

I. Introduction

The Internal Revenue Code requires the National Taxpayer Advocate to submit two annual reports to the House Committee on Ways and Means and the Senate Committee on Finance.¹ The National Taxpayer Advocate is required to submit these reports directly to the Committees without any prior review or comment from the Commissioner of Internal Revenue, the Secretary of the Treasury, the IRS Oversight Board, any other officer or employee of the Department of the Treasury, or the Office of Management and Budget.² The first report, due by June 30 of each year, must identify the objectives of the Office of the Taxpayer Advocate for the fiscal year beginning in that calendar year.

Over the last year there has been a great deal of positive activity at the IRS, including the transition to the Customer Account Data Engine 2 (CADE 2) system, which will fundamentally change (for the better) how the IRS processes tax return information. Several areas of significant change involve programs that I identified as “Areas of Focus” in our past Objectives Reports to Congress. In many of these areas, by pursuing an advocacy strategy that involved both TAS’s Office of Systemic Advocacy and our Case Advocacy (Local Taxpayer Advocate) function, the Taxpayer Advocate Service (TAS) has provided the impetus for this systemic change and then has worked with the IRS or Congress to turn that impetus into reality. To highlight just a few of these areas:

- The initial implementation of regulation of federal tax return preparers, which will improve filing compliance and provide consumer protection for taxpayers;³
- The test involving outbound calling in the Centralized Offer in Compromise (COIC) units, which has shown that primarily by reaching out and talking with taxpayers the

¹ IRC § 7803(c)(2)(B).

² IRC § 7803(c)(2)(B)(iii).

³ See 2002 National Taxpayer Advocate Annual Report to Congress 69-74 (Most Serious Problem: *IRS Oversight of EITC Return Preparers Can Be Improved*); 2004 Annual Report to Congress 67-88 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); 2006 National Taxpayer Advocate Annual Report to Congress 197-221 (Most Serious Problem: *Oversight of Unenrolled Return Preparers*); 2009 National Taxpayer Advocate Annual Report to Congress 41-69 (Most Serious Problem: *IRS Lacks a Servicewide Return Preparer Strategy*); 2011 National Taxpayer Advocate Objectives Report to Congress 24-26 (*As the IRS Implements the New Return Preparer Initiative, TAS Will Continue to Monitor Its Scope As Well As Advocate for Several Statutory Changes*).

IRS has increased its offer acceptance rate to 66 percent for test cases and from 26 percent to 39 percent for all COIC cases from fiscal year (FY) 2010 to FY 2011;⁴ and

- The repeal of the Form 1099 reporting requirement for purchases of goods (or other property) made in the course of business, which, if implemented, would have imposed substantial burden on business taxpayers without a corresponding compliance benefit.⁵

As with most systemic changes, these improvements take time. They require the IRS – a large organization with many competing priorities and a stovepiped management and structure – to change direction or shift its long-held perspective on how things should be done. To facilitate systemic change, Congress both required the Taxpayer Advocate Service to bring an independent, taxpayer-focused perspective to problems and placed us inside the IRS, because Congress wanted us to understand the challenges facing the IRS even as we make a compelling case for change.

Admittedly, many of the issues we identify are complex. In fact, the most difficult changes are often the most necessary and urgent, because their difficulty has caused them to be deferred, ignored, or brushed under the rug. It is TAS's job to identify issues that must be addressed in order to mitigate taxpayer problems with the IRS, and to advocate compellingly – with research and analysis, logic, policy, and real-world examples – for the IRS to address those issues now. But our work does not end when the IRS agrees to address our recommendations in theory – which it does most of the time.⁶ As former IRS Commissioner Charles Rossotti once pointed out to me, TAS was placed inside the IRS not just to make recommendations but also to be part of the solution.

4 See IRS response to TAS information request (email from SB/SE Campus Compliance Services Program Manager), July 21, 2011 (providing the 66 percent test acceptance rate); IRS, Collection Activity Report, NO-5000-108, Monthly Report of Offer in Compromise Activity (Oct. 5, 2010) (providing FY 2010 acceptance rate) and June 2, 2011 (providing acceptance rate for first eight months of FY 2011). See also 2001 National Taxpayer Advocate Annual Report to Congress 52-55 (Most Serious Problem: Processing Offer in Compromise (OIC) Applications); 2002 National Taxpayer Advocate Annual Report to Congress 15-24 (Most Serious Problem: *Processing OIC Cases*); 2003 National Taxpayer Advocate Annual Report to Congress 99-112 (Most Serious Problem: *OIC*); 2004 National Taxpayer Advocate Annual Report to Congress 311-341 (Most Serious Problem: *Offers In Compromise*); 2007 National Taxpayer Advocate Annual Report to Congress 374-387 (Most Serious Problem: *Offers In Compromise*); 2008 National Taxpayer Advocate Annual Report to Congress 15-38 (Most Serious Problem: *The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experiencing Economic Difficulties*); 2009 National Taxpayer Advocate Annual Report to Congress 196-216 (Most Serious Problem: *The Steady Decline of the IRS Offer In Compromise Program Is Leading to Lost Opportunities for Taxpayers and IRS Alike*); 2010 National Taxpayer Advocate Annual Report to Congress 311-318 (Status Update: *The IRS Offer-In-Compromise Program Continues to be Underutilized*); FY 2011 National Taxpayer Advocate Objectives Report to Congress 20-22 (*IRS Initiatives to Improve the Offer In Compromise Program Have Not Yet Achieved Tangible Results*).

5 Pub. L. No. 112-9, 125 Stat. 36 (Apr. 14, 2011). See FY 2011 National Taxpayer Advocate Objectives Report to Congress 9-13 (*TAS Will Examine the Administrative Challenges Presented by New Information Reporting Requirements*).

6 For FY 2007 through FY 2009, the IRS agreed to address 208 of 366 TAS recommendations. In addition, TAS made 698 suggestions to the IRS on Internal Management Documents/Single Point of Contact (IMD/SPOC) documents. Of those suggestions, 68 percent – 474 suggestions – were accepted. Data obtained from the Systemic Advocacy Management System (SAMS). See *Advocating through the National Taxpayer Advocate's Annual Report to Congress*, *infra*.

TAS continues to advocate for stronger taxpayer protections in the area of collection.

In last year's Objectives Report to Congress (and in several of the Annual Reports to Congress we deliver at the end of each year), we identified the IRS's Notice of Federal Tax Lien (NFTL) filing and withdrawal policies⁷ and the IRS's handling of cases similar to the *Vinatieri* case, where economic hardship is present, as two areas of focus for us in fiscal year 2011.⁸ Our strategy was two-fold: first, advocate forcefully, compellingly, and persistently in specific cases involving these issues and issue Taxpayer Assistance Orders (TAOs) where the IRS did not agree with our case-specific recommendations; and second, use the case examples to advocate for changes to Internal Revenue Manual (IRM) provisions and other internal guidance as well as training. In FY 2010 and FY 2011, TAS issued 42 TAOs dealing with NFTLs and 19 dealing with levy releases where economic hardship was present, and the IRS ultimately complied with the terms of the TAOs in 76 percent and 74 percent of the cases, respectively.⁹ We worked with Collection Policy to change various IRM provisions to make clear that if a taxpayer meets the criteria for currently not collectible (CNC) hardship status, the taxpayer's account should be placed in that status even if the taxpayer has unfiled returns.¹⁰ We also worked with Collection Policy to revise various IRM provisions to make clear that the IRS must release a levy where the taxpayer demonstrates economic hardship, even if the taxpayer has unfiled returns.¹¹

Most significantly, we negotiated the recently issued guidance on the IRS's NFTL withdrawal policies.¹² In addition to allowing NFTL withdrawals where the taxpayer agrees to a direct debit installment agreement (within certain dollar limits), the IRS has finally issued guidance allowing NFTL withdrawals after the lien has been released, reversing its longstanding position that it could not legally do so.¹³ From securing the counsel opinion

7 See National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*), 357-364 (Legislative Recommendation: *Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens*); 2010 National Taxpayer Advocate 2010 Annual Report to Congress 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien-Filing Policies on Taxpayers and Future Tax Compliance*); National Taxpayer Advocate FY 2011 Objectives Report to Congress 13-18 (*The National Taxpayer Advocate Remains Concerned About IRS Collection Practices that Do Not Promote Future Voluntary Compliance and Can Unnecessarily Harm Taxpayers*).

8 In *Vinatieri v. Commissioner*, the United States Tax Court held that if, during a Collection Due Process (CDP) hearing, the taxpayer establishes that the proposed levy will create an economic hardship (within the meaning of Internal Revenue Code (IRC) § 6343(a)(1)(D)), the IRS cannot proceed with the proposed levy action as a matter of law, even if the taxpayer did not file all required tax returns. *Vinatieri v. Comm'r*, 133 T.C. 392 (2009). See National Taxpayer Advocate 2010 Annual Report to Congress 85-97 (Most Serious Problem: *IRS Collection Policies and Procedures Fail to Adequately Protect Taxpayers Suffering an Economic Hardship*); National Taxpayer Advocate FY 2011 Objectives Report to Congress 18-19 (*The IRS's Delay in Incorporating the Tax Court's Decision in Vinatieri v. Commissioner into the Internal Revenue Manual (IRM) and Other Guidance Unnecessarily Harms Taxpayers Who Are Experiencing Economic Hardship*).

9 Data obtained from TAMIS.

10 See e.g., IRM 5.16.1.2.9(9) (Apr. 29, 2011); IRM 8.22.2.4.2(4) (Dec. 14, 2010).

11 See IRM 5.19.4.4.10(4)(j) (Mar. 8, 2010).

12 SB/SE *Interim Guidance Memorandum*, Control No. SB/SE-05-0611-037 (June 10, 2011).

13 See National Office Program Manager Technical Advice, PMTA-2009-158 (Oct. 9, 2009). In that advice, the IRS Office of Chief Counsel reevaluated its prior legal conclusion that NFTLs could not be withdrawn after the underlying liens were released that was reflected in IRM 5.12.3.37 (Sept. 7, 2006). See also IRM 5.12.3.35 (June 13, 2005); IRM 5.12.3.26.1 (July 15, 2003).

authorizing such withdrawals,¹⁴ to issuing TAOs in these cases,¹⁵ to negotiating with other IRS organizations and providing language and examples for the guidance, to working with members of Congress on lien filing legislation,¹⁶ TAS has driven the development of this new NFTL withdrawal policy. It may have taken two years from start to finish, but true systemic change – in which all parties understand the need for change so they can implement it properly and not repeat the problem somewhere else – takes time. I am proud of TAS employees for their extraordinary advocacy on this issue, and I applaud the IRS for listening, heeding, and implementing this change. It will benefit taxpayers and tax compliance for years to come.

Having said that, there is much more to do. As we describe in this year's Areas of Focus, TAS still must work with the IRS to improve its NFTL *filing* (as opposed to NFTL *withdrawal*) policies. Both TAS and the IRS must focus on improving Earned Income Tax Credit (EITC) case procedures, so that they are not disallowing the EITC simply because the taxpayer cannot comply with all of the burdensome audit requirements.¹⁷ TAS will continue to work with the IRS to help improve its procedures for resolving identity theft cases and reducing the burdens on identity theft victims during future filing seasons.¹⁸ TAS will develop training for IRS public contact employees on working with victims of domestic abuse and violence. TAS will continue to work with the IRS on health care implementation. TAS will advocate for small exempt organizations that must re-apply for exempt organization status because their status was revoked for failing to file Form 990-N (the e-Postcard). TAS will monitor the IRS's implementation of its voluntary disclosure initiatives to ensure fairness and protection of taxpayers' rights.

Budget limitations may drive the IRS to automate more decision-making, curtailing personal interaction with taxpayers and failing to consider their specific circumstances.

Notwithstanding the progress made in several areas over the last year, I remain concerned that the IRS is falling backward in its commitment to taxpayer service and being a customer-focused organization. As we discuss in this report, the overriding concern here is the impact of budget decisions.¹⁹ Simply put, if the IRS is not funded adequately while its

14 See National Office Program Manager Technical Advice, PMTA-2009-158 (Oct. 9, 2009).

15 Through May 31, TAS issued 16 lien withdrawal TAOs in FY 2011, of which the IRS complied with nine and seven remain open. In FY 2010, TAS issued 22 lien withdrawal TAOs, of which the IRS complied with 18, TAS rescinded one, and three remain open. Data obtained from TAMIS.

16 See Targeted Tax Lien Act, H.R. 6439 (111th Cong.); Taxpayer Bill of Rights Act, S. 3215 (111th Cong.); Taxpayer Bill of Rights Act, H.R. 5047 (111th Cong.).

17 See TAS's *Continued Advocacy Efforts to Improve the EITC Program*; *Improving Advocacy in TAS's Earned Income Tax Credit Cases*; and Appendix VIII: *Earned Income Tax Credit Case Review Report*, *infra*. See also *Hearing on Improper Payments in the Administration of Refundable Tax Credits, Before the Subcomm. on Oversight, H. Comm. on Ways and Means*, 112th Cong. (statement of Nina E. Olson, National Taxpayer Advocate) (May 25, 2011).

18 See *The IRS Needs to Improve Its Identity Theft Victim Assistance Strategy*, *infra*. See also *Hearing on The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, A Drain on the Public Treasury, Before the Subcomm. on Fiscal Responsibility and Economic Growth, S. Comm. on Finance*, 112th Cong. (statement of Nina E. Olson, National Taxpayer Advocate) (May 25, 2011).

19 See *TAS Will Continue to Focus on the IRS's Ability to Collect Taxes and Meet Taxpayer Needs as Its Responsibilities Have Expanded and Its Funding Has Been Reduced*, *infra*.

work is increasing and expanding into new areas, it will turn to more automation and less interaction with taxpayers.

In the context of enforcement initiatives, automation means more rule-based decisions to issue levies and file liens, with enforcement actions occurring without any personal contact with taxpayers; more pressure for the (inappropriate) use of math error authority or truncated audit processes; greater use of correspondence examinations with no outbound calls to taxpayers; and more decision-making tools like the Reasonable Cause Assistant, which supplants the individual employee's determination regarding whether a penalty should be abated for reasonable cause.

On the taxpayer service side, automation could be a positive thing – if only the IRS could harness the use of electronic accounts and communication to enable taxpayers to see their own accounts, communicate directly with the IRS electronically, and have videoconferences with the IRS in remote locations (even as part of “correspondence” audits or collection matters). The IRS could also communicate with taxpayers through cellphone/smartphone technology, for example, by sending text or email message reminders of filing or payment deadlines, or due dates for submission of information in audits or collection matters.²⁰ The possibilities are endless, and the resources freed up by these initiatives could be retained to meet the needs of those taxpayers who need to talk with the IRS about their tax issues, either by phone or in person.

As noted above, the downside of having to do more with fewer resources is that the IRS will apply more “bright-line” tests to taxpayer situations, because having to look at a taxpayer's specific facts and circumstances is time-consuming and costly.²¹ Indeed, bright-line tests are useful, since many – even a great majority – of taxpayers will still get fair results. But the test of fairness – of due process – is how government action applies to all taxpayers, including the minority.

So bright-line tests require a safety valve, and that safety valve involves allowing for and encouraging the exercise of judgment and discretion when the bright-line test brings about an unfair or improper result. What I see in parts of the IRS, however, is a trend toward greater reluctance to exercise discretion with respect to the non-bright line situations, and this reluctance is reinforced by the fact that exercising discretion takes time and resources, which in this budget environment the IRS believes it does not have.

20 The IRS must continue to place priority emphasis on protecting confidential taxpayer return information from disclosure, but that does not mean it should not enter the Internet age. Banks, credit card companies, and other financial institutions also place a priority on customer privacy, yet they have been making account information and transaction options available to customers for more than a decade. If the IRS tests using email and texting simply to provide reminders to taxpayers and does not embed confidential taxpayer return information in its messages, it can explore the benefits of electronic access and communication with minimal risk of disclosures.

21 We use the phrase “bright-line test” to apply to IRS programs or procedures that require the IRS employee to review the taxpayer's situation according to a limited set of yes/no questions. If the taxpayer meets these requirements, then the employee must take a specific, predetermined action. This action can either benefit or harm the taxpayer.

At its heart, though, the IRS's discomfort with exercising judgment and discretion is not about budgets. I believe it reflects a failure on the IRS's part to view taxpayers as human beings and to recognize that as a tax agency we deal with taxpayers as we find them, with all the vagaries of human existence, *i.e.*, "life in all its fullness." Think about it – there are few more intimate acts that a person has with his government than to tell it about one's family, income, expenses, losses, gains, educational activities, purchasing activities, retirement saving activities, and so on. Tax returns are not mere pieces of paper. Tax returns are reflections of people's lives – who they are and what they did – and to an astounding extent, they are voluntarily sharing this information with their government.²²

The human drama of taxation and tax return filing was brought home to me this filing season during the First-Time Homebuyer Credit (FTHBC) debacle. As discussed elsewhere in this report, taxpayers who received the first iteration of the FTHBC were required to make their first repayment of the interest-free loan on their 2011 tax returns.²³ The IRS's failure to program its systems with sufficient lead time for review and issuance of guidance led to a massive breakdown in the return filing process for these taxpayers. In short, as I write this preface in June, there are still taxpayers who filed in January 2011, reporting the repayment of the FTHBC, who have not received the balance of their refunds.

These taxpayers did not take these delays quietly. They banded together, creating a Facebook page and sharing their stories. They published my own email address, along with those of other IRS officials. To date, I have received 114 emails from taxpayers, pleading for assistance. Their emails describe sustained economic difficulties caused by inexcusable refund delays. Even more disturbing for the prospect of ongoing compliance, they describe the lack of compassion evidenced by IRS (and even TAS) employees. These taxpayers write that after being given numerous promises of dates on which their refunds would be issued, none of which were met, they are "tired of being lied to" by their government. Several taxpayers speculated about what would happen if they took as long to pay a balance due on a tax return as the IRS was taking to pay them their refunds. All of this is out there on the web. None of this bodes well for the public's confidence in the tax system.

Taxpayers have also demonstrated how seriously they think about taxation by responding to my invitation in the 2010 Annual Report to Congress to share with us their thoughts about tax reform. On our website, we asked that taxpayers tell us what tax provision(s) they would give up if doing so would make taxes simpler, and what tax provision(s) they think is most unfair. I wanted to get the direct participation of taxpayers because I believe that true tax reform will not occur until the taxpaying public itself demands it, and I wanted to know what was on their minds.

22 For tax year 2001, the voluntary filing compliance rate was 87.3 percent. IRS, *Tax Gap Update* (Feb. 2006).

23 The \$7,500 FTHBC allowed under the Housing and Economic Recovery Act of 2008 requires repayment of the credit over 15 years. Pub. L. No. 110-289, § 3011, 122 Stat. 2654, 2888 (July 30, 2008). See *IRS Administration of the First-Time Homebuyer Credit Became a Debacle*, *infra*.

To date, we have received over 1,500 comments,²⁴ and with the publication of this report, we are posting some of them on our tax toolkit website at www.TaxpayerAdvocate.irs.gov. My selection of these comments is not meant to be statistically representative of the whole. Instead, I have selected a range of comments that illustrate the diversity of thought and the seriousness with which taxpayers responded. In some instances, the comments show the need for more education about the different forms of taxation.²⁵ My office is considering how we may be able to use our web-based tax toolkit to provide taxpayers with a general understanding of taxes and tax systems, so that they can better understand the choices available to the government as it moves along the road to tax reform and be better equipped to participate in the discussion.

These two experiences – the FTHBC returns and the tax reform comments – have enabled me to hear directly from taxpayers. They also demonstrate the power of social media and the Internet to communicate and exchange (not just push out) information. As a result, I am establishing a blog on the TAS website, so I can communicate directly with taxpayers on a variety of topics, including filing season issues and education about taxpayer rights and the tax system. But most importantly, it will provide the National Taxpayer Advocate with an opportunity to hear from taxpayers and do a better job advocating on their behalf.

Respectfully submitted,



Nina E. Olson
National Taxpayer Advocate
30 June 2011

²⁴ TAS received 1,515 comments from January 5 through June 18, 2011. See Tax Reform Suggestion Box at www.TaxpayerAdvocate.irs.gov.

²⁵ For example, some submitters said they wanted a “flat” tax and explained it as a system that would tax income at x% up to a certain income level, y% between that and a higher level, and z% above the higher level, essentially describing a graduated income tax system.