increase in cases decided for the IRS, a decrease in dismissed cases, and a significant decrease in cases where taxpayers presented frivolous arguments. Seventy-five percent of the CDP cases were brought before the courts by the taxpayer without the benefit of counsel (i.e., pro se), down from 88 percent in the previous report. The decisions also reflect a continued confusion on the part of taxpayers about many aspects of the CDP hearing process.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien filed by the IRS or a proposed levy action. The IRS Restructuring and Reform Act of 1998 (“RRA 98”) established the Collection Due Process (CDP) hearing to extend the protections taxpayers have in dealing with other creditors to their dealings with the Internal Revenue Service.

The IRS sends a notice to the taxpayer’s last known address by certified or registered mail, notifying him or her of the opportunity to request a CDP hearing. The notice regarding a lien filing is sent after the lien is filed and is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action and is required to be sent not less than 30 days before the day of the first levy.

The decisions also reflect a continued confusion on the part of taxpayers about many aspects of the CDP hearing process.
the IRS has reason to believe collection of the tax is in jeopardy, the IRS will stop levy action during the 30-day period.8

When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals officer will conduct one hearing.9 If the taxpayer's request is timely filed, the IRS will suspend collection action throughout the process.10 Internal Revenue Code § 6330(e)(1) requires the statutory collection period to be suspended until the date the Appeals determination is final or the taxpayer withdraws the request for a hearing.11

The issues a taxpayer may raise at a CDP hearing include one or more of the following issues relating to the unpaid tax:

- Appropriateness of collection actions;12
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;13
- Appropriate spousal defenses;14 and
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.15

The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding.16

Collection Due Process hearings are informal. Depending on the preference of the taxpayer, the hearing can be conducted face-to-face, by telephone, or by correspondence.17 The hearing is to be held by an impartial officer from the Appeals function of the IRS.18 Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court or where appropriate, the U.S. District Court.19 The notice of determination, which sets forth Appeals' findings and decisions, provides instructions for appealing the decision, including the court of jurisdiction.20

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8 IRC § 6330(a).
9 IRC § 6320(b)(4).
10 IRC § 6330(e)(1).
11 IRC §§ 6330(e)(1), and Treas. Reg. §§ 301.6320-1(g)(1) and 301.6330-1(g)(1).
12 IRC §§ 6330(c)(2)(A)(ii) and 6320(c).
13 IRC §§ 6330(c)(2)(A)(iii) and 6320(c).
14 IRC §§ 6330(c)(2)(A)(i) and 6320(c).
15 IRC §§ 6330(c)(2)(B) and 6320(c).
16 IRC §§ 6330(c)(4) and 6320(c).
18 IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).
19 IRC §§ 6330(d)(1) and 6320(c).
The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS’ administrative CDP determinations. Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the liability will be reviewed by the appropriate court on a de novo basis. Where the appropriateness of the collection action is at issue, the court will review the IRS’ administrative determination for abuse of discretion.

ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the Federal court system between June 1, 2003, and May 31, 2004. One hundred eighty-two CDP decisions were published by the courts during this period, nine percent fewer than the 199 CDP cases reported in the previous 12 months. Table 1 in Appendix 2 provides a detailed listing of litigated CDP cases, including specific information about the types of taxpayers involved.

Favorable outcomes for taxpayers in Appeals from CDP hearings cases continued to decline this year. Table 3.1.1 below compares court decisions for the 2002, 2003, and 2004 Reports to Congress in categories of cases decided for the IRS, dismissed, decided for the taxpayer, remanded to Appeals or decided in part for the taxpayer and in part for the IRS (“split decision”). This table reflects a continued increase in decisions in favor of the IRS and a decrease in dismissed cases.

<table>
<thead>
<tr>
<th>Court Decisions</th>
<th>2002 Percentage</th>
<th>2003 Percentage</th>
<th>2004 Percentage</th>
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<tr>
<td>Decided for IRS</td>
<td>54%</td>
<td>73%</td>
<td>81%</td>
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<tr>
<td>Dismissed</td>
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<td>23%</td>
<td>14%</td>
</tr>
<tr>
<td>Decided for Taxpayer</td>
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<td>1%</td>
</tr>
<tr>
<td>Remanded Back to Appeals</td>
<td>4%</td>
<td>0%</td>
<td>3%</td>
</tr>
</tbody>
</table>

21 H.R. Rep. No.105-599 at 266.
23 The phrase abuse of discretion means an adjudicator’s failure to exercise sound, reasonable, and legal decision making; an appellate court’s standard for reviewing a decision that is asserted to be grossly unsound, unreasonable or illegal. Black’s Law Dictionary, 10 (7th ed. 1999). For discussion of the abuse of discretion standard, see the following cases: Woodahl v. Comm’r, 112 T.C. 19, 23 (1999); Fargo v. Comm’r, T.C. Memo. 2004-13; Razo v. Comm’r, T.C. Memo. 2004-101.
25 Dismissals are those decisions where the court dismissed the case or granted the motion to dismiss because (1) the taxpayer failed to state a claim upon which relief could be granted, (2) the taxpayer was late in requesting a CDP hearing or petitioning the court, (3) the court otherwise lacked jurisdiction, and (4) other miscellaneous reasons.
26 This analysis considered a “split decision” as one where part of the decision favored the taxpayer and part of the decision favored IRS.
CDP cases litigated in Federal courts involved both the procedural aspects of CDP hearings, and substantive legal issues unrelated to the CDP hearing process. The National Taxpayer Advocate has identified the lack of appropriate administrative procedures in CDP hearings as a Most Serious Problem affecting taxpayers for the past two years.\footnote{National Taxpayer Advocate, \textit{Annual Report to Congress}, Publication 2104, 38 (Rev. 12-2003); National Taxpayer Advocate, \textit{Annual Report to Congress}, Publication 2104 (Rev. 12-2002), 110.} In this report, the National Taxpayer Advocate proposes revisions to the CDP hearing process in a Key Legislative Recommendation.\footnote{See this report, supra.}

\section*{CDP Procedural Issues}

Procedural issues raised by CDP participants generally fall into one of seven categories:

\begin{itemize}
  \item Whether the taxpayer was in the right court;
  \item Whether the taxpayer satisfied filing requirements;
  \item Whether taxpayer received a face-to-face hearing;
  \item Whether taxpayers are permitted to tape record the hearing;
  \item Whether the taxpayer was permitted to raise the underlying liability;
  \item Whether the IRS abused its discretion in considering collection alternatives; and
  \item Whether taxpayer’s change in circumstances should be considered.
\end{itemize}

\subsection*{Which Jurisdiction Controls?}

As the \textit{pro se} analysis demonstrates below, taxpayers are often unrepresented in CDP hearings. One byproduct that flows from the lack of representation is that taxpayers, who are often unfamiliar with the mechanics of litigation, must determine for themselves what legal documents need to be filed in which courts. Appeals from CDP hearings present an added layer of confusion because appeals from income tax cases are made to the Tax Court, while appeals from employment related taxes are made to the appropriate U.S. district court.\footnote{IRC §§ 6330(d)(1) and 6320(c).} Appeals to the Tax Court are termed \textit{petitions}\footnote{U.S. Tax Court R. 20(g).} and the forms are accessible from the Tax Court Internet site.\footnote{See http://www.ustaxcourt.gov.} Appeals to the U.S. district courts are termed \textit{complaints};\footnote{Fed. R. Civ. P. 7(a).} and there are no readily available forms for \textit{pro se} taxpayers to use in appeals from CDP cases. As a result of this confusion, numerous appeals from CDP hearings were
filed in the wrong court.\textsuperscript{33} Congress should continue its efforts to centralize CDP hearings in the Tax Court.\textsuperscript{34}

**Have Filing Requirements Been Satisfied?**

A number of cases involved the taxpayer’s failure to make timely filing requirements under either of the two 30-day filing deadlines,\textsuperscript{35} (i.e. the 30-day deadline for requesting a CDP hearing\textsuperscript{36} and the 30-day deadline for requesting an appeal to the Tax Court or the U.S. district court, as appropriate, after issuance of the notice of determination).\textsuperscript{37} As these cases demonstrate, courts cannot provide a taxpayer relief where the deadlines are missed. For example in Carmichael v. Commissioner, the taxpayer failed to request a hearing after receiving the first IRS notice of intent to levy.\textsuperscript{38} Upon receipt of a second notice, the taxpayer requested a CDP hearing, which the IRS did not grant. On appeal, the court determined that the taxpayer lost the right to a CDP hearing upon the lapse of the 30 days after receiving the first notice, and dismissed the case.\textsuperscript{39}

**What Type of Hearing is Required?**

Taxpayers continue to litigate over the type of CDP hearing granted.\textsuperscript{40} The Treasury Regulations present conflicting information as to the nature of the CDP hearing. For example, one part of the regulations suggests that the hearing need not be conducted

\textsuperscript{33} Fingado v. Mares, 92 A.F.T.R.2d (RIA) 6283 (D. N.M. 2003) (dismissing case brought against IRS Appeals officers for alleged deficiencies in CDP process because jurisdiction belonged in U.S. Tax Court); Porter v. U.S., 91 A.F.T.R.2d (RIA) 946 (9th Cir. 2003) (affirming dismissal since Tax Court had proper jurisdiction rather than District Court); Hart v. U.S., 291 F.Supp.2d 635 (N.D. OH 2003); Randle v. U.S., 92 A.F.T.R.2d (RIA) 5542 (E.D. PA 2003) (holding Tax Court was proper forum); Render v. Comm’r, 309 F.Supp.2d 938 (E.D. Mich. 2003) (holding case would not be dismissed from District Court even though dismissal from wrongly filed Tax Court petition had not yet been ruled upon); Vodker v. Nolen, 365 F.3d 580 (7th Cir. 2004) (holding Tax Court had exclusive jurisdiction concerning taxpayer’s complaints about CDP process in income tax case); Desire Community Housing Corp. v. U.S., 93 A.F.T.R.2d (RIA) 1463 (E.D. La. 2004) (in case where taxpayer was represented, court held issues raised about CDP hearing process were exclusive jurisdiction of Tax Court); Perkins v. U.S., 314 F.Supp.2d 664 (E.D. Tex. 2004) (holding Tax Court had exclusive jurisdiction); and Brown v. Donan, A.F.T.R.2d (RIA) 7409 (M.D. N.C. 2003) (holding District Court has no jurisdiction over CDP issues).

\textsuperscript{34} The Tax Administration Good Government Act, S. 882, Section 301, 108th Cong. (2004), contains a provision to centralize CDP hearings in the Tax Court.


\textsuperscript{36} IRC §§ 6330(a)(3) and 6320(a)(3).

\textsuperscript{37} IRC §§ 6330(d)(1) and 6320(c).


\textsuperscript{39} Id. It is important to note that the Treasury Regulations do provide an “equivalent hearing” for taxpayers who fail to make a timely request for a CDP hearing; however, there is no right to further appeal from an equivalent hearing. Treas. Reg. § 301.6330-1(i)(1).

face-to-face but may be the exchange of correspondence. In a subsequent provision, however, the regulations appear to indicate the taxpayer will receive a face-to-face hearing upon request. A number of cases illustrate the confusion taxpayers experience regarding this issue. For example, in Cavanaugh v. U.S., the taxpayer requested a face-to-face hearing; however, the IRS took the position that the CDP hearing had taken place during a telephone conference with the taxpayer and that a face-to-face hearing was not required even when requested by the taxpayer. The court held that the Appeals officer abused her discretion in denying the face-to-face hearing, especially in light of the fact that the taxpayer claimed he did not even know that the telephonic hearing was (in the IRS’s view) his CDP hearing.

Recent policy shifts suggest that the IRS is seeking to minimize the number of face-to-face hearings, which may have the effect of further litigation in this area. First, the IRS Office of Appeals has initiated a process of sending a letter to taxpayers who request hearings that presumptively establishes the CDP hearing as a telephonic proceeding, and the taxpayer will receive a face-to-face hearing only if he or she specifically makes the request. Second, Appeals has initiated a process of sending some CDP case files to IRS campuses, which will remove cases from the taxpayer’s geographic location.

41 Treasury Regulation §301.6330-1(d), Q-D6 & A-D6 provides as follows:
A CDP hearing may, but is not required to, consist of a face-to-face meeting, one or more written or oral communications between an Appeals officer or employee and the taxpayer or the taxpayer’s representative, or some combination thereof.

42 Treasury Regulation §301.6330-1(d)(2), Q-D7 & A-D7 provides as follows:
Q-D7. If a taxpayer wants a face-to-face CDP hearing where will it be held?
A-D7. The taxpayer must be offered an opportunity for a hearing at the Appeals office closest to taxpayer’s residence or, in the case of business taxpayers, the taxpayer’s principal place of business. If that is not satisfactory to the taxpayer, the Appeals officer or employee will review the taxpayer’s request for a CDP hearing, the case file, any other written communications, if any, submitted in connection with the CDP hearing, and any notes of any oral communications with the taxpayer or the taxpayer’s representative. Under such circumstances, review of those documents will constitute the CDP hearing for the purposes of section 6320(b).


45 Internal Revenue Service, Letter 3855 (03/04).
Is Tape Recording of CDP Hearing Permitted?

The right of a taxpayer to tape record CDP hearings was an issue raised in a number of cases during the period reviewed for this analysis. The Treasury Regulations provide:

A transcript or recording of any face-to-face meeting or conversation between an Appeals officer or employee and the taxpayer or the taxpayer’s representative is not required.

In Keene v. Commissioner, however, the Tax Court held that IRC § 7521 requires Appeals officers to permit recordings of the CDP hearing if the taxpayer requests it and provides the necessary recording equipment. Other courts have declined to follow the Tax Court’s ruling in Keene. In conformity with Keene, the IRS should amend the Treasury Regulations to clarify that taxpayers have the right to record their CDP hearings, and the IRS should advise taxpayers of this important right. In the regulations, of course, the IRS can clarify that the request to record must be made timely and cannot be made as a way to unduly delay the proceedings.

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46 Keene v. Comm’r, 121 T.C. 8, 17 (2003); Fingado v. U.S., 92 A.F.T.R.2d 6283 (D. N.M. 2003) (holding District Court did not have jurisdiction to hear taxpayer’s complaint about being precluded from recording hearing); McDonald v. U.S., 92 A.F.T.R.2d (RIA) 7197 (N.D. Tex. 2003) (failure to allow recording is not an abuse of discretion where taxpayer raised only frivolous issues); Snyder v. Comm’r, 93 A.F.T.R.2d 2004-425 (N.D. Ohio 2003) (taxpayer does not have a right to record CDP hearing); Norsworthy v. U.S., 93 A.F.T.R.2d 1700 (W.D. Tex. 2004) (taxpayer does not have a right to request hearing when taxpayer could not contest liability); Yuen v. U.S., 209 F. Supp. 2d 1220 (D. Nev. 2003) (no right to record where taxpayer was making frivolous arguments); Brashear v. Comm’r, T.C. Memo. 2003-196 (taxpayer may have a right to remand but not necessary to remand in this case); Kemper v. Comm’r, T.C. Memo. 2003-195 (no right to record where issues raised are frivolous); Horton v. Comm’r, T.C. Memo. 2003-197 (no right to record where issues raised by taxpayer are frivolous).

47 Treas. Reg. §301.6320-1(d) A-D6 and Q-D6.

48 IRC § 7521 permits taxpayers to record any “interview” with IRS personnel relating to the determination or collection of a tax.

49 Keene v. Comm’r, 121 T.C. 8, 17 (2003).

What Issues May Be Raised at a CDP hearing?

Many taxpayers also do not understand what issues may be argued under which circumstances in appeals from CDP hearings. Taxpayers attempted to argue the underlying liability in many cases when they had either received a notice of deficiency or previously had an opportunity to argue the tax and therefore were not permitted to reopen that issue.51

In one important case, however, the Tax Court clarified the scope of issues that taxpayers can raise at a CDP hearing where the taxpayer has self-assessed the tax liability on his or her tax return. In Montgomery v. Commissioner, the IRS argued that in a CDP hearing the taxpayer cannot challenge liabilities that the taxpayer self-assesses on his or her own tax return. 52 The Tax Court held that the taxpayer is entitled to argue the underlying liability at a CDP hearing in the case of self-assessment because the taxpayer did not receive a notice of deficiency from the IRS and did not have any other opportunity to argue the underlying liability after assessment. 53 As a result of the Montgomery decision, the IRS has provided its employees guidance to comply with the decision.54

Was Collection Action Lawful?

Internal Revenue Code §§ 6330(c)(2)(A)(ii) and 6320(c) specify that taxpayers may raise the appropriateness of collection actions at a CDP hearing. In a number of cases, taxpayers asserted that the proposed collection action was unlawful because of an IRS procedural defect.55 In Hyler v. U.S., a U.S. district court addressed some of the different issues

51 Plettner v. U.S., 92 A.F.T.R.2d 5762 (N. D. Ill. 2003) (holding officer of company previously had opportunity to dispute liability under IRC section 6672 and was unable to argue the matter at his CDP hearing); Johnson v. U.S., 92 A.F.T.R.2d 7233 (N.D. Ga. 2003) (holding officer of company previously had opportunity to dispute liability under IRC section 6672 and was unable to argue the matter at his CDP hearing); Ordunez v. U.S., 92 A.F.T.R.2d 6297 (9th Cir. 2003) (taxpayer had received Notice of Deficiency); White v. U.S., 92 A.F.T.R.2d 5179 (W.D. Wash. 2003) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); Miller v. U.S., 93 A.F.T.R.2d 1148 (E.D. Pa. 2004) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); Letter v. U.S., 93 A.F.T.R.2d 793 (D. Kan. 2004) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); Dixon v. Comm’r, T.C. Memo. 2003-319 (taxpayer had received Notice of Deficiency); Sciola v. Comm’r, T.C. Memo. 2003-334 (taxpayer had received Notice of Deficiency); Alvarez v. Comm’r, T.C. Memo. 2003-319 (taxpayer had received Notice of Deficiency); Thomas v. Comm’r, T.C. Memo. 2003-231 (taxpayer had received Notice of Deficiency); Smith v. Comm’r, T.C. Memo. 2003-205 (taxpayer received Notice of Deficiency); Aaron v. Comm’r, T.C. Memo. 2004-65 (although court acknowledged this taxpayer had many hardships, taxpayer had received Notice of Deficiency and so could not argue underlying liability); Barbrie v. Comm’r, T.C. Memo. 2004-88 (taxpayer received Notice of Deficiency, so could not argue underlying liability); Milam v. Comm’r, T.C. Memo. 2004-94 (taxpayer received Notice of Deficiency, so could not argue underlying liability); Robertson v. Comm’r, T.C. Memo. 2004-72 (taxpayer could argue underlying liability for years where no Notice of Deficiency received); and Nicol v. Comm’r, T.C. Summ. Op. 2004-47 (taxpayer received Notice of Deficiency so cannot argue liability).

52 Montgomery v. Comm’r, 122 T.C.1 (2004). Montgomery, in which five judges dissented, was a full court-reviewed decision, i.e. where the full Tax Court reviews the decision; thus, the case has value as precedent before the Tax Court.


54 IRM 8.7.2.3.11(6).

frequently raised in appeals from CDP hearings. The taxpayer, at a CDP hearing, attempted to raise the underlying liability of a Trust Fund Recovery Penalty under IRC § 6672 for trust fund taxes that the taxpayer’s business failed to pay. The IRS determined that the taxpayer already had an opportunity to raise the issue with the Office of Appeals and was not entitled to raise the issue of the underlying liability. The taxpayer filed an appeal of the notice of determination to the Tax Court. The Tax Court dismissed the case because it lacked jurisdiction over employment taxes. The taxpayer then filed with the appropriate district court; however, in the interim, the IRS had levied on the taxpayer’s property in satisfaction of the trust fund taxes. The district court ruled that the taxpayer’s allegation as to the lawfulness of the levy action was now moot because the IRS had already levied in satisfaction of the debt.

Did the IRS Abuse Its Discretion in Rejecting a Collection Alternative?

Internal Revenue Code §§ 6330(c)(2)(A)(iii) and 6320(c) specify that taxpayers may raise collection alternatives at a CDP hearing. A taxpayer can challenge the IRS decision on the collection alternative under an abuse of discretion standard. However, the cases litigating this issue demonstrate the formidable burden of proof upon a taxpayer, under this standard, and courts will generally sustain the IRS determination if its administrative procedures were followed by Appeals. In Ramirez v. Commissioner, however, the Tax Court held it was an abuse of discretion for an Appeals officer to fail to refuse consideration of an offer in compromise that was in the possession of the Appeals officer prior to the issuance of the notice of determination.

57 Id.
Should Change in Circumstances be Considered?
In appeals from CDP hearings, courts are confronted with two different legal issues related to a taxpayer’s change in the taxpayer’s circumstances:

- Whether the IRS must consider a taxpayer’s change in circumstances during a CDP hearing; and
- Whether a court has the authority to consider a taxpayer’s change in circumstances if evidence of the change was not before the Appeals officer.

In Cavanaugh v. United States, the U.S. district court remanded the case back to Appeals for a CDP hearing that would include an opportunity for the taxpayer to present evidence of changed financial circumstances, to support his offer in compromise of less than what the IRS determined he could pay. The IRS argued that as a matter of policy it does not consider changed circumstances because if it were required to do so, devious taxpayers could make these claims repeatedly and avoid paying taxes indefinitely. The court noted that changed financial circumstances are relevant to a proposed levy, and interpreted the statutory language to require that Settlement Officers consider taxpayers’ claims of changed financial circumstances at CDP hearings.

The Tax Court has also ruled that the IRS must consider a taxpayer’s change in circumstances when evaluating an offer in compromise. In Ashurst v. Commissioner, the taxpayers claimed on appeal from their CDP hearing that their circumstances had changed dramatically, and requested their case be sent back to Appeals for a reconsideration of their offer. The Tax Court ordered the case returned to consider the change in circumstances, though it retained jurisdiction of the case. After Appeals reconsidered the case, it determined that the taxpayers’ offer in compromise should not be accepted. The Tax Court ruled that the subsequent determination by Appeals was not an abuse of discretion.

Courts have been less willing to consider a taxpayer’s change in circumstances if the evidence was not provided at the CDP hearing. For example, in Living Care Alternatives of Utica, Inc. v. U.S., the U.S. District Court noted that its jurisdiction was limited to a review of the administrative record before the Appeals officer. Similarly, in Chandler v. Commissioner, the U.S. Tax Court stated that the petitioner’s claims of current financial hardship could not be considered in the proceeding because they were not raised before the Appeals officer. These cases reflect the importance of taxpayers placing all pertinent facts before the IRS Appeals officer. These cases also demonstrate that the IRS’ concerns...
about taxpayers continuously raising changed circumstances in order to perpetually keep a
case in litigation are not well founded.

Was Opportunity for CDP Hearing Denied?
CDP cases occasionally involve the issue of whether the statutory right to a CDP hearing
was effectively denied to the taxpayer. For example, in Brown v. Commissioner, the taxpayer
requested a CDP hearing following receipt of notices of intent to levy for tax years 1995
and 1996. The taxpayer requested a CDP hearing and entered into discussions with the
Appeals officer in advance of the hearing. IRS records reflected that a notice of deficiency
was issued for the tax year 1996. The taxpayer attempted to raise the underlying liability
of interest and penalties with the Appeals officer, but was told not to bother attending
any hearing if his intent was to dispute the underlying liability. The Tax Court held that
the taxpayer was denied his right to a hearing and remanded the case to Appeals so that
the taxpayer could receive his CDP hearing.

SUBSTANTIVE LEGAL ISSUES
The cases described above primarily involved issues unique to the CDP process. Because
any relevant issue can be raised at a CDP hearing (provided the taxpayer has not previ-
ously had an opportunity to raise the issue), substantive legal issues unrelated to the CDP
hearing process are also litigated in CDP hearings, including the following issues:

- Whether taxes were discharged in bankruptcy;
- Whether the Federal tax lien on assets exempt from bankruptcy survived
  bankruptcy;
- Whether assets of the bankruptcy estate were applied against the tax liability;

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67 Id.
68 Id.
69 Swanson v. Comm’r, 121 T.C. 111 (2003) (holding that the tax liabilities were not discharged in bankruptcy
because the substitute for returns prepared by the IRS did not constitute filed returns for purposes the
Bankruptcy Code, the taxpayer did not file his required returns, and as a result, the tax liabilities were except-
ed from discharge within the meaning of under 11 U.S.C. § 523(a)(1)(B) (2000)). See also Ramsdell v. Comm’r,
70 Iannone v. Comm’r, 122 T.C. 287 (2004) (holding that the existing Federal tax lien was not extinguished as a
result of the bankruptcy discharge and rejecting the taxpayer’s contention that his retirement account was
exempt from levy); Fusaro v. Comm’r, T.C. Memo. 2003-345 (holding that the taxpayer’s pension plan,
although exempt property in the bankruptcy proceedings, was subject to collection by the IRS because a valid
Notice of Federal Tax Lien had been filed prior to the bankruptcy). Pursuant to 11 U.S.C.A. § 522(C)(2)(B),
the IRS may pursue collection of certain assets exempt from bankruptcy proceedings. For example, if the IRS
has filed a Notice of Federal Tax Lien against a taxpayer’s home prior to the bankruptcy proceeding, the IRS
may pursue collection action on that property, even though the tax liabilities are discharged against the tax-
payer personally in the bankruptcy proceeding. Also see IRM 25.17.2.9.1.1 (Rev. 07-01-2002).
71 Wingert v. Comm’r, T.C. Memo. 2003-172, (finding the taxpayer provided no credible evidence that $5,243 of
his bankruptcy estate was applied to pay his 1994-1996 taxes).
Whether the statute of limitations period for collection had expired when the final notice of intent to levy was issued;\textsuperscript{72}

Whether overpayments and offsets were properly applied;\textsuperscript{73}

Issues related to notices of Federal tax lien (NFTL), such as correct place for filing a NFTL, perfecting the lien filing, effectiveness of liens, and real estate title and lien attachment;\textsuperscript{74}

Whether criminal prosecutions extinguish civil liabilities;\textsuperscript{75}

Payment applications by the IRS;\textsuperscript{76}

Interest abatement issues;\textsuperscript{77} and

Trust Fund Recovery Penalty (TFRP) issues;\textsuperscript{78}

\textit{Pro Se Analysis}

Seventy-five percent (137) of the 182 cases litigated were brought before the courts by the taxpayer, \textit{pro se}, without benefit of counsel. This is a decrease from 88 percent in the previous year.\textsuperscript{79} At least part of the decline is due to the reduced number of taxpayers that requested CDP hearings and raised only frivolous issues.\textsuperscript{80} The percentage of frivolous fil-

\textsuperscript{72} IRC § 6502(a)(1) defines the collection period as ten years from the time the tax liability is assessed. \textit{See Gnifkowski v. Comm'}, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the offer in compromise filed by the taxpayer tolled the collection statute); \textit{Roberts v. Comm'}, T.C. Memo. 2004-100 (finding that the Form 900 (Tax Collection Waiver) was valid. \textit{Even if the taxpayer had signed a blank Form 900 (Tax Collection Waiver), his failure to repudiate the extensions, complain about any irregularity in their execution, and his numerous payments pursuant to an installment agreement with IRS, which effectively forestalled enforced collection action against him, demonstrate that the waivers were valid and not improperly obtained).} \textit{See also this report, Most Litigated Issue, Trust Fund Recovery Penalty, infra.}

\textsuperscript{73} \textit{Rabinovich v. Comm'}, T.C. Summ. Op. 2003-126, (holding that IRC § 6511(a) barred the application of overpayments to the taxpayer's outstanding liabilities).

\textsuperscript{74} \textit{Goldman v. Comm'}, T.C. Memo. 2004-3 (finding that the taxpayers were the true owners of real estate in Florida, and as a result, the IRS did not abuse its discretion in rejecting the taxpayers' offer in compromise).

\textsuperscript{75} \textit{Gnifkowski v. U.S.}, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the taxpayer's civil liability was not extinguished as part of the criminal proceeding).

\textsuperscript{76} \textit{Gnifkowski v. U.S.}, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the IRS properly exercised its discretion when it applied the funds collected via levies to the non-Trust Fund Recovery Penalty tax liabilities).

\textsuperscript{77} \textit{Leiter v. U.S.}, 93 A.F.T.R.2d (RIA) 793 (D. Kan. 2004) (holding that the IRS did not abuse its discretion in denying the request for abatement of interest, and the taxpayer provided no evidence of a ministerial or managerial act of the IRS causing a delay).

\textsuperscript{78} The Trust Fund Recovery Penalty (TFRP) is a penalty provided by IRC § 6672 against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. The penalty is equal to the total trust fund portion, i.e. employee's portion, amount of tax evaded, not collected, or not accounted for and paid over. \textit{See IRM 5.7.3.1 (3) (Rev. 12-1-2003). See Leiter v. U.S.}, 93 A.F.T.R.2d (RIA) 793 (D. Kan.2004), (holding that the taxpayer's liability for the TFRP was separate and distinct and he was potentially liable for the entire amount). \textit{See also this report, Most Litigated Issue, Trust Fund Recovery Penalty, infra.}

\textsuperscript{79} National Taxpayer Advocate, \textit{Annual Report to Congress}, Publication 2104 (Rev. 12-2003), 322.

\textsuperscript{80} The criteria used to identify a case as frivolous were: (1) an IRC § 6702 penalty (commonly referred to as frivolous return penalty) upheld by the court, (2) an IRC § 6673 sanction asserted by the Tax Court (or Appeals Court), or (3) the court labeling the arguments presented by the taxpayer as frivolous.
ers dropped from 52 percent (in the previous year) to 23 percent; of this group, 85 percent were pro se. The 45 cases in which taxpayers retained representation involved 22 individual and 23 business taxpayers.

The National Taxpayer Advocate believes that legal representation is vital to a taxpayer who is engaged in litigation or is contemplating litigation against the IRS. IRS employees should be trained to advise taxpayers about the benefits of counsel representation. For those who qualify, Low Income Taxpayer Clinic assistance and other available legal aid may help the taxpayers to better understand why the collection actions taken in their cases were appropriate.

Table 3.1.2 shows the breakdown of pro se and represented taxpayers and the decisions rendered by the court, indicating that approximately 97% of pro se taxpayers receive no relief in appeals from CDP hearings.

**Table 3.1.2, Pro se & Represented Taxpayers in CDP Cases**

<table>
<thead>
<tr>
<th>Court Decisions</th>
<th>Taxpayer Pro Se</th>
<th>Representation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volume</td>
<td>Percentage Of Total</td>
</tr>
<tr>
<td>Decided for IRS82</td>
<td>132</td>
<td>96%</td>
</tr>
<tr>
<td>Decided for Taxpayer83</td>
<td>2</td>
<td>2%</td>
</tr>
<tr>
<td>Split Decision</td>
<td>3</td>
<td>2%</td>
</tr>
<tr>
<td>Totals</td>
<td>137</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Conclusion**

The CDP hearing process continues to be the subject of much litigation. Recent procedural decisions, such as the movement toward conducting CDP hearings via telephone and not informing taxpayers of their right to audio record a hearing, could increase litigation, as may the handling of CDP cases in the IRS campus (service center) environment. Further, it is anticipated that increased IRS collection activity will bring more requests for CDP hearings. Finally, the significant reduction (from 52 percent last year to 23 percent this year) in frivolous CDP cases being brought before the courts demonstrates that the CDP process is beginning to be utilized in the manner for which it was intended.

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83 Included in this number are appeals from CDP hearings that were dismissed by courts, as all of the dismissals were favorable to the IRS.
84 Included in this number are cases remanded back to the Office of Appeals, as all remands except one were providing the taxpayer the relief requested. In *Harrell v. Commissioner*, the Tax Court rejected the taxpayer’s argument that the Appeals officer had abused her discretion but remanded the case to Appeals to give the taxpayer an opportunity to submit a collection alternative. This case was reported as a split decision. *Harrell v. Comm’r*, T.C. Memo. 2003-271.
85 Internal Revenue Service, Letter 3855 (03/04). The letter presumes a telephonic hearing, placing the obligation on the taxpayer to contact Appeals within 14 days to request a face-to-face hearing.
86 *Keene v. Comm’r*, 121 T.C. 8, 19 (2003) (stating the taxpayer was entitled to record his CDP hearing with the Appeals office). IRS Publication 1660 does not inform taxpayer of this right.